Client Alert

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Delaware Court Dismisses Claims Against REIT Directors Following Company's Merger with Alleged Controlling Stockholder

The Delaware Court of Chancery recently held that individual members of Rouse Properties Inc.'s board of directors, who negotiated and approved a merger with the company's largest stockholder in 2016, were protected under *Corwin*[1] by the business judgment rule from claims by plaintiff stockholders that the board, allegedly controlled by the stockholder, had breached their fiduciary duties.

Background

In Re Rouse Properties, Inc. Fiduciary Litigation[2] arose out of the 2016 merger between Rouse Properties Inc. ("Rouse"), a Delaware corporation and real estate investment trust, and Brookfield Asset Management, Inc. ("Brookfield"), a Canadian global asset management corporation. In January 2016, Brookfield, owning 33.5% of the outstanding shares of Rouse, made an offer to acquire all of Rouse's remaining outstanding shares for $17 per share. In response, Rouse formed a special committee of independent directors to negotiate with Brookfield and consider strategic alternatives. The parties ultimately agreed on a price of $18.25 per share and signed a merger agreement, which was subsequently approved by 82.44% of Rouse's non-Brookfield-affiliated shares.

In their post-closing class action lawsuit, the plaintiffs sued Brookfield, claiming it was a controlling stockholder of Rouse during the time of the transaction and breached fiduciary duties it owed to the minority stockholders. The plaintiffs also sued the members of the Special Committee, claiming they had breached their fiduciary duties to stockholders in grossly undervaluing the company. In response, Brookfield and the board members argued that Brookfield was not a controlling stockholder and because there had been "un-coerced and informed" approval by a majority of the disinterested stockholders in accordance with *Corwin*, the business judgment rule applied to the transaction.

The Court of Chancery's Opinion

The Delaware Court of Chancery first examined whether Brookfield, despite owning less than 50% of Rouse's outstanding shares, was nevertheless the company's "controlling stockholder." If Brookfield was deemed a controlling stockholder, then it would trigger heightened judicial scrutiny and require certain additional deal procedures to qualify for business judgment rule protection.[3] Under Delaware law, a

[1] *In Re KKR Fin. Hldgs. LLC S'holder Litig.*, 101 A.3d 980 (Del. Ch. 2014), aff'd sub nom., *Corwin v. KKR Fin. Hldgs. LLC*, 125 A.3d 304 (Del. 2015).

[2] *In Re Rouse Properties, Inc. Fiduciary Litig.*, C.A. No. 12194-VCS (Del. Ch. March 9, 2018).

[3] Specifically, the following conditions must be met for business judgment rule protection of a controlling stockholder's freeze-out of the minority shares: (i) the controller conditions the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders; (ii) the special committee is independent; (iii) the special committee is empowered to freely select its own advisors and to say no definitively; (iv) the special committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority. *See Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

stockholder owning less than 50% of the company is controlling if it "exercises control over the business affairs of the corporation." The court noted that meeting this standard is "not easy," as the stockholder's power "must be so potent that independent directors cannot freely exercise their judgment, fearing retribution."

To demonstrate Brookfield's control over the Special Committee, plaintiffs argued that two out of its five members were not independent from Brookfield. One member, the company's CEO, was approached by Brookfield during the merger negotiations to discuss his post-closing employment and he also helped Rouse develop an executive retention plan, which was designed to retain Rouse's management team during the negotiations. The other member was designated to serve on Rouse's board of directors by Brookfield. The court held that these facts alone were insufficient to call into question the independence of the directors. Among other reasons, the court noted that Rouse's CEO never actually engaged in employment discussions with Brookfield, he ultimately resigned from Rouse after the merger, the executive retention plan paid the executives regardless of whether Rouse consummated a transaction with Brookfield, and the plaintiff had not pled that the CEO "actually facilitated Brookfield's bargaining position at the expense of Rouse." The court also said that, even if the plaintiff adequately pled that the two Special Committee members lacked independence, that would not be enough to make Brookfield a controlling stockholder given the independence of the other three members.

The court also rejected plaintiffs' arguments that the Special Committee had "tilted the playing field" in favor of Brookfield by, among other things, agreeing to "onerous deal protection devices" that would dissuade third parties from offering Rouse a better deal. The court found that the Special Committee had been empowered to explore other proposals and reject Brookfield's offer, and that the committee had "negotiated hard" with Brookfield. Brookfield did not at any time threaten Rouse or attempt to interfere with the stockholder vote.

The court ultimately found that Brookfield's influence, including its 33.5% share ownership, did not come even "remotely close" to the level of control necessary to be deemed Rouse's controlling stockholder. Brookfield did not, for example, have the ability to elect directors, break up the corporation, amend the certificate of incorporation or sell all of the corporate assets, which would suggest the presence of a dominating stockholder. That Brookfield's 33.5% minority interest might allow it to "influence" the corporation did not alone support an inference of control.

Given that Brookfield was not a controlling stockholder, it did not owe fiduciary duties to the public stockholders and the claims against it were dismissed. The members of the Special Committee, pursuant to *Corwin*, were protected by the business judgment rule because fully informed and un-coerced stockholders not affiliated with Brookfield had approved the merger. The court rejected plaintiffs' arguments that the stockholders had been misinformed about the value of their shares, finding that the company's disclosures regarding the merger prior to the vote were adequate. The court noted that the standard of disclosure is whether there is a substantial likelihood that a reasonable shareholder would consider information important in deciding how to vote, not whether information "might be helpful."

Conclusion

In *Rouse*, Vice Chancellor Slights explained that "a pattern has emerged" following acquisitions by a less-than-majority stockholder in which plaintiffs (i) plead facts in hopes of supporting a reasonable inference that the minority stockholder is actually a controlling stockholder and (ii) failing that, plead facts in hopes of supporting a reasonable inference that the stockholder vote was uninformed or coerced, in either case so that *Corwin* does not apply. The court flatly rejected plaintiffs' attempts in this case to make both of these arguments.

Still, the analysis of whether a large stockholder is a "controlling" stockholder is a contextual one. In particular, *Rouse* can be contrasted with Vice Chancellor Slights' March 28, 2018, opinion in *In re Tesla Motors, Inc. S'holder Litigation*,[4] in which he denied a motion to dismiss claims brought against the board of directors of Tesla, Inc. in connection with its acquisition of SolarCity. There, the plaintiffs argued that Elon Musk, who owned 22.1% of Tesla's common stock, was its controlling stockholder and, therefore, the transaction was subject to heightened judicial scrutiny. Musk also owned 21.9% of SolarCity. Vice Chancellor Slights found it "reasonably conceivable," based on the allegations in the complaint, that Musk was a controlling stockholder. He reasoned that Musk, as the company's visionary and CEO, allegedly was "the face of Tesla," had "extraordinary influence" over the company, and was heavily involved in the board's process of considering the acquisition. In addition, there were various directors who were allegedly beholden to or dominated by him, thus increasing his influence.

Rouse is also another reminder of the importance of process and creating an objective record to demonstrate it. The court favorably viewed the Special Committee's "hard" negotiations with Brookfield and other actions taken, including identifying and contacting 40 other potential purchasers (none of whom ultimately made offers); the Special Committee's rejection of multiple offers by Brookfield as inadequate; negotiating a higher purchase price; and the Special Committee's insistence upon a provision in the merger agreement that would require approval of the merger by a majority of stockholders *unaffiliated* with Brookfield, going a step further than the majority approval required by Delaware statute. In addition, the court observed Brookfield's role that helped support the process, including the absence of any allegations that Brookfield threatened Rouse or used strong-arm tactics.

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[4] *In re Tesla Motors, Inc. Stockholder Litigation*, C.A. No. 12711-VCS (consol.), memo. op. (Del. Ch. Mar. 28, 2018).