Akin Gump STRAUSS HAUER & FELD LLP

Client Alert

January 21, 2014

Top 5 Delaware Case Developments in 2013 for M&A Practitioners

During 2013, in addition to the important changes to the Delaware General Corporation Law ("DGCL") and the Limited Liability Company Act, described here, the Delaware courts issued a number of decisions that have a direct impact on the M&A practice. Below are our Top 5 case law picks for M&A practitioners:

1. A new look at the standard of review in going-private mergers (the Business Judgment Rule)
2. Deal process considerations for target company boards
3. Validity and enforcement of forum selection clauses
4. Financial manipulation and/or missed sales forecasts may lead to a material adverse effect
5. Directors must protect the interests of common stockholders (vs. preferred stockholders)

1. A new look at the standard of review in going-private mergers (the Business Judgment Rule)

In its In re MFW Shareholders Litigation (May 29, 2013) decision, the Court of Chancery held that in going-private mergers with a controlling stockholder on both sides the deferential business judgment standard of review applies, instead of the entire fairness standard, if certain procedural safeguards are included from the beginning. Specifically, the controlling stockholder has to agree at the outset to proceed with the merger only if the transaction is both (1) negotiated and approved by an attentive special committee comprised of directors who are independent of the controlling stockholder and fully empowered to decline the transaction and to retain its own financial and legal advisors and (2) conditioned on the un-coerced, fully informed and non-waivable approval of a majority of the unaffiliated minority stockholders.

The *entire fairness standard* requires the controlling stockholder to affirmatively show both a fair process and a fair purchase price. Under the deferential *Business Judgment Rule*, on the other hand, the board is entitled to the presumption that its business decision will not be overturned if it can be attributed to a rational business purpose, and any challenge to a transaction must be dismissed unless no rational person in good faith could have thought such transaction was fair to the minority stockholders. Separately, it is interesting to note that, while the court affirmed that under Delaware law there is a presumption that directors are independent, the court also referred to the NYSE independence rules as a useful source for assessing the directors' independence in this case. In general, however, Delaware courts have used a fact-specific inquiry into independence that looks beyond the relevant exchange's rules.

This is an important case, because if all of the conditions described above are met, it changes the actual standard of review in the event of litigation involving this type of going-private merger. Previously, the burden of proof of the entire fairness standard shifted to the plaintiff if the transaction was approved by either an independent special committee or by the majority of the minority stockholders. In addition, the Delaware courts have applied the business judgment rule in cases, such as In re John Q. Hammons Hotels Inc. Shareholder Litigation (October 2, 2009) and Southeastern Pennsylvania Transportation Authority v. Volgenau, et al. (August 5, 2013), where the transaction involved a third party and a company with a controlling stockholder, but the transaction was recommended by an independent, special committee and approved by the majority of the minority stockholders. Now, if the MFW decision survives the appeals process (the Delaware Supreme Court heard oral argument in December 2013), parties will be encouraged to structure going-private transactions involving a controlling stockholder on both sides in a way that provides a more predictable and likely less expensive process for controlling stockholders and also more protection for the minority stockholders.

2. Deal process considerations for target company boards

A. Single-bidder Process and Market Checks

In the In re Plains Exploration & Production Co. Stockholder Litigation (May 9, 2013) case, the Court of Chancery ruled that the decision-making process of the board of directors of Plains Exploration & Production Co. ("Plains") in a sale-of-control transaction involving a single bidder was reasonable and that the Plains board did not violate its Revlon duties. In Koehler v. Netspend Holdings, Inc. ("Netspend") (May 21, 2013), however, the Court of Chancery determined that the board likely breached its Revlon duties, although the court did not enjoin the transaction, because even though the sales process was flawed, the court did not want to jeopardize the only transaction available to the company.

With respect to a board's Revlon duties, In Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc. (1986), the Delaware Supreme Court held that, in a sale-of-control transaction, a company's directors must focus their fiduciary duties on one objective: to obtain the best price reasonably available for the stockholders. The Revlon duty "is not an independent duty, but rather a restatement of directors' duties of loyalty and care." Revlon claims are reviewed under an *enhanced scrutiny test* pursuant to which the court evaluates the reasonableness of the process employed by a board for obtaining the best price and whether the directors were fully informed and acting in good faith, which is highly dependent on the particular facts of the transaction.

In Plains, the board only negotiated with one potential bidder, but the court determined that the board's decision not to form a special committee was reasonable under the circumstances, as there was no dominating chief executive officer (CEO) and seven of eight directors were independent and experienced in the industry. In addition, the court held that having the CEO lead the negotiations was not per se unreasonable, especially because as a stockholder the CEO's interests were aligned with those of the other stockholders, and because he had the deepest knowledge and experience regarding the company's assets. The merger agreement included a substantial period (of more than five months) between signing and closing and mild deal-protection measures, including a "no-shop" clause with a fiduciary out for superior proposals and a three-percent breakup fee. The court also noted that “a post-agreement market check can be an effective way to ensure that a company obtains the best price reasonably available.”

In Netspend, on the other hand, the court found that, while it was reasonable for the board to decide to pursue a single-bidder process after several failed attempts to sell the company, the board’s actions taken as a whole were not reasonably designed to yield a process that would satisfy its Revlon duties to maximize the price payable to its stockholders. Like in Plains, the court found it reasonable that the NetSpend board did not establish a special committee and instead allowed the CEO to lead the negotiations, as the interests of the CEO, who was a significant stockholder, and the four directors appointed by the two largest stockholders were aligned with those of the other stockholders. In addition, the Netspend board instructed the CEO not to discuss any management retention agreements until after material deal terms had been agreed upon, and the board remained heavily involved in the negotiation process. Unlike the Plains board, however, the Netspend board decided to forego any pre- or post-market check and relied on a fairness opinion that the court determined was “weak” because of dissimilar comparables and a stock value that was 20 percent higher at the lowest end of the range provided in the discounted cash flow (DCF) analysis than the merger price. Furthermore, the Netspend board agreed to deal protection measures, such as a short “no-shop” clause with a fiduciary out (of about two months), and a prohibition on the waiver of “don’t ask, don’t waive” standstill clauses in pre-transaction confidentiality agreements. The court determined that, in the aggregate, these measures resulted in the board not having sufficient information to create a process to obtain the best price for the stockholders.

As a result, while a single-bidder sale process is not per se unreasonable, if a board elects to pursue a single-bidder process and forgo a pre-signing market check, the board must be aware that, in order to satisfy its Revlon duties, the other actions it takes with respect to such sale process, taken as a whole, must result in a process that is reasonably designed to maximize the price to be received by the stockholders. In addition, in a single-bidder sale process, the ability (or lack thereof) of the target to conduct a “de facto,” post-signing market check may be significant to a Delaware court, which a target’s board should be aware of in negotiating both the deal protection measures and length of the pre-closing period for the acquisition agreement. For a further analysis of the differences between the process used in each of Plains and Netspend, see here.

B. Use of Fairness Opinions

In recent years, plaintiffs and courts have more carefully scrutinized fairness opinions rendered in the context of public M&A transactions. Following the Great Recession, fairness opinions have generally included more robust disclosure on projections and deal economics, but shareholder claims now typically focus on conflicts of interest, the analysis used by the financial advisor and management’s projections.

The Netspend case from May 2013 (see above) demonstrated the scrutiny imposed on a fairness opinion when it is being relied upon as the sole market check in the transaction. The Netspend board did not perform a pre-agreement market check; acquiesced to strong deal protections, including, most notably, “don’t ask, don’t waive” provisions against private equity bidders; and relied upon a “weak” fairness opinion. The financial advisor who rendered the opinion relied on the stock price as a basis for valuation, when, in fact, the stock price was highly volatile, resulting in the Court of Chancery determining that the fairness opinion was a "particularly poor simulacrum of a market check." The court criticized the investment bank for using dissimilar comparables, most of which were old and predated the financial crisis, and for using projections that exceeded the customary practices of management. This highlights the importance for a financial advisor to ensure that the valuation methods used, and the projections made, are those normally utilized by the company. The merger price was also less than the lowest end of the range provided in the DCF analysis, which was one of the analyses supporting the opinion.

In the In re Bioclinica, Inc. Shareholder Litigation (October 16, 2013) case, the Court of Chancery, among other things, distinguished the Netspend decision, rejecting plaintiff's claims against the Bioclinica directors alleging breach of the directors' duties to the stockholders and against the private equity buyer for aiding and abetting the directors. The case involved the sale of a company to a private equity consortium after a lengthy (eight month) bidding process participated in by both private equity bidders and strategic acquirers. The merger agreement contained several deal protection measures in favor of the private equity buyer, including a non-solicitation clause, termination fee, information rights, a top-up option and an exclusive waiver of the poison pill.

The court emphasized in Bioclinica that the scrutiny placed by the court on the weakness of the fairness opinion in the Netspend case was heightened in the absence of a market check, and that such review is necessarily "contextual." The court explicitly clarified that its decision in Netspend does not create a new basis to challenge every sales process, thereby limiting the scope of that decision. The deal protection measures employed by the board in Bioclinica were deemed non-preclusive, where the sales process was otherwise reasonable. For additional details regarding the use of fairness opinions, see here.

3. Validity and enforcement of forum selection clauses

A. In Organizational Documents

Many publicly traded Delaware corporations have adopted forum selection bylaws designating Delaware as the exclusive venue for stockholder derivative suits and certain other stockholder suits. The purpose of these provisions is to reduce the high cost of duplicative, multi-forum suits challenging corporate actions and to help ensure that the matters in dispute will be heard relatively swiftly by a knowledgeable and highly regarded judiciary. However, the validity of these types of bylaw provisions had been in doubt.

That is, until the decision in Boilermakers Local 154 Retirement Fund v. Chevron Corporation and Iclub Investment Partnership v. FedEx Corporation (June 25, 2013), where the Court of Chancery upheld the statutory validity of the forum selection bylaws unilaterally adopted by the boards of directors of Chevron and FedEx. The bylaws in question were held to be within the power of the boards to adopt under the DGCL and contractually valid and enforceable. The court relied on Section 109(b) of the DGCL, as "forum selection bylaws, which govern disputes related to the "internal affairs" of the corporations, easily meet [the section's] requirements" although some commentators wonder if these bylaws really fall within the internal affairs doctrine. In addition, the court held that the bylaw provisions were contractually valid and enforceable because the DGCL allows corporations, through their certificates of incorporation, to grant directors the power to adopt and amend the bylaws unilaterally, and the certificates of incorporation of

Chevron and FedEx so authorized their boards. As the court noted, when stockholders invest, they agree to the bylaws when they purchase stock in those companies. The plaintiffs in these cases withdrew their appeal in October 2013, so as of now, the decision is unchallenged. For additional details and a description of other factors companies should consider when deciding whether to adopt forum selection clauses, including whether courts in other jurisdictions will also honor these clauses, see here and here.

In Edgen Group Inc. v. Genoud (November 5, 2013), the Court of Chancery denied Edgen's motion for a temporary restraining order to stop the plaintiff from proceeding in Louisiana in violation of the forum selection provision in Edgen's certificate of incorporation, which required that any stockholder claims of breach of fiduciary duty should be filed in Delaware. In its decision, while the court confirmed the presumptive validity of forum selection provisions in charters, it then described the process for enforcing them against stockholders who file claims in violation of the provisions. The court held that, notwithstanding the violation by the stockholder, "the forum selection provision would be considered in the first instance by the other court, by the court where the breaching party filed its litigation, not through an anti-suit injunction in the contractually specified court." So, while forum selection clauses in organizational documents are clearly held to be valid, they are not self-enforcing and a plaintiff can file a suit in another jurisdiction, where the courts will need to enforce the clauses.

B. In Contracts

In National Industries Group v. Carlyle Investment Management LLC (May 29, 2013), the Delaware Supreme Court upheld the authority of the Court of Chancery to enforce a forum selection clause in a subscription agreement through an injunction. In this case, the forum selection clause stated that any dispute would be subject to the exclusive jurisdiction of the "courts of the State of Delaware." That wording appears more appropriate than a clause vesting this authority exclusively in the Court of Chancery, because of the Court of Chancery's limited equity jurisdiction. The court reiterated that "a valid forum selection clause must be enforced," and noted that in M/S Bremen v. Zapata Off-Shore Co. (1972), the U.S. Supreme Court held that forum selection clauses are generally valid, unless the objecting party can demonstrate that enforcement would be unreasonable or unjust or that the clause was invalid because of fraud or overreaching, neither of which applied in this case. The U.S. Supreme Court recently also reaffirmed that forum selection clauses in contracts are presumptively enforceable in Atlantic Marine Construction Co. v. United States District Court for the Western District of Texas (2013). The U.S. Supreme Court in this case described the process for enforcing such clauses and held that the objecting party has the burden of establishing that public interests against transfer outweigh the parties' agreed-upon choice of forum.

4. Financial manipulation and/or missed sales forecasts may lead to a material adverse effect

In Osram Sylvania Inc. v. Townsend Ventures, LLC (November 19, 2013), plaintiff, a stockholder of Encelium Holdings, agreed to purchase the other issued and outstanding capital stock of the company not already held by the plaintiff pursuant to a stock purchase agreement, which was executed on the last day of the third quarter of 2011. The purchase price was based on the company's forecasted sales for the 2011 third quarter, as well as representations relating to the company's financial condition, operating results, income, revenue and expenses. Following the October 2011 closing, the plaintiff became aware that the company's third quarter results were approximately half of its forecast and alleged that the company and the sellers knew of the results prior to closing. The plaintiff further alleged that the company's and the sellers' failure to disclose these results prior to closing violated a provision in the stock purchase agreement that required them to disclose facts that amount to a material adverse effect. Finally, the plaintiff alleged that the company and the sellers had manipulated the company's second quarter results to make its business appear more profitable than it was.

The Court of Chancery declined the defendants' motion to dismiss the contract and tort-based claims and held, among other things, that:

Financial manipulation prior to execution of a purchase agreement may lead to an MAE. The court held that, since the sellers warranted against it, it is reasonably conceivable that alleged practices of billing and shipping excess product without applying proper credits or discounts and the restructuring of the company's business segments could produce consequences that are materially adverse to the company. The court indicated that it was reasonably conceivable that the plaintiff could prove that the sellers breached certain representations and warranties in the agreement, including those regarding the financial condition of the company. The court also noted that it is "reasonably conceivable that the plaintiff could prove damages resulting from these breaches," as it may have paid more for the company based on its inflated results.

Failure to meet sales forecasts may lead to an MAE. The court determined that the third quarter results could be interpreted as reflecting a change in circumstances that was materially adverse to the company's business, but was not disclosed by the sellers to the plaintiff prior to the closing. Therefore, the court held that the plaintiff's claim, which was based on a breach of the covenants to operate the company in the ordinary course of business and to inform the plaintiff of anything occurring that might produce a material adverse effect, survived the motion to dismiss. The court also noted that the plaintiff could prove damages resulting from these breaches by overpaying for the company. The court did note, however, that the failure to notify the plaintiff of the missed forecasts generally will not constitute fraud.

No implied contractual obligations existed to support a claim based on the implied covenant of good faith and fair dealing. The court held that the implied covenant of good faith and fair dealing was inapplicable, given that the sellers' obligations were governed by express contractual provisions of the agreement, and dismissed the plaintiff's claim under the implied covenant.

This case highlights the court's focus on the potential long-term effects of the financial manipulation, instead of the manipulation itself, to determine a possible material adverse effect. In addition, parties should consider the common explicit exclusion of the failure to meet forecasts from the definition of a "Material Adverse Effect," or, alternatively, negotiating for a warranty as to forecasts, which is less common.

5. Directors must protect the interests of common stockholders (vs. preferred stockholders)

In the In re Trados Incorporated Shareholders Litigation case (August 16, 2013), the Court of Chancery reiterated that no special duty is owed by a board of directors of a Delaware corporation to the holders of preferred stock. Rather, the board of directors owes a duty to the residual claimants of a corporation (i.e., the common stockholders), even if the directors were elected by the preferred stockholders.

Preferred stockholders are often provided with a number of preferential rights, including liquidation preferences, special voting rights, rights to board seats and registration rights. However, as the court noted, these rights are contractually established and do not require a fiduciary duty level of protection. Accordingly, these rights will be interpreted in a manner consistent with customary contractual interpretation. Preferred stockholders are owed fiduciary duties only when they do not involve their special contractual rights and rely on a right shared equally with the common stock. Therefore, when directors are in a position to evaluate a liquidity event for a corporation with preferred stockholders, it is incumbent on the directors to build a record of maximizing value for the common stockholders as well as the preferred stockholders. The court emphasized that it is the board's duty to prefer the interests of the common stock over those of the preferred stock.

In this case, the court applied the rigorous entire fairness standard of review to the merger because the majority of the directors who approved the merger were not disinterested and independent. In particular, the court determined that the directors who were principals of venture capital (VC) funds that invested in the company should be considered "interested" (i.e., not independent), because, for example, the VC funds would receive a liquidation preference that the common stockholders would not receive and because VC funds sometimes liquidate even profitable ventures if they do not achieve certain return hurdles. Ultimately, the court held that the board failed to satisfy the fair process prong of the entire fairness standard, but even though management and the preferred stockholders received all of the consideration and the common stockholders received no consideration, the court determined that the merger price was fair to the common stockholders because the common stock of the company as a going concern had no value before the transaction.

Boards should be cautious when considering the relative rights of common and preferred stockholders in a corporation. Moreover, it is important to consider whether special committee structures or other process protections should be implemented when representatives of preferred stockholders have significant membership on a board or meaningful influence over board outcomes and would therefore not be considered disinterested or independent. Alternatively, boards could consider using alternative entities, which allow greater contractual freedom to determine the applicable duties.

Contact Information

If you have any questions regarding this alert, please contact:

Kerry E. Berchem
kberchem@akingump.com
212.872.1095
New York

Carlos M. Bermudez
cbermudez@akingump.com
310.728.3320
Los Angeles - Century City

Elisabeth Cappuyns
ecappuyns@akingump.com
212.872.8011
New York

Daniel I. Fisher
dfisher@akingump.com
202.887.4121
Washington, D.C.

Ackneil M. Muldrow III
tmuldrow@akingump.com
212.872.1064
New York

C.N. Franklin Reddick III
freddick@akingump.com
310.728.3204
Los Angeles – Century City

Adam Keith Weinstein
aweinstein@akingump.com
212.872.8112
New York

