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Cleary Gottlieb

M&A and Board Processes in 2016

Challenges and Conundrums for the West Coast

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REVIEW OF SALE PROCESSES UNDER REVLON

- During the LBO boom of the mid-2000s, the Delaware Court of Chancery was often critical of sale processes, especially single-bidder processes involving private equity acquirers, due to the risk of conflicts on the part of target management – even though the conflicts in most of these LBOs were subtle enough to avoid "entire fairness" scrutiny.
- Coming off of a strong cycle of acquisitions by strategics where the risk of conflicts is greatly reduced, the Court's recent Revlon cases where the claims are based on flawed sale processes suggest that there will be few injunctions and little likelihood of post-closing findings of breach, so long as there is good disclosure of the process pursued by the target board, an honest statement of the rationale for that process, and an absence of any totally irrational behavior (such as blatantly favoring one bidder or baselessly rejecting an alternative bidder).

REVIEW OF SALE PROCESSES UNDER REVLON (CONT'D)

- Is this a fair characterization of the direction of the Court?
- Will the primary pre-closing remedy in Revlon cases based on process claims be additional disclosure about the flaws of the sale process and adequate time for shareholders to digest that disclosure?
- If the rationale for not doing a "better" pre-signing market check is weak, but not the product of a conflict, will it be hard to establish a non-exculpated post-closing claim?
- Should there be more focus on the adequacy of process per the "heightened" scrutiny of Revlon, or does the availability of the remedy of adequate disclosure of material flaws in the process suffice to protect shareholders?
- How do quasi-appraisal claims fit into the rubric of Corwin v. KKR?

FINANCIAL ADVISOR ENGAGEMENT AND CONDUCT

- The recent Zale decisions by the Delaware Court of Chancery focused on whether conflicts on the part of the target's financial advisor, of which the target board was unaware at the time of its deliberations preceding the signing of the merger agreement, constituted a predicate breach of duty by the board and grounds for aiding and abetting liability on the part of the financial advisor.
  - These conflicts stemmed from financial analyses based on public information that the target's advisor had presented to the bidder during a pitch before the current engagement commenced and that suggested a bid price that coincided with the merger price being paid now in the actual merger.
  - The second Zale decision held that there was no predicate breach due to deference resulting from shareholder approval of the merger, per the Corwin decision.
  - That deference was available only because there had been full disclosure of the conflict in the proxy statement preceding shareholder approval.
- Subsequently, in the Rural Metro decision, the Delaware Supreme Court did not take any positions that contradicted the Zale decisions, but the tone of Rural Metro emphasized the need for scienter to establish aiding and abetting liability and disclaimed the idea that the target's financial advisor is a general "gate-keeper" of the board's compliance with its duty of care.
- Meanwhile, in an article in *The Business Lawyer*, a Morris Nichols partner who had clerked for two Chancery Court judges, advocated for detailed representations and covenants by financial advisors in their engagement letters as a means to identify conflicts.

FINANCIAL ADVISOR ENGAGEMENT AND CONDUCT (CONT'D)

- Tension between provision by financial advisors of full disclosure of potential conflicts to the target board as soon as possible to avoid embarrassment and liability versus practical impediments.
  - Walls within investment banks that make information relevant to conflicts unavailable
  - Confidentiality considerations – often the conflicts information is confidential to another client
  - Unwieldy number of bankers roaming the globe making presentations outside formal engagements
  - Unwieldy number of "likely" bidders at time of engagement of a target's financial advisor for a sale process
- When management teams and boards want to engage a financial advisor because they are familiar with the relevant business and known to add value, is there a general perception that the big banks are all conflicted but will nevertheless deliver good service and get the job done? What is the difference between a disabling conflict and a conflict that ought to be considered but is not disabling?
- In the tech sector, a small number of bankers regularly visit a company and its competitors, often the same day, to pitch ideas. How do you ensure that your financial advisory team will be loyal to you?

FINANCIAL ADVISOR ENGAGEMENT AND CONDUCT (CONT'D)

- In light of reforms in board room protocol and within investment banks since Rural Metro and Del Monte and further reform since Zale, what are the prospects for aiding and abetting liability going forward, especially in view of Rural Metro's scienter focus? Any risks for legal or other advisors beyond investment banks?
- The Corwin decision permitted the business judgment rule to apply to director conduct in approving mergers due to deference resulting from shareholder approval. Good news for directors. But the Corwin decision left open the possibility of finding of predicate breaches by the board for the purpose of establishing aiding and abetting claims against advisors if the plaintiffs can show that there is a "wide disparity" between what the directors actually did and what "would have been reasonable" to do. Will the Corwin decision really clear the docket? Will plaintiffs now scour the board record after closing in attempts to find these "wide disparities" so that they can establish aiding and abetting claims against advisors, despite shareholder approval based on full information?

COLLECTIVE ACTION IN PRIVATE M&A

- The collective action principle behind a merger provides the perfect structure for private M&A transactions where the target has a broad shareholder base, as is often the case in Silicon Valley (with shareholders frequently including not only management, founders and VC Funds, but also a significant number of low-level employees, former employees, strategic investors and individual, fund and institutional investors).
- The Delaware Chancery Court's Cigna decision made clear that the collective action of a shareholder vote cannot bind shareholders to the provisions in the merger agreement other than those specific to the strict definition of merger consideration. Excluded provisions include indemnity obligations and the appointment of a stockholder representative to settle indemnity claims.
- Some acrobatic techniques can be used within a merger agreement so that some of the otherwise "excluded" provisions appear as part of the definition of merger consideration.
- In addition, the ability to implement collective action with respect to these excluded provisions arguably already exists if comprehensive drag-along rights are drafted correctly and included in charters or in contractual agreements signed by all shareholders. But there is definitely room for improvement in the comprehensive drafting of drag-along provisions.
- Should the DGCL be amended to expand the definition of merger consideration, or otherwise to expressly provide for collective action for some of these provisions that are not part of the consideration to be paid at a merger's closing, but are critical to M&A where there are a significant number of non-insider stockholders?

CONFLICTS IN PRIVATE M&A

- Private M&A involving startups often involves conflicts, since the board of most startups consists solely of holders of preferred stock and members of management who both have special change in control benefits and, when the company is sold, typically benefit from generous retention pools.
- Such conflicts are relatively unimportant when the merger consideration is high enough that the payouts exceed the liquidation preference of the preferred stock, especially when the holders of common stock ultimately receive more than, or at least the same amount per share as, the holders of preferred stock.
- But if high prices were paid for common stock in earlier rounds (and arguably in a setting where there was asymmetry of information between the insiders and the new non-insiders investing in common stock) and, subsequently, the company is sold at a disappointing price, common stockholders may be disgruntled, as seen in the Trados and Nine Systems cases, as well as the Good Technologies case now being litigated.
- Both Trados and Nine Systems found the fair dealing/process prong of the entire fairness test could *not* be satisfied since, among other factors, target directors were all conflicted. Those cases instead focused on the fair price prong and both found the price to be fair – in Trados holding that there had been no breach of duty and in Nine Systems that there had been a breach but no damages had been suffered.

CONFLICTS IN PRIVATE M&A (CONT'D)

- As a practical matter, how can an acquirer manage the risk presented by acquisitions of startups with boards dominated by management and VC funds without any outside directors?
  - Special indemnification by the target insiders for appraisal claims and fiduciary duty breaches
  - Conditioning the merger on consent of a majority of the disinterested common holders
  - Requiring target and the preferred shareholders to adjust the charter's waterfall to result in more equitable treatment of all classes of shares
- In an entire fairness claim where the price was fair but the process flawed, is the right result to find a breach but no damages (as in Nine Systems) or to find no breach (as in Trados)? Does the nature and degree of the flaws in the process affect the answer?
  - Implications for director indemnification, availability of insurance, and plaintiffs' counsel fees

LITIGATION EFFICIENCY

- The number of class actions suits in the Delaware Chancery Court has been dropping since Vice Chancellor Glasscock's Riverbed decision and other holdings that rejected global releases in disclosure-only settlements.
- *The Chancery Daily* recently reported that it had observed a "pronounced decline" in the number of class action complaints filed in the last quarter of 2015, both as compared to prior months of that year, and as compared to prior months in 2014.
- Why should merger parties be able to obtain only a limited release in the event of a disclosure-only settlement? Shouldn't the parties be free to contract on a rational basis even in the case of weak lawsuit?
- Might companies be reluctant to adopt Delaware-exclusive forum bylaws due to a belief that they will be able to settle quickly, and more globally, if sued in another state?

LITIGATION EFFICIENCY (CONT'D)

- In Rural Metro, Robbins Geller objected to the global release in the disclosure-only settlement that a fellow plaintiffs' firm had negotiated. The rationale was that there might be more bases for breaches of duties present and that the then-lead plaintiff class counsel had not adequately investigated this potential. Why not leave the system to operate like this – with aggressive plaintiff firms like Robbins Geller policing when there is a flawed basis for a global release?
- Trends relating to parties' negotiating and agreeing to narrower releases, and voluntary withdrawal of weak cases.
- Disclosure claims by plaintiffs often focus on the banker book and on the financial advisor's past relationships, especially the amount of fees received by the financial advisor from the parties for past assignments. Should the final banker book and the conflicts memo be attached as annexes to all proxy statements, since these are produced in discovery anyway? Doing so would presumably remove numerous issues without any material prejudice to the financial advisor.

LITIGATION EFFICIENCY (CONT'D)

- In an article in the *Texas Law Review*, Vice Chancellor Laster suggested that the Court should re-examine the standard for what showing is needed to commence expedited pre-vote M&A litigation, a standard which has historically been quite low.
- Vice Chancellor Laster reasoned that removing the pressure of a potential preliminary injunction would give defendants time to evaluate the strength of the claim and determine whether to moot it with voluntary disclosure and leave the claim to be adjudicated in the ordinary course post-closing and with the potential benefit of Corwin.
- Does the Chancery Court have any appetite to make the standard for expedited discovery harder to satisfy? Might Delaware's generous standard for granting motions to expedite discovery drive corporations to choose exclusive forum out of the state?
- What are the attractive cases that plaintiffs are looking for, and what kind of cases will continue in this new regime?
- What dictates plaintiffs' counsel's decision on forum?

RELATED PARTY TRANSACTIONS

- Per the Delaware Supreme Court's MFW opinion, related party transactions can benefit from the business judgment rule if they have, from the time of the initial proposal, a condition of approval of an empowered special committee and of a majority of the disinterested shareholders. But requiring approval of a majority of the disinterested shareholders increases execution risk, especially by inviting hedge funds to hold a deal hostage.
- In addition, footnote 14 of the MFW opinion indicates that pleadings that allege "any reasonably conceivable set of facts" calling into question the price, process or disclosure would survive dismissal at the pleading stage.
- Thus, to benefit from MFW's business judgment rule safe harbor, there's an argument that one must essentially satisfy entire fairness anyway, and allegations questioning the adequacy of the negotiating tactics or independence of the special committee will preclude a win on the pleadings. Though in Swomley v. Schlecht, the Delaware Court of Chancery granted a dismissal on the pleadings based on MFW compliance and the Delaware Supreme Court has affirmed.
- What is the future of MFW? Will it evolve to provide a workable safe harbor?
- Will MFW function as an impediment to successful suits challenging related party transactions?

ACTIVISM / SHAREHOLDER ENGAGEMENT

- Last year we discussed how activists support spin-offs not only because they generate increases in multiples for the spinco and/or the parent, but also because they foresee the possibility that spinco and/or the parent will be ripe targets to be acquired at a premium.
- Since last year, activists have tended to insist that spincos have relatively weak defense profiles – no staggered boards, no supermajority provisions, and even commitments not to put poison pills in place.
- Given the challenges that come with a spin-off, is it advisable to agree to these demands since it will set the spinco on a path to good governance and avoid having the board and management distracted by demands for structural reform and threats of withhold votes during the spinco's early years as a new public company? Or should the spinco be given a grace period by governance advocates and activists during which a stronger than average defense profile is accepted for the sake of stability while it becomes accustomed to operating as a stand-alone public company?
- Shareholder engagement – some advisors are advocating for one-on-one meetings with significant institutional investors, with top executives and even outside directors present, two or even three times a year, but this level of engagement can be overkill from the perspective of many asset managers who profess to prefer the usual telephonic updates from IR unless the investor expressly requests otherwise. What level of engagement makes sense?

APPRAISAL RIGHTS

- The DGCL was recently amended to prevent some appraisal arbitrage by enabling the company to stop the generous rate of interest from accruing by paying the merger price to dissenting stockholders rather than waiting for the final appraisal decision which sometimes takes over a year after closing. However, there is still no tracing of the shares that exercise appraisal rights to shares that voted against the merger.
- Perhaps this will change if and when all shares switch to a digital system using blockchain technology. For now, the risk of appraisal claims remains meaningful in mergers and is of special concern for deals in which there is a lot of leverage and therefore additional cash payouts could turn the transaction from accretive to dilutive.
- There have been a number of good decisions in recent years deferring to the merger price as the fair price set by the market.
- How conscientious are financial advisors when producing books for acquirer boards to ensure they do not overstate the value of the target? These books are discoverable in appraisal proceedings and can serve as excellent exhibits for the dissenting stockholders.
- In the tech sector, there are many justifications for very high valuation ranges and astronomical future projections. The Delaware Court of Chancery has, since the 1990s, been skeptical of relying on DCFs of optimistic projections in the tech sector for purposes of appraisal proceedings. But documents prepared internally by the acquirer can still serve as excellent exhibits for the dissenting shareholders in appraisal proceedings. Is it futile to try to regulate what projections and financial analyses are produced internally by the acquirer for the sake of mitigating appraisal rights risks?