Delaware Law Developments/ Recent Judicial Decisions Affecting M&A Transactions and Corporate Governance Part 1

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The Real Deal

A Webinar Series for M&A and Securities Professionals

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Speaker

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James Smith is ranked in the area of “New York Litigation: Securities” by *Chambers USA 2017*, which notes that he is “increasingly recognized for his securities litigation practice, which includes a strong focus on M&A cases” and that “[c]lients praise his ‘*extraordinary knowledge*’ of Delaware law, as well as highlighting his ability to ‘*provide practical and nuanced advice while being sensitive to the specifics of our situation*.’” He is also recommended by The Legal 500 in “Securities Litigation – Defense” as a “’great lawyer with excellent judgment.’”

His practice areas comprise a broad range of complex commercial litigation, with a focus on M&A-related litigation and contests for corporate control, federal securities fraud class action defense, corporate governance litigation and advice, the defense of shareholder derivative suits and shareholder derivative demand response, and state deceptive sales practices/consumer fraud class action defense.

James is a first-chair trial lawyer and has tried numerous cases (including in the Delaware Court of Chancery) and argued notable appeals before various state and federal appellate courts. He has represented clients in a variety of industries, including: technology/e-commerce; commercial and investment banking; private equity; hedge funds; derivatives and securitization; insurance; energy; oil and gas; health care; biotech; semiconductors; and telecommunications.

Agenda

- **Delaware: A Transfigured Topography**
- The New Litigation Landscape
- Evolution of Take-Private Transactions Involving Controlling Stockholders
- The “Sea Change”: The MFW Structure
- 2017 Controlling Stockholder Take-Private Decisions
- Other Key 2017 Decisions Relevant To Take-Privates: The Future of Appraisal

The “First State” Circa 2017: A Transfigured Topography

- For decades, Delaware has been the preeminent “jurisdiction of choice” for incorporation based on, among other things, the carefully curated predictability of its corporate jurisprudence.

- This month, for the first time ever, the U.S. Chamber of Commerce downgraded Delaware from its perch as the No. 1 business-friendly jurisdiction in the country, dropping it ***10 spots***.
  - Poll of litigators, GCs and other corporate executives

- ***What’s going on here?***
  - To be sure, judicial decisions in Delaware over the past 2-3 years have radically altered the litigation landscape.
  - But have they really transformed the State into an unpredictable, or even hostile, forum for business?
  - To the contrary.

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Setting the Stage: The New Litigation Landscape

2014-2016: Some Seemingly Ominous Developments

- The Demise of Disclosure-Only Settlements
  - ***In re Trulia, Inc. S'holder Litig.*, 129 A.3d 884 (Del. Ch. 2016)**, and its progeny
  - Migration to federal court
- Massive Post-Closing Damages Awards
  - ***In re Dole Food Co., Inc., Stockholder Litig.*, C.A. No. 8703-VCL (Del. Ch. Aug. 27, 2015)**
- Amped-up Appraisal Arbitrage
  - Despite some legislative reining in, multiple decisions awarded appraised "fair value" above the deal price

Setting the Stage: The New Litigation Landscape (cont'd)

On the Other Hand …

- The Demise of Disclosure-Only Settlements: The Flip-Side
  - Dramatic decrease in merger objection class actions in Delaware
  - The Mootness Approach
- *Corwin* "Cleansing"
  - ***Corwin v. KKR Financial Holdings*, 125 A.3d 304 (Del. 2015)**
    - Shareholder ratification of a deal via a fully informed, uncoerced vote of unaffiliated stockholders results in irrebuttable business judgment rule presumption
- Appraisal Arbitrage Redux
  - Numerous decisions focus on the deal price as best indicator of "fair value" in arm's-length transactions
  - The "synergy deduct" – "fair value" less than the deal price

Setting the Stage: The New Litigation Landscape (cont'd)

On the Other Hand … (cont'd)

- Controlling Stockholder Transactions
  - Definition of "Control"
    - Under *Corwin*, key inquiry with respect to less-than-50% holder is actual ability to determine the board decision on *this* transaction (*e.g.*, through threat of director removal), as opposed to day-to-day operational control
      - ***Financial Holdings LLC Stockholder Litig.*** (Del. Ch. Oct. 14, 2014); ***In re Crimson Exploration Stockholder Litig.*** (Del. Ch. Oct. 24, 2014)
  - Dismissal of exculpated claims against independent directors (DGCL 102(b)(7)) available even where controlling stockholder transaction is otherwise subject to entire fairness
    - ***In re Cornerstone Therapeutics, Inc. S'holder Litig.*****, 115 A.3d 1173 (Del. 2015)**
  - Last but not least, ***Kahn v. M&F Worldwide Corp.*****, 88 A.3d 635 (Del. 2014)**

Setting the Stage: The New Litigation Landscape (cont'd)

"Alexander … wept for there were no more worlds to conquer."

- So, should ***plaintiff's counsel*** be breaking out their handkerchiefs?

- Not so fast …

  - What's left?
    - Controlling stockholder take-privates (and other interested transactions)
    - Appraisal actions in MBOs and controlling stockholder take-privates may be the last frontier
      - Risk of judicial "fair value" award above the deal price

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The Evolution of Legal Challenges to Take-Private Transactions Involving Controlling Stockholders

Fiduciary Duty Recap:

- Duty of care requires fiduciary to exercise the "care which ordinarily careful and prudent [people] would use in similar circumstances."
  - Fiduciaries must act on an informed basis after considering relevant information, including the input of financial and legal experts
  - Duty of loyalty obligates fiduciary to act in "good faith" and refrain from putting his or her interests ahead of the corporation
    - A plaintiff can challenge a fiduciary's loyalty by demonstrating that he or she (i) was interested in the transaction under consideration or not independent of someone who was, or (ii) failed to pursue the best interests of the corporation and its stockholders and therefore failed to act in good faith

The Evolution of Legal Challenges to Take-Private Transactions Involving Controlling Stockholders (cont'd)

Standard of Review Recap:

- Business Judgment Rule ("BJR")
  - Has been characterized as a "principle of ***non-review*** that reflects and promotes the role of the board of directors as the proper body to manage the business and affairs of the corporation" – not the stockholders or the courts
  - Presumes that, in reaching a business decision, directors are informed, operating in good faith, and believe that the "action taken was in the best interests of the company."
  - Under this forgiving standard, a business decision must "lack[] any rationally conceivable basis" for a court to "infer bad faith and a breach of duty."
- "Entire Fairness" – Until recently, applied in all controlling stockholder or other "interested" transactions
  - Burden of proof with defendants to demonstrate that transaction was "entirely fair" – *i.e.*, that it mirrored an arm's-length negotiated transaction
  - Standard has two components: fair dealing and fair price

The Evolution of Legal Challenges to Take-Private Transactions Involving Controlling Stockholders (cont'd)

- Historically, defendants could ***shift*** burden of proof to plaintiff by showing that the transaction was approved by ***either***:

  (1) a well-functioning committee of independent directors; ***or***

  (2) an informed vote of a majority of the minority (unaffiliated) stockholders ("majority of the minority" provision)

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The “Sea Change”: The MFW Structure

The Return of the BJR

- ***Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014)**
  - MacAndrews and Forbes (“M&F”) was the controlling stockholder (43%) of M&F Worldwide (“MFW”) and offered to purchase MFW’s outstanding equity for $24 per share
  - The stock was trading at $16.96 at the close of the last business day prior to M&F’s offer
  - Shareholders brought suit alleging that the merger was unfair and seeking a post-closing damages remedy
  - **At the outset**, M&F conditioned consummation of any going-private transaction on the transaction being approved by **both** (i) an independent special committee **and** (ii) a vote of a majority of the disinterested stockholders
  - The Court of Chancery held that the appropriate standard of review, given those two procedural protections, was the BJR and granted judgment in favor of defendants

The “Sea Change”: The MFW Structure (cont’d)

- The Delaware Supreme Court affirmed
  - Controller-led take-private transactions will be subject to BJR review when conditioned – *from the outset* – on the approval of both:

    (i) a fully empowered, disinterested and independent special committee, and

    (ii) a fully informed and uncoerced “majority-of-the-minority” vote

The “Sea Change”: The MFW Structure (cont’d)

To Summarize, BJR Protection Can Be Achieved If:

1. The controlling stockholder conditions the transaction on both a special committee approval and a majority-of-the-minority vote of stockholders;
2. The special committee is independent;
3. The special committee is empowered to freely select its own advisors and definitively say “no” to the transaction;
4. The special committee fulfills its duty of care in negotiating a fair price;
5. The vote of the minority stockholders is informed; ***and***
6. There is no coercion of the minority stockholders.

The “Sea Change”: The MFW Structure (cont’d)

<u>BUT</u> the structure, once in place, *can be subverted* – to disastrous effect

- ***In re Dole Food Co., Inc., Stockholder Litig.*, C.A. No. 8703-VCL (Del. Ch. Aug. 27, 2015)**
  - Controller and management strayed from the straight and narrow
    - Two sets of projections, unauthorized meetings, etc.
  - Committee and advisors did the best they could, but could not cure controller’s conduct
  - Court found that Company’s 40% stockholder and de facto controller, together with its president, COO and GC, were jointly and severally liable for more than **$148 million in damages** on a $1.2 billion deal
  - Cautionary tale
    - **<u>MOREOVER</u>, a question remained in the minds of practitioners whether this new framework would permit pleading-stage (i.e., pre-discovery) dismissals**

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2017 Controlling Stockholder Take-Private Decisions

Challenge to *MFW*-Compliant Controlling Stockholder Take-Private Dismissed Notwithstanding Special Committee's Rejection of Materially Higher Third-Party Bid

- ***Books-A-Million, Inc. S'holders Litig*., C.A. No. 11343-VCL, 2016 WL 5874974 (Del. Ch. Oct. 10, 2016), *aff'd*, No. 515, 2016, 2017 WL 2290066 (Del. May 22, 2017)**
  - Relied on *MFW* to dismiss a complaint alleging a controlling stockholder breach of fiduciary duty in a going-private transaction
  - Court focused on plaintiffs' argument that special committee members were not independent – *i.e*., the transaction did not satisfy the second *MFW* prerequisite – because they had acted in bad faith by agreeing to a deal at $3.25 – a 95% premium over the average closing price for the prior 90 trading days) – when another bidder had offered $4.21
  - Controlling stockholder was a buyer, not a seller

2017 Controlling Stockholder Take-Private Decisions (cont'd)

- ***Books-A-Million, Inc. S'holders Litig.*** (cont'd)
  - "[T]he difficult route of pleading subjective bad faith is [a] theoretically viable means of attacking the [*MFW*] framework," but plaintiffs failed to meet their burden because the Special Committee had:
    - (i) Explored third-party offers to test whether the controller would stick to its "I'm not a seller" position given the opportunity to sell (it did); and
    - (ii) Looked to third-party offers to determine whether the controller's was so low as to warrant rejecting it outright (they determined it was not).
  - Court concluded that "[r]ather than supporting an inference of bad faith, the Committee's actions support an inference of good faith."
  - The Delaware Supreme Court affirmed without comment.
    - ***Books-A-Million, Inc. S'holders Litig.*****, No. 515, 2016, 2017 WL 2290066 (Del. May 22, 2017)**

2017 Controlling Stockholder Take-Private Decisions (cont'd)

Claim Based on Allegations of Unfair "Side Deal" with Controller Dismissed Where Third-Party Buyout Complied with *MFW*

- ***Larkin v. Shah***, **et al., C.A. No. 10918-VCS, memo. op. (Del. Ch. Aug. 25, 2016)**
  - Even where controller is on only one side of the transaction, "entire fairness" applies where a controller who stands to earn "different consideration or some unique benefit" might "flex his control to secure that self-interested deal to the detriment of minority stockholders."
  - Noted that dual procedural protections in *MFW* operate similarly in the one-sided controller context.
- ***In Re Martha Stewart Living Omnimedia, Inc. S'holder Litig.*, C.A. No. 11202-VCS, 2017 WL 3568089 (Del. Ch. Aug. 18, 2017)**
  - Alleged that controlling shareholder received unfair employment and trademark side deals in a third-party buyout
  - Buyer, target and controller complied with the *MFW* roadmap

2017 Controlling Stockholder Take-Private Decisions (cont'd)

- ***In Re Martha Stewart*** (cont'd)
  - Court noted two typical conflict scenarios in controlling stockholder context, triggering entire fairness:

    (i) controller stands on both sides of transaction; and

    (ii) controller does not stand on both sides of transaction but exploits its position on sell-side to extract different consideration or derive some unique benefit not shared with the common stockholders.
  - Court first held that plaintiffs failed to adequately allege a basis to infer that the controller's "side deals" with the buyer diverted consideration that otherwise would have been available to the minority stockholders.
  - Then went on to note that, even if plaintiffs ***had*** adequately alleged a controller conflict, BJR would apply at the pleadings stage due to the presence *ab initio* of the dual procedural protections prescribed in *MFW*, which can apply to trigger BJR review at the pleadings stage of cases challenging third-party buyouts of controlled companies in which the controller received disparate consideration or a unique benefit.

2017 Controlling Stockholder Take-Private Decisions (cont'd)

Corwin "Cleansing" Applied to Dismiss Claims Arising Out of Sale "Involving" a Controller

- ***In re Merge Healthcare Inc. S'holders Litig*., C.A. No. 11388-VCG, 2017 WL 395981 (Del. Ch. Jan. 30, 2017)**
  - In its 2015 decision in *Corwin v. KKR Financial Holdings LLC,* the Delaware Supreme Court determined that the BJR irrebuttably protected directors in a change of control transaction approved by a majority of fully informed, uncoerced disinterested stockholders
  - A series of recent decisions by the Court of Chancery have dismissed post-closing claims under *Corwin*
  - In *In re Merge Healthcare*, the Court of Chancery (Vice Chancellor Glasscock) held that so-called "*Corwin* cleansing" applied to a merger notwithstanding the presence of a controlling stockholder that was unaffiliated with the buyer
    - Court assumed without deciding that Chairman of the Board (26% indirect holder) was a controller, but found that he "did not extract any personal benefits" and that "his interests were fully aligned with the other common stockholders."
      - Controller's alleged need for liquidity did not alter the analysis

Other Recent Controlling Stockholder Decisions

- ***Emp. Ret. Sys. v. TC Pipelines GP, Inc*. (Del. Dec. 19, 2016)** (appropriate to determine *MFW* applicability at pleading stage)
- ***Sandys v. Pincus,* 2016 WL 7094027 (Del. Dec. 5, 2016) ("Zynga")** (Delaware Supreme Court, in a majority opinion, held that the derivative plaintiff had pleaded enough particularized facts – including joint ownership of a plane with the controller – to raise a reasonable doubt that a majority of the directors of Zynga, Inc. could impartially consider a pre-suit demand on the board)

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Other Key 2017 Decisions Relevant To Take-Privates: The Future of Appraisal

"Fair Value" for Appraisal Purposes: A Preference (If Not a Presumption) for the Merger Price in Fully-Shopped Deals

- ***In re DFC Global Corp*. v. *Muirfield Value Partners, L.P*. (Del. Aug. 1, 2017)**
  - Court of Chancery (Chancellor Bouchard) applied its own DCF analysis and concluded that "fair value" was 7.47% ***higher*** than the merger price.
  - Departed from merger price because the deal, while widely shopped (the process "appeared to be robust"), was negotiated during a period of significant regulatory uncertainty in which management repeatedly revised its projections downward and the deal price was based in part on the PE buyer's internal rate of return analysis.
  - Delaware Supreme Court reversed.
    - While rejecting argument that exclusive or presumptive weight should be given to the deal price, and confirming the Court of Chancery's statutory discretion to take into account all relevant factors, Court essentially found, based on economic principles, that, ***in the absence of external influences such as a controlling stockholder***, the price achieved in a robust, unconflicted sale process is the best evidence of fair value and any relative weighting of competing valuation methodologies must be grounded in the record.

Other Key 2017 Decisions Relevant to Take-Privates: The Future of Appraisal (cont'd)

Role of the Deal Price in MBOs, Controlling Stockholder Take-Privates and Other "Interested" Transactions

- ***In re Appraisal of Dell, Inc.*, C.A. No. 9322-VCL (Del. Ch. May 31, 2016)**
  - MBO context
  - Court of Chancery (VC Laster) applied its own DCF analysis and concluded that "fair value" was $17.62 per share, approximately ***30% higher than the $13.75 deal price***
    - LBO pricing model focused on PE buyer's short-term internal rate of return
    - Post-signing "go shop" of limited utility given size and complexity of company
  - Currently on appeal to the Delaware Supreme Court
  - Will the Court extend *DFC*?

Upcoming Real Deal Webinar

Mark Your Calendar!

October 24 – Delaware Law Developments/Recent Judicial Decisions Affecting M&A Transactions and Corporate Governance – Part 2

Thank You

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