M&A Hot Topics

Quarterly Update (October 25, 2017)

1. SEC and Stock Exchange Updates

- **SEC Issues New Guidance for GAAP Reconciliations of Non-GAAP Projections**: On October 17, 2017, the SEC updated its Compliance & Disclosure Interpretation on non-GAAP financial measures in the context of business combination transactions. Revised Questions 101.01 and 101.02 clarify that (1) GAAP reconciliation is not required when non-GAAP projections were disclosed in proxy statements because they were provided to a financial advisor for the purpose of rendering a financial opinion for an M&A transaction; and (2) registration, proxy and tender offer statements must include GAAP reconciliation for non-GAAP projections when the projections are not provided to a financial advisor for purposes of a fairness opinion. The new C&DI clarifies the SEC's position on GAAP reconciliation for non-GAAP projections following a number of deal-related lawsuits filed in federal court in which plaintiffs alleged that merger-related proxy disclosures were deficient due to the absence of GAAP reconciliations for non-GAAP projections included in the associated proxy statements.
- **SEC Issues Comment Letters on Sales into Sanctioned Countries Through Intermediaries**: A number of issuers have recently, in connection with '34 Act filings, received SEC comments relating to their sales through intermediaries into sanctioned countries such as Iran. *See, e.g.*, *XL Group Ltd.*, *Equinix, Inc.*, *Monolithic Power Systems, Inc.*. These comments serve as good reminders in the acquisition context that buyers should diligence sales through intermediaries.
- **NYSE Rule Changes on Announcements Outside Market Hours**: The New York Stock Exchange has amended its rules regarding public announcements by listed companies outside of market hours. The amendments may impact the manner in which M&A transactions are announced. First, listed companies must provide notice to the NYSE at least ten minutes before making any public announcement with respect to dividends irrespective of the time of day or day of the week. The SEC approved this amendment on August 14, 2017. The rule's effectiveness will be delayed to give companies and the NYSE enough time to put in place appropriate procedures. The NYSE will give companies at least 30 days' notice via email of the new effective date, which will be no later than February 1, 2018. Secondly, on August 29, 2017, the NYSE submitted a proposal to prohibit listed companies from releasing material news for up to five minutes after market close; the SEC has yet to approve this proposal. More details on the rule changes are available in S&C's recent client memo.

2. Regulatory Updates

- **EU Framework for Screening of Foreign Direct Investments**: In his State of the Union speech on September 13, 2017, Jean-Claude Juncker, President of the European Commission, announced a proposed Regulation establishing a framework for the screening of foreign direct investments into the European Union. The measure, which stops short of creating a formal EU mechanism for screening foreign takeovers, would allow the European Commission to review and issue non-binding opinions on certain foreign investments of "Union interest." While highlighting the EU's "open investment environment," the European Commission's proposal attempts to establish a framework to promote closer cooperation among EU Member States reviewing foreign investments on a national level – without prejudice to the Member States' exclusive competence for the maintenance of national security. More details are available in S&C's recent client memo.

- **CFIUS Continues to Present an Obstacle to Chinese Acquisitions**: On September 13, 2017, President Trump issued an Executive Order blocking investment firm Canyon Bridge Capital Partners Inc. from acquiring Lattice Semiconductor Corporation, citing national security concerns. In the last 30 years, a U.S. President has blocked a transaction out of concern for national security only four times, but all four examples involved Chinese investors and three of the four occurred within the last five years.
- **Senate Democrats Push for Tougher Merger Enforcement**: On September 14, 2017, Senator Klobuchar (D-MN), Ranking Member of the Senate Judiciary Committee's Subcommittee on Antitrust, Competition Policy and Consumer Rights, introduced legislation to curtail market concentration and enhance antitrust scrutiny of mergers and acquisitions. Two bills were submitted to the Senate: the Consolidation Prevention and Competition Promotion Act (CPCPA) and the Merger Enforcement Improvement Act (MEIA). Both bills propose amendments to the Clayton Antitrust Act of 1914 and were announced as part of Senate Democrats' "A Better Deal" antitrust agenda.
- **DOJ Initiates Post-Closing Challenge to Parker Hannifin's $4.3 Billion Acquisition of Clarcor**: Parker Hannifin announced in late November 2016 that it had entered into an agreement to acquire rival Clarcor, a maker of filtration products, and the transaction closed in February 2017. However, the DOJ sued Parker Hannifin post-closing, on September 26, 2017, arguing that the merger of Parker Hannifin and Clarcor combined the only two domestic companies that make aviation fuel filtration systems and parts used by the military and airlines and would thus eliminate the head-to-head competition for the systems. The DOJ's post-closing investigation raises the question of whether parties should proactively address significant anti-trust issues pre-close, even if the DOJ does not raise an issue during its review of their HSR filings.

3. Delaware Appraisal Litigation

In 2017, the Delaware Court of Chancery has appraised a number of different companies in connection with mergers. Many of the cases, which are summarized below, address what weight the deal price should be given in an appraisal proceeding.

- On August 1, 2017, the Delaware Supreme Court reversed and remanded the Court of Chancery's appraisal decision arising out of the 2014 acquisition of DFC Global by private equity firm Lone Star Funds, in which the Court of Chancery had determined that the "fair value" of DFC Global was $10.30 per share, $0.80 above the merger price. While the Supreme Court stopped short of accepting the petitioners' argument that an appraisal court should give exclusive or presumptive weight to the deal price, the Court stated that economic principles suggest that the price achieved in a robust and unconflicted sale process is the best evidence of fair value. Further analysis can be found in S&C's recent client memo.
- On September 27, 2017, the Delaware Supreme Court heard oral arguments in the appeal from the Court of Chancery's post-trial opinion in *In re Appraisal of Dell Inc.* in light of the *DFC Global* opinion. The Supreme Court considered whether the Court of Chancery's decision to rely on its own valuation analysis and assign no weight to the final merger consideration in determining the "fair value" of the petitioners' stock was supported by the record. As noted above, in *DFC Global*, the Supreme Court found under

similar circumstances that the Court of Chancery's decision was unsupported by the record.

- In contrast to the Court of Chancery's decision in *Dell* in 2016, three recent cases (described below) found the targets' fair value to be at or below the deal price.
  - On May 26, 2017, the Court of Chancery (VC Slights) appraised PetSmart following its merger at an $83 deal price, rejecting the petitioners' proposed $128.78 fair value. The court found that the sale process had been robust and that the deal price was therefore a reliable indicator of fair value. The court found the shareholders' discounted cash flow ("DCF") analysis unreliable because the management projections undergirding the analysis were "saddled with … telltale indicators of unreliability." It also rejected the petitioners' contention that a leveraged buyout pricing model cannot be a reliable indicator of fair value because the model is driven by "a required internal rate of return that will always leave some portion of the company's going concern value unrealized.
  - On May 31, 2017, in *In Re Appraisal of SWS Group*, the Court of Chancery (VC Glasscock) appraised the SWS Group merger using a DCF analysis and found the fair value of the target's shares was less than the deal price. The court noted that, consistent with its recent *PetSmart* decision, the public sales process that develops market value is often the best evidence of statutory fair value; here, however, the court found that the SWS sale was made in market conditions that rendered the deal price unreliable. In fact, neither party had proposed deal price as an appropriate valuation method, but instead, using traditional valuation methodologies, had arrived at near-mirror image valuations 50% above and 50% below the deal price. VC Glasscock therefore did his own DCF calculation that resulted in a price below the deal price, which was "not surprising" given that it was a "synergies-driven transaction whereby the acquirer shared value arising from the merger with SWS."
  - On July 21, 2017, the Court of Chancery (VC Laster) issued its ruling in *Sprint v. Clearwire*, appraising the fair value of Clearwire Corp. stock at nearly 60 percent below the Sprint Nextel Corp.'s buyout price of $5.00 per share. VC Laster found the fair value of Clearwire stock to be $2.13 per share, almost eight times lower than Aurelius Capital Management LP's valuation of over $16 per share. In his analysis, VC Laster did not consider the deal price at all because neither side argued it was the fair value. VC Laster's analysis also did not consider synergies, since the court is by statute not allowed to consider deal-specific factors. The court adopted Sprint's analysis in total, stating that Aurelius "did not prove its more aggressive valuation contentions."

4. Other Selected Legal Developments

- In 2017, the Delaware Court of Chancery has continued to refine the appropriate standard of review for breach of fiduciary duty claims. A selection of recent cases is summarized below:
  - **Chancery Court Finds that Shareholder Vote was Structurally Coerced**: On May 31, 2017, in *Sciabacucchi v. Liberty Broadband Corporation*, the Court of Chancery denied a motion to dismiss the plaintiff's claim that a vote by Charter Communications, Inc. ("Charter") stockholders approving a share issuance to and voting agreement with Liberty, a stockholder of Charter, was structurally coercive. The court found that while "inherent coercion" did not exist because the large stockholder did not control the company, the plaintiffs had stated a claim for structural coercion because stockholders were forced to approve those transactions to avoid a detriment, not because the transactions were beneficial to the company. A

structurally coerced vote meant that the board's actions could not receive *Corwin* cleansing, which would have entitled the board's actions to business judgment review.

- **Chancery Court Grants in Part Fiduciary Duty Claims Arising from a Self-Tender Offer**: On July 24, 2017, the Court of Chancery denied in part a motion to dismiss claims for breach of the fiduciary duty of loyalty brought by minority stockholders in R. L. Polk & Co., Inc. against the directors of Polk and members of the Polk family in a self-tender offer. The court first noted that it would review the transaction under the entire fairness standard because the transaction involved self-dealing by the Polk family, the controlling shareholder. The court denied the motion to dismiss as to the Polk family, finding that those who tendered their shares at the self-tender price missed out on dividends amounting to one-third the tender price, and a cash-out merger consideration three times that of the tender price. The court granted the motion to dismiss as to the independent directors, finding the Complaint did not sufficiently allege why the independent directors had a conflict of interest in the 2011 self-tender offer.
- **Chancery Court Dismisses Stockholders' Breach of Fiduciary Duty and Aiding and Abetting Claims in Stock-For-Stock Merger**: On August 17, 2017, in *In re MeadWestvaco Stockholders Litigation*, the Court of Chancery dismissed claims brought by stockholders of MeadWestvaco against the MeadWestvaco directors for breach of duty of loyalty based on allegations that they acted in bad faith in approving a strategic stock-for-stock merger of equals. The court's ruling suggests that (1) the standards of "waste" and "bad faith" are equivalent; (2) non-controller, non-Revlon transactions, like the one in *MeadWestvaco*, continue to be subject to business judgment review both pre- and post-closing; and (3) there is still some uncertainty whether the *Corwin* doctrine cleanses bad faith by directors.
- **Chancery Court Applies *MFW* Business Judgment Review to Controlling Shareholder Selling to a Third Party**: On August 18, 2017, the Court of Chancery dismissed claims made by former stockholders of Martha Stewart Living Omnimedia against Martha Stewart, the former controlling stockholder, for alleged breaches of her fiduciary duty in the sale of the company to a third party buyer. The court applied the business judgment rule instead of the stricter entire fairness test, the default standard of review for challenges to conflicted controller transactions. The court found that (1) Martha Stewart's personal arrangements, alleged by the plaintiffs to have diverted merger consideration to Stewart away from the public, did not render Stewart a "conflicted" controller since she received the same stated price per share as the public stockholders, and (2) even if the personal arrangements had rendered Stewart conflicted, the three procedural protections afforded to the minority stockholders in the sale, as laid out in *MFW*, would have lowered the standard of review to business judgment regardless.
- **Chancery Court Dismisses Suit Asserting Breach of Fiduciary Duty and Quasi-Appraisal Remedy**: On August 28, 2017, the Court of Chancery dismissed a class action against Kreisler Manufacturing Corporation's board of directors in connection with the sale of Kreisler to Arlington Capital Partners. The court held that (1) no controlling stockholder was involved in the transaction, (2) the majority of the board was not interested in the transaction, and (3) Kreisler's charter contained an exculpation provision, so plaintiff could only successfully plead a breach of fiduciary duty claim by alleging the directors acted in bad faith. The court found that the directors' alleged "side deals" and new employment agreements with Arlington were insufficient to plead bad faith.

- **Role of Independent Auditor in Purchase Price Adjustment Disputes**: On June 27, 2017, the Delaware Supreme Court reversed the Court of Chancery's ruling in *Chicago Bridge*, cautioning that an independent auditor's role was to function "solely as an expert and not an arbitrator." The Supreme Court determined that an independent auditor appointed to resolve purchase price adjustment disputes could not hear the seller's arguments that the purchase price should be reduced because historical financial statements and accounting practices were not GAAP compliant, claims that were akin to breach of representation and warranty claims. The Court held that allowing the independent auditor to resolve disputes concerning the breach-related claims would "render[] meaningless" the contract's particular "liability bar" under which the buyer had agreed that its sole remedy for breach of representations and warranties was to refuse to close, and the buyer had, in fact, closed.
- **Amendments to the DGCL**: In its last session, the Delaware Legislature passed a number of amendments to the DGCL which were effective August 1, 2017, and included:
  - Authorization of the use of "blockchain" or "distributed ledger" technology, which is a collection of replicated, shared, and synchronized digital data geographically spread across multiple sites, rather than relying on a central source, for the maintenance of corporate records. Use of this technology could reduce settlement times for share transfers and could facilitate keeping an accurate record of authorized shares which would streamline proxy voting. A distributed ledger could eventually allow for corporate filings, such as certificates of merger, with the Secretary of State to be made through the blockchain.
  - Various technical changes to statutory sections relating to the authorization and execution of mergers and consolidations.
- **Ontario Court Interprets Tail Fee Provision Under Financial Advisor Engagement Letter**: In early 2016, plaintiffs RBC sued Defendant Crew Gold Corporation for a success fee that RBC alleged it was owed under an Ontario-law-governed agreement for the provision of investment banking services. The parties had agreed that RBC was entitled to fees for work performed plus a success fee payable on completion of a "Transaction," a term that was broadly defined. While the RBC engagement letter was in force, Crew was the subject of a takeover in which RBC was not involved. However, RBC claimed it was still entitled to a success fee under its engagement letter because the takeover fell within the definition of "Transaction." On August 10, 2017, the Court of Appeal upheld the Trial Court's decision in favor of Crew Gold Corporation that (1) there was no causal link between the services provided by RBC and the takeover, (2) the trial judge did not rely on the parties' subjective intentions in his interpretation of the contract and (3) the trial judge's interpretation considered commercial reasonableness.
- **Shareholders Sufficiently Allege Misleading Proxy Materials**: In *NECA-IBEW Pension Trust Fund v. Precision Castparts Corp.*, on October 3, 2017, an Oregon magistrate judge found that former shareholders had adequately alleged that Precision Castparts Corp. ("PCC") had disseminated false and misleading proxy statements. PCC announced an acquisition by Berkshire Hathaway on August 10, 2015; in October, PCC filed a proxy recommending the acquisition, and the acquisition was approved in January 2016. However, the magistrate judge found that the proxy statement contained inaccurate forecasts that contemplated no acquisitions for five years, which was in direct contrast to PCC's longstanding aggressive M&A strategy.