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Client Alert

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Director's Abstention on Merger Vote Deemed Material to Stockholders

The Delaware Supreme Court recently held that the reason a company's founder and chairman had abstained on a vote to approve a merger was material information that should have been disclosed to the company's stockholders. The court said that the abstaining director's view that it was an inopportune time to sell the company and that mismanagement had negatively affected the sale process would be important to an investor who was considering the board of directors' recommendation in favor of the transaction.

Background

In *Appel v. Berkman*,[1] the founder, chairman, and largest stockholder of Diamond Resorts International (the "Company") abstained on the board of directors' vote to approve the sale of the Company through a two-step merger. The minutes of the board meeting stated that "he was disappointed with the price and the Company's management for not having run the business in a manner that would command a higher price, and that in his view, it was not the right time to sell the Company."

The Company's SEC filings relating to the transaction disclosed that "[a]ll of the directors voted in favor of [the transaction] with the exception of the Company's chairman, who abstained." The Company also disclosed that, to its knowledge, "the chairman of the board of directors has not yet determined whether to tender… his shares." The disclosures did not address the reasons the chairman abstained on the vote or had not yet committed to tender his shares.

The Court of Chancery dismissed a stockholder lawsuit challenging the sale of the Company. The lower court held that the chairman's reasons for abstaining would not have materially altered the total mix of information given to stockholders about the transaction. The stockholder appealed to the Delaware Supreme Court.

Delaware Supreme Court's Ruling

The Supreme Court found that the omission about the chairman's reasons for abstaining constituted a disclosure violation. As a result, it said the transaction had not been approved by fully informed stockholders in a manner that would invoke the protection of the business judgment rule to justify dismissal of the lawsuit.

The Supreme Court focused on the fact that the abstaining director was the Company's chairman and founder—"a 'key board member' if there ever was one." To emphasize this point, the Supreme Court referenced the Company's last annual proxy statement preceding the merger negotiations in which the Company touted the chairman's qualifications and experience. Among other things, the proxy statement

[1] No. 316, 2017 (Del.).

said he had "a unique understanding of the opportunities and challenges that we face and … in-depth knowledge about our business."

The Supreme Court then explained that the dissenting views of such a key board member in the "high-stakes context" of selling the Company were material when contrasted with the Company's other disclosures that supported the transaction. It continued that a disclosure indicating that the chairman "believed the company had been managed suboptimally and that this mismanagement negatively affected the sale price would catch a reasonable stockholder's attention and 'significantly alter the total mix of information' … about whether it was a favorable time to sell and why."

The Supreme Court rejected the defendants' argument that the disclosure of the abstention, standing alone, was sufficient because stockholders could infer that the chairman was not supportive of the transaction. The court also rejected the defendants' argument that they only had to disclose facts and were not required to disclose the chairman's "opinion."

Implications

The *Appel* decision is noteworthy for requiring the board of directors to disclose the reasons a key director abstained in a vote to sell a company. Board votes to approve mergers with unaffiliated third parties are almost always unanimous. When the vote is not unanimous, it is usually attributed to a disclosed relationship the director has with the acquiror. Thus, it is not surprising that an unexplained abstention from a company's founder, chairman, and largest stockholder based on the merits of the transaction attracted judicial scrutiny.

The Supreme Court's analysis is fact-specific and does not create brightline disclosure rules concerning a director's abstention or dissent. It does raise some interesting issues, though. For example, what if the abstaining director was simply an outside director rather than the chairman, founder, and largest stockholder? And what disclosure might be required if the board of directors did not have sufficient information about why a director abstained or voted against a transaction or was skeptical about the director's stated reasons? Boards act collectively, and the directors' disclosure duties require disclosure of all material information "within the board's control." This was not an issue in *Appel*, where the board meeting minutes clearly stated the chairman's objections to the transaction, but that may not be the case in other situations. And if the board lacks such information, what duties does the abstaining or dissenting director have to include his views in the company's disclosure documents? Finally, what judicial remedy is available where, such as here, the omission was clear to the plaintiff based on a reading of the company's SEC disclosures, yet the plaintiff failed to seek pre-closing injunctive relief?

Appel also demonstrates what is at stake when a company prepares its disclosures. Under *Corwin*, a third-party transaction will be protected by the business judgment rule if it has been approved by an uncoerced and fully informed vote of a majority of disinterested stockholders. This doctrine has been extremely effective in obtaining dismissal of stockholder lawsuits. For that reason, it also provides a strong incentive for companies to ensure full disclosure. Moreover, because a finding that a stockholder vote was fully informed will essentially foreclose any further litigation, Delaware judges can be expected to scrutinize certain issues such as director conflicts of interest and, apparently, dissenting views within the board.

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