The Mergers & Acquisitions Review

Fifth Edition

Editor
Simon Robinson

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EDITOR'S PREFACE

After a prolonged period of uncertainty and decreased M&A activity, deal-making is undergoing something of a resurgence. Over the course of recent years, corporations across the world have been carefully navigating the economic downturn and attempting to consolidate their positions. In 2011 the market has proved more conducive to M&A and, at least in the first half year, confidence seems to be returning. Opportunities are seemingly limited to those companies and private equity houses that enjoy a stable financial basis. Governments have addressed the perceived failings of the regulatory framework and, for the most part, reforms have now been implemented. One of the underlying reasons for the drop in M&A was the drought of acquisition finance; without the necessary funding, few players were able to launch major takeover bids. However, the loan market appears to have gained a new lease of life and banks are adamant that they are willing and able to fuel well-conceived bids. The task that lies ahead of companies and funds is identifying truly value-generative targets and negotiating the new regulatory framework. There is increased emphasis on the views of shareholders following the financial crisis, and companies are best advised to gauge shareholder sentiment early. The provenance of M&A is undergoing a gradual shift, with deal-making in the Asia-Pacific region reaching its highest-ever level in 2010 and also representing its highest proportion of the total global value of M&A. In addition, the emerging markets are witnessing heightened deal activity, in particular the BRIC nations. These trends seem set to continue.

It would be premature, however, to suggest that M&A has completed a Lazarus-like revival. The recovery of deal-making is in its infancy and it is still highly susceptible to external forces. A number of major political and economic factors may impede sustained M&A activity, and could even force it to retreat. The sovereign debt tribulations in Europe, the weakening of the US economy, the 'Arab Spring' uprisings, the earthquake in Japan, rising commodity prices and global austerity measures all pose severe challenges. Given the fragile state of the global economy, such issues could well shackle the fledgling M&A revival. In short, economists remain uncertain about the health of M&A, and although many commentators hope that it will continue to gather pace, albeit slowly, there are a number of variables that may waylay deal-making. Economists have not ruled out short-term stagnation in deal value and volume, as a precursor to the dawning of an M&A renaissance further down the line.

I wish again to thank all the contributors for their continued support in producing this book – one would hope that in this uncertain time the following chapters should provide cause for cautious optimism, while also reiterating some of the lessons from the recent lean years.

Simon Robinson
Slaughter and May
London
August 2011

Chapter 63

US: DELAWARE

*Rolin P Bissell and Elena C Norman**

I OVERVIEW OF DELAWARE M&A LAW DEVELOPMENTS 2010/2011

Although one of the smallest of the 50 United States in both size and population, Delaware plays an outsized role in US corporation law. Delaware corporations comprise more than 60 per cent of the Fortune 500 companies and more than 50 per cent of the corporations listed on the NYSE, NASDAQ and AMEX. As one law professor put it: 'The Delaware brand is to corporate law what Google is to search engines.'[1]

2010 and the first five months of 2011 showed the acceleration of the upswing in the M&A market that started at the end of 2009. Perhaps reflecting the belief that the recession had caused many companies to be under-valued, 2009 and 2010 saw a number of freeze-out transactions through which controlling stockholders sought to make a company private by buying out the other public stockholders. In that environment, and as discussed in last year's Review, it is perhaps unsurprising that Delaware courts issued a spate of significant judicial decisions, which reviewed transactions to make sure that insiders were not scooping up companies on the cheap and at the expense of the public stockholders.[2]

In late 2010 and early 2011, valuations improved and the M&A market warmed up as companies looked to expand and put idle cash to work. In this rising market, the nature of transactions and the focus of legal challenges to those transactions shifted.

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1 Simmons, Omari Scott, 'Branding the Small Wonder: Delaware's Dominance and the Market for Corporate Law'. 42 *University of Richmond Law Review* 1129 (May 2008).

2 *In re Revlon, Inc. S'holders Litig.* ('Revlon II'), 2010 Del. Ch. LEXIS 48 (16 March 2010); *In re John Q. Hammons Hotels Inc. S'holders Litig.* 2009 Del. Ch. LEXIS 174 (2 October 2009); *In re Cox Radio, Inc. S'holders Litig.* ('Cox Radio') 2010 Del. Ch. LEXIS 102 (6 May 2010); *In re CNX Gas Corp. S'holders Litig.* ('CNX') 2010 Del. Ch. LEXIS 119 (25 May 2010).

The past year saw an increasing number of judicial decisions concerning acquisition targets seeking to use defensive techniques to ward off unwanted acquisition offers or negotiate better terms in response to a perceived inadequate offer. The rising market also saw acquirers seeking to lock up deals to protect themselves against deal jumpers offering a topping price, or fickle targets who might seek to renegotiate the terms of a merger agreement as their economic prospects improved. This led to an increasing number of stockholder challenges to a variety of deal protection measures as being too restrictive and preventing superior offers from coming forward. Challenges to deal protection measures were often combined with claims that companies had been inadequately marketed before being sold, thus leading to an inadequate price.

But the last 12 months were not just about challenges to defensive measures, deal protection devices and sales processes. Through a series of cases, the 'top-up option' received judicial blessing as a legitimate aid to increase the certainty that a friendly tender offer would succeed. The energy sector was also a prime source of deal litigation. Because a significant number of entities in those areas are limited partnerships and limited liability companies, the Delaware courts were asked to interpret the partnership agreements and limited liability company agreements governing those entities and speak on the issues of the extent to which fiduciary duties could be eliminated by written agreement and whether contractual mechanisms for dealing with conflict transactions would hold up. Finally, Delaware courts provided significant guidance on the recurring issue of the extent to which a merger extinguishes derivative claims that a company's stockholders have against the target's board at the time of the merger, and how those claims should be valued in a merger.

II GENERAL INTRODUCTION TO THE FRAMEWORK AND SOURCES OF DELAWARE M&A LAW

The framework of Delaware law related to mergers and acquisitions has two main sources – Delaware state statutes and judicial decisions handed down by the Delaware courts, chiefly the Delaware Court of Chancery (a court that has unmatched experience and expertise in resolving corporate disputes) and the Delaware Supreme Court. The Delaware General Corporation Law ('DGCL') is a broad enabling statute that governs the formation and internal affairs of Delaware corporations. The statutory framework for director and stockholder approval of mergers can be found in DGCL Section 251.

Legal challenges to M&A transactions under Delaware law come in the form of private lawsuits by hostile bidders or, more often, by stockholders, either derivatively on behalf of the company or on behalf of a class of similarly situated stockholders. As a result, over the last century, the Delaware courts have promulgated an extensive body of decisional law pertaining to the obligations that directors, controlling stockholders and corporations owe to stockholders in connection with M&A transactions. Although this decisional law often addresses interpretation and application of the statutory provisions of the DGCL, it even more frequently concerns application of judge-made concepts of fiduciary duty and other equitable principles.

At its core, Delaware fiduciary duty cases are based on the duty of care (a director's obligation to act with due care and on an informed basis in decision-making) and the duty of loyalty (a director's obligation to refrain from self-dealing and act in the corporation's best interest). However, the complex factual context of M&A transactions and the sheer number of decisions have resulted in the Delaware courts applying these two basic fiduciary duties in a wide variety of ways. It is nonetheless possible to discern four standards of review the Delaware courts are most apt to apply in assessing a legal challenge to an M&A transaction.

First is the business judgement rule, which, if applicable, means the courts will give deference to the business judgements of a corporation's directors, typically causing the legal challenge to the M&A transaction to fail.

Second, when a target responds to a proposed M&A transaction, particularly a hostile one, the courts review the defensive manoeuvres the target has employed to see whether those defensive manoeuvres are both reasonable and proportionate responses to a reasonably perceived threat to corporate policy under the *Unocal*[3] line of cases. Defensive manoeuvres, such as the poison pill and deal protection measures to lock up a deal (for example, termination fees, superior proposal provisions, and voting covenants found in merger agreements), are typically reviewed under *Unocal*.[4]

Third, when a company has embarked on a transaction that has made a change of control inevitable (whether on its own initiative or in response to an unsolicited offer), the board must seek to get 'the best price reasonably available' for the stockholders under the *Revlon*[5] line of cases. In general, Delaware companies are under no obligation to sell themselves and are free to 'just say no' to unwanted suitors. But under *Revlon*, once a change of control becomes inevitable, the directors are transformed into the auctioneers of the company.

Fourth, in transactions between an interested party and a corporation – for example, a controlling stockholder attempting to take a company private through a freeze-out transaction – the entire fairness doctrine applies. Under the entire fairness doctrine, the courts will look more closely to determine both whether the transaction was the result of fair dealing and whether it was at a fair price.

With this overview in mind, we turn to the developments of the last year.

3 *Unocal v Mesa Petroleum*, 493 A.2d 946 (Del. 1985).

4 In addition, defensive and other actions in response to a proposed transaction that interfere with the stockholder franchise must have a compelling justification under *Blasius Industries, Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988). Over the last several years, Delaware courts have questioned the analytic force of *Blasius* and have suggested that issues arising out of directors' actions affecting the stockholder franchise can be properly analysed under *Unocal*. See for example, *Mercier v. Inter-Tel* (Delaware), Inc.,929 A.2d 786 (Del. Ch. 2007). There were no significant developments in the *Blasius* doctrine during the last three years.

5 *Revlon, Inc. v MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

III DEVELOPMENTS RELATING TO *UNOCAL*, POISON PILLS AND OTHER DEFENSIVE ISSUES

Significant developments in the use of poison pills and other defensive devices have been shown under Delaware law in 2010 and 2011. Following the disillusionment with the performance of boards of directors leading up to the financial crisis, some questioned whether Delaware's courts would show less deference to decisions by the boards of directors. In particular, some activist investors hoped the courts would take a harder look at the boards' decisions to employ poison pills and other defensive measures to prevent stockholder votes on mergers that the board believes not to be in a company's best interests, even though the stockholders might think otherwise. There has been no shift in policy. A trio of decisions, *Yucaipa*,[6] *Airgas*[7] and *Selectica*,[8] show that the poison pill is alive and well and that the Delaware courts continue to support a board of directors' use of defensive devices when corporate policy is threatened by a hostile bidder.

In *Yucaipa*, the board of bookseller Barnes & Noble implemented a poison pill in response to rapid share purchases of Barnes & Noble's stock by Yucaipa American Alliance Fund II LP. The implementation of the poison pill came in the course of a proxy contest that Yucaipa undertook to elect three directors to Barnes & Noble's board. Specifically, Barnes & Noble's poison pill (1) capped all stockholders, except its largest stockholder, and director, Leonard Riggio, at 20 per cent of the company's stock; (2) grandfathered Riggio's approximately 30 per cent shareholdings, but prevented additional stock purchases by Riggio without board approval; and (3) provided that a stockholder would be considered to beneficially own the shares of any other stockholder with whom it reached an 'agreement, arrangement or understanding [...] for the purpose of [...] voting [...] any voting securities of the company.'

The poison pill thus prevented Yucaipa from (1) acquiring any additional shares of Barnes & Noble that would allow Yucaipa to equal or approach the percentage held by the Riggio's insider block, or (2) form a group to conduct a proxy contest with other stockholders. In February 2010, another longtime Barnes & Noble stockholder, an investment fund called Aletheia, increased its stake in Barnes & Noble from 6.3 per cent to 17.44 per cent.

In May 2010, Yucaipa brought suit to invalidate the poison pill, claiming that Barnes & Noble's board was seeking to entrench the Riggio interests, and thus the board had breached its fiduciary duties by implementing the poison pill. In particular, Yucaipa challenged the beneficial ownership provision of the poison pill on the grounds that it effectively precluded the formation of groups to conduct a proxy contest challenging Riggio and incumbent management and was not reasonably related to any legitimate

6 *Yucaipa Am. Alliance Fund II, L.P. v Riggio*, 2010 Del. Ch. LEXIS 172 (12 August, 2010) (Strine, V.C.) (a post trial ruling that rights plan passed *Unocal* analysis), aff'd sub nom., No. 565, 2010 (3 March 2011).

7 *Airgas, Inc. v Air Prods. & Chems., Inc.*, 2011 Del. Ch. LEXIS 22 (8 February 2011) (Chandler, C.) (finding the board entitled to maintain a rights plan in the face of an all cash, all shares tender offer, where stockholders were fully informed).

8 *Versata Enters v Selectica, Inc.*, No. 193, 2010 (4 October 2010) (opinion by Holland, J.).

corporate objective. In addition, Yucaipa challenged the 20 per cent 'trigger level' of the poison pill as being unreasonably low given the pre-existing insider voting block of approximately 35 per cent held by Riggio. Finding that *Unocal* was the proper standard of review, the Court of Chancery concluded that the poison pill survived scrutiny because (1) the Barnes & Noble board made a good faith and reasonable determination that Yucaipa was a threat, and (2) the rights plan was a proportional response to the threat that Barnes & Noble faced because Yucaipa was the probable winner of the proxy contest, even with the poison pill in place.

Yucaipa subsequently lost the proxy contest. Although Yucaipa successfully obtained the vote of the majority of the shares not held by the insider group, it was unable to obtain the supermajority necessary to overcome the ownership advantage that the poison pill preserved for the insiders led by the Riggio block.

In *Airgas*, Air Products & Chemicals Inc made a non-discriminatory, all cash, all shares, fully financed tender offer for the stock of Airgas, Inc. The board of Airgas believed that the offer was inadequate. The Court of Chancery found that the Air Products offer posed a threat under *Unocal* because Delaware law 'recognised inadequate price as a valid threat to corporate policy and effectiveness'. Moreover, Delaware law 'has also made clear that the "selection of the timeframe for achievement of corporate goals [...] may not be delegated to the stockholders".' In making this ruling, the Court of Chancery found that the Airgas stockholders had all of the information required to make a fully informed decision with respect to Air Products' offer. Nonetheless, the Court of Chancery found that there was a threat that a majority of Airgas's stockholders would tender into Air Products' offer despite its inadequate price, leaving the minority 'coerced' into taking \$70 as well. Accordingly, the court ruled that it could not order Airgas to redeem its poison pill so that the tender offer could succeed. Interestingly, the Court of Chancery noted that although it was constrained by precedent to reach this result, it did not agree with the outcome. The court noted that (1) Air Products' best and final offer was on the table; (2) the Airgas board had more than a year to inform the stockholders about its view of Airgas's intrinsic value; (3) Airgas had time to demonstrate its ability to meet its projected goals; and (4) Airgas's stockholder base was sophisticated and well informed.

Significantly, the Court of Chancery ruled, based on *Selectica*, that the combination of Airgas's poison pill and the staggered board provision was not preclusive, even though it would require an acquirer to maintain for two years its campaign to acquire Airgas. The court expressed some scepticism that there was a practical difference between 'permanently unattainable' and unattainable for two years. Nonetheless, the court held that the poison pill was not preclusive because Air Products had a reasonable possibility of obtaining control of the Airgas board if it ran another slate of directors at the next annual meeting. Air Products' campaign was undermined by the fact that it had recently elected three directors to Airgas's board. After joining Airgas's board, those three directors took a 'fresh look' at the Air Products offer, decided it was inadequate and then decided to support the continuation of the Airgas poison pill.

As reported in last year's Review, in *Selectica* the Court of Chancery upheld the validity of a net operating loss ('NOL') poison pill put in place by Selectica, Inc.[9] Under the US tax laws, NOLs may lose value if there is a change of control. Applying *Unocal*, the court held that the protection of NOLs was a proper use of a poison pill even though the value of the NOLs was unknowable. After finding that the NOLs were a permitted subject of protection, the court found that the NOL pills used by Selectica were a proportionate response to the perceived threat to the NOLs and were neither coercive nor preclusive. The court found that the NOL pills did not render a successful proxy contest an impossibility or utterly moot, given the specific threat at hand. Thus, the NOL pills were not coercive under *Unocal*.

This year, the Delaware Supreme Court upheld the Court of Chancery's decision in *Selecta* validating the NOL pill. The court determined that protection of NOLs was a proper use of a poison pill. In addition, the court found that the NOL pills were a proportionate response to the threat by the challenger, a competitor of and stockholder in Selectica, and were neither coercive nor preclusive. The NOL pills did not render a successful proxy contest a near impossibility. In particular, the court noted that the board engaged in internal debates; a committee was established to monitor the effect of the NOL pills; the challenger failed to suggest a meaningful different manner of protecting the NOLs; and a low threshold for triggering the NOL pills was imposed by an external standard, created neither by the board nor by the court.

Whether viewed alone or together, the *Yucaipa*, *Airgas* and *Selectica* decisions are indicative of the considerable deference the Delaware courts will give to a target board's decision on whether to block a proposed acquisition.

IV *REVLON* DUTIES AND DEAL PROTECTION MEASURES

The years 2010 and 2011 have also seen a number of challenges by stockholders to the sales processes that boards have put in place to shop companies before agreeing to merger agreements and deal protection measures contained in those agreements. For the most part, these cases have affirmed the validity of already well-known and litigation-tested deal protection measures. In particular, no shop clauses that are balanced by a fiduciary-out to consider superior proposals, matching rights that give the acquirer the right to match superior offers, informational rights that give the acquirer the right to receive the same information that the target disseminates to any other potential bidders, and termination fees in the neighbourhood of 3 per cent of deal price have been widely upheld whether on their own or taken together.

Despite the ever growing body of case law approving their use, termination fees remain an active area of litigation. In particular, *In re Cogent Inc Shareholders Litigation*[10]

9 *Selectica, Inc. v. Versata Enters.*, 2010 Del. Ch. LEXIS 39 (26 February 2010) (Noble, V.C.) (holding that a 5 per cent right plan implemented to protect NOLs passed the *Unocal* test).

10 *In re Cogent, Inc. S'holders Litig.*, 7 A.3d 487 (Del. Ch. 5 October 2010) (Parsons, V.C.) (denying motion for preliminary injunction of allegedly coercive merger), appeal denied by, 2010 Del. LEXIS 529 (19 October 2010).

and other decisions the Delaware courts explored the proper way to measure 'deal price' for the purpose of determining what percentage of deal price the termination fee represents. For most acquisitions, the deal price is going to be the 'equity value' of the company. However, the court left open the possibility that for highly leveraged companies, 'enterprise value' may be an even more appropriate measurement. The key is to approximate the actual consideration being paid by the acquirer.

In re Orchid Cellmark Inc Shareholders Litigation,[11] the Court of Chancery provided additional clarity on 'poison pill carve-outs'. A poison pill carve-out requires the target to pull its poison pill with regard to the acquirer only and explicitly precluding the target from pulling the pill with respect to other bidders without first terminating the merger agreement and paying the acquirer the termination fee. The court found that the poison pill carve-out did not prevent the target, Orchid, from pulling the pill for a suitor other than LabCorp, the acquirer, but rather only conditioned Orchid's ability to do so on the paying of the termination fee. Thus, the requirement that the poison pill only be redeemed for a bidder making a superior offer cost the target no more than would acceptance of a superior offer or termination of the merger agreement for some other reason. Thus, the poison pill carve-out was not preclusive of other bidders.

Not only do boards enjoy great freedom in weighing the benefits and costs of deal terms, they also enjoy great latitude in weighing the adequacy of the price the acquirer says it is willing to pay. *In re Dollar Thrifty Shareholders Litigation*,[12] the Court of Chancery turned aside a *Revlon* challenge to Hertz's agreement to acquire Dollar Thrifty for $41 a share. The Dollar Thrifty board did so despite a $46.50 per share topping bid made by Avis. The court found that the board was free to consider factors other than the premium over market price in determining whether the competing offers were attractive. The court also found that the Dollar Thrifty board had acted reasonably. There was no evidence that the board was motivated by anything other than its desire to obtain the best deal for Dollar Thrifty stockholders. Moreover, the court concluded that the board was diligent in 'attending to its duties'. Both the concern about the risk of a deal with Avis falling through and the antitrust risk to closing with Avis were proper considerations for the Thrifty's board. The court did not enjoin the stockholder vote, but the Dollar Thrifty stockholders subsequently rejected a $50 share offer from Hertz.

The deference of the Delaware courts to a board's conduct of a sales process is not without limit. The Court of Chancery's decision *In re DelMonte Foods Company Shareholders Litigation*[13] shows how the board can run afoul of *Revlon* duties by hiring a

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11 *In re Orchid Cellmark Inc. S'holders Litig.*, 2011 Del. Ch. LEXIS 75 (12 May 2011) (denying a request for preliminary injunction of a stockholder vote on merger challenged on Revlon grounds).

12 *In re Dollar Thrifty S'holders Litig.*, 2010 Del.Ch. LEXIS 192 (8 September 2010) (Strine, V.C.) (holding that a board may consider factors other than premium over market price in determining whether an offer is attractive).

13 *In re DelMonte Foods Co. S'holders Litig.*, 2011 Del. Ch. LEXIS 30 (14 February 2011) (Laster, V.C.) (preliminarily enjoining for twenty days sale to third-party acquirer where target board failed to adequately oversee self-interested investment banker's role in sale process).

conflicted investment banker and then accepting the banker's advice without question. In *DelMonte*, the DelMonte Corporation explored sale opportunities. DelMonte's investment bank, Barclays, undermined the sale process that it was running by getting DelMonte's board to approve, without much deliberation, two bidders to 'team', despite anti-teaming provisions to which the bidders had previously agreed. The teaming foreclosed a potential bidding war between two potential acquirers, who had been the two highest bidders in an early bidding process. In addition, the DelMonte board permitted Barclays to provide buy-side financing to one of the bidders that allowed Barclays to earn an additional $24 million in fees in the transaction. Moreover, the conflict created by Barclay's participating on the buy-side caused DelMonte to pay $3 million in connection with obtaining a second fairness opinion. Finally, despite Barclay's buy-side involvement, the DelMonte board permitted Barclays to manage a 45-day go-shop following the entry into a merger agreement with the 'teamed' bidders. The financial incentives created by Barclay's participation in the buy-side financing raised questions concerning how vigorously it would pursue superior offers during the go-shop. In light of the flaws in the sales process created by Barclays' multiple conflicts, the court enjoined the deal for 20 days to allow DelMonte to continue to be marketed under the go-shop provision.

V TOP-UP OPTIONS

In 2010 there were a stream of cases concerning the validity of the 'top-up option'. Top-up options are used as part of a tender offer. Although the terms vary, top-up options typically require the target to issue stock to a bidder if the bidder gets 50 per cent or more of the target's stockholders' tender. The bidder typically pays for its purchase of the top-up shares through a promissory note. Thus, the top-up option allows a bidder, who gets above 50 per cent of the target stockholders tendering, to get to 90 per cent ownership in the target almost immediately. Once 90 per cent ownership is reached, the bidder can do a back-end short-form merger. The advantage of the top-up option is that it allows the target stockholders to receive the merger consideration more quickly. It also allows the acquirer to do the second-step merger more quickly and benefit from the short-form merger procedure, which allows a merger to occur without a stockholder vote.

Challenges to top-up options came in three main categories. First, the top-up option affects appraisal rights because the potentially massive amount of shares that issue pursuant to the top-up option creates the threat of 'appraisal dilution'. Both the *Olsen v. ev3, Inc*[14] and *Cogent* courts rejected this argument because Section 262(h) of the DGCL provides that shares are to be valued 'exclusive of any element of value arising from the accomplishment or expectation of the merger or consideration'. Second, the top-up option is coercive or preclusive of competing offers. This objection has also been turned aside. The bidder needs to obtain a majority of the company's stock before the top-up option can come into play. Indeed, top-up options usually require a super-majority tender. Third, there are several challenges to the nuts and bolts mechanics of the top-

14 *Olson v. ev3, Inc.*, 2011 Del. Ch. LEXIS 34 (21 February 2011) (Laster, V.C.) (holding that two-step merger top-up options must set forth material terms of the option).

up option. In particular, top-up shares can have an eye-popping price tag. But they typically only exist for a very brief period. Usually, payment of this amount is covered by a promissory note that obliges the acquirer to pay the target. The promissory note used to pay for the top-up shares is typically cancelled following the short-form merger. Thus, some stockholder plaintiffs have argued that the promissory note was really a sham. The courts have found that although the life of the promissory note may be short, and it ultimately will end up being cancelled when the second-step short-form merger closes, the promissory note is an enforceable obligation of the bidder and therefore valid.

Despite the moth-like lifespan of the promissory note, its details are important. The court in *Olson* required that the material terms of the promissory note be spelled out in the merger agreement and in the top-up option. The court deemed that the settlement agreeing to these changes was of significant benefit to the target's stockholders, thereby justifying an award of a significant attorney's fee to the stockholder's lawyers. The original top-up option left the option terms open. Thus, the shares issued pursuant to the original option likely would have been void.

VI ELIMINATION OF FIDUCIARY DUTIES AND APPROVAL OF CONFLICT TRANSACTIONS IN ALTERNATIVE ENTITIES IN THE ENERGY SECTOR

A number of energy firms are structured as alternative entities – master limited partnerships or LLCs. Reflecting that the energy market place is in a growth cycle, a number of energy companies have found it useful to pursue acquisitions or simplification transactions between them and affiliated entities. These transactions have presented issues as to the extent to which the limited partnership and limited liability company agreements governing these alternative entities could eliminate fiduciary duties, including *Revlon* duties and entire fairness review of conflict transactions. In addition, to the extent those agreements replaced traditional fiduciary duties with contractual standards of review, questions have arisen about how those standards of review should be interpreted. Both *In re Inergy LP Unitholder Litigation*[15] and *Lonergan v. EPE Holdings LLC*[16] made clear that fiduciary duties can be eliminated. In those cases, the courts rejected *Revlon* and entire fairness review challenges to interested transactions between MLPs and their affiliates. The courts also upheld contractual standards of review that provide that the actions of the general partner or manager of the entities are not a breach of the agreement so long as that general partner or manager acted in the 'absence of bad faith' and 'reasonably

15 *In re Inergy L.P. Unitholder Litig.*, 2010 Del. LEXIS 217 (29 October 2010) (Parsons, V.C.) (denying plaintiffs' motion for a preliminary injunction and holding that Section 17-1101(d) of the DRULPA permits master limited partnerships to restrict or eliminate any fiduciary duties owed by a partner to the master limited partnership or to other limited partners).

16 *Lonergan v. EPE Holdings LLC*, 5 A.3d 1008 (Del. Ch. 2010) (Laster, V.C.) (denying a motion to expedite on the grounds that plaintiffs' claims for breach of fiduciary duty and breach of the implied covenant of good faith challenging the transaction through which a two-tier limited partnership was flattened were not colourable).

believed' their actions to be in or not inconsistent with the best interest of the entity. These cases show the tremendous transactional flexibility that can be achieved through the alternative entity structures.

VII A MERGER'S EFFECT ON DERIVATIVE CLAIMS

As a result of the financial crisis, a number of companies were acquired while they had derivative claims pending against them. The standing requirement of Section 327 of the DGCL requires that a derivative plaintiff be a stockholder both at the time of the wrongdoing and throughout the pendency of the derivative suit. In a merger, the shares of the stockholder typically are converted into shares of the acquirer or cashed out. Because the stockholders of the target are no longer the stockholders, they lose standing to assert a derivative claim. Delaware law provides an exception to this standing rule and allows stockholders of the target to maintain their derivative standing following a merger if they can show that the merger was done for the purpose of depriving the target stockholders of the right to bring a derivative suit. This exception was very narrowly construed and difficult for stockholders to meet.

In *Lambrecht v. O'Neal*,[17] in answering a certified question of law from the United States District Court for the Southern District of New York, the Delaware Supreme Court made clear that there was another route that the target stockholders can take to bring derivate claims after the target has been acquired. Following a stock-for-stock merger, the pre-merger stockholders of the target may bring a double-derivative action so long as they are current stockholders of the post-merger parent corporation. In a double-derivative action, the stockholder of the parent (i.e., the acquirers) must make a demand on the parent that it take action to assert claims on behalf of its subsidiary (i.e., the pre-acquisition target) or show that demand is excused. To maintain their derivative standing, the pre-merger target stockholders do not have to demonstrate that at the time of the alleged wrongdoing they owned stock in both the acquirer and the target, or that the acquiring corporation owns stock in the target.

In re Massey Energy Co Derivative & Class Action Litigation,[18] the Court of Chancery further explained the viability of post-merger derivative claims by former stockholders of the target. But the court also noted that these claims will typically be of little value to the acquiring company and thus very difficult to bring on a double-derivative basis. Massey Energy Company's stockholders sought to enjoin a stockholder vote on Alpha Natural Resources, Inc's $8.5 billion proposal to buy Massey. Although Alpha's offer was at a premium to Massey's current market price, the stockholder plaintiffs claimed that Massey's stock price had been depressed by what they estimated to be over $1 billion of claims against the directors of Massey arising out of lack of oversight on Massey's record of poor safety compliance. The court assumed that the claims against the directors for failure of oversight of Massey's safety might very well have merit, but refused to enjoin the transaction. The court explained how the Massey stockholders could bring these

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17 *Lambrecht v. O'Neal*, 2010 Del. LEXIS 427 (27 August 2010) (opinion by Jacobs, J.).

18 *In re Massey Energy Co. Derivative & Class Action Litig.*, 2011 Del. Ch. LEXIS 83 (31 May 2011).

claims as double-derivative claims following Alpha's acquisition of Massey and denied the stockholder plaintiffs' request to enjoin a stockholder vote on the merger.

The availability of the double-derivative claim for the target stockholders post-merger is a mixed blessing for targets and acquirers. On the one hand, the availability of the double-derivative remedy takes away a basis to enjoin a transaction. The stockholders can no longer argue they will lose valuable derivative claims if the deal goes through. However, the availability of the double-derivative remedy expands the potential for post-merger claims that the acquirer will have to deal with. As a result, in considering a merger, both the target board and the acquirer board may need to spend more time analysing the viability and value of these claims before entering into a merger agreement.

VIII OUTLOOK

In the last 12 months, Delaware courts showed again that they are ready to protect a board's discretion in dealing with or defending against stockholder challenges or third-party suitors. In doing so, the Delaware courts showed that a well-informed and unconflicted board of directors will enjoy a great deal of latitude in determining what course of action is best for a company, even in a change-of-control situation. Thus, it has turned out to be very difficult for stockholder plaintiffs making *Revlon* claims that the board has failed to obtain the best price reasonably available to enjoin transactions to prevent a stockholder vote on them. By contrast, when the directors have determined when an acquisition poses a threat to corporate policy under *Unocal*, that decision has a good chance of preventing a stockholder vote on a unwanted transaction. Thus, the past year's transactions suggest that Delaware courts continued to adhere to a 'director-centric' view of corporate decision-making. Directors are the primary decision makers, and stockholders are a check on that decision-making process through either voting down transactions they deem to be inadequate or seeking to elect new directors. As a corollary, Delaware courts seem sceptical of the 'stockholder democracy' school of thought that seeks to put the primary power to decide corporate policy in the hands of the stockholders. However, when the stockholders can show that the board has been supine or its process subject to conflict, such as *DelMonte*, the Delaware courts have not hesitated to step in to protect stockholder interest.

Appendix 1

ABOUT THE AUTHORS

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Rolin Bissell is Chair of Young Conaway's Corporate Counseling and Litigation Section. His practice focuses on corporate advice and litigation in the Delaware Court of Chancery, including disputes about mergers and acquisitions, going private transactions, 'interested party' transactions, proxy contests, valuation and appraisal issues, indemnification and advancement and stockholder access to books and records. He has represented numerous non-US entities in Delaware litigation that needs to be coordinated with proceedings in European and other foreign jurisdictions.

Mr Bissell holds degrees from Columbia College (BA) and the University of Virginia School of Law (JD). Mr Bissell writes and speaks regularly on corporate law issues.

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Elena Norman is a partner in Young Conaway's Corporate Counseling and Litigation Section of Young Conaway Stargatt & Taylor, LLP. Her practice focuses primarily on dispute resolution relating to corporate governance and in contested merger and acquisition transactions. Many of the cases in which Ms Norman is involved involve cross-border issues. Ms Norman also practised law in the New York and Tokyo offices of an international law firm, where she represented numerous US and foreign entities in federal and state courts and arbitration proceedings involving complex business disputes.

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