IN THE

Supreme Court of the State of Delaware

ALAN KAHN, Plaintiff Below, Appellant v. MICHAEL D. STERN, EDWARD A. STERN, JOSEPH P. DALY, JOHN W. POLING and JEFFREY P. BACHER, Defendants Below, Appellees.	No. 393,2017 Court Below: Court of Chancery of the State of Delaware, C.A. No. 12498-VCG

APPELLANT'S OPENING BRIEF

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NATURE OF PROCEEDINGS

This case challenges a going-private, written-consent sale of Kreisler Manufacturing Corporation ("Kreisler" or the "Company") to Arlington Capital Partners ("Arlington") for $18 cash per share (the "Merger"). Arlington initially bid $18.75 per share and then the Company's Board of Directors (the "Defendants") accepted $18 per share after certain insiders negotiated side deals for themselves. The Court of Chancery improperly dismissed Plaintiff's sole claim of breach of fiduciary duty, which alleged Defendants acted in bad faith in approving the Merger that diverted Merger consideration from stockholders to the Company's insiders. *Kahn v. Stern*, C.A. No. 12498-VCG, 2017 WL 3701611, at *1 (Del. Ch. Aug. 28, 2017). Specifically, the Court below erred by ignoring the applicable standards, failing to consider the allegations in their entirety, and failing to allow Plaintiff the required inferences on a motion to dismiss.

Defendants initiated a closed sales process limited to buyers that would accommodate the self-interests of the Company's sole executive officers (brothers who were descendants of the Company's founders and each owned large stakes in the Company) who wanted to cash out at the expense of the public stockholders. A010-12. These two siblings (Edward Stern and Michael Stern) hired bankers and lawyers, drafted the Confidential Information Memorandum used to pitch the sale, and otherwise set the parameters for a sale to accommodate their interests. A011.

After those insiders set up the sales process, the Board created a Special Committee (including a director it appointed that same day without any disclosure to stockholders)[1] that failed to hire independent advisors but instead chose to use the same bankers and lawyers that the siblings selected. A019.

After Arlington submitted an $18.75 per share bid, Defendants agreed to a series of side deals to divert Merger consideration to the two siblings and away from public stockholders. A021-22. The side deals included: an amended Employment Agreement to increase the termination benefits for Edward Stern, who would leave the Company in a few weeks; a new Employment Agreement and Rollover Agreement for Michael Stern, who would continue working for the new buyer; and a "Sale Bonus Agreement" providing that both Stern brothers would be paid a cash bonus (representing about $0.11 per share on a fully diluted basis) upon the closing of the Merger. *Id*. As a result of these new financial burdens negotiated after the $18.75 bid, Arlington lowered its bid to $18 per share, which Defendants accepted. A023. The merger agreement included an "Appraisal Out" provision whereby Arlington could walk away if appraisal was sought with respect to more than 10% of Kreisler's outstanding shares. A024.

[1] Though its common stock was publicly traded, Kreisler was a dark corporation not subject to SEC reporting requirements. A010, A016. Thus, while the new director (defendant Jeffrey Bacher) was appointed to the Board on August 21, 2015, that information was not provided to Kreisler public stockholders until (*cont'd.*)

The decision to approve the Merger was supported by: the two self-interested directors; a director whom the Board considered to be conflicted and who was looking to sell his illiquid block of shares by any means necessary; a director with no interest whatsoever in the Company and who was appointed the same day the Special Committee was created; and a director whom a hedge fund had months earlier sought to oust from the Board. A010-12, A015-16, A019-20.

The Court of Chancery concluded that the Stern brothers were interested, but erred in not drawing other inferences in Plaintiff's favor. Specifically, the Court of Chancery held that some of the Defendants' actions attacked by Plaintiff may have had a rational purpose and that allegations as to other Defendants' actions lacked specificity. However, especially in light of the limited public information available for a dark corporation such as Kreisler, Plaintiff has more than adequately pleaded that it is reasonably conceivable that all the directors acted in bad faith by, among other things: (1) agreeing to divert consideration to the side deals benefiting directors and from the Company's stockholders (A011-12, A021-24); (2) covering up the terms of the side deals by failing to provide stockholders with complete information in the Information Statement (A024-30); (3) limiting other information available to stockholders, such as failing to provide complete disclosure regarding

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(*cont'd.*)
the Information Statement was mailed to stockholders on May 31, 2016.

the financial projections of the Company and the reasons why the Defendants agreed to a $0.75 per share price reduction after the Stern brothers negotiated to receive their own special benefits (A026-30);[2] (4) using counsel and a banker selected by the Sterns, rather than retaining independent advisors (A011, A018-19); and (5) conducting a process that only sought bidders willing to accommodate the Sterns (A011, A017-18). The Court of Chancery either failed to consider, or chose to provide alternative explanations, for each of these factors rather than properly determining that they collectively raise the specter of bad faith.

The Court of Chancery held that the Sale Bonus Agreements perhaps could have been explained by a potential desire on behalf of the Board to "incentivize proper management of the Company through and after the Merger." 2017 WL 3701611, at *13. But the Stern brothers collectively held approximately 25% of the Company's outstanding common stock and were the sole executives of the Company. No sale could have been completed without their consent, and the Information Statement never claimed that there was any need to incentivize the

[2] The merger agreement and side agreements were not made available to stockholders. A024-26. The sole document that was provided to stockholders, the Information Statement, failed to meaningfully disclose the terms and value of the side deals, the reasons the Defendants were willing to divert consideration from stockholders to the Sterns and the Company's financial projections created by management. A024-30. The Court of Chancery conceded that the disclosures "would be found material and support injunctive relief" but found that the lack of disclosures was insufficient to state a claim based solely on disclosure violations. (*cont'd.*)

Stern brothers. A016. Moreover, the Merger was approved by written consent, with very little lag time between approval and consummation (just enough for the buyer to confirm no trigger of the 10% Appraisal Out), and no need to provide any such incentivization.

Despite finding that Edward Stern's amended Employment Agreement was "problematic" because he was not planning to continue with Kreisler after the Merger, the Court of Chancery nevertheless held that the pleadings were insufficient because they did not provide "details about the nature and materiality of the benefits provided to Edward Stern in his amended Employment Agreement." 2017 WL 3701611, at *13. The reason for any lack of detail, however, is because Defendants concealed this and other material information in the Information Statement provided to stockholders.[3] As a result, the Court of Chancery essentially found that the Defendants are entitled to favorable inferences as a result of hiding the facts that would show their bad faith.

The Court of Chancery also improperly found that "Plaintiff's Complaint still does not plead facts creating a reasonable inference of bad faith, because the amount of the reduction actually arising from the Side Deals, and hence its

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(*cont'd.*)
2017 WL 3701611, at *16.

[3] The Complaint does allege that the Stern brothers' Sale Bonus Agreement payments were in the amount of up to $105,000 each. A012, A022-23.

materiality, is never pled." 2017 WL 3701611, at *11. This is not true. As to the Sale Bonus Agreements, Plaintiff alleged that these agreements amount to the Stern brothers each receiving an extra $0.11 per share. A012, A023. This alone is a material 4% decrease in the per share amount to be provided to stockholders. And Plaintiff alleges that the decrease in Arlington's offer price followed immediately after the Stern brothers' side-agreements were negotiated. A023. Plaintiff's allegations raise a reasonable inference that the Stern brothers insisted on material side benefits for themselves that resulted in the price decreasing from $18.75 per share to $18.00 per share – a direct causal link that was approved by all of the Defendants based on a bad faith desire to further the Stern brothers' personal interests as the expense of the stockholders.

SUMMARY OF ARGUMENT

1. The Court of Chancery erred in in dismissing the sole count of the Complaint. Plaintiff's allegations state a reasonably conceivable claim that the Kreisler's Board of Directors acted in bad faith by agreeing to the written-consent Merger that, among other things: (a) diverted merger consideration from the public stockholders to Company fiduciaries through side deals, including an amended Employment Agreement to increase the termination benefits for the executive who would leave the Company in a few weeks; a new Employment Agreement and Rollover Agreement for the executive and Board member who would continue working for the new buyer; and Sale Bonus Agreements where both insiders would be paid a cash bonus upon the closing of the Merger; (b) was orchestrated by the same insiders who received the side deals; and (c) was not fully disclosed to Company stockholders (indeed, Defendants did not disclose the merger agreement and misrepresented that it would be available to any stockholder upon request). The Court of Chancery failed to credit Plaintiff's well-pleaded allegations, erred in not drawing inferences in Plaintiff's favor and wrongfully suggested alternative inferences and explanations for these bad faith acts.

STATEMENT OF FACTS

Kreisler is a Delaware corporation headquartered in New Jersey. A015. The Company was co-founded in 1918 by the Stern family and has been part-owned and managed by them ever since. *Id*. The members of Kreisler's Board of Directors at the time of the Merger were Michael D. Stern ("Michael"), Edward A. Stern ("Edward"), Joseph P. Daly ("Daly"), John W. Poling ("Poling"), and Jeffrey P. Bacher ("Bacher"). A014-15. Michael and Edward, who are brothers, have been employed by Kreisler since 1991, both holding the title of Co-President. A015. Michael was also CEO and Treasurer, and Edward was also Chief Corporate Officer and Corporate Secretary. *Id.* Michael and Edward were the sole executive officers of the Company at all relevant times. *Id.* The Stern family members, all siblings, collectively owned 42.6% of the Company's outstanding shares: Michael and Edward each owned 12.3% of the Company's shares, and Jeffrey R. Stern and Jody Stern (neither of whom worked for Kreisler) each owned 9%. A016.

Though its common stock was publicly traded, Kreisler was a dark corporation not subject to SEC reporting requirements. A016. The stock was thinly traded in an inefficient market, with no analyst coverage, and only limited information provided to public stockholders. *Id.*

After an unsuccessful proxy fight in late 2014/early 2015,[4] the Stern brothers began the process of exploring a sale of the Company that would accommodate their respective financial and employment needs. A017-18. Potential buyers who would not accommodate those interests were not considered. *Id*. Before a Special Committee was formed, Michael and Edward hired lawyers and bankers and set the parameters for a sale to accommodate their interests. *Id.*

On June 12, 2015, Michael and Edward hired SunTrust Robinson Humphrey, Inc. ("Robinson Humphrey") as a financial advisor. A018. On July 7, 2015, Michael and Edward, met with Robinson Humphrey "to discuss the potential strategic transaction, timeline and process." *Id*. Thereafter, Michael and Edward also prepared the Confidential Information Memorandum for potential bidders. *Id*.

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[4] In December 2014, AB Value Partners LLC ("AB Value"), which owned 11.6% of the Company's outstanding shares, attempted to initiate a proxy fight but missed the advance notice deadline provided in the Company's bylaws. A016. AB Value commenced litigation in the Court of Chancery on December 2, 2014, seeking a TRO blocking the Company's December 18, 2014 annual meeting of stockholders, naming all directors but for Daly. A016-17, A020. The Court ruled against AB Value. *See AB Value Partners, LP v. Kreisler Mfg. Corp.*, C.A. No. 10434-VCP, 2014 WL 7150465 (Del. Ch. Dec. 16, 2014). A016-17. While Michael and Edward were fighting AB Value, they received a 57% increase in their base salary in 2014. A017. The *AB Value* opinion noted that the Company had failed to inform stockholders of management's new compensation. *Id.* The Company first disclosed that information late on Friday, January 2, 2015, over two weeks after the Court's opinion, with the annual meeting set for 9:00 a.m. on Monday, January 5, 2015. *Id*. Although not disclosed in the Information Statement, it appears that further salary increases were made in 2015, which also were never disclosed to stockholders. *Id*.

Blank Rome, LLP ("Blank Rome"), which is Kreisler's main outside counsel, was the Company's legal advisor in the sales process. *Id*.

After Michael and Edward hired Robinson Humphrey and developed the Confidential Information Memorandum, a Special Committee was formed on August 21, 2015. A018-19. Rather than appointing Daly and Poling, the only two non-inside directors to the Special Committee, the Board chose to appoint a new director, Bacher, to serve on the Special Committee with Poling. A019. The Information Statement stated that the Board elected Bacher as director on August 21, 2015, the same day the Special Committee was created. *Id*. The Company had not publicly disclosed Bacher's election to the Board. *Id*. The Information Statement disclosed that he joined the Board and that he owned no shares of Kreisler common stock, but did not disclose his qualifications or compensation. *Id*.

Plaintiff alleged that, by electing a new director and appointing him to the Special Committee, rather than appointing Daly to the Special Committee, the other members of the Board acknowledged that Daly was not independent. A019. Daly had a large, illiquid block of shares and had aligned himself with the hedge fund that had unsuccessfully attempted a proxy fight because he wanted to divest his shares and a sale of the Company was the only away to do so. A019-20. Daly also agreed to a five-year non-compete and non-solicitation provision in connection with the Merger, demonstrating he had some value to the Company beyond acting as an independent director. A020.

Ultimately, Bacher and Poling chose not to retain any advisors independent of the Company, and instead used Robinson Humphrey as financial advisor and Blank Rome as legal counsel. A019.

While potential bidders were conducting due diligence (from late October through December), Michael and Edward secured new Employment Agreements on October 21, 2015. A020.

Thereafter, according to the Information Statement, the Special Committee directed Robinson Humphrey to secure best and final bids. A021. On January 6, 2016, the Special Committee accepted Arlington's bid of $18.75 per share, "subject to adjustments."[5] A021. Michael and Edward then negotiated extra benefits for themselves. A021-24.

Concurrent with the Merger negotiations, Edward negotiated with the "Compensation Committee" (whose membership was never disclosed) for another amendment to his new Employment Agreement in order to obtain better benefits upon his desired termination from the Company when the Merger was completed. A022. On May 3, 2016, Edward and Kreisler entered into that amendment to his

[5] The Information Statement did not disclose what "subject to adjustments" meant. A021.

Employment Agreement, just a few weeks before the Merger that would trigger the termination of his employment by the Company. *Id*. The Information Statement did not provide any information as to the content of this amendment nor did it explain why such an amendment was necessary only a few months after his prior employment agreement had been entered into in October 2015. A028-29.

At the same time the Company was negotiating the merger agreement, Michael was negotiating with Arlington to secure new employment with the post-Merger entity, and a rollover of a portion of his existing equity position into a new equity position in Arlington's subsidiary, United Flexible Technologies, Inc. ("United Flexible"). A021-22. Concurrently with the execution of the merger agreement, Michael entered into a Rollover Agreement with United Flexible, and an Employment Agreement with Kreisler and Arlington. *Id.* Under the terms of the Employment Agreement, Michael would become president and a director of post-Merger Kreisler, and would be permitted to attend all Board meetings of United Flexible. *Id*.

Also at the same time the Company was negotiating the merger agreement, both Michael and Edward were negotiating the Sale Bonus Agreements with the Company, which were entered into on April 11, 2016. A022. The Sale Bonus Agreements provided that Michael and Edward would each receive up to a $105,000 payment (or just over $0.11 per share in value on a fully diluted basis that could have otherwise been distributed to stockholders), depending on the Company's cash balance as of the closing of the Merger. *Id*.

These side agreements diverted consideration from the stockholders. Ultimately, Arlington's $18.75 per share bid was reduced to $18 per share. A023. The Information Statement did not explain why the Defendants agreed to the Sale Bonus Agreements and other side agreements that diverted consideration from stockholders to the Company's insiders. A022-23, A028-29. According to the Information Statement, the full Board met on May 26, 2016, and was provided with a draft of the merger agreement and a draft of the Information Statement. A024, A026. The Board met again on May 27, 2016, received a fairness opinion from Robinson Humphrey, and unanimously approved the merger agreement. A023. Edward, Michael, Daly, Poling and AB Value, together holding 53.2% of the Company's outstanding shares, entered into a Stockholder Support Agreement (also not provided to public stockholders), and delivered a written consent approving the merger agreement (also not provided to beneficial stockholders) without a stockholder vote. *Id*. The Special Committee (which did not have separate advisors) did not meet independently of the full Board on May 26, 2016 or May 27, 2016, when the final agreements and presentations were being considered and the merger agreement was approved. A024.

The merger agreement included an Appraisal Out provision whereby Arlington's obligation to consummate the Merger was subject to the number of shares seeking appraisal not representing more than 10% of the Company's outstanding shares. A024. The failure to provide required disclosures in the Information Statement served to minimize the risk that stockholders would seek appraisal and trigger the buyer's option to walk away from the Merger. *Id*.

Defendants agreed to an unusual provision in the merger agreement whereby only stockholders of record were permitted access to a copy of the merger agreement. A024-25. Worse still, Defendants misrepresented this decision from stockholders. A025. Defendants stated in the Information Statement that:

> The complete text of the Merger Agreement is available for review (but not duplication) at the offices of Blank Rome LLP in Philadelphia, Pennsylvania, upon the request of ***any stockholder*** or other persons for a proper purpose.

A068 (emphasis added); *see also* A024. This was false, and demonstrative of the Defendants' bad faith. The merger agreement was not available "upon the request of any stockholder." A025.[6] Because Defendants were provided with a draft of

[6] On June 15, 2016, Plaintiff Alan Kahn, a beneficial owner of the Company's stock, requested access to the merger agreement as provided in Information Statement and was denied by the Company's counsel. A012-14. Counsel for Defendants responded by email that day stating that access to the merger agreement was limited to record owners. A105. Thus, Defendants knew, prior to the completion of the Merger and prior to the June 20, 2016 deadline to seek appraisal, that the Information Statement misrepresented the terms of the merger (*cont'd.*)

the Information Statement and a draft of the merger agreement during the May 26, 2016 Board meeting, Defendants knew that the provision in the merger agreement limiting access to record owners contradicted the disclosure in the Information Statement that "any stockholder" could access the merger agreement and chose to do nothing. A026. Defendants were advised at this meeting by experienced lawyers who well knew the wealth of guidance Delaware Courts have provided regarding disclosure to stockholders, yet Defendants failed to take any action to provide those disclosures as required by their fiduciary obligations. *Id*. This intentional cover up of the basic terms of the Merger is further indicia of Defendants' bad faith.

The Information Statement also did not include a fair summary of Robinson Humphrey's analysis. A027. Robinson Humphrey performed three valuation analyses: a discounted cash flow analysis, a selected companies analysis, and a precedent transactions analysis. *Id*. The Information Statement discloses only the

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(*cont'd.*)
agreement as to stockholders' right to obtain a copy of the merger agreement. Defendants took no action to correct the misrepresentation. Plaintiff has not yet seen the merger agreement, a fact that surprised the Vice Chancellor during oral argument. A248. ("THE COURT: You have not seen the merger agreement? MR. NOTIS: No, of course not. The merger agreement was limited to stockholders of record. So that's why it was never provided to our client, because our client was only a beneficial owner. So that's likely the majority -- THE COURT: I didn't know that in the interim you had not seen the merger agreement. MR. NOTIS: No, we've never seen the merger agreement.").

results of the discounted cash flow analysis. *Id*. The Information Statement does not include any disclosure of the results of the selected companies analysis or precedent transactions analysis. *Id*. The Information Statement also failed to disclose the Company's five-year projections created by Michael and Edward and provided to Robinson Humphrey. A028. Given that Kreisler was a dark corporation with no analyst coverage, these projections (or any other financial information) were not available from any source other than Defendants. A010, A016. In sum, the Information Statement devoted just three sentences (disclosing the results of the discounted cash flow analysis) to what the Company was worth.

The Information Statement contained no meaningful disclosure regarding the negotiation of the side agreements that benefitted insiders – the Rollover Agreement, the Sale Bonus Agreements, and the new and amended Employment Agreements. A028-30. The chronology of events listed in the Background of the Merger section of the Information Statement made no mention of the Rollover Agreement, Sale Bonus Agreements, or the new and amended Employment Agreements. *Id.*

Finally, there was no disclosure of the Merger negotiations, except for the statement in the Information Statement that Arlington provided a best and final bid of "$18.75 per share, subject to adjustments" on January 6, 2016. A029-30. Defendants did not disclose how, why, or when any "adjustments" were made, and no disclosure of any price movement from the January 6, 2016 "$18.75 per share, subject to adjustments" offer to the $18 per share Merger price agreed to on May 27, 2016. *Id*. The Complaint provides ample support for the Court to conclude that the reduction of the Merger price was directly connected to the side agreements provided to Edward and Michael. And Defendants' failure to disclose the reasons for the price reduction to the public stockholders, who had the ability to stop the Merger and the Stern brothers' side deals through the Appraisal Out, further supports Plaintiff's allegations that Defendants acted in bad faith.

ARGUMENT

I. THE COURT OF CHANCERY ERRED IN HOLDING IT WAS NOT REASONABLY CONCEIVABLE THAT DEFENDANTS ACTED IN BAD FAITH IN APPROVING THE MERGER

A. Question Presented.

Did the Court of Chancery err in holding that the Complaint did not plead reasonably conceivable allegations that Defendants acted in bad faith in approving a Merger that diverted consideration from stockholders to the Stern brothers? This issue was raised below at A179-200.

B. Scope of Review.

The Court of Chancery's ruling on a motion to dismiss is subject to *de novo* review. *Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Holdings, LLC*, 27 A.3d 531, 535 (Del. 2011). When considering a motion to dismiss for failure to state a claim under Court of Chancery Rule 12(b)(6), the Court is required to "(1) accept all well pleaded factual allegations as true, (2) accept even vague allegations as 'well pleaded' if they give the opposing party notice of the claim, (3) draw all reasonable inferences in favor of the non-moving party, and (4) do not affirm a dismissal unless the plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances." *Id.* at 535.

C. Merits of Argument.

1. The Court of Chancery Ignored a Well-Established Standard for Pleading Bad Faith

Section 102(b)(7) does not protect directors whose actions constitute loyalty breaches or whose actions were not in good faith. *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 65 (Del. 2006). Bad faith conduct can be pleaded in different ways, including reliance on (1) allegations that the fiduciary intentionally failed to act in the face of a known duty to act, demonstrating a conscious disregard for his duties;[7] *or* (2) allegations that "the decision under attack was so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any grounds other than bad faith."[8] The Court below erred by ignoring plaintiff's well-pleaded allegations of the defendants' conscious disregard for their duties to act in the best interest of the stockholders and applying only the alternative, more defendant friendly standard that the decision be "inexplicable on grounds other than bad faith." *Compare Kahn v. Stern,* 2017 WL 3701611, at *10-11, *13-14 (indicating that failure to meet the inexplicable standard would lead to dismissal) *with In re PLX Tech. Inc. S'holders Litig.*, Del. Ch., C.A. No. 9880-VCL, trans. at

[7] *Disney*, 906 A.2d at 67; *see also In re Answers Corp. S'holders Litig.*, C.A. No. 6170-VCN, 2012 WL 1253072, at *7 (Del. Ch. Apr. 11, 2012); *In re Saba Software S'holders Litig.*, C.A. No. 10697-VCS, 2017 WL 1201108, at n.123 (Del. Ch. Apr. 11, 2017) (citations omitted).

[8] *Parnes v. Bally Entm't Corp.*, 722 A.2d 1243, 1246 (Del. 1999).

45-48, Laster, V.C. (Sept. 3, 2015) (complaint stated a claim because its allegations supported a "pleading-stage inference that [disinterested directors] acted in bad faith by giving into the wishes of [interested directors]" even though such inference was "not the only possible inference"); *Answers*, 2012 WL 1253072, at *8-9.

2. The Complaint Alleges a Reasonably Conceivable Claim that the Defendants Acted in Bad Faith by Approving a Merger that Diverted Consideration to the Stern Brothers, Was the Product of a Process Dominated by the Stern Brothers, and Concealed the Truth in a Defective Information Statement

The Complaint alleges Defendants acted in bad faith consciously ignoring their fiduciary duties to the stockholders allowing (1) the Stern brothers – directors whose interests diverged from those of the public stockholders – to hire bankers and lawyers, as well as set the parameters for the sale; (2) consideration to be diverted away from the public stockholders and to the Stern brothers;[9] and (3) misleading and incomplete disclosures to be disseminated to stockholders making the likelihood of any Appraisal Out or successful challenge to the deal more remote and, thereby, further protecting the Stern brothers' self-interested Merger.

[9] Indeed, after the Defendants approved these cash concessions (none of which were claimed in the Information Statement to be conditions set by Arlington), Arlington reduced its bid. A023-24.

Allowing the diverted merger consideration is alone sufficient to give rise to a pleading-stage inference of bad faith.[10] The Complaint alleges that Arlington initially agreed to pay $18.75 per share for the Company on January 6, 2016. A011. On April 11, 2016, the Stern brothers each entered into Sale Bonus Agreements entitling them to up to $105,000 each, amounting to $0.11 per share more than the other stockholders. A012, A022-23. Furthermore, on May 3, 2016, Edward entered into an amendment to his October 21, 2015 Employment Agreement to obtain better benefits upon his termination following the Merger (the amount of which was concealed from stockholders). A022. When the Merger was approved on May 27, 2016, the Merger price had been reduced to $18 per share. A013, A023. The Complaint alleges that the Merger price was reduced to fund the grant to the Stern brothers of side benefits. *Id.*

Defendants and the Court of Chancery have conceded that "[it] is undisputed that two of the five directors, the Stern Defendants, were interested in the Merger." *Kahn*, 2017 WL 3701611, at *8. Thus, Plaintiff need only demonstrate the three remaining defendants were "either . . . interested in the sales process or acted in bad faith in conducting the sales process." *Answers*, 2012 WL 1253072, at *7

[10] The Court of Chancery improperly relied on the fact that "materiality, is never pled." *Kahn*, 2017 WL 3701611, at *11. Materiality is not relevant in a case of diversion of Merger consideration. Once the amount of the merger consideration is fixed, no amount may be diverted from stockholders to insiders in (*cont'd.*)

(finding the three directors were interested in the merger and the four other independent members "of the Board consciously failed to seek the highest value reasonably available for Answers' shareholders.").

Daly,[11] Poling and Bacher all acted in bad faith by consciously failing to exercise their fiduciary duties and by putting the interests of the Stern brothers above the interests of public stockholders. Permitting merger consideration to be diverted from stockholders to insiders has consistently been held as bad faith even where there is a majority independent board. In *Crescent/Mach I Partners, L.P. v. Turner*, 846 A.2d 963, 981 (Del. Ch. 2000), the Court held that although the majority of the board was disinterested, plaintiffs had "pleaded facts evidencing the remaining directors' 'indifference to their duty to protect the interests of the corporation and its minority stockholders.'" The Court denied a motion to dismiss, finding that Turner, the company's controlling shareholder, CEO and Chairman of the Board, by means of side-deals secured "substantial benefits to him that will not be available to . . . minority stockholders." *Id*. at 982. The Court explained:

(*cont'd.*)
good faith.

[11] Plaintiff also raised arguments that Daly was conflicted. The Court of Chancery rejected this argument. While Plaintiff contends that the Court of Chancery erred by failing to provide Plaintiff with all reasonable inferences, as it must at the pleading stage, Daly's independence or lack thereof is not outcome determinative here as his acquiescence to the process that led to the diversion of consideration from stockholders to the Sterns was in bad faith.

> [I]t does not matter here that the Complaint fails to establish that [the independent directors] were either interested directors or that they lacked the ability to form an independent judgment. Their approval of [the inside director's] alleged self-interested 'side-deals' allegedly taint the entire merger process and strips the board of the protection of the business judgment rule.

Id.; *see also Alidina v. Internet.com Corp.*, C.A. No. 17235-NC, 2002 WL 31584292, at *5-6 (Del. Ch. Nov. 6, 2002) (in buyout context, where a fiduciary provides some consideration for the side-deal obtained from the company, but the well-pleaded allegations demonstrate that the consideration is grossly inadequate, dismissal should likewise be denied, as in *Parnes*, *supra* and *Crescent/Mach I Partners, L.P.*, *supra*).

Daly's, Bacher's and Poling's "approval of [the insider director's] alleged self-interested 'side-deals' . . . taint the entire merger process and strips the board of the protection of the business judgment rule." *Crescent/Mach I Partners, L.P*, 846 A.2d at 982. Like the plaintiff in *Alidina*, Plaintiff alleged that Daly, Bacher and Poling "knew [the Sterns] allegedly sought out an interested merging partner[s] [A011, A017-18], dictated the terms of the Transaction [*id*.], secured a valuable asset[s for themselves A011-14, A021-23] . . ., and diverted funds away from the Company to [themselves A012-14, A023]." *Alidina*, 2002 WL 31584292, at *6. These "allegations . . . sufficiently pled that the directors' acquiescence to this process, passive or otherwise, was beyond the bounds of reasonableness." *Id*.

The Court of Chancery's attempt to distinguish *Alidina* from this case ignores the well-pleaded allegations in Plaintiff's Complaint. The Court of Chancery stated that "*Alidina* alleged that the Board 'knew' that the interested party sought out the merger partner." *Kahn*, 2017 WL 3701611, at *12. Yet Plaintiff allegations of Defendants' misconduct here have a similar result. The Complaint stated that "M Stern and E Stern first hired bankers and lawyers and set the parameters for the sales process and an acceptable merger partner." A018. While a Special Committee was later formed, it did not hire independent advisors, relied on the Confidential Information Statement prepared by the Stern bothers and met together with the Sterns (and not independently) to review and approve the merger agreement. A018-20.

The Court of Chancery also noted that the insider in *Alidina* "demanded" the side-deals and "that the side-deal diverted substantial funds away from the company to the insider." *Kahn*, 2017 WL 3701611, at *12. The same is pleaded here. A011-12. The merger agreement was not subject to a vote but rather required the consent of the Sterns. A012. The Sterns would only provide such consent to a bidder that would meet their demands. A011. Further, the side-deals diverted consideration from stockholders – the $18.75 per share offer ended at $18 per share after the negotiation of the side deals. A012. This is a 4% decrease in consideration for stockholders. *cf. Golaine v. Edwards*, C.A. No. 15404, 1999 WL

1271882, at *7 (Del. Ch. Dec. 21, 1999) (declining to dismiss the complaint on materiality grounds despite its finding that the insider "would have received approximately $13.2 million dollars more in the merger, or 16 cents a share in addition to the $68.365 dollars a share the Exchange Ratio implied. This equals 2/10 of 1% of the total merger consideration received by the" public stockholders; the amount of the diversion here was 20 times more); *see also In re El Paso Pipeline Partners, L.P. Deriv. Litig.*, 132 A.3d 67, 117-18 (Del. Ch. 2015), (finding that where the "pro rata value of the Liability Award, plus interest, approximates 2.8% of the value of the Merger consideration that the unaffiliated holders of common units received," it is likely material and noting that in "approval of a settlement . . . the Chief Justice regarded a cash settlement payment equal to approximately one-half of one percent of the merger consideration as 'a very large monetary settlement,' 'a very substantial achievement for the class,' 'real money,' and a 'very good settlement for the class.'"), *rev'd sub nom. on other grounds*, *El Paso Pipeline GP Co., L.L.C. v. Brinckerhoff*, 152 A.3d 1248 (Del. 2016) No evidence was presented in *Alidina* or *Crescent/Mach I Partners* that the merger consideration offered to stockholders by the buyer was decreased as a result of the side deals, making the instant diversion more egregious than the conduct deemed to be bad faith in those actions. Finally, there is no plausible reason that Arlington would have "demanded" that Edward (who would have no role at and no ownership interest in the post-Merger Company) enter into an amendment to his Employment Agreement to obtain better termination benefits or that it be subject to a $210,000 cash payment to the Stern brothers ($105,000 to each) in the form of the Sale Bonus Agreements.

The Court of Chancery instead found this matter to be more akin to "*In re Alloy*, [C.A. No. 5626-VCP, 2011 WL 4863716 (Del. Ch. Oct. 13, 2011) where] the Court found certain side-deals alleged were reasonable conditions to the merger that failed to rise to the level of tainting the entire process." *Kahn*, 2017 WL 3701611, at *12. However, *Alloy* is distinguishable for a multitude of reasons.

First, *Alloy* is not a diverted merger consideration case; instead it involved continued retention of management and an equity rollover. 2011 WL 4863716, at *1. There were no allegations of any cash side payments or termination payments to which an insider was not previously entitled. Second, the financial buyer in *Alloy* in its initial bid conditioned its offer on the retention of senior management. *Id*. at *12. Here, there is no evidence that Arlington insisted on paying the Sterns a Sale Bonus Agreement or in increasing Edward's termination benefits. Indeed, it would have been illogical for Arlington to do so. Rather, the Sale Bonus Agreements and the amended Employment Agreement for Edward, at a minimum, are agreements the seller imposed on the buyer. Third, unlike this case where the bid went down after the side deals, the directors in *Alloy* achieved multiple price increases from the buyer. *Id*. at *3. Finally, unlike *Alloy*, this Merger was agreed to by written consent to eliminate the risk of non-consummation, such that the Court of Chancery erred in speculating that the purpose of the side-deals was to incentivize the Sterns to stay through the Merger. *Compare id*. at *5 *with* A012.

Further, the Complaint alleges that the Defendants' bad faith was evidenced by misrepresentations and omissions in the Information Statement – the sole document provided to stockholders describing the Merger. The Information Statement contained an affirmative misrepresentation that a copy of the merger agreement was available "upon the request of any stockholder," when in fact it was only available to stockholders of record. A024-26. Defendants also chose only to disclose one of the three valuation analyses performed by Robinson Humphrey. A027-28. The valuation-related disclosures provided by Defendants amounted to three sentences describing the DCF analysis. *Id*. The Defendants also failed to disclose the reasons for any of the side deals or any description of the negotiations other than that Arlington bid $18.75 per share and Defendants later accepted $18 per share. A028-29. Finally, the Defendants did not disclose the five-year projections created by management and provided to Robinson Humphrey.[12] A028.

[12] The Court of Chancery found the "decision to withhold management projections and other elements leading to the fairness opinion has been held, in appropriate circumstances, to merit injunctive relief. . . Injunctive relief could have been, but was not, pursued." *Kahn*, 2017 WL 3701611, at *14. However, the (*cont'd.*)

These disclosure violations provide ample support for a bad faith finding, especially when viewed holistically along with Defendants' willingness to divert funds from stockholders to the Sterns and other indifferences to the stockholders' interests *See O'Reilly v. Transworld Healthcare*, *Inc.*, 745 A.2d 902, 915 (Del. Ch. 1999) (finding plaintiff sufficiently pleaded "disclosure violations implicated the duty of loyalty" "[g]iven the allegations in the Complaint of self-interest . . . and the reasonable inference that the pleaded disclosure allegations were part of a plan to deceive HMI's stockholders in order to consummate the Merger and fulfill the two HMI directors' and Transworld's self-interests").

(*cont'd.*)
Court fails to address that an injunction would have been meaningless because the stockholders did not have an opportunity to vote down the transaction that had already been approved by written consent.

CONCLUSION

For all of the foregoing reasons, the Court of Chancery erred in dismissing the action. This Court should reverse and remand.

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