The Ropes Recap Mergers & Acquisition Law News ROPES & GRAY

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The Ropes Recap

Mergers & Acquisition Law News

A quarterly recap of mergers and acquisition law news from the M&A team at Ropes & Gray LLP.

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News from the Courts

Delaware Supreme Court Clarifies Fiduciary Duties in Sale Context and Overturns Judicial Imposition of Auction in Deal with Passive Market Check

In a recent opinion, the Delaware Supreme Court reversed a Court of Chancery ruling enjoining a merger transaction between C&J Energy Services, Inc. and Nabors Industries Ltd., holding that *Revlon* duties do not require a board to affirmatively shop a corporation, and that a board can satisfy *Revlon* scrutiny by pursuing a reasonable sale process in good faith, implementing a "passive market check," and providing its stockholders with a full and informed opportunity to vote on the transaction.

The Supreme Court's decision arose from a complex corporate inversion transaction in which C&J merged into a Bermudan subsidiary of Nabors. Initially, the C&J Board considered an acquisition transaction – including a possible acquisition of the Nabors subsidiary – but after evaluating its strategic options determined to merge into the Nabors subsidiary and reap an estimated $200 million tax benefit. However, for the inversion to be effective, Nabors would need to own a majority of the new company. Thus, even though C&J was larger than the Nabors subsidiary into which it merged, Nabors would be the majority stockholder of the post-transaction company. C&J therefore negotiated for certain post-transaction rights for its stockholders, including the right to designate four board members, a requirement that a sale of the new company (or a sale of its major assets) must result in pro rata per share payment to all stockholders, and a requirement that any sale, stock issuance, or bylaw amendment be approved by at least two thirds of the company's stockholders. The C&J Board also negotiated for a fiduciary out in order to permit consideration of potential topping bids.

C&J stockholders challenged the transaction, claiming that C&J's Board was improperly conflicted and had breached its fiduciary duties by, among other things, failing to affirmatively shop the company. The Court of Chancery evaluated the Board's conduct under *Revlon*, and granted the plaintiffs' motion for a preliminary injunction after determining that it was "plausible" that the C&J Board had failed to fulfill their Revlon duties. In so doing, the Court issued a mandatory injunction enjoining the stockholder vote for 30 days and requiring the C&J Board to affirmatively shop the Company during that time period – despite the fact that the merger agreement contained an express no-shop provision and the Court did not make any findings that Nabors was an aider and abettor.

The defendants filed an expedited appeal to the Supreme Court, which reversed the Court of Chancery's ruling. Chief Justice Strine, writing for the Court, held that the Court of Chancery's ruling was improper because "*Revlon* and its progeny do not set out a specific route that a board must follow when fulfilling its fiduciary duties, and an independent board is entitled to use its business judgment to decide to enter into a strategic transaction that promises great benefit, even when it creates certain risks." Thus, Chief Justice Strine reminded that *Revlon* does not require a selling corporation's board to actively shop the corporation prior to signing a definitive acquisition agreement. In so holding, he emphasized that *Revlon* "was largely about a board's resistance to a particular bidder and its subsequent attempts to prevent market forces from surfacing the highest bid." In contrast, the C&J board did not seek to prevent the emergence of another bidder, and there was "adequate time for such a bidder to emerge." Thus, the C&J Board – which had also negotiated for a fiduciary out and a reasonable termination fee – had conducted a permissible "passive market check."

The Supreme Court also concluded that although the Court of Chancery has broad equitable authority, it was improper to "blue pencil" the merger agreement by imposing a mandatory injunction that required the C&J Board to shop the company in violation of a no-shop clause. Because such an injunction is an extreme remedy, it must be based on undisputed facts or post-trial findings of fact. Here, the Court held that the trial record did not support a mandatory injunction or any inference that Nabors aided and abetted a breach of fiduciary duties or otherwise acted improperly. The Court also held that, because there was no reason to believe that the C&J stockholders were not adequately informed about the transaction, "the Court of Chancery should be reluctant to take the decision out of their hands."

The Supreme Court's opinion re-emphasizes existing Delaware case law that provides disinterested boards with broad latitude in making reasonable strategic choices in connection with sale transactions, especially where the selling board does not have a conflict of interest and has not improperly favored a particular bidder. This opinion is also important in that it reinforces a recently-emerging Delaware trend of approving single-bidder sale processes undertaken by disinterested, well-advised and fully-informed boards, particularly with respect to premium transactions with customary deal-protection devices and where the stockholders have a fully-informed opportunity to vote on the deal. Finally, this opinion shows the Delaware courts' reluctance to "blue pencil" agreements, particularly when it interferes with the bargained for rights of an innocent counterparty.

C&J Energy Services, Inc. v. City of Miami General Employees' & Sanitation Employees' Retirement Trust, No. 655/657 (Del. 2014).

<u>Illinois Court Affirms Single-Bidder Sale May Satisfy *Revlon* Duties</u>

In *Keating v. Motorola Mobility Holdings, Inc.,* an Illinois state court held that directors of Motorola Mobility's board did not violate their fiduciary duties to stockholders in selling the company to Google in a single-bidder sale process. In 2011, Google bought Motorola Mobility for $40 per share, a 63 percent premium to its market value. Former stockholders of Motorola Mobility brought suits in both Delaware and Illinois courts, but ultimately the Delaware case was withdrawn. The Illinois plaintiffs alleged that the board did not meet its *Revlon* duties because (1) it agreed to customary deal protections; (2) it lacked the valuations necessary to make an informed decision; and (3) Microsoft had contacted Motorola Mobility's CEO about a potential partnership, of which the board was not aware.

The Illinois Court disagreed with the plaintiffs on all counts and dismissed the case. A number of facts supported the Court's decision, including: the board had hired two separate financial analysts to conduct a fairness analysis, whose fairness opinions provided support for the board's decision; no competing bids were submitted; the board negotiated the price up from $30 to $40 per share; and 99 percent of stockholders approved the transaction.

While this is a case of an Illinois court applying and interpreting Delaware law, it affirms a basic principle of Delaware case law that there is no single, mandated way to conduct a sale process and, in certain circumstances, a board need not conduct a full auction to fulfill its *Revlon* duties. *See In re Plains Exploration & Production Co. Stockholder Litig.* (Del. Ch. May 9, 2013).

Keating v. Motorola Mobility Holdings, Inc., No. 11-CH-228854 (Oct. 2, 2014).

Court of Chancery Strikes Down Indemnification and Release of Claims Provisions in Private Merger

In *Cigna Health and Life Insurance Company v. Audax Health Solutions, Inc.*, the Delaware Court of Chancery granted a plaintiff stockholder a partial victory in its attempt to invalidate portions of the merger agreement, holding that a general release obligation was not supported by adequate consideration because it was contained solely in the letter of transmittal, and that the indemnification obligations of the stockholder were not defined with sufficient clarity to satisfy Delaware law governing statutory mergers.

Optum Services, Inc., a health insurance company and subsidiary of UnitedHealth Group Inc., agreed to acquire Audax Health Solutions, Inc., a privately held health technology company that develops health and lifestyle tracking applications for insurance companies. The plaintiff, Cigna Health and Life Insurance Co., a subsidiary of Cigna Corporation and also a health insurance company, was a preferred stockholder of Audax prior to the merger. A majority of Audax's board of directors and 66.9 percent of Audax's stockholders approved the merger via written consent, and the merger was ultimately consummated in February 2014. Cigna, however, did not consent to the merger.

Cigna objected to the merger agreement's requirement that in order to receive the merger consideration, each stockholder must agree to: (1) release all claims against the surviving company, (2) indemnify the surviving company for breaches of representations and warranties, and (3) appoint a designated stockholder representative. After consummation of the merger, Cigna brought suit to obtain its merger consideration ($46 million) and alleged that each of these three conditions were invalid. In its opinion the Court of Chancery struck down the general release obligation and limited the indemnification obligation.

The Court invalidated the general release obligation on the grounds that it was not in the merger agreement itself, but rather imposed solely in the letter of transmittal that would accompany stockholders' shares when exchanged for cash. Because Cigna would receive no benefit from submitting a letter of transmittal beyond what it was already entitled to receive under the merger agreement, the Court ruled that the letter of transmittal was not a valid contract supported by consideration, and that the general release obligation was therefore not binding.

The Court held that the indemnification obligation was invalid because it violated Section 251 of the Delaware General Corporate Law ("DGCL"). Section 251(b) requires that the merger agreement must set forth the manner in which post-purchase price adjustments may affect the parties. The Court held that the indemnification obligation was not defined with sufficient clarity to satisfy Section 251(b), because the stockholders' liability under the indemnification of the merger agreement in this case could extend up to the full amount of the merger consideration, and certain "fundamental" representations and warranties would survive for an unlimited time. As a result, the Court found that the merger agreement failed to state the "cash, property, [or] rights" which stockholders would receive, as required by Section 251(b)(5).

With respect to the appointment of the stockholder representative, the Court observed that "the propriety of stockholder representatives under the DGCL is the subject of active and ongoing debate," but it declined to rule in favor of Cigna on the technical grounds that it had not provided enough factual or legal support in its briefing to invalidate the stockholder representative appointment.

Though the Court stressed that it was not opining on escrow agreements or post-closing purchase price adjustments generally, and that its decision is limited to the facts of this case, *Cigna Health* provides a reminder that (i) the requirements of statutory mergers set forth in Section 251 will be strictly construed; (ii) any material terms that are to be included in the letter of transmittal must be incorporated into the merger agreement and disclosed in connection with solicitation of votes for stockholder adoption; (iii) it is important to focus on the mechanical details in structuring post-closing remedies in private merger agreement transactions, including how to structure and word post-closing indemnification obligations through escrow or other mechanics; and (iv) to the extent parties want to impose upon stockholders direct release or indemnification obligations, they may need to negotiate for such stockholders to enter into agreements (either by signing the merger agreement or providing stand-alone support or indemnification agreements as a condition to either signing or closing) to effectively implement such arrangements.

Cigna Health and Life Insurance Co. v. Audax Health Solutions, Inc., C.A. No. 9405-VCP (Del. Ch. Nov. 26, 2014).

New York Court Holds that Common Interest Privilege Governs Pre-Merger Communications

In a recent opinion, the Appellate Division, First Department of New York's Supreme Court held that the common interest privilege protected pre-merger communications between parties that ultimately consummated a change-in-control transaction. Importantly, the Court clarified that the common interest privilege can apply even when there is no "pending or reasonably anticipated litigation," which many New York courts had previously held was a necessary predicate to apply the common interest privilege.

This opinion arose in connection with the long-running litigation between Ambac Assurance, an insurer that guaranteed payments on certain residential mortgage-backed securities, and Countrywide Home Loans, which had originally issued many of those securities. Ambac also named Bank of America, which acquired Countrywide in 2008, as a defendant on a theory of successor liability, and sought to compel production of documents exchanged between Countrywide and Bank of America after the transaction had signed but before it closed. Bank of America resisted production of those documents, claiming that they were protected by the common interest privilege. The trial court disagreed, ordering production and concluding that the common interest did not apply where there the communications were not made in connection with "pending or reasonably anticipated litigation."

The First Department, the New York State intermediate appellate court governing New York and Bronx Counties, reversed the trial court's ruling, holding that "litigation need not be actual or imminent for communications to be within the common interest doctrine . . . [s]o long as the primary or predominant purpose for the communication with counsel is for parties to obtain legal advice or to further a legal interest common to the parties." By so holding, the First Department rejected a line of New York cases (including recent cases from the Appellate Division, Second Department) that had imposed an "actual or imminent litigation" requirement. The Court held that such a requirement would not adequately protect parties like Countrywide and Bank of America that had signed a merger agreement and were seeking to finalize a change-in-control transaction. In such situations, the parties "require[] the shared advice of counsel in order to accurately navigate the complex legal and regulatory process involved in completing the transaction."

The First Department astutely observed that refusing to apply the common interest privilege to parties in such a situation would discourage parties with a clearly shared legal interest from pursuing joint legal advice, which might precipitate needless miscommunication and litigation and would "make poor legal as well as poor business policy." The Court also noted that its approach to this issue was guided by the prevailing Delaware test for the application of the common interest privilege, which focuses on the alignment of the parties' legal interests and takes a more pragmatic approach to that determination.

The *Ambac* opinion should provide some comfort to parties seeking to finalize a corporate transaction that otherwise privileged and confidential communications should be protected by the common interest privilege, regardless of whether they relate to actual or imminent litigation. And *Ambac* helpfully moves New York privilege law towards federal and Delaware law on this issue, which assists practitioners by further aligning those standards and providing greater predictability for situations in which it is unclear which jurisdiction's privilege law governs. Unfortunately, there is not uniformity among New York courts on whether pending or imminent litigation is required to invoke the common interest privilege, as other intermediate New York appellate courts have taken a divergent approach. That divergence will hopefully precipitate guidance from the New York State Court of Appeals on this issue.

Ambac Assurance Corp. v. Countrywide Home Loans, Inc., 2014 NY Slip Op 08510 (1st Dep't 2014).

Business Judgment Rule Applied by Appellate Division in Kenneth Cole Take-Private

The New York Appellate Division, First Department, held that the business judgment rule (rather than the more-exacting entire fairness standard) was the proper standard of judicial review for breach of fiduciary duties claims in Kenneth Cole's take-private acquisition of Kenneth Cole Productions, Inc. ("KCP"). The Court ruled in favor of Mr. Cole because the transaction was structured to include dual minority protections – an independent special committee and the affirmative vote of a majority of minority stockholders. The *Kenneth Cole* decision aligns New York law with Delaware law by providing that using *both* of these protective devices may ultimately lead to the more deferential business judgment standard of review in transactions involving a controlling stockholder.

In February, 2012, KCP announced that Mr. Cole (who controlled ~89 percent of the KCP voting power and 46 percent of the economic interests) had proposed a transaction to take KCP private at a valuation of $15.00 per share, a 17 percent premium over the market trading price. To evaluate the proposed transaction, KCP's board created a special committee of independent directors to review and, if applicable, negotiate the proposed transaction. Mr. Cole conditioned his bid on the approval of the special committee and on the affirmative vote of a majority of minority stockholders. As part of his offer, Mr. Cole made it known he was not interested in selling his shares in any third-party transaction. After months of negotiations, the special committee and Mr. Cole agreed to a transaction at a price of $15.25 per share, and the transaction was subsequently approved by more than 99 percent of the minority stockholders who voted.

Plaintiffs, on behalf of the KCP minority stockholders, filed a class action lawsuit alleging that the board of directors breached its fiduciary duties by agreeing to a price that was unfair to the minority stockholders and which had been determined pursuant to an inadequate process. The plaintiffs also claimed that Mr. Cole breached his fiduciary duties as a majority stockholder by announcing publicly his unwillingness to sell to any third party, thereby damaging the continuing value of minority shares.

Applying the business judgment rule, the trial court dismissed the complaint finding that neither the board of directors nor Mr. Cole violated any fiduciary duties. The Court noted that Mr. Cole's actions in his own economic interest were not a *per se* violation of fiduciary duties. As to the director defendants, the Court found that the special committees did not breach its fiduciary duties by failing to solicit or explore other offers as it was clear that Mr. Cole would (and could effectively) reject any such third party proposals.

In evaluating the special committee's independence, the First Department rejected the plaintiffs' contention that the committee members were not independent because they had been nominated by Mr. Cole, following Delaware law in holding that "it is not enough to charge that a director was nominated or elected at the behest of those controlling the outcome of the corporate election." The Court then upheld the trial court's dismissal under a business judgment standard of review, concluding that the plaintiffs had failed to allege any facts "sufficient to demonstrate that the members of the board or the special committee did not act in good faith or were otherwise interested [in the transaction]."

This decision appears to be the first in New York to directly address the proper standard of review for a controlling stockholder take-private transaction. In determining that business judgment should apply where the minority stockholders are adequately protected by an independent special committee and a majority of the minority clause, the Court aligned New York law with the governing Delaware standard stated in *Kahn v. M&F Worldwide*. Like the *Kahn* opinion, the First Department's ruling focused closely on the steps taken by the board to protect the minority stockholders, emphasizing the importance of structuring controlling stockholder take-private transactions in a way that will entitle the transaction to a more deferential standard of judicial review.

In re Kenneth Cole Productions, Inc. Shareholder Litigation, Index No. 650571/12 (N.Y. App. Div. 1st Dep't Nov. 20, 2014).

Court of Chancery Declines to Dismiss Fiduciary Duty Claims against Directors and Aiding and Abetting Claims Against Lender in Connection with a Dead Hand "Proxy Put" Provision in Credit Agreement

Ruling from the bench, Vice Chancellor Laster declined to dismiss fiduciary duty claims against the directors of Healthways, Inc. and an aiding and abetting claim against SunTrust Bank, the lender administrative agent, for entering into a credit facility with Healthways that contained a dead hand "proxy put" provision.

In 2010, Healthways entered into an amended and restated credit agreement that contained a "proxy put." The proxy put at that time would be triggered when, during any period of 24 consecutive months, a majority of the members of the board ceased to be comprised of continuing directors. The proxy put did not contain a dead hand feature (i.e. a definition of "continuing directors" that excludes directors who are nominated outside of the company's director slate or not otherwise approved by the Company's board, regardless of whether such directors are later approved by the company's board). Subsequently, Healthways came under pressure from stockholders. In 2012, the stockholders approved a precatory proposal to declassify Healthways' board. Less than two weeks after the stockholder vote on declassification, Healthways amended its credit agreement and added the dead hand feature to the change of control definition. In late 2013, North Tide Capital, a stockholder, threatened a proxy fight. After negotiation, North Tide Capital gained representation on the Healthways board but those directors were not considered continuing directors for purposes of the dead hand "proxy put."

The plaintiffs sued Healthways' directors and SunTrust, alleging that the director defendants had breached their fiduciary duties by entering into a credit agreement with a dead hand "proxy put" provision, and that SunTrust aided and abetted this breach. The plaintiffs also sought a declaratory judgment that the "proxy put" was invalid and unenforceable under Delaware law.

At the motion to dismiss stage of litigation, the defendant directors argued that the dispute was not ripe because the "proxy put" had not yet been triggered. The Court found the issue to be ripe for judicial determination because the existence of the "proxy put" "necessarily has an effect on people's decision making about whether to run a proxy contest or how to negotiate with respect to potential board representation," because of the fact the North Tide directors had already suffered an injury by being treated as non-continuing directors. However, the Court emphasized that the denial of the motion to dismiss does not mean that the adoption of a "proxy put" was a *per se* breach of fiduciary duties, and that more facts need to be discovered.

SunTrust focused its motion to dismiss argument on the "knowing participation" element for the adding and abetting claim. The Court found that there was "ample precedent" putting lenders on notice that "proxy put" provisions are "highly suspect" and could potentially lead to a breach of duty by the borrower's directors. In addition, the dead hand "proxy put" was included in Healthways' credit agreement only after there were threats of a proxy contest by certain stockholders. Combining the foregoing two factors, the court found that the facts as alleged were sufficient to show "knowing participation" by SunTrust at the pleading stage, and that as a result, the complaint alleged facts sufficient to survive a motion to dismiss.

Pontiac General Employees Retirement System v. Healthways, Inc., C.A. No. 9789-VCL (Del. Ch. Oct. 14, 2014).

<u>Court of Chancery Declines to Dismiss Claim that Deal Protection Measures were Unreasonable</u>

In *In re Comverge, Inc. Shareholders Litigation,* Vice Chancellor Parsons declined to dismiss a claim that a target company's board breached its fiduciary duties when it agreed to deal protection measures that stockholder-plaintiffs claimed were unduly burdensome and restrictive to a potential alternative bidder.

In late 2011, Comverge, Inc., at the time facing severe capital constraints, received a take-private offer from H.I.G. Capital for $1.75 cash per share. As part of the offer, H.I.G. proposed to extend a $12 million bridge loan to Comverge. Following negotiations, H.I.G. raised its offer to $2.15 per share, and the Board granted H.I.G. a 19-day exclusivity period. Two days after the start of the exclusivity period, Comverge received an offer from another bidder to buy the company for up to $4 to $6 per share. The Board pushed H.I.G. to increase its offer, but the parties were unable to agree on an increased price during the exclusivity period. After exclusivity expired, the Board commenced negotiations with the other bidder. Less than two weeks after the exclusivity period expired, H.I.G. notified Comverge that an affiliate of H.I.G. had purchased 51 percent of a convertible note that Comverge had issued to Partners for Growth III. The note afforded its holder blocking rights over any sale of Comverge. In the following days, H.I.G. notified Comverge that it was in default under the note for failing to deliver certain compliance certifications and for failing to meet the required minimum revenue. The Board disputed both points.

On March 5, H.I.G. made a reduced offer of $1.50 cash per share, with the $12 million bridge loan that would involve notes convertible into Comverge common stock at $1.40 per share. After weeks of negotiations, H.I.G. ultimately offered a $1.75 per share price (for a purchase price of $48 million), which represented a negative premium because Comverge's stock was trading at $1.88 per share. H.I.G. also told the Board that if the proposed merger agreement was not signed within two days, it would accelerate the debt under the note and declare the entire principal and outstanding interest due and payable. The Board accepted H.I.G.'s offer, and the parties executed the merger agreement and entered into the bridge loan agreement simultaneously.

Comverge stockholder plaintiffs challenged, among other things, the deal protection measures included in the merger agreement, including (1) the termination fee; (2) Comverge's agreement to reimburse up to $1.5 million of H.I.G.'s expenses if it entered into a superior transaction; and (3) the convertible notes issued to H.I.G., which the plaintiffs alleged could result in at least a $3 million payment to H.I.G. if Comverge entered into a superior transaction, and should be considered in the analysis of the deal protection measures.

The Court denied the Board's motion to dismiss the claims that the Board breached its fiduciary duties by agreeing to these deal protection measures. The Court noted that, even if the lesser fee in the tiered termination fee structure were used and the convertible notes were excluded from the calculation, the combined termination fee and expense reimbursement would be equal to 5.55 percent of the transaction's equity value, which was near the upper limit of what the Delaware Courts have considered a reasonable range for termination fees, even allowing for additional flexibility in the context of a micro-cap acquisition.

The Court also considered whether the convertible notes should be included in the termination fee analysis. Plaintiffs argued that the conversion privileges of these notes could amount to an additional termination fee of at least $3 million (i.e. the additional amount an alternative bidder would need to pay for Comverge if H.I.G. elected to covert its notes). If this amount were taken into account, the total termination fee would amount to 13 percent of the transaction's equity value, an amount which the Court indicated was well above the accepted range of reasonableness. The Court found that it was reasonably conceivable that the convertible notes may have been viewed by potential bidders as additional termination fees, noting communications from an activist investor describing the notes as a second termination fee. Thus, at the motion to dismiss stage, it was appropriate to consider them as a component of the deal protection measures. The Court also noted that its concerns over the protection measures in the case were heightened by the fact that the deal was at a negative premium to the market price, and because H.I.G.'s control of the note gave H.I.G. superior bargaining power in the transaction.

Stockholder plaintiffs almost always assert that the deal protection measures agreed to by the parties in a transaction are improperly preclusive, and this is a rare case in which that claim resonated with the Court. Accordingly, practitioners should note the Court's guidance on the upper boundaries of "reasonableness" for termination fees and other ancillary factors (such as bargaining power and the premium on the deal that is being protected) that Delaware Courts will look at when evaluating the preclusive effect of deal protection measures.

In re Comverge, Inc. Shareholders Litigation, C.A. No. 7368-VCP (Del. Ch. Nov. 25, 2014).

Court of Chancery Allows Stockholders to Demand Appraisal of Shares Acquired After the Record Date, Regardless of Prior Record Holders' Vote on Proposed Merger

In *Merion Capital LP v. BMC Software, Inc.*, the Delaware Court of Chancery held that a stockholder who acquires a merger target's shares after the record date for the proposed merger transaction has standing to seek appraisal of those shares, regardless of whether the prior record holder voted the shares in favor of the proposed merger.

In 2013, BMC Software, Inc. and a consortium of private equity buyers entered into a merger agreement to take BMC private for $46.25 per share of common stock. The plaintiffs, Merion Capital LP and Merion Capital II LP, acquired shares of BMC after the record date for voting on the merger transaction and delivered a formal demand for appraisal of its shares.

The Merion funds are hedge funds that specialize in appraisal arbitrage. In order to capitalize on potentially undervalued transactions, appraisal arbitrageurs acquire equity in cash-out merger targets and exercise statutory stockholder appraisal rights in an effort to collect the difference between what the court determines is the fair value of the target and the transaction price.

BMC contended that Merion had to establish standing by proving that the specific shares for which it was seeking appraisal had not been voted in favor of the proposed merger transaction by any other record holder.

Vice Chancellor Glasscock disagreed and held that "the unambiguous language of the [appraisal rights] statute does not give rise to any such share-tracing requirement," and that Merion had perfected its right to appraisal by complying with Delaware's statutory requirements for appraisal. The Court reasoned that statute's standing requirement focuses on whether the stockholder owned the stock at the appropriate time, made a sufficient demand on the company, and voted the shares its seeks to have appraised. Thus, while a stockholder who votes in favor of a transaction may not pursue an appraisal lawsuit against a merger target, a subsequent owner of the target's shares is free to seek appraisal. Vice Chancellor Glasscock reached the same conclusion in a companion case decided the same day as *Merion Capital* concerning a take-private transaction for Ancestry.com.

This decision provides helpful support and guidance to practitioners of appraisal arbitrage. Under this ruling, any shares sold after the record date are eligible for appraisal. One potential result of this decision is that more shares might seek appraisal than voted against the proposed transaction. While this concern is only theoretical at this time, such a result could prompt action by the Delaware legislature.

Merion Capital LP v. BMC Software, Inc., C.A. No. 8900-VCG (Del. Ch. Jan. 5, 2015); *see also In re Appraisal of Ancestry.com, Inc.*, C.A. No. 8173-VCG (Del. Ch. Jan. 5, 2015).

Court of Chancery Upholds Advance Notice Bylaw

In *AB Value Partners, LP v. Kreisler Manufacturing Corporation,* Vice Chancellor Parsons denied an activist investor's petition for a temporary restraining order barring the implementation of a Delaware corporation's advance notice bylaw.

The case concerned an attempt by the board of Kreisler Manufacturing Corporation to implement a customary advance notice bylaw that required stockholders to submit board candidates between 60 and 90 days prior to the anniversary date of the immediately preceding annual meeting. The plaintiff, activist hedge fund AB Value Partners, held an 11.1 percent stake in Kreisler. AB Value sought to run a dissident slate of directors at Kreisler's 2014 annual meeting, but was restrained from doing so because it missed the deadlines prescribed in the advanced notice bylaw. In arguing why it should be excused from the deadlines provided in the bylaws, AB Value claimed that certain events occurred after the advanced notice deadline which made enforcement of such deadline inequitable, namely (1) the distribution of a 37.2 percent voting bloc of Kreisler's shares from a trust to four of its beneficiaries; (2) salary increases for two members of Kreisler management (both whom were on the four-person Kreisler board of directors); and (3) errors in the meeting notice.

The Court denied AB Value's motion for a TRO against the enforcement of the bylaw. The Court noted generally that advance notice bylaws are commonplace and frequently upheld under Delaware law, although they could be struck down if they unduly restrict the stockholder franchise or are applied inequitably. Here, the Court observed that the bylaw was adopted on a "clear day", before any imminent proxy challenge appeared and created an immediate entrenchment motive, and was otherwise facially valid. The Court also discussed several factors relevant to determining the validity of an advance notice bylaw: (1) whether a change in circumstances happens after the advance notice deadline; (2) whether such change is unanticipated and material; and (3) whether such change was caused by the board of directors. The Court applied these factors to AB Value's claims, denying the TRO request and noting that the dissolution of the voting trust was both immaterial and not caused by the board of directors. The Court also found that the challenged pay increases –roughly $100,000 for each senior manager – were not material for a corporation of Kreisler's size, and that the purported errors in the meeting notice were also immaterial.

This decision demonstrates that the Court of Chancery generally views advance notice bylaws as acceptable, and that it will only enjoin their application when the Court is concerned that enforcement may produce an inequitable result or otherwise improperly benefit incumbent directors. However, this decision also cautions that companies should be cautious when considering the adoption of an advance notice bylaw while in the midst of a proxy challenge, or the enforcement of an advance notice bylaw in situations where a radical shift in corporate direction has taken place following the advance notice deadline.

AB Value Partners, LP v. Kreisler Manufacturing Corporation, et. al., C.A. No. 10434-VCP (Del. Ch. Dec. 16, 2014).

Manager With Operational Control and *de minimis* Ownership Deemed Not a Controller

In the Q3 2013 edition of the *Recap*, we reported on the Delaware Court of Chancery's holding in *In re Morton's Restaurant Group, Inc. Shareholder Litigation* that, without additional indicia of control, a 28-percent stockholder was not a controlling stockholder for purposes of applying entire fairness review to the challenged transaction. In October, in *In re KKR Financial Holdings LLC Shareholder Litigation*, the Court of Chancery issued an opinion providing further guidance on when a minority stockholder may be deemed to be a controller for Delaware law purposes.

The alleged controller in this case was an affiliate of KKR & Co., L.P., the manager of KKR Financial Holdings LLC ("KFN"), a widely held public company holding certain KKR financial assets. KKR controlled the day-to-day operations at KFN, supplied its slate of officers and received management fees under a management agreement that would have been costly for KFN to terminate. However, KKR held less than one percent of KFN's stock and only two of its twelve board seats. After KFN agreed to be acquired by KKR in exchange for publicly-traded KKR units valued at a 35 percent premium to KFN's stock price, plaintiffs filed suit, alleging that the board of KFN had violated its fiduciary duties and that the transaction (as a controlling stockholder transaction) should be reviewed under the entire fairness standard of review.

The Court granted defendants' motion to dismiss, finding that the business judgment rule applied. In making this finding, the Court held that, for determining whether entire fairness applies with respect to a particular transaction, operational control derived from pre-existing contractual obligations is, in and of itself, not sufficient to cause a manager to become a controller. Instead, a party will be deemed a controller only if it controls the board of directors or dominates the board of directors with respect to the transaction at issue so that a majority of the board could not exercise independent business judgment with respect to the transaction. In this case, the Court found that plaintiffs had only made plausible allegations that four of the twelve directors were controlled or dominated by KKR.

As the Court noted in another recent decision, *In re Crimson Exploration Inc. Stockholder Litigation*, determining whether a stockholder without majority ownership exerts actual control over a corporation is a fact-intensive inquiry. The *KKR* decision indicates that, for purposes of this actual control analysis, a stockholder's prominent management role is no substitute for board control or domination.

In re KKR Financial Holdings LLC Shareholder Litigation, CA. No. 9210-CB (Del. Ch. Oct.14, 2014).

<u>Court of Chancery Declines to Grant Preliminary Injunction Preventing Stockholder Vote</u>

In *In re Family Dollar Stores, Inc. Shareholders Litigation*, Chancellor Bouchard of the Delaware Court of Chancery denied the stockholder plaintiffs' motion for a preliminary injunction that would delay Family Dollar's planned stockholders' vote on a potential transaction with Dollar Tree, finding that the plaintiffs were unlikely to prevail on the merits of their claim that Family Dollar's board of directors breached its fiduciary duty to maximize Family Dollar's value by refusing to further engage with Dollar General on its hostile bid for Family Dollar.

In late 2013, Family Dollar's CEO and board chairman engaged in casual talks with Dollar General with respect to a potential combination of the two companies. In early 2014, Family Dollar's board formed a special committee to consider strategic alternatives and evaluate a potential sale transaction. During this process, Dollar Tree also expressed an interest in acquiring Family Dollar. The Family Dollar board of directors ultimately accepted an offer from Dollar Tree, and on July 27, 2014, Family Dollar and Dollar Tree executed a merger agreement pursuant to which Dollar Tree would acquire Family Dollar for approximately $8.5 billion (approximately $74.50 per share), to be paid with a combination of cash and equity. After the merger agreement was signed, Dollar General made an initial bid of $78.50 per share, and later increased its bid to $80 share while also agreeing to divest up to 1,500 stores in order to obtain FTC approval for the transaction. Family Dollar's board of directors declined to negotiate with Dollar General, and Dollar General commenced a tender offer to acquire the outstanding Family Dollar shares for $80 per share in cash. However, that tender offer could not close until Dollar General obtained antitrust approval from the FTC.

The plaintiffs sought to enjoin the stockholder vote with respect to the proposed merger until Family Dollar's board of directors engaged in negotiations with Dollar General and attempted to maximize value for the stockholders.

The Court denied the motion for a preliminary injunction, indicating that the Family Dollar board of directors was motivated to maximize the value to stockholders and acted reasonably within the requirements of the "fiduciary out" provision of the merger agreement in declining to engage in negotiations with Dollar General because of antitrust risks and decreased deal certainty associated with Dollar General's proposal. The Court noted that the board of directors had been advised that a deal with Dollar General had only a 40 percent chance of obtaining antitrust approval and that if it did, Dollar General's offer to divest 1,500 stores was well below what would likely be required by the FTC. On the other hand, advisors to the special committee had advised the board that a deal with Dollar Tree was 95 percent likely to receive antitrust approval from the FTC within the divestiture requirements that had been agreed to by Dollar Tree. The Court found that the board of directors reasonably exercised its judgment when it decided not to engage with Dollar General in a manner consistent with its fiduciary duty under *Revlon* to maximize value for the stockholders. The Court highlighted that Dollar General's higher price did not necessarily equate to a financially superior offer if antitrust issues could prevent the deal from closing.

On January 22, 2015, Family Dollar's stockholders voted to approve the proposed merger with Dollar Tree. Approximately 74 percent of total outstanding shares and 89 percent of total shares voted approved the merger transaction.

In re Family Dollar Stores, Inc. Shareholders Litigation, C.A. No. 9985-CB (Del. Ch. Dec. 19, 2014).

London Update

Takeovers and Cancellation Schemes of Arrangement: Abolition of Stamp Duty Exemption

One of the key changes introduced by the Chancellor's Autumn Statement at the end of last year was the proposed abolition of the stamp duty saving that has been available to date when structuring a takeover of a company as a cancellation scheme of arrangement under the Companies Act 2006. A cancellation scheme of arrangement involves the use of a reduction of capital by a target company in the context of a takeover carried out by means of a scheme of arrangement. It is the method most commonly used when structuring a takeover as a scheme of arrangement.

The proposal is to be implemented by means of an amendment to the Companies Act 2006. This amendment will prevent the use of cancellation schemes of arrangement for companies that are carrying out takeovers, subject only to certain limited exceptions for internal restructurings. Draft regulations have been circulated and the Government intends to bring these into force as soon as possible (the Companies Act 2006 (Amendment of Part 17) Regulations 2015).

Transitional provisions do apply under the regulations to permit schemes where a firm intention to make an offer has already been announced or, for companies that are not subject to the Takeover Code, where the terms of an offer have already been agreed, in each case, at the point at which the new provisions come into force.

Breach of Warranty Claim: A Recent Decision of the Commercial Court

Summary of Key Points

This recent decision of the Commercial Court provides an interesting discussion of a number of the key principles relating to warranty claims in relation to share purchase agreements. In particular, the decision confirms that there is no one valuation methodology to be used when quantifying damages for breach of warranty in the sale of shares and considers how different valuation methodologies may be used by a Court to assess damages, dependent on whether a minority stake or the entire issued share capital of a company has been acquired. The decision also highlights the importance of exercising caution when drafting claim notification provisions in a share purchase agreement and underlines how crucial it is to reflect on how these provisions will operate in practice and to ensure that this is captured clearly in the drafting. It also provides an interesting discussion of the circumstances in which the actions of an employee may be attributed to the employer company, and how, in the context of a breach of warranty claim, the question of attribution might have particularly unfortunate financial implications for the employer, if the employee's actions have been fraudulent.

Facts

An online retail business acquired the entire issued share capital of an online sports nutrition business from its selling stockholders. The sellers received cash (£30 million) and a minority interest in the buyer (worth £28 million) as consideration for their shares in the target. The value of the target had been determined by reference to a multiple of EBITDA. As part of the pre-acquisition negotiations, the senior management team at the buyer had discussed their expectation that an IPO of the buyer would take place a few months following the acquisition of the target, and had discussed how this would have an impact on the value of the sellers' anticipated stake in the buyer.

The sale agreement contained typical warranties in relation to the accounts and management accounts of both the buyer and the target. A few months after completion of the acquisition, a number of irregularities were identified in the accounts and accounting procedures of the buyer, and allegations of fraud were made. Conversely, the buyer also noted that there were a number of irregularities in the management accounts of the target, which had a direct impact on the target's EBITDA during the period that had been warranted.

The buyer brought proceedings against the seller for breach of warranty based on the irregularities in the sellers' management accounts. The sellers counterclaimed for breach of the accounts warranties that the buyer had given to support the value of the consideration shares that the sellers received in the buyer. Moreover, the sellers alleged fraud on the part of the buyer and asserted that, in accordance with the provisions of the share purchase agreement, the cap on liability under the agreement should not apply. In addition, the sellers asserted that the buyer's claim was invalidated since it had not been notified within the timeframe required under the share purchase agreement.

Assessing Damages: Methods of Valuation

The Court confirmed that it would not necessarily be appropriate to use the same valuation methodologies for assessing the respective parties' losses. In this case, the Court accepted the principle that different bases for assessing damages would apply dependent upon the size of the stake in the company that had been acquired.

The Court found that the sellers had breached their management accounts warranty, and that the management accounts had overstated the company's EBITDA for the warranted period. The Court concluded that the buyer's loss was to be established by determining the difference between the "warranty true" valuation of the target (namely, the £58 million consideration that had been paid on the basis that the management accounts warranty was correct) and the "warranty false" valuation of the company (an amount based on a multiple of the actual EBITDA for the relevant period as adjusted by the findings of the Court using a multiplier consistent with that used in the original valuation). The buyer also asserted that the aggregate adjustments to EBITDA were sufficient to merit a reduction in the multiplier that had been used to achieve the initial valuation of the business. Whilst the judge rejected this assertion on the facts of the case, he did not reject the principle. The buyer's loss was held to be £4,317,089.

By way of contrast, the judge confirmed that the appropriate way to value the seller's claim in relation to the minority interest in the buyer was on a discounted cash flow basis, which was calculated by reference to an IPO of the buyer. The Court acknowledged the orthodox position that damages should be assessed at the point of breach, but noted that when the transaction took place both the sellers and the buyer expected that an IPO would take place within a relatively short period of time following the transaction. The Court found that the buyer was in breach of its accounts warranties and the sellers were awarded damages of £10,800,000 (which were not subject to the contractual cap on liability agreed under the share purchase agreement, see below).

Notifying a Claim

The sellers tried to assert that the buyer had failed to notify the claim within the required contractual time period (namely, 20 days after it became aware of the matter). The dispute turned on what was meant by "becoming aware of the matter". The sellers tried to argue that the 20-day time period ran from the point at which the buyer had identified the accounting issues that gave rise to the claim. The Court concluded that to make commercial sense of the agreement, the 20-day time period should run from the date on which the buyer became aware that it had a potential claim under the accounts (namely, following initial advice from its accountants). The Court also rejected the sellers' claims that the notice did not provide sufficient detail of the claim being brought. This does underline the importance of taking care when drafting such provisions in a share purchase agreement so as to ensure that the drafting is unambiguous, that sufficient time periods are permitted to allow a party to take the requisite advice before formalising any notification of claim and, finally, that the level of detail required in the notice is stated clearly.

Fraud: Removing the Cap on Liability

The Court determined that the irregularities in the buyer's accounts were attributable to the fraudulent activities of a specified individual within the buyer's finance team. The Court found that the buyer's cap on liability under the contract did not apply in relation to the award of damages on the basis that the contract specifically excluded the contractual cap in the event of fraud. The buyer tried to argue that the actions of the specified employee could not be attributed to it. The Court rejected this argument on the basis that the individual in question was a senior employee and had been explicitly involved in providing financial information in relation to the buyer in connection with the transaction. This serves as a cautionary reminder of the potential open ended liability of a warrantor in the event of fraud.

The Hut Group Ltd. v. Nobahar-Cookson and another, [2014] EWHC 3842 (QB).

Asia Update

China to Overhaul its Foreign Investment Regulatory Regime

On January 19, 2015, the Ministry of Commerce (MOFCOM) of China released for public comments a draft version of a new law governing foreign investments into China. If passed, this new law will supersede the current structure for the regulation of foreign investments in China and mark a major step in China's efforts to take a more rationalized approach in regulating foreign investments. The closing date for public comments is February 17, 2015.

Replacing the Existing Foreign Investment Laws
The existing foreign investment laws that apply to foreign invested enterprises (FIEs) will be repealed and replaced with this unified law. The transition issues related to vast number of FIEs in China will be closely watched by foreign investors, and the draft has built in provisions to grandfather certain aspects of the current business and operations of existing FIEs. The draft also requires existing FIEs to comply with the Company Law of China (within a defined transition period). This suggests that in the future FIEs will be subject to the same set of rules under China's corporate law which used to apply primarily to domestic companies.

Negative List
In respect of market entries for foreign investments,[1] foreign investors will enjoy "national treatment" except for certain industrial sectors that will be subject to a "negative list." This may be the successor of the foreign investment catalogue that the Chinese government used to publish and update from time to time, and will retain the concepts that exist under the existing regime of industrial sectors in which foreign investment is "restricted" or "prohibited." The key change, however, is that foreign investments in sectors that are not identified in the negative list as "restricted" or "prohibited" will be able to proceed to corporate registration the same way as domestic investors. They will no longer be subject to the existing regime which requires approval by MOFCOM (and potentially other governmental authorities) for each single foreign investment. The draft does not contain a draft of the negative list, which will be promulgated and released by the State Council.

Foreign Investors and the Concept of "Control"
While the existing regime generally determines whether an investor is foreign based on nationality or place of incorporation, the draft introduced the concept of "control" to rationalize the regulatory regime in this regard. "Control" is broadly defined in the draft to include over 50 percent of equity ownership, as well as governance, contractual or other types of rights that provide the ability to exert influence or direct decisions. Hence a domestic entity controlled by a foreign investor will be regarded as a foreign investor, and its investment will be subject to the

[1] "Foreign investment" is broadly defined to include not only equity investments or acquisitions, but also acquisitions of contractual control, real properties or concession rights. It also captures providing financing with a term of over one year.

negative list accordingly.[2] Investors should also be on alert when attempting to obtain "control" (whether by way of acquisition of equity, assets or contractual arrangements) over offshore holding vehicles of Chinese businesses that are on the negative list since such transactions may be regarded as foreign investments.

Domestic Investors and Variable Interest Entity (VIE)

The flip side of the concept of "control" is the domestic investors that conduct "round trip" investments (i.e., investing in offshore entities that will invest back in China). The draft provides that if a foreign investor is actually controlled by a "domestic investor" (i.e., a Chinese citizen, a branch of the Chinese government or any entity controlled by either of those), such foreign investor will be regarded as a de facto domestic investor after being examined by MOFCOM. The draft also provides heavy penalties on contractual arrangements circumventing foreign investment restrictions.

As a result of such sweeping change, investors would wonder (i) whether the controversial "variable interest entity" (VIE) structure will still be necessary in the future for investors that can satisfy MOFCOM's requirements and thus can obtain market access the way as domestic investors, and (ii) how to treat the vast number of VIEs already in the market. For question (i), the draft leaves the door open for Chinese companies to raise financing internationally (e.g., conducting IPOs in the US and Hong Kong markets) through offshore vehicles if MOFCOM can be satisfied that such vehicles are controlled by domestic investors. For question (ii), the explanatory note accompanying the draft proposed three different alternatives (giving MOFCOM different level of discretion) for MOFCOM to conduct examination to determine whether the structure should be characterized as foreign or domestic. It remains to be seen what approach will be adopted in the promulgated new law.

National Security Review

The draft overhauls the current national security review regime (embodied in certain lower-level regulations issued by the General Office of the State Council) by (i) expanding the scope of matters subject to review from investments in certain enumerated businesses/sectors to any foreign investment which damages or may damage the national security of China, and (ii) establishing judicial immunity for national security review cases, meaning that decisions in national security reviews will not be subject to any administrative review or administrative litigation proceedings. The draft also provides a framework on the review process.

Reporting Regime

In conjunction with the Chinese government's efforts to ease upfront approval requirements for each single foreign investment, the draft provides comprehensive reporting requirements on foreign investors, including (i) initial reporting upon the consummation of the foreign investment, (ii) subsequent reporting after occurrence of changes, and (iii) periodic reporting for foreign

[2] Note: Under the current regime, FIEs (which by definition are incorporated in China) can effectively be treated as domestic investors under certain conditions.

investors whose operations in China exceed defined thresholds. It is also worth noting that the scope of matters to be reported is very extensive.

The draft also provides certain guidelines and policy framework for statistics collection and compiling, promotion and protection as well as coordination among foreign investors and the governmental authorities for foreign investments. The draft law, if passed and promulgated in its current form, will have far-reaching impact on the entire foreign investment regulatory regime in China.

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