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YOUR DELAWARE ADVANTAGE

Tips From the Trenches: Recent Developments in Delaware

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What's New in Delaware Law and Practice?

- Public Company M&A
  - Third Party Deals: Does Sound Process Still Matter? *(C&J Energy Services, Inc.)*
  - The Value of an Uncoerced, Fully Informed Vote *(Corwin v. KKR Financial)*
  - Independence of Directors: A Sharper Focus? (*In re Sanchez*)
  - Section 102(b)(7) Exculpation (*Cornerstone*)
- Private Company M&A
  - Indemnification, Releases, and Post-closing Adjustments After *Cigna*
- 2015 Amendments
  - Fee shifting and forum selection provisions
  - Delaware Rapid Arbitration Act
- The Judiciary: A New Era

Public Company M&A Developments

C&J Energy Services, Inc.

- *C&J Energy Services, Inc. v. City of Miami General Employees' and Sanitation Employees' Retirement Trust* (Del. Dec. 19, 2014) (Strine, C.J.)
  - C&J agreed to acquire a division of its competitor, Nabors, through a merger for cash and stock worth $2.8 billion.
  - Although Nabors would own 53% of the outstanding stock in the resulting company, C&J obtained post-closing governance provisions designed to limit Nabors' ability to exercise control and to preserve C&J stockholders' right to a premium.
  - Single-bidder process, with a passive post-signing market check: no-shop with fiduciary out; ability to terminate to take a better deal; and "modest" 2.27% termination fee.
- The Court of Chancery issued a mandatory injunction:
  - Despite the absence of a topping bidder, any evidence of a board-level conflict of interest, or a valid disclosure claim, the Court entered an injunction requiring C&J to conduct a 30-day solicitation effort.

C&J Energy Services, Inc.

- The Supreme Court reversed:
  - The Court did not consider whether the governance provisions that limited Nabors' control and preserved a future control premium for C&J's stockholders had the effect of taking the transaction out of *Revlon*. The Court assumed *Revlon* applied.
  - *Revlon*'s focus is on whether the board's "overall course of action was reasonable under the circumstances as a good faith attempt to secure the highest value reasonably attainable."
  - No evidence that the directors had an improper motive.
  - "Passive" post-signing market check: Given the "modest" deal protections, "there were no material barriers that would have prevented a rival bidder from making a superior offer."
  - Stockholders had a fully informed, uncoerced opportunity to vote to accept or reject the transaction.
  - The Court of Chancery erred in issuing a mandatory injunction requiring C&J's independent directors to conduct an active market check. To issue a mandatory injunction, "the Court of Chancery must either hold a trial and make findings of fact, or base an injunction solely on undisputed facts."

C&J Energy Takeaways

- Confirms there is "no specific blueprint" to satisfy *Revlon*; no obligation to run an auction whenever the board pursues a change of control.
- A single bidder process *may* be appropriate, provided the board considers pros and cons, and there is an "effective" post-signing market check.
  - *C&J* should not be viewed as a blanket endorsement of a single bidder/passive market check process in all circumstances.
- Courts are likely to give stockholders the final word absent a competing bid.
- Not only was the Supreme Court critical of the "mandatory" injunction, but it also appeared skeptical of *Del Monte*-style injunctions that effectively "blue pencil" merger agreements: "[t]he record below did not provide a basis for the Court of Chancery to force Nabors to endure a judicially-ordered infringement of its contractual rights that would, by judicial fiat, not even count as a breach of Nabors' rights."
- *Open issue*: When and under what circumstances can post-closing governance provisions designed to limit a majority stockholder's voting rights and preserve a future control premium for the minority remove a transaction from *Revlon* scrutiny?

Corwin v. KKR Financial

- *Corwin v. KKR Financial Holdings LLC* (Del. Oct. 2, 2015) (Strine, C.J.).
- Plaintiffs challenged stock-for-stock merger in which KKR & Co. L.P ("KKR") acquired KKR Financial Holdings LLC ("Financial Holdings") at a 35% premium to the unaffected market price.
- Plaintiffs argued that the transaction was subject to entire fairness review because (i) the primary business of Financial Holdings was financing KKR's LBO activity, and (ii) an affiliate of KKR managed day-to-day operations of Financial Holdings.
- Court of Chancery earlier held that plaintiffs failed to plead facts supporting an inference that KKR was controlling stockholder of Financial Holdings.
- On appeal, plaintiffs argued that the trial court erred in dismissing the case because, if entire fairness did not apply, the case should have been reviewed under the *Revlon* standard of review.
- Without reaching whether *Revlon* applied, the Supreme Court held that an uncoerced, fully informed stockholder vote invokes the business judgment rule and therefore is outcome-determinative, even if *Revlon* applied.

Delaware County v. Sanchez

- *Delaware County Employees Retirement Fund v. Sanchez* (Del. Ch. Oct. 2, 2015) (Strine, C.J.).
- Plaintiffs challenged a transaction between a private company whose equity was wholly owned by the family of A.R. Sanchez and a public company in which the Sanchez family owned 16% of the equity.
- Court of Chancery dismissed the complaint finding that the plaintiffs had not pled demand excusal under *Aronson* (no more than 2 of the 5 directors were interested and/or not independent).
- On appeal, the Supreme Court held that plaintiffs had pled particularized facts that created a reasonable doubt about the independence of a third director, Alan Jackson.
- Challenges to Mr. Jackson's independence focused on:
  - Allegation that Mr. Jackson and Chairman Sanchez have been close friends for 5 decades
  - Allegation that Mr. Jackson's personal wealth is largely attributable to business interests over which Sanchez has substantial influence.
- Under de novo review, Supreme Court finds that the pled facts, taken together, support an inference that a majority of the board lacked independence.

Section 102(b)(7) Exculpation (*Cornerstone*)

- *In re Cornerstone Therapeutics Inc. S'holder Litig.* (Del. May 14, 2015) & *Leal v. Meeks* (Del. May 14, 2015) (Strine, C.J.).
  - Independent directors who are protected by a Section 102(b)(7) exculpatory provision will be entitled to dismissal from a breach of fiduciary duty case unless the stockholder plaintiff asserts well-pled, non-exculpated claims against the independent directors.
  - This rule applies even in cases challenging controlling stockholder transactions.
  - Resolved a split in authority and clarified prior Supreme Court precedent.
    - Numerous Court of Chancery decisions had read the Supreme Court's decision in *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001) to hold that, if the entire fairness standard applies to a controlling stockholder merger, the independent directors must remain as defendants through trial.
  - A plaintiff can plead non-exculpated claims against an independent director by "pleading facts supporting a rational inference that the director harbored self-interest adverse to the stockholders' interests, acted to advance the self-interest of an interested party from whom they could not be presumed to act independently, or acted in bad faith."
  - Note: The protections of Section 102(b)(7) do not extend to injunctive relief.
  - Even if dismissed from a case, independent directors will still be subject to discovery and will remain likely witnesses.

Private Company M&A Developments

Indemnification, Releases, and Post-closing Adjustments After *Cigna*

- *Cigna v. Audax* (Del. Ch. Nov. 26, 2014) (Parsons, V.C.)
  - Audax, a privately held company, was acquired via a merger.
  - Letter of transmittal included a broad release of claims against the buyer and a provision requiring each stockholder to indemnify the buyer for breaches of Audax's reps/warranties up to the stockholder's pro rata amount of the merger consideration.
  - Cigna, a preferred stockholder, declined to consent to the merger and refused to execute the LOT; the buyer withheld the merger consideration.
  - Release obligation was unenforceable for lack of consideration.
  - Indemnification obligations, although they also were included in the merger agreement, were uncapped and unlimited in duration; as a result, they were unenforceable against non-consenting stockholders.
    - The Court reasoned that this exceeded the limits of the ability to use a facts ascertainable provision under Section 251(b) of the DGCL.
  - The Court emphasized that the holding was limited to the specific facts at issue.

- *Boldin v. Green States Energy, Inc.* (Apr. 23, 2015 transcript) (Laster, V.C.)
  - Vice Chancellor Laster declined to grant a TRO enjoining a merger, but suggested that flawed disclosures and improper structural features could support a post-closing monetary remedy.
  - The Vice Chancellor noted that the LOT contained provisions purporting to require non-consenting stockholders to grant releases and indemnify the buyer, which provisions, in the Vice Chancellor's view, are invalid under Delaware law.

Indemnification, Releases, and Post-closing Adjustments After *Cigna*

- Takeaways
  - Generally, merger agreements may not impose obligations on non-consenting, non-signatory stockholders.
  - Letters of transmittal may not condition receipt of merger consideration on non-consenting stockholders granting releases or agreeing to accept additional obligations, such as direct indemnity obligations. (*See also Roam-Tel Partners v. AT&T Mobility Wireless Operations Holdings Inc.* (Del. Ch. Dec. 17, 2010) (Strine, V.C.).)
  - Alternative structures are possible:
    - Support agreements signed by insiders and significant stockholders (agreeing to be bound by release and indemnification provisions).
    - Requiring, as a condition to closing, that a certain percentage of stockholders sign joinder agreements (agreeing to be bound by release and indemnification provisions).
    - Indemnification escrow structure.
    - Reps and warranties insurance policies.
    - Well-structured drag-along provisions (requiring signatory stockholders to approve future CIC transactions and agree to certain post-closing obligations).
      - Note: *Halpin v. Riverstone National, Inc.* (Del. Ch. Feb. 26, 2015) (Glasscock, V.C.) (holding that contractual waiver of appraisal rights contained in drag-along provision was not applicable because corporation failed to comply with terms of drag-along).

2015 Amendments

2015 DGCL Amendments

- Prohibition on Fee Shifting Bylaws:
  - The amendments to Sections 102(g) and 109(b) prohibit certificate of incorporation and bylaw provisions that impose liability on stockholders for the corporation's litigation fees and expenses in connection with "internal corporate claims."
  - Amendments apply only to stock corporations and do not disturb the ruling in *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014), as it applies to non-stock corporations.
- Validation of forum selection bylaws:
  - Under new Section 115, certificates of incorporation and bylaws may contain provisions requiring that "internal corporate claims" be litigated solely and exclusively in Delaware.
  - The new statute is consistent with the Court of Chancery's ruling in *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013).
  - Charter and bylaw provisions cannot select a non-Delaware forum as exclusive.

Delaware Rapid Arbitration Act ("DRAA")

- Adopted in response to federal dismantling of Court of Chancery arbitration statute.
- Purpose: To give Delaware business entities an efficient, cost-effective method to privately resolve complex business disputes rapidly through voluntary arbitration conducted by expert arbitrators.
- At least one party must be a Delaware organized entity or have its principal place of business in Delaware. Not applicable to agreements with consumers.
- Agreement to arbitrate:
  - must be executed by the parties to the arbitration (thus, cannot force non-signatory stockholders to arbitrate under the DRAA)
  - should expressly reference DRAA
  - arbitration provisions must be governed by Delaware law; parties may select laws of another jurisdiction to govern other portions of the agreement
- Parties free to structure arbitration rules and process. In the absence of agreement, DRAA establishes default rules. Under certain circumstances, arbitrator may be appointed by Court of Chancery.
- Requires completion of arbitration within 120 days of arbitrator's acceptance of appointment (one extension of up to 60 days may be permitted). Failure to meet deadlines results in reduced fee to arbitrator.
- To limit pre-arbitration judicial disputes over the scope of arbitration, arbitrators are vested with authority to determine issues of substantive and procedural arbitrability.
- Appeals are to the Delaware Supreme Court (grounds for challenge limited to those permitted under FAA).
- Alternatively, the parties can waive appeals or, to maintain private process, agree to arbitral appeals.
- No appeals from interim rulings of the arbitrator.

Delaware Rapid Arbitration Act

- Most likely to be used for disputes between parties with long-term business relationships.
  - Companies engaged in significant commercial relationship outside of underlying transaction.
  - Commercial licensing.
  - Joint ventures.
  - PE/VC investments.
- In the M&A context, more likely to be used in private company M&A.
  - Disputes relating to purchase price adjustments, earnouts, and indemnification.
    - DRAA permits parties to select a non-legal arbitrator (such as an accountant).
    - Arbitrator may retain legal counsel to decide legal issues arising during the course of arbitration.
  - Pre-closing disputes (such as MAE disputes, satisfaction of other closing conditions, alleged breaches of interim operating covenants).

The Judiciary:
A New Generation

The Delaware Judiciary
Supreme Court and Court of Chancery: A New Era

- Supreme Court (Four new members in the past 2 years)
  - Chief Justice Leo E. Strine, Jr. (February 2014)
  - Justice Randy Holland (1986)
  - Justice Karen L. Valihura (July 2014)
  - Justice James T. Vaughn, Jr. (October 2014)
  - Justice Collins J. Seitz, Jr. (April 2015)
- Court of Chancery (Two new members since 2014; third pending)
  - Chancellor Andre Bouchard (May 2014)
  - Vice Chancellor John Noble (Dover) (retirement announced)
  - Vice Chancellor Tamika Montgomery-Reeves (November 2015)
  - Vice Chancellor J. Travis Laster
  - Vice Chancellor Sam Glasscock, III (Georgetown)

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