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Saba Software Inc.—Eluding *Corwin* Dismissal

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On March 31, 2017, the Delaware Court of Chancery issued a decision in *In re Saba Software, Inc. Stockholder Litigation* that was the first of its kind. In its October 2015 decision in *Corwin v. KKR Financial Holdings, LLC*, the Delaware Supreme Court held that the fully informed, uncoerced approval of a merger by a majority of disinterested stockholders would restore the presumption of the business judgment rule. *Saba* marks the first time the Court of Chancery has denied a *Corwin*-based motion to dismiss, and it did so on both disclosure and coercion grounds. Despite an unusual set of factual allegations, the decision offers important lessons about what a stockholder plaintiff can do to escape *Corwin*, and also about the continuing vitality of the enhanced scrutiny standard of review in a post-closing damages action.

I. Alleged Facts

Saba Software's Fraud and Settlement with the SEC: Saba's Indian subsidiary is alleged to have committed serious financial fraud and overstated its pre-tax earnings by $70 million from 2008 into 2012. Despite repeatedly committing to do so, Saba failed to restate its past financials to account for the fraud. This failure led to Saba being delisted by NASDAQ and so its shares traded over-the-counter. The failure also led to a settlement with the SEC in which the SEC would deregister Saba's shares if the restated financials were not filed by February 15, 2015.

True to form, however, Saba announced on December 15, 2014 that it would not complete its financial restatement by the February deadline.

Facing deregistration, Saba seeks strategic alternatives: With the looming deregistration having lit a fire under the Saba board, a continuing stream of bad news hammered the company's stock, as it fell from $14 per share to under $9. Early indications of interest in the $11-12 per share range evaporated, and by mid-December, the Company had a single offer for less than $9 per share.

Then in mid-January, Vector Capital offered $9 per share, and so became the high bidder. The Board countered with $9.25 per share, but Vector held firm at $9.00. Needing to make a decision, the Board chose to base its decision on scenarios that reflected the negative impact of the SEC deregistering Saba's shares and also assumed Saba could complete restating its financials later in 2015. Morgan Stanley relied on that negative scenario for purposes of its fairness analysis. On February 9, 2015, the Board accepted Vector's offer, though it represented a 2% discount to Saba's average stock price for the week prior to the February 10 announcement.

Vector agrees to retain key members of management, and both management and the board receive cash in lieu of worthless equity grants: Near the end of the sales process, Vector indicated that it intended on retaining Saba's CEO and

its General Counsel. Because due diligence and negotiations over the merger agreement were nearly completed, the board authorized those two individuals to negotiate their post-merger employment with Vector.

In advance of the merger, the directors also granted themselves synthetic restricted stock units in place of "unvested, suspended, lapsed and/or cancelled equity awards." In doing so, the board members turned their equity awards into cash payments. The board also approved similar cash payments to executives. In total, these cash payments amounted to approximately $4 million.

Saba's stockholders approve the merger: Because Saba's stock was deregistered prior to the stockholder vote, Saba did not submit its proxy or GAAP financials to the SEC for review. Saba's stockholders approved the merger, and the merger closed on March 30, 2015.

II. The Court of Chancery Decision and Key Takeaways

The plaintiffs asserted two claims: (1) a breach of fiduciary duty claim against the sell-side directors, and (2) an aiding and abetting claim against the acquiror. The defendants moved to dismiss both claims, and made three arguments in support. First, the defendants argued that the merger was "cleansed" under *Corwin* by the fully informed, uncoerced approval by a majority of the disinterested stockholders. Second, the defendants argued that certain of the plaintiffs' allegations, and in particular the allegations about the failure to restate the company's prior financials, supported derivative claims for which the plaintiffs had lost standing as a result of the merger. [1] Finally, the defendants argued that the plaintiffs failed to state a claim of the breach of the duty of loyalty that would overcome the application of the company's 102(b)(7) charter provision.

The Court of Chancery held that *Corwin* did not apply because the stockholders were not fully informed: The plaintiffs advanced four separate disclosure arguments, and found success with two of them.

First, the plaintiffs argued that Saba failed to disclose the reason that the company repeatedly failed to restate its financials. The Court of Chancery agreed, and held that this was a material omission in the context of this company at the time of the merger. In so holding, the Court of Chancery distinguished the typical "tell me why" disclosure claims that the court routinely rejects. By contrast, the plaintiffs sought information about "a factual development that spurred the sales process, and if not likely correctible, would materially affect the standalone value of Saba going forward." Without the omitted information, the Court concluded that stockholders could not evaluate the likelihood that Saba could restate its prior financials at any point in the near future, and therefore "had no basis to conclude whether or not the projections made sense."

Second, the plaintiffs argued that Saba failed to disclose "the post-deregistration options available to Saba, as discussed by the Ad Hoc Committee on December 3, 2014." The Court agreed and held that the plaintiffs "make a compelling case for materiality." Although this type of information is not material "in a typical case," the Court concluded that the looming deregistration posed such a "fundamental change to the nature and value" of the stock that it "dramatically affected the environment" surrounding the board's approval of the merger and the stockholder vote. As a result, the Court held that the Board "needed to take extra care to account for this dynamic in its disclosures to stockholders."

The Court of Chancery's refusal to apply *Corwin* because of material disclosure violations offers two important lessons, one procedural and one substantive.

As a matter of procedure, the Court of Chancery stated definitively, albeit in a footnote, that the plaintiffs' failure to pursue pre-closing injunctive relief with respect to their disclosure claims "does not deprive [them] of a right to press disclosure claims post-closing." There has been some tension since *Corwin* about whether a plaintiff must bring disclosure claims pre-closing, when they can be remedied with supplemental disclosure, or whether a plaintiff can pursue disclosure claims in a post-closing damages action. Here, the Court of Chancery concludes that although pre-closing injunctive relief is the "preferred means" by which to address "serious disclosure claims," a plaintiff may elect to raise disclosure claims post-closing to defeat a *Corwin* motion. This is a tension that is unlikely to abate soon, in light of a bifurcated plaintiffs' bar that some have observed is split between those that seek pre-closing disclosure relief and those that seek post-closing money damages.

As a matter of substance, although *Saba* illuminates two paths around the heavy hand of *Corwin*, deal-makers should not view *Saba* as cutting back or weakening *Corwin* at its core. Instead, *Saba* provides a real world reminder of the contextual

importance of disclosure. The Court of Chancery has repeatedly held that "asking 'why' does not state a meritorious disclosure claim," [2] but as in *Saba*, factual developments that so significantly affect the value of the corporation must be explained. Sell-side boards should carefully consider explaining any atypical risks the corporation may face as a standalone company or events that "dramatically affect[] the environment in which the Board conducted the sales process." And yet *Saba* also reinforces that stockholder plaintiffs still face an uphill battle where they allege that corporations should have disclosed projections that did not exist, projections that were prepared by a financial advisor rather than the target company, or other financial minutiae of the "tell me more" variety. And particularly in disclosing potential conflicts of sell-side financial advisors, which again came to the fore in the recent *Vento v. Curry* decision [3] in which the Court of Chancery issued a disclosure-based preliminary injunction, *Saba* makes clear that corporations need not "detail the specific services" the sell-side financial advisor provided the acquiror. A disclosure that plainly states that the financial advisor provided services and the amount of fees received for those services is sufficient.

Alternatively, the Court of Chancery held that *Corwin* did not apply because the stockholder vote was impermissibly coerced: The Court of Chancery found, for purposes of this pleadings-stage decision, that in voting whether to approve the transaction, Saba's stockholders were asked to choose between keeping their deregistered, illiquid stock, or taking $9 per share in cash, a value that was depressed by the company's inability to restate its financials. The Court of Chancery described this as a "Hobson's choice" that was "hoisted upon the stockholders because the Board was hell-bent on selling Saba in the midst of its regulatory chaos." The Court concluded that the combination of this Hobson's choice and the company's inadequate disclosures as discussed above left the stockholders "staring into a black box" with "no practical alternative but to vote in favor" of the merger.

If there is one aspect of *Saba* that portends an increase in stockholder litigation risk, it is the coercion aspect of the decision. *Saba* makes clear that coercion need not be overt and obvious to be actionable. That is, a plaintiff need not show actual threats in the words or tone of the proxy to sidestep *Corwin*. Here, the Court of Chancery concluded that the combination of inadequate disclosure and a near-term deregistration placed the stockholders in a situation where they were forced to vote for the merger "for reasons other than the economic merits of the transaction." Rare will be the case that presents this fact pattern, in which stockholders are asked to choose between a merger or pursue an illiquid, deregistered security, but astute plaintiffs' lawyers will surely seek to combine disclosure claims with near-term calamities facing a merger target in the hope of evading *Corwin*. In short, the facts as alleged here are egregious and unusual, but the coercion aspect of *Saba* will require refinement in future cases for its boundaries to come into clearer focus.

The Court of Chancery applied *Revlon* enhanced scrutiny: Because there was no "cleansing effect" of *Corwin*, the Court held that "*Revlon* enhanced scrutiny" would apply to this post-closing damages action.

Looking through the lens of enhanced scrutiny, the Court of Chancery held that the plaintiffs had adequately pled essentially two non-exculpated claims against the defendant directors. First, with respect to the sale process, the Court held that the company's failure to restate its prior financials was "an elephant in the boardroom," and therefore the plaintiffs' allegations that the Board "rushed the sales process, refused to consider alternatives to a sale, cashed-in significant, otherwise worthless equity awards before the Merger, directed Morgan Stanley to rely upon the most pessimistic projections when considering the fairness of the transaction and then rushed the stockholder vote after supplying inadequate disclosures regarding the circumstances surrounding the failure to complete" the financial restatement were sufficient to plead bad faith. Second, and relatedly, the Court of Chancery held that by replacing their own worthless equity with cash, the defendant directors secured material personal benefits for themselves in connection with the merger, and that this allegation supported a reasonable inference that the Board approved the merger not because it was in the best interest of the stockholders, but because they wished to receive those benefits.

By applying *Revlon* in a post-closing damages action, the Court of Chancery decision in *Saba* highlighted the doctrinal tension between *Corwin* and *RBC Capital Markets, LLC v. Jervis*, another significant Delaware Supreme Court decision from late 2015. In *Corwin* the Delaware Supreme Court described enhanced scrutiny under *Revlon* and *Unocal* as "primarily designed to give stockholders and the Court of Chancery the tool of injunctive relief to address important M&A decisions in real time, before closing. They were not tools designed with post-closing money damages claims in mind…." [4] But then two months later in *RBC*, the Supreme Court applied *Revlon* to affirm the Court of Chancery's decision in a post-closing damages action. By applying *Revlon* after concluding that *Corwin* did not restore the presumption of the business judgment rule, *Saba* aligned itself with *RBC*, and previous Delaware decisions that have applied enhanced scrutiny post-closing. [5]

III. Conclusion

As *Saba* illustrates, a stockholder who seeks post-closing damages in a third-party merger faces a steep uphill climb to survive the pleadings stage, facing the 1-2 punch of *Corwin* and exculpation. First, to elude *Corwin*, a plaintiff must plead successfully that the stockholder vote was either not fully informed or was impermissibly coerced. And next, to survive a motion to dismiss, the plaintiff must also plead a viable claim for a non-exculpated breach of fiduciary duty, which is itself rare. And yet, as *Saba* illustrates, this pleadings-stage burden is not insurmountable in the right case. Time will tell how frequently these cases will arise, but *Saba* has important lessons for deal-makers and litigators regardless.

Endnotes

[1] The Court of Chancery disagreed with the defendants' characterization of the plaintiffs' claims as derivative. The Court of Chancery read the plaintiffs to focus on the "unique benefits" of the merger for the directors and managers and challenge the sale process, thereby stating a direct claim.
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[2] *In re Solera Holdings, Inc. Stockholder Litig.*, 2017 WL 57839, at *12 (Del. Ch. Jan. 5, 2017); *In re Sauer–Danfoss Inc. S'holders Litig.*, 65 A.3d 1116, 1131 (Del. Ch. Apr. 29, 2011).
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[3] 2017 WL 1076725, at *1 (Del. Ch. Mar. 22, 2017).
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[4] *Corwin*, 125 A.3d at 312.
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[5] *See Chen v. Howard-Anderson*, 87 A.3d 648, 669 (Del. Ch. 2014) ("This court's decisions also have applied the enhanced scrutiny standard of review in post-closing settings.")
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