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Case Number 702,2014

IN THE SUPREME COURT OF THE STATE OF DELAWARE

DELAWARE COUNTY EMPLOYEES RETIREMENT FUND, CITY OF ROSEVILLE EMPLOYEES' RETIREMENT SYSTEM and ROBERT FRIEDMAN, Derivatively and on Behalf of SANCHEZ ENERGY CORPORATION,	)	
Plaintiffs Below, Appellants,	)	
v.	)	No. 702, 2014
A.R. SANCHEZ, JR., ANTONIO R. SANCHEZ, III, GILBERT A. GARCIA, GREG COLVIN, ALAN G. JACKSON, EDUARDO SANCHEZ, ALTPOINT CAPITAL PARTNERS LLC, ALTPOINT SANCHEZ HOLDINGS, LLC, SANCHEZ RESOURCES, LLC, and SANCHEZ ENERGY CORPORATION,	)	Court Below: Court of Chancery of the State of Delaware Consol. C.A. No. 9132-VCG
Defendants Below, Appellees.	)	

ANSWERING BRIEF OF DEFENDANTS BELOW - APPELLEES

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NATURE OF PROCEEDINGS

This is an appeal from a memorandum opinion and final order of the Court of Chancery dismissing a stockholder derivative action for failure to comply with the requirements of Court of Chancery Rule 23.1. The challenged transaction (the "Transaction") involved an acquisition of oil and gas leases by Nominal Defendant Sanchez Energy Corp. ("Sanchez Energy," "SN" or the "Company"), in a three-way deal involving Defendant Sanchez Resources, LLC ("SR" or "Sanchez Resources") and Defendants Altpoint Capital Partners LLC and its affiliate Altpoint Sanchez Holdings LLC (together, "Altpoint"). The operative complaint, A18-A54 (the "Complaint" or "Compl."), alleges that two of SN's directors had financial interests in SR. A34. The Complaint (1) concedes that the Transaction was approved by the Audit Committee of Sanchez Energy's board (the "Board"), which consisted of three admittedly disinterested directors, Defendants Gilbert Garcia, Alan Jackson and Greg Colvin, A37, and (2) does not plead particularized facts challenging either the integrity of the committee's process or the completeness or accuracy of the information provided to the committee or its independent financial advisor.

The Court of Chancery correctly held that the Complaint failed to allege with particularity facts that, if true, would raise a reasonable doubt that a majority of the Sanchez Energy directors were independent, or that the Transaction was

otherwise the product of a valid business judgment. *See* Plaintiffs' Opening Brief (cited herein as "POB"), Ex. A (opinion of the Court of Chancery, cited hereafter as "Op.") at 31-32. On appeal, Plaintiffs attack the independence of two of the Audit Committee members, relying on contentions that the Court of Chancery properly rejected as conclusory. POB at 16-21, Op. at 13-17. Plaintiffs also urge that the Transaction, though not challenged as a breach of the duty of care, as wasteful, or (on appeal) as so egregious on its face as to support a claim of bad faith, was not the product of a valid exercise of business judgment. POB at 33-35. The Vice Chancellor correctly rejected this contention as well. Op. at 17-31.

Plaintiffs urge reversal principally on the theory that the two allegedly interested SN directors -- Defendants Antonio R. Sanchez, Jr. ("A.R. Sanchez") and his son, the Company's Chief Executive Officer, Antonio R. Sanchez, III ("Tony Sanchez") -- were "controlling stockholders," notwithstanding their ownership of only 16% of SN's outstanding stock. Plaintiffs argue that the Court should both apply the entire fairness standard and excuse demand, notwithstanding the approval by the disinterested and independent Audit Committee, because of the alleged controlling stockholders' interest in the Transaction. *See* POB at 4-5, 22-35. Neither part of Plaintiffs' contention is correct.

The Court of Chancery properly held that the Complaint does not plead particularized facts that, if true, would show that the Sanchezes are controlling

stockholders. Op. at 26. Even if the Complaint did make such a showing with particularity, however, the presence of a controlling stockholder on the opposite side of a transaction does not by itself excuse demand under the second prong of *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984). Even if a corporation has a controlling stockholder, its directors are presumed capable of making business decisions based on the corporate merits, independently of the controlling stockholder's will, unless the stockholder-plaintiff overcomes that presumption with particularized factual allegations. *See, e.g.*, *Beam v. Stewart*, 845 A.2d 1040, 1054 & n.37 (Del. 2004). In order to plead demand excusal and take over the board's prerogative of deciding whether to assert corporate claims in litigation, a stockholder-plaintiff must show substantial reason to doubt that the specific board or committee decision challenged was an act of disinterested and independent business judgment. *See Aronson*, 473 A.2d at 815. The Vice Chancellor correctly determined that the Complaint's allegations of control over the Company's day-to-day operations did not suffice to excuse demand in a derivative case involving an asset-purchase transaction approved by a disinterested and independent committee. Op. at 22-24.

The judgment of the Court of Chancery should be affirmed.

SUMMARY OF ARGUMENT

1. *Denied*. The Court of Chancery correctly held that the particularized factual allegations of the Complaint were insufficient to excuse demand under the first prong of *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984). The Complaint's conclusory allegations regarding social and financial relationships among the Company's directors fall far short of the standard required to raise a reasonable doubt as to the Audit Committee members' independence.

2. *Denied*. The Court of Chancery correctly held that the Complaint failed to plead that A.R. Sanchez and Tony Sanchez, together with named and unnamed family members, were the Company's controlling stockholders or that they controlled the actions of the Board or the Audit Committee with respect to the Transaction. The Court of Chancery also correctly held that the Complaint failed to plead particularized facts raising a reasonable doubt that the directors acted honestly and in good faith or that the directors were adequately informed in making their decisions. Accordingly, the Court of Chancery correctly concluded that demand was not excused under the second prong of *Aronson*.

COUNTER-STATEMENT OF ALLEGED FACTS

Plaintiffs claim to be Sanchez Energy stockholders. A21-22. Plaintiffs chose not to make a demand under 8 *Del. C.* § 220 to inspect any books and records of the Company -- including documents relating to the Transaction that were not required to be filed publicly, such as the presentation of the Audit Committee's financial advisor -- before filing suit. *See* POB at 35 n.11. Consequently, many of Plaintiffs' allegations arise from inaccurate speculation. More significantly, the Complaint is devoid of any particularized attacks against, or even any description of, the process by which the Transaction was negotiated or the financial advice that the Audit Committee received in approving the Transaction. *See, e.g.*, A37 (Compl., ¶¶ 64-65) (alleging an "unfair process" but without any substantive description of the process).

The Company and Its Business

Nominal Defendant Sanchez Energy, a Delaware corporation, is an oil and gas exploration and production company based in Houston, Texas. A22. The Company was formed in August 2011 and made an initial public offering of its common stock in December 2011. A26-27. The Company's shares trade on the New York Stock Exchange under the ticker symbol "SN." A22. The Company's market capitalization at the time of the Transaction was approximately $800 million. *See* B106.

Tony Sanchez is the Company's CEO. A23. A.R. Sanchez and Tony Sanchez together own approximately 16% of the Company's outstanding common stock. Plaintiffs assert that the elder and junior Mr. Sanchez together own 21.5% of the stock. A27; POB at 8. This is incorrect, as was pointed out and conceded in the Court below. B18, B142-44, A137-38, A191-92 ("Yes, they only own 16% of [Sanchez] Energy….").

According to the Complaint, the Company was formed by the Sanchez Oil & Gas Corporation ("SOG") as a vehicle to raise capital to fund oil and gas exploration and production in the Eagle Ford Shale in South Texas. A27. SOG and its affiliates have participated in and managed the drilling of over 900 oil and gas wells and have invested substantial amounts of capital in numerous aspects of the oil and gas business, including in "mineral rights leaseholds on thousands of acres of land." A25.

At the time of SN's formation and initial public offering in 2011 -- before any of the Plaintiffs owned SN stock -- the Company entered into several agreements with SOG and certain affiliates, including a services agreement under which SOG provides management, administrative and operational services to SN and is reimbursed for those services, and a licensing agreement under which SN has a license to the unrestricted proprietary seismic, geological and geophysical information owned by SOG and relating to SN's properties. A27, A29. The

Company has no employees other than its officers and directors, and conducts all its operations through SOG and its affiliates under these agreements. A25, A27.

Plaintiffs claim for the first time on appeal that this structure and these agreements -- which were fully disclosed in the Company's SEC filings, A27-28, and which Plaintiffs lack standing to challenge -- creates a "structural deficiency unique to Sanchez Energy," POB at 8, that compromises the integrity of the information available to the Board and thereby compromises the Board's ability to protect SN's stockholders' interests. This contention is unsupported by any citation to the Complaint or the record below because it was never raised below. The Complaint nowhere alleges that the Board or the Audit Committee lacked access to or failed to inform itself of any item of information material to the decisions at issue in this case.

The Tuscaloosa Marine Shale

The Tuscaloosa Marine Shale ("TMS") region, located in Mississippi and Louisiana, was a new area of focus for the Company and a relatively new area of focus for the oil and gas industry at the time of the Transaction in 2013. A29. The Complaint alleges that oil and gas production in the TMS was "slow and costly to develop." A19. Conventional oil and gas production has never been cost-effective in the area, but recent improvements in unconventional exploration and production techniques have opened the region to economically viable exploration. A19, A33.

The TMS began to attract the interest of oil companies, including SOG, in 2010 and 2011. A29.

SOG formed SR in September 2010, and SR set about raising capital to invest in drilling rights in the TMS. A26, A29. Altpoint, an independent private equity firm based in New York, made a "significant investment" in SR in October 2010 and obtained three SR board seats. A30. Both SR and SOG accumulated oil and gas leases in the TMS during 2010 and 2011, and SOG assigned some of these leases to SR during 2012. *See* A29-30, A35. According to paragraph 45 of the Complaint, SR's undeveloped TMS reserves were proved in 2013, and this determination -- that the petroleum resources could be extracted in an economically viable way under then-present conditions -- was the impetus for the Transaction.[1] A30.

The Absence of Allegations Regarding the Transaction Process

The Complaint's narration of the facts omits any description of the process leading to the Transaction. Paragraph 45 of the Complaint, A30, alleges that, after SR's reserves in the TMS were proved in 2013, Altpoint did not wish to provide financing for SR to develop those reserves. The following paragraph, paragraph

[1] "Proved reserves are those quantities of petroleum which, by analysis of geological and engineering data, can be estimated with reasonable certainty to be commercially recoverable, from a given date forward, from known reservoirs and under current economic conditions, operating methods, and government regulations…." *See* B531-44 (Society of Petroleum Engineers, Glossary).

46, jumps forward to the announcement of the Transaction on August 8, 2013. A30-31. The Complaint contains no description at all of the process by which the Transaction was negotiated, structured, reviewed and approved, other than an admission, in paragraphs 64-65, A37, that the Audit Committee reviewed and approved those parts of the Transaction to which SN was party, and relied on the advice of an investment banker, Scotiabank, in doing so.[2] There is no allegation that A.R. Sanchez, Tony Sanchez or any other member of the Sanchez family participated in or improperly influenced the Audit Committee's deliberations.

Nor is there any particularized pleading that the Audit Committee's process was in any way less than fully deliberate, careful and well-informed. Plaintiffs appear to accept that the Audit Committee's charter, which was submitted to the Court of Chancery for judicial notice without objection by Plaintiffs, properly authorized the Audit Committee to review and approve the Transaction on SN's behalf. *See* B546-53, cited at Op. 6 n.6. Plaintiffs urge -- for the first time on appeal -- that the Audit Committee lacked "full and complete access to corporate information," *see* POB at 9, and that "there was no independent management team, or even a single employee, that the Audit Committee or its advisors could have turned to for unbiased information about Sanchez Energy in order to adequately

[2] According to the November 10, 2013, *Wall Street Journal* article on which Plaintiffs relied, A32, the Audit Committee also received advice from independent counsel. *See* B556.

inform themselves with respect to the Transaction." *See* POB at 30. But the Complaint nowhere alleges, and Plaintiffs never contended below, that the Audit Committee failed to inform itself as to all material information reasonably available, that the Committee failed to obtain independent financial and technical advice, there was any item of material information that was unavailable to the Committee, or that the information actually provided to the Committee or its advisors was false or incomplete in any respect.

What the Complaint actually says is that "the financial data provided to [the Audit Committee's financial] advisor undoubtedly came from members of the Sanchez family themselves."[3] Compl. ¶ 65, A37. Even if that speculative assertion is true, it does not follow, and the Complaint does not say, that the information provided to the Audit Committee and its financial advisor was fabricated, materially incomplete, or biased. Plaintiffs chose not to seek the advice presented to the Audit Committee through a Section 220 demand or otherwise before instituting suit. They cannot rely on that tactical choice to generate for themselves an inference that the Audit Committee and its advisors were less than

[3] Plaintiffs have dropped on appeal the speculative and conclusory assertion in their Complaint, A37, that Scotiabank may not have been aware of material terms of the Transaction. The Complaint does not assert that Scotiabank was unable, or failed, to obtain accurate and independent technical and financial information in support of its advice to the Audit Committee.

fully informed. *See, e.g.*, *Guttman v. Huang*, 823 A.2d 492, 493 (Del. Ch. 2003); *Scattered Corp. v. Chi. Stock Exch., Inc.*, 701 A.2d 70, 78-79 (Del. 1997).

The Transaction

The Transaction took place in three steps. First, SR and Altpoint agreed that Altpoint would transfer its SR equity units back to SR, and in exchange SR would give Altpoint (i) a distribution of a 32.4% working interest in SR's TMS acreage with an aggregate approximately 75% net revenue interest,[4] and (ii) a promissory note in the amount of $1 million, which note was convertible into a 1% overriding royalty interest in the acreage. A35-36.

Second, under a Purchase Agreement between Altpoint and SN, the Company purchased the 32.4% working interest in the TMS acreage from Altpoint in exchange for $53.5 million in cash and 342,760 shares of Sanchez Energy common stock, valued at approximately $7.5 million. A31-32, B558-88. Altpoint retained the $1 million promissory note convertible into a 1% overriding royalty interest in the TMS acreage.

[4] That is, SR retained for itself in this step an overriding royalty approximately equal to the positive difference (if any) between 25% of the revenues derived from the acreage and the royalties owed under preexisting royalty arrangements (*e.g.*, to the landowner). A35-36. Plaintiffs repeatedly characterize this retention of a royalty as a "kickback," *see* POB at 2-3, 5, 11, 13, 14, 34, but SR's retention of an interest in the potential production from acreage in which it had previously invested, as part of the overall financial terms of the Transaction, was in no way unusual or improper.

Third, in an agreement between SN and SR, the Company acquired an additional 17.6% working interest in the TMS acreage (also with an approximately 75% net revenue interest) from a subsidiary of SR in exchange for $14.4 million in cash and a commitment to carry SR's 50% share of the cost of the first three to six wells to be drilled, with the cost of subsequent wells split equally between SR and SN.[5] A32. The Complaint, following the *Wall Street Journal* article on which its allegations are based, estimates the value of the carry at "roughly $22 million." A32, B555-56. The consideration SN paid to SR for the 17.6% working interest in the third step of the Transaction is closely proportional to the consideration SN paid to Altpoint for the 32.4% working interest in the second step.

As a result of the Transaction, the Company and SR established an 80,000 acre Area of Mutual Interest in the TMS, with each entity owning a 50% undivided working interest. A31. Plaintiffs do not dispute that the consideration SN obtained in the Transaction was of significant value, and they do not claim that the Transaction was wasteful. They have dropped on appeal the assertion in paragraph 71 of the Complaint, A38-39, that the Transaction was so intrinsically unfair that the Audit Committee's approval of it "amount[ed] to bad faith that is not subject to the business judgment rule." *See* A99 at n.18 (disclaiming below effort to plead waste); POB at 33-34 (asserting that the Complaint "contains particularized

[5] The carry term is more fully described at B24-25, B106, B590-601.

allegations that the Transaction price was unfair," without attempting to argue waste or bad faith); Op. 25-30. Plaintiffs have never sought to plead gross negligence or a breach of the duty of care.

The Company announced the Transaction on August 8, 2013. A35. The Complaint quotes extensively, A30-34, from the transcript of the Company's quarterly earnings call the same day, on which the Company's officers discussed the Transaction in detail and addressed each of the three substantive claims on which Plaintiffs premise their claim that the Transaction was not the product of a valid exercise of business judgment. *See* POB at 33-35.

First, Plaintiffs, quoting selectively from Tony Sanchez's comments on the call, assert that the price of the Transaction "was *not* based on the fair value of the [acreage purchased by SN from Altpoint], but rather was based on what Altpoint required to give up its equity interest in [SR]." POB at 33. As the Vice Chancellor correctly noted, Mr. Sanchez's comments in reality reflect "a realistic assessment of the goals of the negotiating parties." Op. at 30. That is, what Mr. Sanchez actually said was that taking Altpoint out of its preexisting position in SR was Altpoint's negotiation goal, not that it was SN's. B25-26, B115, B892 at n.4.

Second, Plaintiffs assert that SN overpaid for the leasehold interests it acquired, and offer the Court a comparison with an approximately contemporaneous transaction between Goodrich Petroleum and Devon Energy, in

which Goodrich allegedly paid to Devon a lesser amount per leased acre in the TMS than SN paid to SR and Altpoint.[6] POB at 33-34; A33. Asked specifically about the Goodrich-Devon transaction on the August 8, 2013, earnings call, Tony Sanchez discussed at length the substantive differences between the leaseholds involved in the Goodrich-Devon transaction and those involved in the Transaction. B28-31, B113-15, B646, B901-02. For example, Mr. Sanchez pointed out that over 80% of the acreage involved in the Goodrich transaction was subject to leases that expired within a year, which would require a buyer to invest significant new capital to renew or maintain the leases. B113. In addition, the majority of the Goodrich position was outside what SN believed was the core area of expected production. B115. As the Court of Chancery correctly noted, the Complaint does not allege information about the "nature, quality and duration" of the respective interests sufficient to support an inference that Plaintiffs' comparison, based solely on a dollars-per-acre metric, is meaningful. Op. at 28. Nor does the Complaint allege that the Audit Committee and its advisors were unaware of the Goodrich-Devon transaction or the other claimed comparables.

[6] As the Court of Chancery noted, Plaintiffs' other proffered comparable transactions had occurred several years previously, before the resources were proved; that is, before geological and engineering studies determined that oil and gas could be extracted economically from the leases under current technological and regulatory conditions. Op. at 28-29.

Finally, Plaintiffs urge that the Defendants structured the Transaction so as to avoid disclosing in SEC filings that SR retained an overriding royalty interest in the acreage conveyed to SN.[7] POB at 2, 3, 34. That assertion is speculation, ungrounded in the particularized allegations of the Complaint, and the contention makes no sense, especially in light of the absence of any disclosure claim. Moreover, the salient fact -- that the total royalty burden on the acreage is 25%, so that SN will be entitled to 75% of the proceeds of drilling -- was disclosed in response to a question on the August 8, 2013 earnings call. *See* B112. And as the Complaint itself points out, because the oil and gas leases were real estate interests subject to recording requirements in Louisiana and Mississippi, the royalty arrangements are a matter of public record. Plaintiffs have never claimed that the Company's SEC filings are defective or that the royalty arrangements are material to the Transaction as a whole. The suggestion that an alternative transaction structure might have implicated different disclosure obligations, and that the

[7] Plaintiffs' theory on appeal, *see* POB at 2, 13, is different from the theory proposed in paragraph 63 of the Complaint (and waived on appeal), that the overriding royalties were "added to Sanchez Energy's lease obligations by Altpoint Holdings and Sanchez Resources with the consent of Sanchez Energy's Board *after* the substance of the transaction was announced." A36 (emphasis in original); *see also* Compl., ¶ 99, A46. That contention was plainly incorrect, as demonstrated below and in the papers incorporated by reference in the Complaint. *See* B558-88 (Purchase Agreement and the form of lease agreement annexed to the Purchase Agreement); B112 (August 8, 2013 earnings call during which the Company's then-Chief Operating Officer stated that the royalty burden on the acreage involved in the Transaction was 25%).

Defendants structured the Transaction as they did to avoid those different disclosure obligations, is conclusory speculation. *See* A234-36.

The Company's Board of Directors and the Complaint's Allegations Regarding Demand Futility

Plaintiffs concededly did not make a demand on the Board to pursue the claims at issue. The Board consisted of five members at the time of suit: A.R. Sanchez, Tony Sanchez, and the three Audit Committee members, Messrs. Colvin, Garcia and Jackson. The Complaint contains only the most minimal of allegations regarding the backgrounds and personal circumstances of the Audit Committee members. A23-24, A40-42. There is no dispute as to the disinterestedness of the three Audit Committee members, and no challenge to the independence of Mr. Colvin. All three Audit Committee members are independent for purposes of the New York Stock Exchange Corporate Governance Rules and of Rule 10a-3. B13 at n.3, B38, B135, B897.

Plaintiffs attack Mr. Garcia's independence on the ground that he purportedly "has been a business associate of the Sanchez family for at least 30 years." POB at 20. The allegations relating to Mr. Garcia appear in paragraphs 24, 64, 76 and 77 of the Complaint, A23-24, A37, A41-42, and those allegations are entirely conclusory. Although the Complaint alleges -- on the basis of filings in a court proceeding in 2000, B158-65, B167-70 -- that Mr. Garcia and an entity affiliated with A.R. Sanchez were co-investors at that time in two entities, the

Complaint makes no effort to describe the nature or magnitude of the investment, or to show that the investment, if it still exists, is material to Mr. Garcia. The Vice Chancellor correctly concluded that the allegations in the Complaint do not attempt to explain the significance of these business relationships or how these relationships could have affected Mr. Garcia's ability to evaluate the Transaction independently. Op. at 15-16; *see also* B42-43, B898-99.

The Complaint is equally conclusory with regard to the second challenged director, Mr. Jackson. The Complaint claims a friendship of long standing between A.R. Sanchez and Mr. Jackson, but does not describe the nature of the friendship. A20-21, A37, A40-41. Plaintiffs attempt to bolster the Complaint's allegations with references to a 2001 newspaper article that was introduced for the first time at oral argument below, A202-03, objected to at that time, A222, and properly excluded by the Vice Chancellor as untimely submitted. *See* Op. at 14 n.26. Even if that article is considered, however, the Complaint fails to overcome the presumption of independence.

The Complaint alleges that Mr. Jackson is employed by IBC Insurance Agency, Ltd. ("IBC"), a subsidiary of International Bancshares Corporation ("International Bancshares"), and that A.R. Sanchez is one of nine directors and a minority stockholder in International Bancshares. A23, A40-41. Plaintiffs' papers conflate International Bancshares with its subsidiary IBC, *see* POB 9 n.4, 18, but

as the Vice Chancellor correctly held, Op. at 14, the particularized facts pled do not explain how A.R. Sanchez could have used his position as a non-executive director and minority stockholder in International Bancshares to retaliate against Mr. Jackson, an employee of IBC.

Nor does the Complaint allege that Mr. Jackson's employment at IBC is material to him, or indeed anything about his overall financial circumstances. *See* A40-41. The Complaint does not even allege the terms of Mr. Jackson's compensation from IBC, although it alleges a range of salaries purportedly earned by other people with similar job titles in the region. A40. Mr. Jackson is in his 70s and for many years co-owned an insurance brokerage that he has now sold. Even if Mr. Sanchez could deprive Mr. Jackson of his job, the Complaint fails to show that the loss would be material to Mr. Jackson.

ARGUMENT

I. THE COURT OF CHANCERY CORRECTLY HELD THAT THE COMPLAINT FAILS TO ALLEGE PARTICULARIZED FACTS OVERCOMING THE PRESUMPTION OF DISINTERESTEDNESS AND INDEPENDENCE AS TO A MAJORITY OF THE BOARD.

A. Question Presented

Did the Complaint allege particularized facts sufficient to overcome the presumption of disinterestedness and independence as to a majority of the Board? *See* B9, B13-17, B38-47, B888-89, B897-900, B903-06, A121-32, A222-23.

B. Scope of Review

The parties agree that the scope of the Court's review on this issue is *de novo* and plenary. *See Wood v. Baum*, 953 A.2d 136, 140 (Del. 2008). The Court should draw all reasonable inferences in Appellants' favor, but "[s]uch reasonable inferences must logically flow from particularized facts alleged by the plaintiff. Conclusory allegations are not considered as expressly pleaded facts or factual inferences. Likewise, inferences that are not objectively reasonable cannot be drawn in the plaintiff's favor." *See id.* (internal quotation marks omitted).

C. Merits of the Argument

The Board's statutory power to manage the business and affairs of the Company, *see* 8 *Del. C.* § 141(a), encompasses the decision to initiate litigation on the Company's behalf. *See Spiegel v. Buntrock*, 571 A.2d 767, 773 (Del. 1990). Because a derivative suit inherently "impinges on the managerial freedom of

directors," *Aronson*, 473 A.2d at 811, Court of Chancery Rule 23.1 requires a plaintiff to "allege with particularity the . . . reasons for the plaintiff's failure to obtain the action or for not making the effort." Ct. Ch. R. 23.1(a). The demand requirement prevents "a stockholder [from causing] the corporation to expend money and resources in discovery and trial in the stockholder's quixotic pursuit of a purported corporate claim based solely on conclusions, opinions or speculation." *Brehm v. Eisner*, 746 A.2d 244, 255 (Del. 2000). Thus, where no demand has been made, a complaint "must comply with stringent requirements of factual particularity that differ substantially from . . . permissive notice pleadings," and plaintiffs must allege "particularized factual statements that are essential to the claim." *Id.* at 254. Plaintiffs' reliance on *Central Mortgage Co. v. Morgan Stanley Mortgage Capital Holdings LLC*, 27 A.3d 531, 536 (Del. 2011), *see* POB at 15, 32, a Rule 12(b)(6) case, is misplaced in the demand excusal context.

"[D]irectors are entitled to a presumption that they were faithful to their fiduciary duties," and "the burden is upon the plaintiff in a derivative action to overcome that presumption." *Beam*, 845 A.2d at 1048-49. "A prolix complaint larded with conclusory language, like the Complaint here, does not comply with these fundamental pleading mandates." *Brehm*, 746 A.2d at 254. Where plaintiffs cannot meet their burden and cannot satisfy the "stringent requirements of factual particularity," *id.*, the complaint must be dismissed.

The Court of Chancery correctly determined that the Complaint failed to overcome the presumption of independence as to Messrs. Jackson and Garcia. Plaintiffs did not challenge Mr. Colvin's independence below or in their opening brief. Accordingly, three of the five members of the Board at the time suit was filed were disinterested and independent, and the Vice Chancellor properly so held.

1. The Court of Chancery Correctly Held That, On the Particularized Factual Allegations of the Complaint, Mr. Jackson Is Independent.

Plaintiffs assert that Mr. Jackson lacked independence from A.R. Sanchez due to the alleged friendship between the two men and Mr. Jackson's employment at IBC, a subsidiary of International Bancshares, on whose board of directors the elder Mr. Sanchez serves. *See* POB at 16-20. The allegations in the Complaint relevant to these contentions, whether considered in isolation or together, fall well short of creating a reasonable doubt as to Mr. Jackson's independence.

Where a stockholder-plaintiff attacks a director's independence on the grounds of friendship with an allegedly interested person, this Court has characterized the pleading burden as follows:

> The Court of Chancery in the first instance, and this Court on appeal, must review the complaint on a case-by-case basis to determine whether it states with particularity facts indicating that [the] relationship … is so close that the director's independence may *reasonably* be doubted….
>
> [F]or presuit demand purposes, friendship must be accompanied by substantially more in the nature of serious allegations that would lead

> to a reasonable doubt as to a director's independence. That a much stronger relationship is necessary to overcome the presumption of independence at the demand futility stage becomes especially compelling when one considers the risks that directors would take by protecting their social acquaintances in the face of allegations that those friends engaged in misconduct. To create a reasonable doubt about an outside director's independence, a plaintiff must plead facts that would support the inference that because of the nature of a relationship or additional circumstances other than the interested director's stock ownership or voting power, the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director.

Beam, 845 A.2d at 1051-52 (footnote omitted). Moreover, Plaintiffs must show that any relationship claimed to affect a director's independence is subjectively material to the director in question, "in the sense that the alleged ties could have affected the impartiality of the individual director." *See Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 649 (Del. 2014).

As noted above, the Complaint does not plead any particularized facts concerning the nature or closeness of Mr. Jackson's alleged friendship with the elder Mr. Sanchez. Plaintiffs' assertion to the contrary, POB at 17-18, is simply incorrect. The allegations are at most comparable to those found plainly insufficient in *Beam v. Stewart*, 833 A.2d, 961, 980 (Del. Ch. 2003) (rejecting contention of disabling friendship between Martha Stewart and Darla Moore, despite complaint's citation of article in Fortune magazine describing their "close personal friendship"), *aff'd*, 845 A.2d 1040, 1054 (Del. 2004) ("In our view, these bare social relationships clearly do not create a reasonable doubt of

independence."). The Vice Chancellor properly concluded that the allegations of friendship between Mr. Jackson and Mr. Sanchez do not overcome the presumption of independence. Op. at 13.

The Court of Chancery also correctly determined that the allegations regarding Mr. Jackson's executive position at IBC do not create a reasonable doubt as to his independence. The Complaint does not explain how the elder Mr. Sanchez, allegedly one of nine directors and a minority stockholder of IBC's parent corporation (International Bancshares), but not of IBC, could have retaliated against Mr. Jackson. Op. at 14-15; A128-130. The Complaint also fails to plead facts showing that Mr. Jackson's current employment is of material significance to him in the context of his individual financial circumstances. *See* B46, B905-06.

Plaintiffs' contention that the Court of Chancery failed to view their allegations regarding friendship and employment "holistically," *see* POB at 19-20, is misplaced. There is no indication that the Vice Chancellor failed to consider all of Plaintiffs' allegations together, and together or apart, the allegations are simply inadequate to raise a reasonable doubt as to Mr. Jackson's independence. *Compare Beam*, 833 A.2d at 981 ("In sum, plaintiff offers various theories to suggest reasons that the outside directors might be inappropriately swayed by Stewart's wishes or interests, but fails to plead sufficient facts that could permit the Court reasonably to infer that one or more of the theories could be accurate.").

2. The Court of Chancery Correctly Held That, On the Particularized Factual Allegations of the Complaint, Mr. Garcia Is Independent.

As the Court below correctly noted, Plaintiffs' allegations regarding alleged personal ties between Mr. Garcia and the Sanchez family are even weaker than those with regard to Mr. Jackson, as Plaintiffs conceded at argument. Op. at 16; A205. The allegations regarding Mr. Garcia's co-investment with A.R. Sanchez fail for lack of a particularized pleading of materiality to Mr. Garcia and lack of any particularized explanation as to how the alleged outside business relationship could have affected Mr. Garcia's evaluation of the Transaction. *See* B42-43, B904, A125-28. Plaintiffs' contention that the alleged co-investment was material to Mr. Garcia is entirely conclusory and does not flow logically from the particularized allegations of the Complaint. *See White v. Panic*, 783 A.2d 543, 549 (Del. 2001). The Complaint fails to overcome the presumption of independence with regard to Mr. Garcia.

II. THE COURT OF CHANCERY CORRECTLY HELD THAT THE COMPLAINT FAILED TO ALLEGE PARTICULARIZED FACTS RAISING A REASONABLE DOUBT THAT THE TRANSACTION WAS PROPERLY THE PRODUCT OF BUSINESS JUDGMENT.

A. Question Presented

Did the Complaint allege particularized facts sufficient to overcome the presumption that the Transaction resulted from a valid exercise of business judgment? B9-11, B23-24, B47-52, B890-91, B892-97, B900-02, B906-15.

B. Standard of Review

The parties agree that the scope of the Court's review on this issue is *de novo* and plenary. *See Wood*, 953 A.2d at 140. The Court should draw all reasonable inferences in Appellants' favor, but "[s]uch reasonable inferences must logically flow from particularized facts alleged by the plaintiff. Conclusory allegations are not considered as expressly pleaded facts or factual inferences. Likewise, inferences that are not objectively reasonable cannot be drawn in the plaintiff's favor." *See id.* (internal quotation marks omitted).

C. Merits of the Argument

Plaintiffs' principal argument under the second prong of *Aronson* is that the Transaction involved an alleged controlling stockholder -- the Sanchez family -- and that as a consequence, the standard of review is entire fairness *ab initio* and demand is excused, even though the Audit Committee members were disinterested and independent. Plaintiffs implicitly recognize that they have not pled facts

sufficient to rebut the presumption of the business judgment rule as to the Audit Committee's approval of the Transaction. That is, they have dropped on appeal the claim that the Transaction was so egregiously unfair as to constitute bad faith, *compare* A38-39, A44 *and* A100-03 *with* POB at 35, and they have never attempted to plead a claim that the Audit Committee failed to act on an informed basis. Instead, they seek to meet their "heavy burden," *see Aronson*, 473 A.2d at 814, by analogizing this derivative action about an asset purchase to this Court's line of precedents involving cash-out mergers with controlling stockholders, including *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994).

This analogy fails for two reasons. First, the Complaint fails to plead particularized facts creating a reasonable inference that the Sanchez family controlled SN or that they controlled the Audit Committee's decision with regard to the Transaction. The Court of Chancery correctly so held, Op. at 26, and its judgment properly may be affirmed on this basis alone. Second, the judgment of the trial court should be affirmed on the alternative ground, presented below but unnecessary to the Vice Chancellor's decision and for that reason not reached, B911-14, A132-37, Op. at 17-18, that no basis exists in Delaware law for demand excusal and application of the entire fairness standard to a transaction between a corporation and its claimed controlling stockholder, when that transaction does not

require stockholder approval and is approved by a committee of independent and disinterested directors, as the Transaction at issue here was.

1. The Complaint Does Not Plead Particularized Facts Creating A Reasonable Inference That A.R. Sanchez and Tony Sanchez Controlled SN or Controlled The Company's Actions With Regard To The Transaction.

It is undisputed that A.R. Sanchez and Tony Sanchez own far less than a majority of the outstanding SN stock.[8] Plaintiffs rely on broad language in *Lynch* to argue that a minority stockholder who "exercises control over the business affairs of the corporation" is a controlling stockholder. *See* POB at 25 (quoting *Lynch*, 638 A.2d at 1113-14). Plaintiffs assert that this language means that a party with "*operational* control" or "control over the day-to-day management and … operations," *see* POB at 27, is a controlling stockholder for purposes of *Lynch*. The Vice Chancellor correctly rejected this contention, holding instead that a minority stockholder is a controller only if that stockholder exercises control *over the board* with respect to the challenged transaction. *See* Op. at 19-22.

That holding was a correct reading of *Lynch* -- which itself was a case involving a board acceding to the demands of a large minority stockholder instead

[8] The Court of Chancery assumed without deciding that A.R. Sanchez and Tony Sanchez should be viewed as a singular entity for purposes of the controlling stockholder analysis. Op. at 22 n.48. However, as the Vice Chancellor correctly held, the "Sanchez family" is "a group undefined in the Complaint," and the Complaint does not offer particularized facts in support of the assertion that the "Sanchez family" should be viewed as a unit for that purpose. *See* Op. at 9.

of exercising its independent business judgment, *see* 638 A.2d at 1114-15 -- and its progeny. *See In re Crimson Exploration Inc. S'holder Litig.*, 2014 WL 5449419, at *12 (Del. Ch. Oct. 24, 2014) (collecting cases); *In re KKR Fin. Hldgs. LLC S'holder Litig.*, 101 A.3d 980, 993-94 (Del. Ch. 2014) (characterizing issue of whether alleged controller possessed coercive power over the board as "the operative question under Delaware law"). In order to plead that A.R. Sanchez and Tony Sanchez were controlling stockholders, Plaintiffs had the burden to allege:

> well-pled facts showing that the minority stockholder exercised actual domination and control over the directors. That is, under our law, a minority blockholder is not considered to be a controlling stockholder unless it exercises such formidable voting and managerial power that it, as a practical matter, is no differently situated than if it had majority voting control. Accordingly, the minority blockholder's power must be so potent that independent directors cannot freely exercise their judgment, fearing retribution from the controlling minority blockholder.

In re Morton's Rest. Grp., Inc. S'holders Litig., 74 A.3d 656, 664-65 (Del. Ch. 2013) (footnotes and internal quotation marks omitted); *see also Superior Vision Servs., Inc. v. ReliaStar Life Ins. Co.*, 2006 WL 2521426, at *4 (Del. Ch. Aug. 25, 2006) ("focus [is] on control of the board"). It is not sufficient to allege control over day-to-day operations under the terms of management service agreements. *See KKR Fin. Hldgs.*, 101 A.3d at 991-95.

No allegations sufficient to meet this test appear in the Complaint. Plaintiffs' theory that a minority stockholder may be deemed a controller due to

day-to-day control over the operations, without controlling the decisions of the board that chooses who will exercise such day-to-day control, is inconsistent with a fundamental premise of the Delaware General Corporation Law, that the "business and affairs" of the corporation "shall be managed by or under the direction of [the] board of directors." *See* 8 *Del. C.* § 141(a); B908-10.

The cases on which Plaintiffs rely are not demand-futility cases and are distinguishable. In *Williamson v. Cox Communications, Inc.*, 2006 WL 1586375 (Del. Ch. June 5, 2006), the Court denied a Rule 12(b)(6) motion where the transactions at issue were required by the certificate of incorporation to be approved by the Series B directors, all of whom were appointed by the alleged controlling stockholders who were the transaction counter-parties, and where a special committee, appointed only a day before the board vote, did not retain financial or legal advisors. *Id.* at *2. That is, the alleged controllers had veto power over the board's actions and engineered a transaction without meaningful review by the independent directors.

And in *In re Zhongpin, Inc. Stockholders Litigation*, 2014 WL 6735457 (Del. Ch. Nov. 26, 2014), a Rule 12(b)(6) case involving a cash-out merger, the corporation's Form 10-K characterized the alleged controller as "our controlling shareholder" and stated that he was "able to exercise significant influence over our company, including, but not limited to, any shareholder approvals for the election

of our directors and, indirectly, the selection of our senior management, the amount of dividend payments, if any, our annual budget, increases or decreases in our share capital, new securities issuance, mergers and acquisitions and any amendments to our By-laws." *Id.* at *7. The Vice Chancellor held that this admission, while not conclusive on its own, read in conjunction with other allegations supported an inference of controlling status. *Id.* at *9. Nothing similar is alleged here.

The trial court also correctly held that the Complaint does not plead particularized facts showing that the Sanchezes controlled the Audit Committee's decision to approve the Transaction. Op. at 25-26. The Complaint simply alleges nothing about the process the Audit Committee followed, apart from entirely conclusory allegations of domination. *See supra*, 8-11. Plaintiffs argue that the Vice Chancellor should have inferred that Tony Sanchez's comments on the August 8, 2013, earnings call about the negotiation process constituted an admission that he had disloyally bargained in SR's and/or Altpoint's interests, rather than SN's. *See* POB at 31-32. These semantic arguments are baseless, as the Vice Chancellor held. Op. at 29-30. That Mr. Sanchez, SN's Chief Executive Officer, negotiated with Altpoint as part of structuring a three-party deal with Altpoint and SR, is not in the least suspicious, and in any event suggests nothing about the integrity of the Audit Committee's decision to approve the Transaction.

2. The Complaint Does Not Plead Particularized Facts Creating A Reasonable Doubt That The Audit Committee's Approval Of The Transaction Is Protected By The Business Judgment Rule.

Moreover, even if the Court accepts, for purposes of the demand futility analysis, that the Complaint adequately pleads that the Sanchez family controlled SN, there is no basis in Delaware law for application of the entire fairness standard to a transaction between a corporation and its controlling stockholder where that transaction (1) does not require stockholder approval, and (2) is approved by a committee of independent and disinterested directors, acting on an informed basis and in good faith. "Outside the controlling stockholder merger context, it has long been the law that even when a transaction is an interested one but not requiring a stockholder vote, Delaware law has invoked the protections of the business judgment rule when the transaction was approved by disinterested directors acting with due care." *In re MFW S'holders Litig.*, 67 A.3d 496, 526-27 (Del. Ch. 2013), *aff'd sub nom. Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014); *see also Orman v. Cullman*, 794 A.2d 5, 20 n.36 (Del. Ch. 2002) ("Recognizing the practical implications of the automatic requirement of an entire fairness review has led our Supreme Court to limit such automatic requirement to the narrow class of cases in which there is a controlling shareholder on both sides of a challenged merger."). Plaintiffs' contention to the contrary, like their argument of controlling stockholder status, relies on an over-reading of broad language from *Lynch*.

The Court of Chancery dismissed the Complaint on the basis of failure to plead demand futility. In the demand excusal context, directors are presumed capable of acting independently even of controlling stockholders, absent particularized factual allegations to the contrary. *See, e.g.*, *Aronson*, 473 A.2d at 815-17 (holding directors capable of evaluating demand as to transaction between corporation and its 47% stockholder); *Beam*, 845 A.2d at 1054 (under *Rales* standard, directors presumed capable of considering demand to sue the corporation's founder, CEO, eponymous brand and holder of 94% of the voting power). Even if Plaintiffs are right that the Sanchezes control the Company and that *Lynch* applies to the Transaction, so that the standard of review is entire fairness (and they are wrong on both points, as described above) the decision to bring or not to bring such a claim belongs in the first instance to the Board. It makes no sense to say that directors are presumed independent of a controlling stockholder (*i.e.*, that demand is not excused under the first prong of *Aronson* merely because the purported controlling stockholder is a transaction counter-party or the potential target of suit), if as Plaintiffs contend the presence of a controlling stockholder as a transaction counter-party automatically excuses demand under the second prong.

Plaintiffs' reliance on the Court of Chancery's transcript ruling in *Montgomery v. Erickson Air-Crane, Inc.*, C.A. No. 8784-VCL (Del. Ch. Apr. 15,

2014) (TRANSCRIPT), *see* POB 22-23, fails because the transaction at issue there involved a requirement of stockholder approval (given by the controlling holder), *see id.* at 28, and because the directors employed neither a majority-of-independent-stockholders vote nor an approval by an independent committee, *see id.* at 64. The traditional rule, that a transaction between a corporation and its fiduciary is entitled to business judgment rule deference if it receives *either* approval by a committee of independent and disinterested directors acting with due care *or* approval by the disinterested stockholders, *see MFW*, 67 A.3d at 526-27, was not implicated in *Montgomery*, but is implicated in this case.

Plaintiffs' remaining arguments, *see* POB at 33-35, under the second prong of *Aronson* may be dealt with summarily. *See supra*, 13-16. As noted above, a fair reading of Mr. Sanchez's comments on the August 8, 2013, earnings call makes clear that extricating Altpoint from its SR investment was Altpoint's negotiating goal, not SN's or Mr. Sanchez's, and the Vice Chancellor properly so interpreted those comments. *Supra*, 13, Op. at 29-30. Plaintiffs' criticism of the financial terms, now that Plaintiffs have abandoned the claim that the Transaction was so egregious as to constitute bad faith, is nothing more than a disagreement with the Audit Committee's business judgment. And the suggestion that the Defendants structured the deal as they did to avoid disclosing in SEC filings the royalties retained by SR -- even though SN's officer forthrightly answered a

question about the royalty burden on the August 8, 2013 earnings call, even though the royalties are in the public land transfer records, even though Plaintiffs have not asserted a disclosure claim against a Transaction that did not require stockholder approval, and even though Plaintiffs have not even sought to plead the materiality of the royalty terms to the fairness of the Transaction as a whole -- makes no sense. None of these criticisms, separately or together, can support an inference that the Audit Committee's approval of the Transaction was anything other than an appropriate, careful and informed exercise of business judgment by a disinterested and independent committee of the Board.[9]

CONCLUSION

The judgment of the Court of Chancery should be affirmed.

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[9] Although briefed and argued below, the Court of Chancery did not address the merits of the aiding and abetting claim in its opinion, but dismissed all claims, including the aiding and abetting claim, under Court of Chancery Rule 23.1. If the Court were to consider that claim on the merits, it should be dismissed for the reasons argued below. *See* B796-802, B813-25, B854-62, B870-80.

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