*a few things you should know …*

# What's Happening in Delaware M&A – Spring 2017

## *Director Independence*

- *PERSONAL AND PROFESSIONAL CONNECTIONS MAY UNDERMINE DIRECTOR INDEPENDENCE*

In *Sandys v. Pincus*, the Delaware Supreme Court held, in a rare 4-1 split decision, that certain personal and professional ties among Zynga, Inc.'s ("Zynga") founder and controlling stockholder, Mark Pincus, and three of Zynga's directors were sufficient to render the directors as non-independent. As three of the six other Zynga directors were clearly non-independent, the court excused the plaintiff stockholder from making a pre-suit demand in a derivative action involving claims of breaches of fiduciary duty and improper approval of an insider stock sale. The court found that one of the directors in question could not be independent because she and her husband co-owned a private airplane with Mr. Pincus, which, according to the court suggested "an extremely intimate personal friendship" that would likely hinder that director's ability to act impartially. The court also rejected the defendants' assertion as to the independence of two other directors who were partners in a venture capital firm that owned 9.2% of Zynga's equity, primarily on the basis that Zynga's board had not designated either such director as "independent" under Nasdaq listing standards. In addition to the Nasdaq determination, the court examined various overlapping business interests between Mr. Pincus and the two venture capital directors (and their firm), noting that such interests, while common with venture capital investors, could compromise the directors' ability to act impartially.

- Impact: Director independence can be a critical tool both in evaluating and approving corporate transactions and in establishing litigation defenses. Companies, and particularly controlled companies, should be aware of the various ways in which plaintiffs may challenge the independence of directors previously presumed to be independent – some of which may not be obvious. *Sandys* highlights that a company's determination as to whether an individual director may be "independent" for the relevant stock exchange rules might also determine that director's independence under Delaware law. Directors appointed by venture capital and private equity funds, and the companies on whose boards such directors sit, should also carefully evaluate potential interlocking relationships that could impair a director's ability to act impartially.

## *Evaluating Disclosure Claims in Private Company Mergers*

- *DELAWARE CHANCERY COURT EXAMINES ADEQUACY OF PRIVATE MERGER DISCLOSURE STATEMENT IN SHORT-FORM MERGER; REJECTS QUASI-APPRAISAL REMEDY*

"Quasi-appraisal" is an uncommon post-closing remedy that Delaware courts may award in cases where stockholders receive insufficient information to decide whether to accept the merger consideration or seek appraisal, therefore resulting in irreparable injury. In such circumstances, the court may permit the plaintiff stockholders to maintain a quasi-appraisal action to determine the fair value of their shares, despite the fact that the plaintiffs failed to comply with the statutory appraisal requirements (e.g., they might have voted for the merger and/or received the actual merger consideration). In *In re United Capital Corp., Stockholders Litigation*, minority stockholders of United Capital Corp. ("United Capital") sought quasi-appraisal in connection with a merger between United Capital and its controlling stockholder, which was effected by Section 253 of the Delaware General Corporation Law (also known as a "short-form" or "squeeze-out" merger). Specifically, the minority stockholders alleged that the disclosure statement sent to all stockholders prior to closing contained numerous material omissions, including with respect to financial projections, the company's working capital and future use of cash, and the special committee's process in determining a fair price, ultimately resulting in a breach of the duty of disclosure. The court examined each of the alleged disclosure violations separately and dismissed them all, noting in particular that the pre-merger notice was eighty-pages long, contained comprehensive information regarding the company's business and financial performance, discussed factors considered by the special committee in determining the merger price was fair, and described various board and special committee conflicts. The notice also attached financial statements for the current and prior two fiscal years and included an extensive analysis from management as to the company's financial performance (including certain forward-looking information); given this breadth of financial information disclosed, it

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was unclear how financial projections would be material to the "total mix" of information available. Because the plaintiffs failed to show fraud, illegality or a disclosure violation, the court concluded that the plaintiff minority stockholders' sole remedy in challenging the short-form merger was appraisal.

- Impact: Although it does not establish any new rules or tests, the Chancery Court's analysis of the alleged disclosure violations in this case is illuminating for M&A practitioners and private company boards alike. The opinion underscores the importance and value in providing thorough disclosure – especially financial data – in connection with private company mergers, and serves as a useful reminder to evaluate the adequacy of disclosure not based on any one particular piece of data, but rather based on the "total mix" of information available to facilitate a stockholder's decision to exercise appraisal.

## *Resolving Post-Closing Purchase Price Adjustments*

- *DELAWARE CHANCERY COURT HONORS CONTRACTUAL AUTHORITY OF "INDEPENDENT AUDITOR" IN PURCHASE AGREEMENT; REFUSES TO RESOLVE $2 BILLION WORKING CAPITAL DISPUTE*

In December, the Delaware Chancery Court ruled that the plain language of a purchase agreement required the parties to resolve their approximately $2 billion dispute regarding the calculation of the purchase price with an independent auditor. *Chicago Bridge & Iron Co. N.V. v. Westinghouse Electric Co. LLC*. Westinghouse Electric Company LLC ("Westinghouse") purchased the nuclear construction business of Chicago Bridge & Iron Company N.V. ("CB&I") for no cash up front, subject to a post-closing purchase price adjustment based on closing working capital (among other items), and potential future contingent consideration. The purchase agreement contained a typical post-closing purchase price resolution mechanism. It required CB&I to submit a pre-closing good faith estimate of the working capital, and it required Westinghouse to deliver a post-closing calculation of working capital. Each statement had to be prepared in accordance with GAAP and consistent with certain identified accounting principles. Following delivery by Westinghouse of its post-closing statement, the purchase agreement provided CB&I with 60 days to raise any objections; if it did raise objections and the parties could not resolve their dispute within 30 days, either party could then refer the dispute to an independent auditor. Once invoked, the independent auditor process became mandatory. Westinghouse's post-closing statement identified a working capital deficiency of more than $2 billion, in large part because certain items in CB&I's estimate were not GAAP-compliant. During the 60-day review period, CB&I filed an action in the Chancery Court for declaratory relief, advancing two principle arguments. First, it argued that Westinghouse was effectively precluded from raising GAAP objections. In this regard, it noted that CB&I made representations and warranties elsewhere in the purchase agreement regarding the target business's financial statements being GAAP-compliant, and those representations and warranties did not survive the closing. Second, CB&I argued that Westinghouse's calculation breached the implied covenant of good faith and fair dealing. The court rejected both arguments. In doing so, the court noted that the "no-survival" provision regarding the representations and warranties expressly stated that it shall not operate to interfere with the provisions regarding resolution of the purchase price, and that the plain language of the purchase agreement established that disputes over the purchase price were to be resolved by the independent auditor. The court also refused to entertain CB&I's argument regarding the implied covenant of good faith and fair dealing since the purchase agreement sufficiently addressed each party's responsibilities with respect to resolving a purchase price dispute, and the implied covenant should not be used to infer language that contradicts the parties' express intentions. Of note, the court specifically stated that the size of the potential dispute should have no bearing on the authority of the independent auditor.

- Impact: As noted, the post-closing purchase price adjustment mechanism included in the purchase agreement was typical for transactions of this type. *Chicago Bridge & Iron* is an important reminder of the necessity to draft clear, unambiguous provisions regarding how the parties to a transaction will resolve disputes and to think carefully about the limits of authority, if any, the parties may wish to impose on independent auditors and other non-tribunal arbitrators. GAAP-related issues, particularly as they relate to working capital adjustments, can often be complex and it behooves parties to an M&A transaction to work with their accountants, lawyers and other advisors in anticipating such issues and identifying potential disagreements.

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## *The Business Judgment Rule and Fully Informed Stockholder Votes*

- ***FOLLOWING CORWIN, DELAWARE CHANCERY COURT CONSISTENTLY DEFERS TO FULLY INFORMED, DISINTERESTED STOCKHOLDER VOTES AND NARROWS THE APPLICABILITY OF THE ENTIRE FAIRNESS STANDARD TO THESE TRANSACTIONS***

In a series of recent opinions, the Delaware Chancery Court reinforced the rule of giving deference to the vote of fully informed, disinterested stockholders in connection with post-closing breach of fiduciary duty claims, as previously articulated in *Corwin v. KKR Financial Holdings LLC*, *Singh v. Attenborough* and *In re Volcano Corp. Stockholder Litigation*. Drawing upon those cases, in *City of Miami General Employees' and Sanitation Employees' Retirement Trust v. Comstock*, Chancellor Bouchard examined whether to review a merger under the "entire fairness" standard based on allegations that directors of C&J Energy Services, Inc. were subject to conflicts of interest and had been deceived by the company's Chief Executive Officer in approving a merger. Finding the plaintiff's allegations to be without merit and noting that the requisite uncoerced, fully informed and disinterested stockholders had approved the transaction, the court applied the business judgment rule and dismissed the breach of fiduciary duty claims. The following day, in *Larkin v. Shah*, Vice Chancellor Slights declined to apply a *Comstock*-like analysis of whether an allegedly flawed process invokes entire fairness review. The *Larkin* court held that absent the presence of a controlling stockholder who extracts personal benefits from a transaction, the business judgment rule irrebuttably applies to a deal approved by the requisite disinterested, uncoerced and fully informed stockholders. The *Larkin* court further clarified that the only transactions subject to entire fairness that cannot be cleansed by proper stockholder approval are those involving a controlling stockholder. Once obtained, proper stockholder approval restores the application of the business judgment rule for transactions that might otherwise be tainted by facts indicating that a majority of board members breached their fiduciary duties, but not for transactions involving a conflicted controlling stockholder. The court went on to state that coercion is inherent, and entire fairness is invoked, in a conflicted transaction involving a controlling stockholder because the controller stands on both sides of the deal or stands on only one side of the deal "but competes with the common stockholders for consideration." After *Larkin*, post-closing cases alleging breach of directors' fiduciary duties outside the controlling stockholder context have focused on the adequacy of the disclosures supplied to stockholders regarding the proposed transaction. In each of *In re Om Group, Inc. Stockholders Litigation*, *In re Solera Holdings, Inc. Stockholder Litigation*, and *In re Merge Healthcare Inc. Stockholders Litigation*, the Chancery Court examined the disclosures contained in the companies' respective proxy statements. In each case, the court found that the disclosures were adequate and, absent the presence of a controlling stockholder and any allegation of waste, the cleansing vote of the disinterested stockholders rendered the board's decision on the transaction subject to the business judgment rule. In *In re Merge Healthcare*, the court, following *Larkin*, found that even if the board chairman who held 26% of the company's stock was a controlling stockholder, the transaction was not subject to entire fairness because his interests were fully aligned with those of the other stockholders. The court went on to discuss the standard for satisfying "fully informed," explaining that the threshold inquiry is whether the alleged omission or misrepresentation is material. A board's subjective motivation or opinion is not *per se* material as long as the facts material to the transaction are accurately disclosed—"'asking "why" does not state a meritorious claim' under [Delaware] law." The court further noted that information need not be disclosed merely because a plaintiff alleges it would be helpful or interesting. On the contrary, the court noted that a company is not required to provide all financial data that would allow stockholders to make an independent determination of value, and that disclosure of any financial analyses performed by investment bankers "must be sufficient for the stockholders to usefully comprehend, not recreate, the analysis."

- Impact: *Corwin* and its progeny have made it increasingly difficult for plaintiffs to bring post-closing damages claims in merger transactions. Since *Corwin*, Delaware courts have consistently applied the business judgment rule to transactions approved by the requisite disinterested and fully informed stockholders where no controlling stockholder was present. In light of recent decisions, the most viable post-closing challenge to a board's exercise of its fiduciary duties lies in the adequacy of disclosures made to stockholders when soliciting their approval. As such, the sufficiency of full and fair disclosure to stockholders is critical to invoking the deferential presumption of the business judgment rule and the best protection for companies defending against a challenge to the adequacy of their disclosure or their process.

## *"Disclosure-Only" Settlements*

- *NEW YORK ESTABLISHES NEW FACTORS FOR APPROVAL OF DISCLOSURE-ONLY SETTLEMENTS*

  In *Gordon v. Verizon Communications, Inc.*, the Appellate Division of the Supreme Court of New York reversed the trial court by approving the proposed settlement of a stockholder class action challenging the acquisition by Verizon Communications, Inc. ("Verizon") of Vodafone Group PLC's ("Vodafone") interest in the Verizon Wireless joint venture. In doing so, it clearly diverged from Delaware's recent rejection of disclosure-only settlements. The proposed settlement in *Gordon* provided for incremental disclosure relating to the financial advisor's valuation analysis, a requirement that Verizon obtain a fairness opinion from an independent financial advisor in connection with any future disposition of greater than five percent of Verizon's assets, and approval of attorneys' fees of up to $2 million for plaintiff's counsel. Certain Verizon stockholders objected to the non-monetary settlement on the grounds that it did not provide any material benefit to and was not in the best interests of the Verizon stockholders. Applying New York law as dictated by a choice of law clause in the proposed settlement agreement, the court held that all five of the factors that New York courts consider in reviewing proposed nonmonetary class action settlements under *In re Colt Industries Shareholder Litigation*, 553 N.Y.S.2d 138 (1st Dept. 1990): (1) the likelihood of success, (2) the extent of support from the parties, (3) the judgment of counsel, (4) the presence of bargaining in good faith, and (5) the nature of the issues of law and fact, weighed in favor of the proposed settlement. In addition, the court added two new factors to this test: whether the proposed settlement is in the best interest of the putative settlement class as a whole, and whether the settlement is in the best interest of the corporation. The court noted that there have been "a significant number of cases where courts have termed the benefits of the derivative litigation before them to be 'scant,' 'slight,' 'modest,' or even 'minimal,' and have nevertheless granted attorneys' fees, albeit fees largely reduced from the sums demanded." After determining that these additional factors also weighed in favor of approving the settlement, the court concluded that the benefits plaintiff's counsel obtained for Verizon's stockholders were sufficient to warrant an award of attorneys' fees, and remanded the matter to the trial court to determine the appropriate amount.

  - Impact: The holding in *Gordon* makes clear that disclosure-only settlements remain viable under New York law. In light of the Delaware Chancery Court's continued disfavor of disclosure-only settlements (as articulated in *In re Trulia, Inc. Stockholder Litigation*, 129 A.3d 884 (Del. Ch. 2016)), litigants favoring this type of remedy may increasingly look to New York as an alternate venue to the extent consistent with applicable exclusive forum bylaws and choice of law clauses. Companies looking to avoid potentially frivolous merger-related lawsuits now have an additional reason to consider adopting an exclusive forum bylaw.