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2017 Del. Cases That Reflected Transformation In M&A Law

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After three decades of evolution in the Delaware courts of an analytical framework for judicial review of board decisions relating to mergers and acquisitions, M&A law has been transformed in the past two to three years. As characterized by Vice Chancellor Joseph Slights (as reported in The M&A Lawyer), this transformation has involved "a narrowing of the more exacting standards of review toward business judgment deference" in M&A matters.

The new framework is reflected in the following Delaware Supreme Court decisions:

1. Corwin (2015), which provides for review under the deferential business judgment rule of post-closing actions for damages challenging noncontroller transactions (even if a higher standard, such as Revlon, applied preclosing), so long as the transaction was approved by the stockholders in a "fully informed" and "uncoerced" vote;

2. MFW (2014), which provides for review under the business judgment rule (rather than the traditionally applicable and more stringent "entire fairness" test) of post-closing actions for damages that challenge controller transactions, so long as certain procedural protections are provided to the minority stockholders;

3. C&J Energy (2014), which reflects greater flexibility in the standards for the process required under Revlon for a board to fulfill the duty to seek to obtain the best price reasonably available in a sale-of-the-company transaction; and

4. Cornerstone (2015), which provides that, even when the transaction at issue is subject to an entire fairness standard of review, claims against disinterested directors are dismissible at the early pleading stage of litigation, unless the heightened standard for pleading a violation of the duty of loyalty or good faith (i.e., a breach of nonexculpated duties) is met.

In addition, the Delaware Court of Chancery's 2016 Trulia decision requires greater

judicial scrutiny of traditional disclosure-only settlements of preclosing M&A litigation. Indeed, post-Trulia, these types of settlements have virtually disappeared in the Court of Chancery. Also of note, more restrictive judicial standards are being applied for the award of legal fees in connection with bringing putative M&A class actions; the courts are reluctant to issue "targeted" preliminary injunctions that enjoin the specific features of transaction agreements that are viewed as problematic — with a perspective, instead, that a preliminary injunction should address the transaction as a whole and either the entire transaction should be enjoined or no injunction should issue. Moreover, the courts are reluctant to enjoin transactions based on preclosing actions brought by stockholders in a context in which the possibility of an alternative transaction was theoretical only (i.e., when there was no actual alternative bid available to the stockholders). Finally, statutory changes now permit, and many Delaware corporations have adopted, forum selection bylaws requiring that M&A litigation be brought only in Delaware.

The procedural consequences that have accompanied the changes in the substantive law have resulted in a much greater likelihood of success with motions to dismiss and limitations on or the elimination of discovery; and, although this is not a change, there has been consistent affirmation of the remote nature of any possibility of personal liability for independent, disinterested directors — due to (1) the almost universal inclusion of exculpation provisions in company charters, which, as permitted by the Delaware statute, preclude liability for duty of care violations, and (2) the courts' ongoing strict interpretation of the duty of loyalty in the context of M&A transactions.

The predominant influences precipitating this transformation in the law appear to have been (1) the Delaware judiciary's view that the rise of sophisticated institutional investors (with the ability to influence the direction of the corporations in which they invest and to determine the outcome of M&A events), combined with increased sophistication of directors, results in less need for judicial protection than was required in the past (as Vice Chancellor J. Travis Laster has commented), as well as (2) a reaction against the fact that litigation challenged virtually every M&A deal that was announced, which many viewed as reflecting an essential failure in the system.

To be sure, notwithstanding the new paradigm, there remain compelling reasons for faithful adherence by directors to a proper standard of conduct.

First, liability issues aside, directors generally want to fulfill their duties to stockholders and to maintain their personal reputations for professionalism and integrity. Second, in a preclosing action in which stockholders seek to enjoin a proposed transaction, claims of breach of fiduciary duties continue to provide a foundation for judicial injunction of a transaction. Finally, Delaware law has been context-driven and the facts have been critical. Some of the emphasis on facts and circumstances no doubt has diminished as the court has moved conceptually to more black-line approaches (as evident in the MFW and Corwin decisions). But even in these cases it appeared that the factual context was critical: Did the board and special committee operate effectively? Was the proxy statement an accurate and fair description of the events and developments described? Whatever the issue that may arise in litigation, as a practical matter, albeit within a broad range, the judicial result is likely to be strongly influenced by the "atmospherics" resulting from the general approach and overall course of conduct in which the directors have engaged.

The transformation in M&A law has had dramatic effects, as reflected in and amplified by the Delaware decisions issued in 2017.

Litigation

There has been a significant shift by plaintiffs away from bringing fiduciary duty actions in the Court of Chancery. Instead, M&A transactions are more often being challenged (a) with books-and-records actions (under Delaware General Corporation Law § 220) and appraisal petitions in the Court of the Chancery, and (b) with claims under the federal securities laws in the federal courts.

Appraisal

2017 developments in appraisal suggest that fewer appraisal cases are likely to be litigated through trial and that appraisal claims generally will be driven by controller transactions, management buyouts, and transactions involving a flawed sale process. The Court of Chancery increasingly relied on the merger price to determine appraised "fair value" in cases involving third-party arm's-length mergers and a "robust" sale process that provided for "meaningful competition" (Merge Healthcare, Jan. 30, 2017, and PetSmart, May 26, 2017, which reinforce Merion v. Lender Processing, December 2016). The Delaware Supreme Court strongly endorsed this approach (DFC Global, Aug. 1, and Dell, Dec. 15). Although the Supreme Court declined to adopt an express judicial presumption in favor of reliance on the merger price under specified circumstances, the strong language and tone in these opinions suggest that a presumption of sole or primary reliance on the merger price when the merger price was robust is now effectively operative. (We note that, among the remaining open issues are what will constitute a "robust" sale process for these purposes, whether a controller transaction could ever be viewed as having involved a robust sale process, and when an MBO will be viewed as more like a controller transaction or more like an arm's-length transaction with a robust sale process.)

Also of note, the Court of Chancery determined fair value to be below the merger price in two cases in which it relied on a discounted cash flow analysis (SWS Group, May 30 — about 8 percent below; and Sprint v. Clearwire, July — about 56 percent below). In both cases, the court attributed the result to the fact that the deals were highly synergistic (as the DCF methodology does not take into account the value of expected synergies while such value was part of the merger price).

Corwin

In almost all cases involving stockholder-approved third-party arm's-length mergers, the Court of Chancery has found that the stockholder vote was "fully informed" and "uncoerced" and, thus, under Corwin, has applied the business judgment rule and dismissed fiduciary claims at the pleading stage (Solera, Jan. 5; Merge Healthcare, Jan. 30; Columbia Pipeline, March 7; Paramount Gold and Silver, April 13; and Cyan, May 11). Notably, in Columbia Pipeline, the Court of Chancery dismissed the claims notwithstanding that they involved a more "vivid" duty of loyalty claim (with the court finding a valid pleadings-stage claim that the directors actually acted primarily in their own self-interest, rather than, as in past cases, the allegations being that the directors were not independent and disinterested).

Corwin was found inapplicable (for the first time) in three cases due to the stockholder vote not having been "fully informed" and "uncoerced." In its April 11 decision in Saba Software, the court found "situational coercion" — as, due to action by the board, the stockholders had no practical alternative but to vote for the transaction. In a May 31 decision in Sciabacucchi v. Liberty Broadband, the court found "structural coercion" — as the vote on the merger had been tied to an unrelated equity arrangement with a corporate insider. However, in our view, these decisions underscore that it is only in egregious circumstances that the court will find Corwin to be inapplicable due to coercion.

On Nov. 30, in van der Fluit v. Yates, the court found that the failure to identify the individuals who led

the sales outreach process and negotiation of the merger was a material disclosure violation — in a context where the company co-founders (one of whom was also the CEO and chair), who owned 30 percent of the outstanding stock, had arranged for post-merger employment for themselves and conversion of their unvested stock options. The court nonetheless dismissed the case based on a finding that none of the sale process claims involved bad faith and therefore they were exculpable — which reflects the narrowness of the path to success for post-closing fiduciary claims given that, even if Corwin is inapplicable, claims will be dismissed under Cornerstone unless they meet the high bar for supporting an inference of disloyalty or bad faith.

In Salberg v. Genworth, the Court of Chancery confirmed on Aug. 23 that, post-Corwin, the plaintiff in a § 220 action (seeking to investigate whether a merger properly valued the plaintiff-stockholders' pre-existing derivative claims for purposes of maintaining derivative standing) still had to have a "credible basis" for the demand (i.e., the court would not read in a Corwin business presumption). On Dec. 29 in Lavin v. West, the court held that Corwin would not block the § 220 demand made to investigate a possible breach of fiduciary duties by directors relating to a stockholder-approved merger.

In Paramount Gold and Silver (April 13), the Court of Chancery left open the issue whether, in a post-closing damages action, a defensive action taken by a board in response to a corporate threat (such as adoption of a termination fee in the merger agreement), which was approved by stockholders in a fully informed and uncoerced vote, would be subject to business judgment review under Corwin or the heightened scrutiny of Unocal.

Controllers

MFW has provided a path to review of conflicted controller transactions under the business judgment rule rather than the more stringent "entire fairness" test when certain minority stockholder protections are in place. MFW involved a "two-sided" controller transactions (i.e., a target being acquired by its controller). The Court of Chancery has now expanded application of the MFW framework beyond two-sided mergers. In Martha Stewart Omnimedia (Aug. 18), the court indicated in dicta that it would apply MFW to "one-sided" conflicted controller transactions (i.e., transactions where the controller is selling its shares in a third-party acquisition of the company it controls and the controller is conflicted not because it stands on both sides of the transaction but because it is obtaining a "side benefit" in the merger that is not shared pro rata by the other shareholders). The court also indicated that a "side benefit" would not create a conflict if it only replicated the premerger arrangements the controller had and/or fulfilled an appropriate corporate purpose.

In NRG Yield v. Crane (Dec. 11), the court applied MFW to a recapitalization, proposed by a controller, involving a pro rata distribution of nonvoting equity to all of the stockholders to provide the company with currency with which to effect acquisitions without diluting the controlling stockholder's control position. The court ruled that the recapitalization was a "conflicted" controller transaction invoking entire fairness because the controller obtained the "unique benefit" (not shared with the other stockholders) of perpetuation of its control. We note that the decision may suggest that a recapitalization involving a pro rata distribution that perpetuates a control structure, at least under certain circumstances, may be subject to the entire fairness standard unless independent director and minority stockholder approval was obtained — and that, in that connection, were entire fairness to apply, there would be substantial uncertainties as to how to determine fairness in the context of a pro rata distribution that perpetuates control.

The Court of Chancery reaffirmed the high bar to the finding of "control" by a less-than-majority

stockholder. In van der Fluit v. Yates, the court found that the two co-founders of the target who owned 30 percent of the outstanding stock (one of whom was the CEO-chair) were acting with "a concurrence of self-interest" in supporting a tender offer made by an acquirer who agreed to provide them with post-merger employment and a conversion of their unvested stock options — but did not actually have control. In Sciabacucchi v. Liberty Broadband, the court deemed a 35 percent stockholder not to be a controller even though, in letters to the SEC, it had argued that it was not required to register as an investment adviser under the Investment Company Act of 1940 because it was a controller. The court found that the stockholder was not a controller because it did not exercise actual control over the company — given its 35 percent ownership and the "contractual handcuffs" that existed (including stockholder agreement provisions that permitted it to appoint only four of 10 directors and imposed standstill restrictions on it, and a charter provision that required approval of certain transactions by the stockholders not affiliated with it).

Two Court of Chancery cases underscored the potential liability for private equity sponsors and controllers. In Hsu v. ODN (April 25), at the pleading stage, the court declined to dismiss the plaintiff's claims of breach of fiduciary duty by the directors, and aiding and abetting by the PE sponsor, in connection with the company's redemptions of preferred stock held by the PE sponsor). Rather than effecting a "de facto liquidation" of the company at "seemingly fire-sale prices" and "stockpiling cash," the court wrote, the board "could have grown [the company's] business, gradually redeemed all of the preferred stock, and then generated returns for its common stockholders." The court also held that the directors' abstaining from the formal vote on the two redemptions did not necessarily shield them from liability because they had been involved in the various steps underlying the redemptions. The key distinguishing features in Hsu accounting for the court's decision appear to be that the court deemed the preferred stockholder to be a controller, the court viewed the board as meaningfully influenced by the controller and not independent and disinterested, and, critically, the board apparently neither engaged in an adequate process to consider the interests of the common stockholders nor established a contemporaneous record indicating the bases for its decision to redeem the preferred stock. In Buttonwood Tree v. R.L. Polk (July 24) the court, at the motion-to-dismiss stage, found it reasonably conceivable that a company self-tender had not been "entirely fair" given that the consideration per share paid in a third-party merger two years later was three times the self-tender valuation. The court declined to dismiss fiduciary claims against the 90-percent-shareholder family and the directors affiliated with it, noting that, while the exculpation provision in the company's charter protected directors against liability for duty-of-care violations, it did not apply to a defendant in his capacity as a controlling stockholder.

M&A Agreements

The Delaware Supreme Court held that a reasonable best efforts clause in a merger agreement requires not only that the parties not take action to prevent the merger but also that they affirmatively "take all reasonable actions to complete the merger" (Williams v. ETE, Jan. 11). The Supreme Court also held that the burden was on the alleged breaching party (in this case, the acquirer, ETE) to prove that any alleged breach had not materially contributed to the failure of a condition to the merger. The Supreme Court found that ETE had not breached the agreement when its tax counsel failed to deliver a tax opinion that was a condition of closing, as the counsel had "independently" made the determination that it could not deliver the opinion (and ETE's desire to terminate the deal had not "contributed materially" to the failure of the condition to be satisfied). Notably, Chief Justice Leo Strine wrote a lengthy dissent — agreeing with the interpretation of the efforts covenants and burden of proof, but disagreeing with the "terse conclusion" that ETE had not influenced its tax counsel. The decision highlights (1) the risks for a party to a merger agreement associated with a closing condition for the counterparty the satisfaction of

which involves action by the counterparty itself or by the counterparty's own adviser and (2) the advisability of considering whether language should be included in a merger agreement to expressly impose an obligation on the parties to restructure a transaction to permit satisfaction of the conditions.

The Court of Chancery reaffirmed that (1) the precise language of merger agreements will be critical to the judicial result in contract disputes and that post-closing purchase price adjustment and earnout provisions will generally be interpreted narrowly (Chicago Bridge, June 28, and GreenStar v. Tutor Perini, Oct. 31); (3) there is a very high standard for pleading fraud (leading to buyer risk when relying on an anti-fraud carveout to an anti-reliance provision) Sparton v. O'Neil, Aug. 9); (4) the history of the parties' drafting and negotiations can be evidence of their intent at the time of contracting (when extrinsic evidence is considered by the court) (SRS v. Gilead Sciences, March 15) (and this was affirmed by the Supreme Court, Dec. 12); and (5) the implied covenant of good faith and fair dealing is not applicable when both parties anticipated a development that created an issue under the contract but chose to remain silent about it (Simon-Mills v. KanAm, March 30).

Financial Advisers

The high bar for aiding-and-abetting claims was affirmed — with the Supreme Court affirming that there cannot be aiding and abetting without an underlying director fiduciary breach (Volcano, Feb. 9); and the Court of Chancery holding that the passive failure of a banker to ensure adequate disclosure did not support an aiding-and-abetting claim (Buttonwood Tree, July 24). The trend of requiring expanded disclosure of financial adviser fees was reinforced (Vento v. Curry, March 22, and SEC cease-and-desist order with CVR Energy, Feb. 14) — but the Court of Chancery held that, if a banker's equity stake in its client's counterparty is disclosed in prior 13F filings, it need not also be disclosed in the proxy statement (at least when there was not an actual conflict of interest) (Columbia Pipeline, March 7). Finally, the Court of Chancery, in a bench decision following oral argument, cast doubt on the efficacy of the standard provisions that have been utilized to avoid Rural Metro-like outcomes when fiduciary duty claims are settled with defendant directors, leaving a financial adviser against whom aiding-and-abetting claims were made as the "last defendant standing" (Good Technology, May 26, Transcript).

Shareholder Activism

Notwithstanding some decline (starting in late 2016) in the assets under management and the number of campaigns conducted by activists, activism remained a persistent and prominent feature of the M&A landscape, with significantly more capital deployed in 2017 than in 2016. Some notable trends included (1) a blurring of the lines between (a) pure activism and (b) hostile bids or private equity deals (i.e., more transactions had elements of both); (2) more and quicker settlements with activists (but then there was institutional shareholder reaction against these settlements, citing board support of "short-termism"); (3) increased attention by activists to a broader range of companies (especially very large companies); (4) more pressure relating to board composition and removal of CEOs; (5) the emergence of more first-time activists; and (6) more proactive preparedness by companies.

Antitrust and Tax

The Federal Trade Commission and the U.S. Department of Justice have been more aggressive in challenging M&A transactions on antitrust grounds (including, in three cases, after the transaction had closed); the new head of the DOJ's antitrust division has stated that the division will cut back on "behavioral" commitments, such as consent orders regulating conduct, and will instead rely more on structural changes, such as divestitures, to remedy merger concerns; and approval of transactions by

the Committee on Foreign Investment in the United States has become more difficult, with the committee more reluctant than in the past to resolve national security concerns through negotiated mitigation (particularly for transactions involving China). The tax reform legislation enacted in December is also expected to have a significant impact on the structuring and terms of M&A transactions going forward.

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