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Fried Frank M&A/PE QUARTERLY

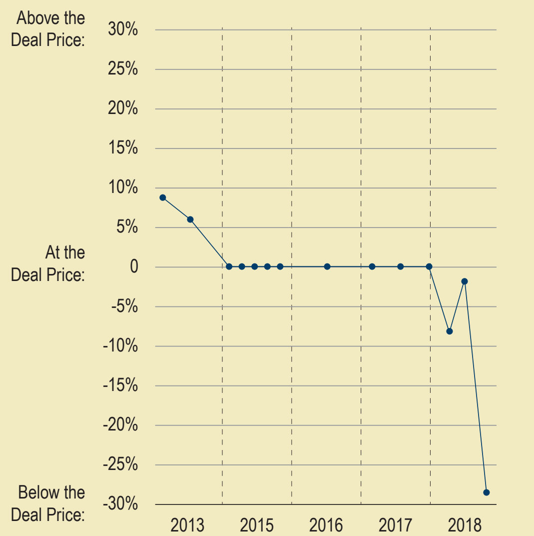
A quarterly roundup of key M&A/PE developments

April 2018

EQUITY OWNERSHIP NOT THE CRITICAL FACTOR IN DETERMINING CONTROLLER STATUS FOR MINORITY STOCKHOLDERS– KEY CASES 2014-1Q 2018

% Equity Ownership	Case	Deemed to be a Controller?
34%	Rouse (2018)	NO
34%	Crimson (2014)	NO
28%	Oracle (2018)	**YES**
26%	Liberty (2017)	NO
26%	Calesa (2016)	**YES**
23%	Larkin (2016)	NO
22%	Tesla (2012)	**YES**
22%	Sanchez (2014)	NO
17%	Zhongpin (2014)	**YES**
16%	Dell (2017)	NO
1%	KKR (2015)	NO

APPRAISAL RESULTS IN ARM'S-LENGTH MERGER CASES (2013-1Q 2018)



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Critical Decisions on Controllers and on Appraisal

CONTROLLERS: When Minority Stockholders May Be Deemed to be Controllers—Rouse, Tesla, Oracle *and* NEA

In March 2018, the Court of Chancery issued several decisions that highlighted that a minority stockholder that is viewed by the court as having a rare, "outsized" level of influence may be deemed to be a controller. These decisions reaffirmed, however, that a *minority* stockholder generally will *not* be deemed by the court to be a controller. In connection with a company transaction in which an influential minority stockholder is "self-interested," the risk of the stockholder being considered by the court to be a controller with respect to the transaction will be on a continuum based on (a) the extent of the stockholder's influence over the board (generally and with respect to the board's decision on the specific transaction) and (b) the extent of the process, if any, put into place to separate the stockholder from the board's discussions and vote, a special committee with independent advisors, and a fairness opinion). Even with a special committee process in place to separate the stockholder from the board's consideration of a transaction, a stockholder with "outsized influence" may be considered to be a controller with respect to the transaction. Thus, from the stockholder's point of view, whether it should be a proponent of the board's implementing a process (and what the appropriate process

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would be) will depend on a weighing of the likelihood that the process would materially reduce the litigation risk relating to the controller issue against the increased business risk associated with the process. Please see here the Briefing we issued entitled, *Minority Stockholders With "Outsized Influence" May Be Deemed to be Controllers Even When There Is a Special Committee Process—and Other Points from Controller Decisions Issued in 1Q 2018*—Rouse, Tesla, Oracle *and* NEA.

APPRAISAL: New, Meaningful Risk of <u>Below</u>-the-Deal-Price Results in Most Cases Involving Arm's-Length Mergers—Aruba, AOL *and* SWS

In February 2018, the Delaware courts issued the first post-Dell appraisal decisions—*Aruba* and *AOL* (issued by the Court of Chancery) and *SWS Group* (issued by the Delaware Supreme Court, affirming the Court of Chancery decision below). In *Dell*, the Supreme Court had held that, in the case of an arm's-length merger with a "robust" sale process, the deal price is generally the best "proxy" for appraised fair value and should be given "heavy, if not determinative weight" in determining fair value. The Supreme Court had also directed that, even if the deal price were not *fully* reliable for determining appraised fair value (for example, because the sale process was not fully robust), the Court of Chancery still should consider the deal price and accord it an appropriate weight. In *Aruba* and *AOL*, however, as well as previously in *SWS*, the Court of Chancery ascribed *no* weight to the deal price and determined that fair value was <u>*below*</u> the deal price.

These decisions indicate that there is now a meaningful risk of a below-the-deal-price appraisal result in most cases involving arm's-length mergers—whether the court deems the sale process to have been fully robust (as in *Aruba*) <u>or</u> <u>not</u> (as in *AOL* and *SWS*). At the same time, in our view, generally, the court is more likely to continue to reach *above*-the-deal-price results in <u>*non*</u>-arm's-length merger cases (such as controller transactions, squeeze-outs, and certain MBOs-unless the transaction complies with the *MFW* prerequisites), and may also do so in arm's-length merger cases involving a *seriously flawed* sale process. The new, meaningful risk of a potentially significant loss from seeking appraisal rather than accepting the merger consideration in an arm's-length merger will accelerate the trend already underway of appraisal claims becoming rarer in this type of transaction. Further development awaits the possible appeal of *Aruba* and *AOL* and decisions by the Court of Chancery in *Dell* and *DFC Global* on remand. Please see **here** the in-depth analysis in our previously issued Briefing, *When Appraisal is Likely to be Below the Deal Price in Arm's-Length Mergers—And When It Is Not—The Meaning of* Aruba, AOL *and* SWS.

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In the First Case Finding Corwin *Not Applicable Because the Stockholder Vote Was Not "Fully Informed," the Delaware Supreme Court Held that the Founder-Director's Reason for Abstaining Had to be Disclosed*—Appel v. Berkman

In *Appel v. Berkman* (Feb. 20, 2018), the Delaware Supreme Court, reversing the Court of Chancery, held that *Corwin* was not applicable because the stockholder vote that approved the challenged transaction had not been "fully informed." Under *Corwin*, if stockholders have approved a transaction in a fully informed and uncoerced vote, then business judgment review applies and "cleanses" any breaches of fiduciary duties by the company's directors in connection with the transaction. The Delaware courts have only three times found *Corwin* to be inapplicable due to the stockholder vote having been "coerced," and this is the first case in which *Corwin* was found to be inapplicable due to the vote not having been "fully informed."

Key Point

- **Under certain circumstances, the reason for a director's objection to a sale of the company approved by the board, and for his abstention from the board's vote, must be disclosed.** The Supreme Court was clear that the reason for a director's abstention need not *always* be disclosed. In this case, the information that the director thought it was not the right time to sell the company was material, the court held, due to the director's unique perspective on the company as he was also the founder, largest stockholder, longtime past CEO and still Chairman of the company.

Background. "CJ" founded Diamond Resorts International in 2007 and served as its CEO and Chairman from its inception through 2012. When the company went public in 2013, CJ remained as its Chairman. In 2016, the Diamond board formed a committee to review strategic alternatives for the company and the committee commenced a sale process. Two bids were received: one from private equity firm Apollo and one from another party that was at a lower price and subject to due diligence. After successfully negotiating with Apollo for a higher price, the board recommended that the stockholders sell their shares to Apollo. The proxy statement included expansive disclosure of reasons for and against the transaction and disclosed that all of the directors had unanimously approved it, other than CJ, who had abstained. Apollo acquired Diamond in a two-step cash tender offer followed by a merger under DGCL 251(h). Certain stockholders brought a post-closing action alleging breaches of fiduciary duties by the directors in connection with the transaction. The Court of Chancery had dismissed the case, at the pleading stage, under *Corwin*, as the court found that the facts pled in the complaint did not lead to a reasonable inference that the stockholders approving the transaction had not been fully informed or had been coerced. The Delaware Supreme Court, in an opinion written by Chief Justice Strine, reversed and remanded the case, holding that the alleged facts supported a reasonable inference that the vote had not been fully informed because the reasons for CJ's objection to the deal and abstention from the vote had not been disclosed.

Under certain circumstances, reasons for an abstention may be material information that must be disclosed. The Supreme Court rejected the argument that, based on a long line of cases on which the Court of Chancery had relied, the reasons for a directors' abstaining or dissenting vote on a sale of the company can never be material information that must be disclosed. CJ had abstained, he had told the board, because, in his view, mismanagement of the company (since its IPO and his steeping down as CEO) had "negatively affected the sale price and it was therefore not the right time to sell the company." The Supreme Court reasoned that stockholders would have wanted to know this information and that it would have changed the total mix of information available to the stockholders amidst the "acres and acres" of space in the company's Schedule 14D-9 devoted to disclosing the reasons for the sale.

When the reasons for an abstention may be material. The Supreme Court emphasized a "contextual approach" to determining whether the reasons for an abstention would be material. The court focused on CJ's role as the founder, longtime CEO, still Chairman, and largest stockholder of the company. "For a Chairman to abstain from voting on the sale of the business he founded and led is no common thing…." The court appeared to suggest that CJ's key roles provided him with a unique perspective on the company that made his reasons for objecting to the sale of particular interest to the stockholders. The court noted that the company had described CJ in its most recent proxy statement as having "a unique understanding of the opportunities and challenges that [the company] faces and in-depth knowledge of [the company's] business, including [its] customers, operations, key business drivers and long-term growth strategies, derived from his 30 years of experience in the… industry and his service as [the company's] founder and past Chief Executive Officer." It was material, the court concluded, that CJ—"the Chairman of the Board, the very person who founded [the company] and under whose leadership as CEO the company flourished and became a global operation"—thought it was the wrong time to sell the company. The court also noted the "high stakes context" of a sale of the company in further supporting the materiality of the information that CJ—"a key board member if ever there were one"—objected to the timing of the transaction.

Practice Points. The decision is a reminder of the need for even greater focus on disclosure than in the past given the downside risk of flawed disclosure precluding the application of *Corwin.* If a "key director" who may have a unique perspective on the company due to his special roles (for example, as a founder) abstains from a vote, the company should consider whether disclosure of the reasons for the abstention should be disclosed.

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Superior Court Rules that Delaware Law Does Not Preclude Insurance for Director Breaches of the Duty of Loyalty Based on Fraud—Arch v. Murdock

In *Arch v. Murdock* (Mar. 29, 2018), the Delaware Superior Court ruled that Delaware public policy does not preclude an insurer from indemnifying officers and directors for breaches of the duty of loyalty based on fraudulent conduct. The plaintiff insurance companies sought to apply California law, which expressly prohibits insuring directors against liability for willful misconduct. The Delaware court ruled that Delaware applied to Dole Food Company, Inc. (which is a Delaware corporation); and that "no Delaware case" has held, and no Delaware statute provides, that D&O liability insurance cannot cover fraudulent conduct.

Background. The plaintiff insurance companies provided Dole's overall D&O liability insurance package. Dole, its former CEO and its former COO sought indemnification under the policies for the $222 million that they had agreed to pay in settlement of two stockholder suits in connection with the 2013 Dole take-private transaction. In one of these suits, the defendants were found to have breached the duty of loyalty through fraudulent misconduct and were assessed liability of almost $150 million. In a settlement of the suit, they agreed to pay 100% of the assessed damages plus interest, in lieu of appealing. In the other suit, a settlement was reached through mediation. When Dole and the officers sought indemnification for the settlement amounts under its D&O insurance, the insurance companies sought a declaratory judgment that public policy precluded their being obligated to fund a settlement of claims for fiduciary breaches that are based on fraudulent conduct. The Delaware Superior Court ruled to the contrary and subsequently refused to certify the case for expedited appeal to the Delaware Supreme Court.

No Delaware precedent that insuring against fraud claims is against public policy. The insurance companies contended that (i) California law applied, which expressly prohibits insuring against fraud; and (ii) if Delaware law applied, public policy precludes insuring against fraud. The Superior Court ruled that Delaware law applied and that, "[a]lthough it may strain public policy to allow a director to collect insurance on a fraud," there is "no Delaware case" that has held that an insurance company providing indemnification for fraud would violate public policy and no explicit prohibition in Delaware statutory law. The Superior Court found that, in one of the underlying actions, the Court of Chancery's post-trial rulings relating to fraud were "sufficiently definite to be a final judgment on the merits"—and therefore the parties were collaterally estopped from re-litigating those findings. The Superior Court refused to dismiss the case on the motion for summary judgment, however, finding that material issues of fact remained with respect to the breach of contract claims relating to whether Dole sufficiently cooperated with the insurance company as required under the policy and whether the insurance companies unreasonably withheld consent of the settlements.

Practice Points. The decision raises the issue whether, in their D&O policies, insurance companies will seek to expressly exclude indemnification for fraud. The decision also serves as a reminder that choice of law provisions in merger agreements should take into account the differences in state law with respect to fraud claims. In addition, the decision serves as a reminder to companies to carefully comply with the terms of insurance policies with respect to notice, consent and cooperation requirements relating to the settlement of claims.

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Delaware Supreme Court's Comments on Bad Faith Appear to Lessen Plaintiffs' Pleading Burden in Post-Closing Actions—Kahn v. Stern

In *Kahn v. Stern*, the Delaware Supreme Court issued an order (Mar. 15, 2018), written by Chief Justice Strine, which affirmed the Court of Chancery's decision below (where claims of breaches of the duty of loyalty by directors in connection with a merger were dismissed). Much confusion has arisen as to the meaning of the following sentences in the order: "To the extent that the Court of Chancery's decision suggests that it is an invariable requirement that a plaintiff plead facts suggesting that a majority of the board committed a non-exculpated breach of its fiduciary duties in cases where *Revlon* duties are applicable, but the transaction has closed and the plaintiff seeks post-closing damages, we disagree with that statement. Likewise, to the extent that the Court of Chancery's decision might be read as suggesting that a plaintiff in this context must plead facts that rule out any possibility other than bad faith, rather than just pleading facts that support a rational inference of bad faith, we disagree with that statement as well."

Kahn v. Stern. Vice Chancellor Glasscock dismissed the post-closing challenge to the $34.2 million sale of Kreisler Manufacturing Corp. to Arlington Capital Partners. The merger was accomplished with written consents of the major stockholders; therefore, there was no stockholder vote. The plaintiff-stockholder claimed that the company's two co-Presidents (who were also directors) had extracted side benefits (including amendment of their employment agreements and the right to cash bonuses depending on the company's cash balance at closing) and that those benefits had resulted in about a 4% reduction in the merger consideration. The plaintiff contended that the side benefits represented a breach of the duty of loyalty for the two co-Presidents as well as three independent directors. The Court of Chancery rejected the contention that the independent directors may have breached the duty of loyalty; emphasized that there is a high bar to overcoming the presumption of loyalty; and stated that the alleged facts did not come close to meeting the required standard. The court observed that the company ran a robust sale process with independent advisors and that the merger price represented a 57% premium to the trading price on the day before the deal was announced.

The Supreme Court's sentences. The plaintiff claimed that the directors had breached their fiduciary duties as (i) a majority of the board approving the transaction was not independent and disinterested; (ii) the side benefits favored the two director-co-Presidents at the expense of the other stockholders; and (iii) the disclosure relating to the directors' conflicts was inadequate. The Court of Chancery wrote that, "[a]t [the] post-closing damages stage of proceedings, the plaintiff [has]…the burden… to plead facts from which the Court can reasonably infer that a majority of the Director Defendants were interested in the transaction, or dominated or controlled by an interested party, or that the majority of the Board failed to act in good faith." The Court of Chancery stated, with respect to the claim of inadequate disclosure that, in a post-closing action for damages, inadequate disclosure alone is not enough to avoid dismissal at the pleading stage—rather, it is only if the inadequate disclosure was knowing and intentional (*i.e.*, constituted bad faith) that there would be grounds for not dismissing the claims. The Supreme Court's first sentence appears to be directed at rejecting the concept that inadequate disclosure is sufficiently pled in a post-closing action only if it involves bad faith. The sentence seems to indicate that, in a post-closing action, inadequate disclosure claims will be sufficient to avoid dismissal under *Corwin* even without a bad faith component. Further, the Supreme Court's second sentence appears to suggest that, to validly plead bad faith, a plaintiff need not plead facts supporting a reasonable inference that an action taken appears to be so far outside the bounds of reasonableness that the *<u>only</u>* possible explanation is that the action was motivated by interests other than the corporate interest. Rather, the sentence suggests that facts must be pled that support a reasonable inference that bad faith may be *<u>one</u>* explanation for the act taken. Since one definition of bad faith has been that there could be *no other explanation* for the conduct reviewed but bad faith, it is unclear to what extent the distinction drawn by the Supreme Court's second sentence may be intended to affect the standard for pleading bad faith.

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Court of Chancery Emphasizes that Violations of Industry Best Practices Do Not Excuse Demand—Wilkin v. Orexigen

In *Wilkin v. Orexigen* (Feb. 28, 2018), the Court of Chancery dismissed claims against the directors of Orexigen Therapeutics Inc. for alleged breaches of fiduciary duties in connection with their having mishandled clinical drug trials the company was conducting.

Key Point

- **Violations of industry best practices do not excuse demand on directors to bring litigation.** The decision reaffirms that the likelihood of personal liability for a majority of directors for violations of "positive law" will support a claim of demand futility and highlighted that violations of industry best practices will *not* support a claim of demand futility.

Background. Orexigen was developing an obesity drug that, in early trials, indicated unexpectedly that it might have "revolutionary" positive effects on cardiovascular health. Due to flawed handling of the confidentiality of the processes for seeking regulatory approval and patent protection for the drug, more people than anticipated became aware of the preliminary data. This threatened the integrity of the trial and necessitated the substantial expense of commencing a new trial. In addition, through the patent process, the preliminary data became public and, although the market initially reacted positively, when later data revealed that the preliminary results relating to cardiovascular benefits were an aberration (although the drug was still viable as a treatment for obesity), the stock price declined on the news. Stockholder-plaintiffs brought an action, claiming breaches of fiduciary duties. The defendants moved to dismiss the action for failure to plead demand futility and to state a claim. Vice Chancellor Montgomery-Reeves dismissed the case for failure to plead demand futility.

Failure to plead demand futility cannot be based on violations of best practices. The plaintiff alleged that seven of the eight directors knowingly caused the company to violate regulations and breach its confidentiality obligations with respect to the test results. The court concluded, however, that the directors' actions, while they had violated industry best practices, did not violate any actual "legal obligations." The court wrote: "A failure to follow best practices does not create a substantial likelihood of liability" that results in demand futility.

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Proposed Amendment to Delaware Statute Would Limit Appraisal in Two-Step Stock-for-Stock Transactions

Section 251(h) of the Delaware General Corporation Law, which was adopted in 2013, permits a "short-form," two-step acquisition structure, without a stockholder vote being required in the second-step merger if, after the first-step, the acquiror holds the percentage of shares that would be required for approval of the merger if there were a vote. Under the Delaware appraisal statute as currently written (Sections 262(b)(1) and (2)), there is a "market-out exception" to appraisal rights in the case of long-form mergers (i.e., appraisal rights are not available if the merger consideration in a *long-form* merger consists solely of securities that are listed on a securities exchange or held by more than 2,000 holders). However, appraisal rights for *short-form* mergers are granted under Section 262(b)(3), which does not contain a market-out exception. Therefore, appraisal rights have applied in short-form mergers even when the merger consideration is comprised solely of marketable securities. An amendment to the appraisal statute, which was proposed on March 20, 2018, would extend the market-out exception to Section 251(h) mergers—which would then provide the advantage to companies of insulation from appraisal claims for these transactions. We note that, even though a Section 251(h) merger does not involve a stockholder vote, a *Corwin* defense is still available to directors in the case of a challenge to the merger (based on the Volcano decision, where the Court of Chancery, affirmed by the Delaware Supreme Court, held that the tender of shares by stockholders was the equivalent of a vote for *Corwin* purposes). Notably, however, other features of the 251(h) structure may continue to limit its attractiveness to companies—including that the timing advantage over a long-form merger may be obviated due to the requirement that the acquiror's shares be registered, as well as the fact that, where a regulatory review period is applicable (and stockholders have the right to withdraw their shares until expiration of the period), the acquiror will be exposed to the potential of a topping bid during the extended offering period.

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Fried Frank M&A/PE Briefings Issued This Quarter

(Click on the title below to read the Briefing)

- **Controllers:** *Minority Stockholders With "Outsized Influence" May Be Deemed Controllers Even When There Is a Special Committee Process—and Other Points from Controller Decisions Issued in 1Q 2018*—Rouse, Tesla, Oracle, NEA (Apr. 11, 2018)
- **Appraisal:** *When Appraisal is Likely to Be Below the Deal Price in Arm's-Length Mergers…and When It Is Not—The Meaning of* Aruba, AOL *and* SWS (Mar. 14, 2018)
- **LLC Board Duties:** *LLC Board Did Not Have Duty to Maximize Price on Sale of the Company that Favored the Controller*—Miller v. HCP (Feb. 13, 2018)
- **Earnouts:** *The Enduring Allure and Perennial Pitfalls of Earnouts*—Tutor Perini *and Practice Points* (Jan. 23, 2018)
- **Appraisal:** *The Appraisal Landscape After the Delaware Supreme Court's* Dell *and* DFC Global *Decisions—Key Points, Open Issues and Practice Points* (Jan. 8, 2018)

Fried Frank M&A/PE Round-Up

Fried Frank's M&A practice advises clients on some of the largest and most complex US and global deals, providing counsel to a full spectrum of companies on sophisticated transactions that are often multi-jurisdictional and, in some cases, transformational. With over eighty attorneys in four offices, our team has deep experience advising public and private companies, special committees, audit committees, and boards of directors in complex negotiated and contested situations, including negotiated mergers, hostile takeovers and takeover defense, proxy contests, financial adviser representations, and restructuring transactions.

Members of our M&A team were recent recipients of the Burton Awards' Law360 Distinguished Legal Writing Award (for their article published in the *New York Law Journal* titled, "The Dramatic Transformation of M&A Law Since 2014.")

Highlights of our 2018 first quarter work include representations of:

Goldman Sachs' Merchant Banking Division

Counsel to **Goldman Sachs' Merchant Banking Division** in its agreement to invest across West Street Energy Partners, West Street Infrastructure Partners III, and West Street Capital Partners VII, together with Riverstone Holdings, to acquire Lucid Energy Group II in a 50:50 joint venture arrangement for US$1.6b.

Higman Marine, Inc.

Counsel to **Higman Marine, Inc.** and its affiliated companies in its US$419m sale to Kirby Corporation.

VIAVI Solutions Inc.

Counsel to **VIAVI Solutions Inc.** in its US$455m acquisition of the Test and Measurement business of Cobham plc.

Nant Capital, LLC

Counsel to **Nant Capital, LLC** in its US$500m acquisition of the Los Angeles Times, The San Diego Union-Tribune and various titles in the California News Group from tronc, Inc., plus the assumption of US$90m in pension liabilities.

Intermex Wire Transfer Inc.

Counsel to **Intermex Wire Transfer Inc.**, a portfolio company of Stella Point Capital, LP, in its US$350m merger with FinTech Acquisition Corp. II whereby FinTech will acquire Intermex and the combined company will be renamed Intermex Wire Transfer, Inc.

Ascential plc

Counsel to **Ascential plc** in its acquisition of Clavis Insight for an initial cash consideration of US$119m paid in December 2017 plus future earnout payments payable over three years.

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Fried Frank M&A/PE Quarterlies for 2017- 2018

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