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Delaware M&A Quarterly

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Spring 2018

Delaware Courts Issue Appraisal Awards below Merger Price

In the first quarter of 2018, the Delaware Court of Chancery issued two appraisal decisions, and the Delaware Supreme Court affirmed an earlier appraisal decision, each of which made an appraisal award below the applicable merger price. The effect of these decisions is likely to continue to decrease the attractiveness of appraisal litigation as an investment strategy.

In the first decision, *Veriton Partners Master Fund Ltd.* v. *Aruba Networks, Inc.*, the Delaware Court of Chancery, in an opinion by Vice Chancellor Laster, appraised the fair value of Aruba Networks, Inc. to be about 30.6% less than the agreed deal price in its acquisition by Hewlett-Packard Company. While recent Delaware Supreme Court decisions in *Dell, Inc.* v. *Magnetar Global Event Driven Master Fund Ltd.* and *DFC Global Corp.* v. *Muirfield Value Partners, L.P.* (discussed here and here) have strongly urged reliance on deal price in determining fair value in such situations, the court found Aruba's 30-day average unaffected stock price, and not deal price, to be the most reliable indication of fair value (despite the existence of arm's-length negotiations and Aruba's status as a widely held, public company), in part because possible human error in estimating the deal's significant synergies (which must be subtracted from the deal price in a Delaware appraisal action) made the deal price a less reliable indication of fair value than the unaffected stock price. For more, click here.

In the second decision, the Court of Chancery, in an opinion by Vice Chancellor Glasscock, relied solely on its own discounted cash flow ("DCF") analysis to appraise the fair value of AOL Inc. below the deal price paid in its acquisition by Verizon Communications Inc. While reiterating that deal price is the best evidence of fair value and must be taken into account when appraising "*Dell*-compliant" transactions, the court held this was not such a transaction. The court found that certain of the deal protections combined with informational disparities between potential bidders and certain actions of the parties were preclusive to other bidders, and therefore, the court assigned no weight to deal price in its fair value determination. Applying its own DCF analysis, the court ultimately determined fair value to be approximately 3% lower than the deal price (possibly due to synergies, which must be excluded from the court's fair value determination under the Delaware appraisal statute). For more, click here.

Finally, the Delaware Supreme Court summarily affirmed the Court of Chancery's earlier decision (discussed here) appraising the fair value of SWS Group, Inc. to be approximately 8% lower than the deal price in its acquisition by Hilltop Holdings, Inc., again due to high synergies in that strategic transaction. For the Supreme Court's order, click here.

Delaware Supreme Court Holds Reasons for Director's Vote Abstention to be Material Information

In *Appel* v. *Berkman*, the Delaware Supreme Court (in an opinion by Chief Justice Strine reversing an earlier Court of Chancery decision) found that the failure to disclose the reasons that the chairman of the board of the target company chose to abstain from the board of directors' vote to approve the sale of the company constituted a disclosure violation. While the company disclosed that the chairman (who was also the company's founder and largest stockholder) did abstain, and that he had not yet determined whether to tender his shares, the Supreme Court explained that his reasons for abstaining (*i.e.*, his belief that the company had been managed sub-optimally, which negatively affected the sale price) were material when contrasted with other company disclosures supporting the transaction. For the Supreme Court's opinion, click here.

Delaware Court of Chancery Holds that *MFW Ab Initio* Requirement Satisfied Where Protections Agreed to Before Negotiations

In *In re Synutra International Inc. Stockholder Litigation*, the Delaware Court of Chancery, in an order granting defendants' motion to dismiss by Vice Chancellor Laster, held, in part, that the business judgment rule applied to the buyout of Synutra International Inc. by a control group under *Kahn* v. *M&F Worldwide* ("*MFW*") (discussed here). Plaintiffs in the fiduciary duty action alleged that the transaction did not satisfy the *ab initio* requirement of the *MFW* framework (*i.e.*, that to qualify for business judgment review, a controlling stockholder going-private transaction must be conditioned *ab initio* upon both (i) the approval of an independent, adequately empowered special committee that fulfills its duty of care and (ii) the uncoerced, informed vote of a majority of the minority stockholders) because the controller's initial offer was not conditioned on obtaining the required *MFW* protections. Instead, the controller conditioned its offer two weeks later, which importantly was after a special committee had formed and before negotiations began. The court, in dismissing the plaintiff's claims, found that this timing (*i.e.*, where the conditions are announced prior to initiation of negotiations) satisfied the *MFW ab initio* requirement. For the court's order, click here.

Delaware Court of Chancery Issues Opinions Considering When Minority Stockholders are Deemed to be Controllers

In two opinions issued this quarter, the Delaware Court of Chancery considered whether minority stockholders constituted controllers of the respective companies. In *In re Rouse Properties, Inc. Fiduciary Litigation*, the Court of Chancery, in an opinion by Vice Chancellor Slights, held, in connection with a stockholder challenge to the acquisition of Rouse Properties Inc. by its 33.5% stockholder, Brookfield Asset Management, Inc., that Brookfield did not constitute a controlling stockholder such that *MFW* would apply to the transaction. Instead, the court found that *Corwin* applied to the transaction, and because the stockholder vote approving the transaction was not coerced or uninformed, business judgment review applied to the transaction, and the court dismissed the claims against the board. The court observed that the case was indicative of a pattern arising in post-closing challenges to corporate acquisitions where a minority stockholder sits on either side of the transaction, and the corporation has not taken steps to neutralize the stockholder's presumptively coercive influence (because it does not recognize the stockholder as a controller), although the company had established a special committee here. In such cases, stockholder plaintiffs, like the plaintiffs in *Rouse*, plead facts with the hope of showing that the minority stockholder is a controller such that *MFW* applies to the transaction, and failing that, plead facts to support a reasonable inference that the stockholder vote was coerced or uninformed such that *Corwin* does not apply. For the decision, click here.

Contrast *In re Tesla Motors, Inc. Stockholder Litigation*, however, where the court (in an opinion by Vice Chancellor Slights) declined to grant defendants' motion to dismiss because the court found it reasonably conceivable that Elon Musk, a 22.1% stockholder of Tesla Motors, Inc., was a controlling stockholder and therefore Tesla's 2016 acquisition of

SolarCity Corporation (of which Musk was the largest stockholder and founder) would be subject to a stringent entire fairness review. In this regard, it is rare for Delaware courts to find that a stockholder with such "relatively low" ownership levels is a controller. They have done so only, as was the case here, where there is other evidence that the stockholder exercised "actual domination and control over . . . [the] directors" and wielded more power than may be evidenced by the stockholder's minority holdings. The court's conclusion that Musk was a controller meant that stockholder approval of the acquisition did not ratify the transaction and invoke business judgment review because *Corwin* v. *KKR Financial Holdings LLC* does not apply to controller transactions. For more on *Tesla*, click here.

Delaware Court of Chancery Finds Nominal Damages to be Only Available Remedy for Breach of Fiduciary Duty in Connection with Self-Interested Option Grants

In *The Ravenswood Investment Company, L.P.* v. *The Estate of Bassett S. Winmill*, the Delaware Court of Chancery found, in an opinion by Vice Chancellor Slights, that the grant of stock options by the directors of Winmill & Co., Incorporated to themselves were subject to entire fairness review, and, given the "thin" process to determine whether to grant the options, the court found that the directors breached their fiduciary duty of loyalty with respect to the option grants having failed to meet the stringent standard of review. However, the court found that plaintiff had failed to demonstrate any proper form of damages as possible remedies for the breach of fiduciary duty. There was no evidentiary basis for compensatory damages; rescission or rescissory damages were not available because the company lacked sufficient funds to repay the defendants what they had already paid for their options, and there was no basis for cancellation as a remedy. While the court noted that specific performance of certain promissory notes that the company forgave in favor of the directors might be an available remedy, plaintiff did not seek it. In the end, the only damages that the court found to be available were nominal damages. The court did acknowledge that plaintiff was requesting attorneys' fees and that it would consider that request separately. For the opinion, click here.

Delaware Court of Chancery Declines to Apply Implied Covenant of Good Faith and Fair Dealing Where Minority Receives Little or No Consideration in Merger

In *Miller* v. *HCP & Co.*, the Delaware Court of Chancery, in an opinion by Vice Chancellor Glasscock, dismissed an action brought by minority unitholders of Trumpet Search, LLC, challenging the sale of the limited liability company to an unaffiliated third party for $43 million after the board determined not to conduct a broad auction for the company. The sale was championed by HCP & Company and its affiliates, the company's largest unitholder, who controlled the board. Under a waterfall provision in the operating agreement, HCP would receive the first $30 million in proceeds and the remaining unitholders would receive little or no proceeds. The operating agreement also permitted the board to determine the manner in which a company sale occurred, provided the sale was to an unaffiliated third party, and waived all fiduciary duties. In the motion to dismiss, the court held that there was no gap in the operating agreement to which the implied covenant would apply, because to do so would be to "rewrite a contract simply because a party now wishes it had gotten a better deal." The court held that it was all the more hesitant to apply the implied covenant due to the elimination of fiduciary duties in the operating agreement, which "'implies an agreement that losses should remain where they fall' rather than being shifted after the fact through fiduciary duty review." For the opinion, click here.

Delaware Court of Chancery Addresses Issues in Stockholders' Agreements

This quarter, the Delaware Court of Chancery engaged in two instances of interpreting stockholders' agreements. In the first, *Schroeder* v. *Buchanic*, the Court of Chancery, in an order granting plaintiffs' motion for judgment on the pleadings by Vice Chancellor Laster, rejected the attempt of holders of a majority of the company's common stock to act by written consent to remove and replace the company's CEO on the board. The dispute centered around language in the applicable stockholders' agreement that required the parties to vote to ensure that the board included "three (3) representatives

designated by the holders of a majority of the Common Stock, one of whom shall be the Chief Executive Officer of the Company." The stockholders seeking to remove the CEO argued that this language required the board to appoint a CEO whom a majority of the common stock supported as their designee. The court rejected this interpretation, finding that the language instead required the subject stockholders to vote to ensure that the corporation's CEO (who was selected by the board) is one of the three designees. For the court's order, click here.

In the second opinion, *Southpaw Credit Opportunity Master Fund, L.P.* v. *Roma Restaurant Holdings, Inc.*, the court, in an opinion by Vice Chancellor Montgomery-Reeves, held that a stock issuance made by the board under a new equity compensation plan with the purpose of diluting a group of stockholders who recently acquired additional shares of stock on the open market was void under the terms of the applicable stockholders' agreement. Specifically, the court pointed to provisions in the stockholders' agreement that (i) prohibited the issuance of shares to any person who had not already signed a joinder to that agreement and (ii) declared that stock issued in violation of this requirement was void *ab initio*. Notably, the court clarified that it was not analyzing the issue of whether stock issued in violation of any contractual obligation is void or voidable under Delaware law. Instead, it noted that issuances made in violation of a governing instrument are void under Delaware law, and because defendants did not contest the plaintiffs' argument that the stockholders' agreement was a governing instrument, defendants had waived the issue. For the opinion, click here.

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M&A Markets

The following issues of M&A at a Glance, our monthly newsletter on trends in the M&A marketplace and the structural and legal issues that arise in M&A transactions, were published this quarter. Each issue can be accessed by clicking on the date of each publication below.

- January 2018
- February 2018
- March 2018

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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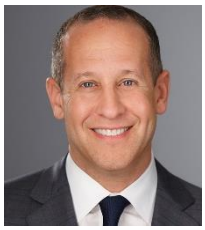

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