

# Business Judgment Rule Applies Where Stockholder Failed to Plead Merger Was Interested Transaction

Related People:  
John Basenfelder

## Delaware Law Update

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In *Flannery v. Genomic Health, Inc.*, C.A. No. 2020-0492-JRS (Del. Ch. Aug. 16, 2021) (hereinafter *Flannery*), the Delaware Court of Chancery dismissed a complaint in which the plaintiff failed to adequately plead that a merger transaction was fundamentally unfair because it involved conflicted controlling stockholders. The court concluded that the business judgment rule was the proper standard of review.

The *Flannery* case involved a 2019 merger whereby Exact Sciences Corp., a publicly traded Delaware corporation (Exact), acquired Genomic Health, Inc., another publicly traded Delaware corporation (Genomic), for cash and stock valued at \$2.8 billion. Brothers Julian Baker and Felix Baker controlled several Delaware limited partnerships (the Baker Brothers LPs) that together owned 25.9 percent of Genomic at the time of the merger. Prior to the approval of the merger by Genomic's board of directors (the Board), Exact demanded that the Baker Brothers LPs enter into a voting agreement to vote in favor of the merger. The Baker Brothers LPs refused to agree to certain trading restrictions in the voting agreement, but advised Exact that they intended to vote in favor of the merger. After the Board approved the merger, the Baker Brothers LPs entered into the voting agreement with Exact whereby they committed to vote for the merger.

The plaintiff, who was a Genomic stockholder at the time of the merger, alleged, among other things, that (i) the Baker Brothers LPs were conflicted controlling stockholders of Genomic and this resulted in a fundamentally unfair price for the Genomic stockholders, and (ii) the merger was in violation of Section 203 of the Delaware General Corporation Law (Section 203).

The *Flannery* court dismissed the plaintiff's argument that the transaction should be reviewed under an "entire fairness" standard. The court explained that entire fairness is not triggered simply because a transaction involves a controlling stockholder—the complaint must also allege that the controller was involved in an interested transaction. Here, the court noted that the plaintiff failed to allege that the Baker Brothers LPs were controlling stockholders. The court further reasoned that even if the Baker Brothers LPs were, together, controlling stockholders, the plaintiff would still have to show that the Baker Brothers LPs acted under a conflict of interest with respect to the merger. With respect to the

merger, the court noted that the plaintiff had to plead that the Baker Brothers LPs somehow extracted a unique benefit over the other stockholders. The *Flannery* court concluded that the plaintiff failed to do so. While the Baker Brothers LPs sought liquidity in the merger, their interests were not divergent with those of the other stockholders. The court reiterated that controlling stockholders “have the right to deal freely with their shares of stock and to dispose of them at the best price they are able to obtain, so long as they are acting in good faith” and that Delaware does not demand that a controlling stockholder must benefit minority stockholders by engaging in self-sacrifice.

The plaintiff alternatively sought to have the transaction reviewed under a *Revlon* enhanced scrutiny standard. The court explained that *Revlon* is the appropriate standard of review where, among other circumstances, the approval of a transaction results in a change of control of the company. The *Flannery* court emphasized that the merger was comprised of 58 percent stock and 42 percent cash. Under these circumstances, *Revlon* was not implicated because there was no change of control. The stock retained by Genomic’s stockholders stayed in a large, fluid, changeable, and changing public market, and the stockholders retained the possibility of gaining a future control premium. The merger did not change the control dynamic, as there was no controlling stockholder at Genomic, and there was no reason to infer that the stock component of the merger compromised Genomic’s stockholders’ ability to secure a control premium in the future. The court ultimately concluded that Genomic had not abandoned “its long-term strategy, triggering a duty to maximize short-term gain, where 100% of Genomic’s stockholders received Exact stock in exchange for 58% of their shares.”

The plaintiff also alleged that the merger was defective under Section 203 because Exact was an interested stockholder at the time of the merger. Section 203 provides that a company cannot engage in any business combination with a stockholder that owns 15 percent or more of the company’s outstanding stock for a period of three years after such stockholder becomes interested. But Section 203 also provides a safe harbor where a board of directors approves the transaction that results in the stockholder becoming interested. The plaintiff argued that Exact became an interested stockholder prior to the merger when the Baker Brothers LPs allegedly agreed to vote in favor of the merger. The court disagreed and found that Exact was not interested and that the Board had nevertheless implicitly approved of the voting arrangement prior to the merger.

In *Flannery*, the Delaware Court of Chancery reaffirmed that a board of directors will be afforded the presumption of business judgment where a plaintiff fails to adequately plead that a controlling stockholder facilitated an interested transaction. Likewise, *Revlon* enhanced scrutiny does not apply to “change of control” transactions where stock retained by the target company’s stockholders remains in a large, changing public market where the stockholders retain the possibility of obtaining a future control premium. Finally, the *Flannery* court confirmed that Section 203’s safe harbor provisions will protect a merger involving an interested stockholder where the board previously approved the transaction that resulted in the stockholder becoming an interested stockholder.