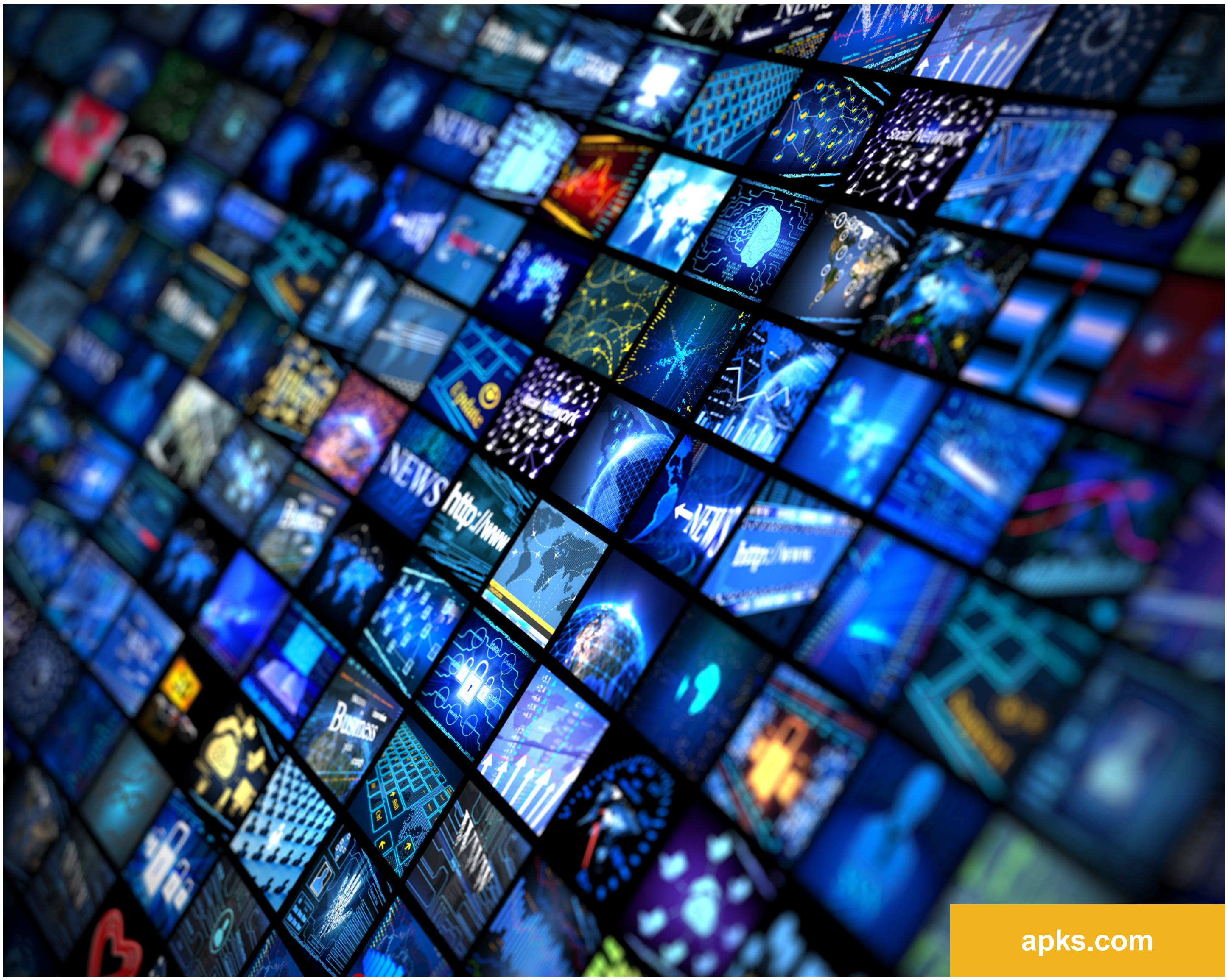
SIGNIFICANT 2017 DECISIONS AFFECTING PRIVATE COMPANY M&A



ARNOLD & PORTER KAYE SCHOLER

ARNOLD & PORTER KAYE SCHOLER

January 19, 2018

Significant 2017 Decisions Affecting Private Company M&A

Newsletter

By Nicholas O'Keefe, Edward A. Deibert, Ronald R. Levine, II, Michael J. Isaacs, Alexa D. Jones

The following compilation is our fourth annual review of significant Delaware and other key state court decisions relating to private mergers and acquisitions and disputes. All eight decisions were issued in 2017. The decisions provide important guidance on several aspects of the M&A process. Some of the decisions concern drafting points, such as working capital adjustments and fraud carve-outs, while others address the fiduciary duty implications of action by controlling stockholders and governance matters. The final decision, from the Texas court, alerts of the risks of being deemed to have formed a contract through the exchange of emails.

Table of Contents

- *Chicago Bridge & Iron Co. N.V. v. Westinghouse Electric Co. LLC* (Del. June 27, 2017)
- *EMSI Acquisition, Inc. v. Contrarian Funds, LLC* (Del. Ch. May 3, 2017)
- *Frederick Hsu Living Tr. v. ODN Holding Corp.* (Del. Ch. Apr. 14, 2017)
- *Buttonwood Tree Value Partners, L.P. v. R.L. Polk & Co., Inc.* (Del. Ch. July 24, 2017)
- *Frechter v. Zier* (Del. Ch. Jan. 24, 2017)
- *Nguyen v. View, Inc.* (Del. Ch. June 6, 2017)
- *In re Appraisal of GoodCents Holdings, Inc.* (Del. Ch. June 7, 2017)
- *Le Norman Operating LLC v. Chalker Energy Partners III, LLC* (Tex. App. Oct. 3, 2017)

Chicago Bridge & Iron Co. N.V. v. Westinghouse Elec. Co. LLC, 166 A.3d 912 (Del. June 27, 2017)

Parties should make express in their purchase agreements whether a dispute over whether the closing balance sheet complies with GAAP must be resolved as part of the purchase-price-adjustment process, or under the indemnities for breach of the financial statements representation.

Chicago Bridge involved a working capital true up dispute in connection with the sale by Chicago Bridge & Iron Co. N.V. (Seller) of its nuclear power plant construction company, CB&I Stone & Webster Inc. (the Company), to Westinghouse Electric Company (Buyer). In presenting its closing statement as part of a two-step true-up process, Buyer maintained that the net working capital amount was more than $2 billion lower than the target amount, due mainly to alleged failures of Seller's calculations to be based on a proper application of GAAP. In reversing the Chancery Court decision for Buyer, the Delaware Supreme Court held that the purchase agreement required that the true-up process be limited to determining changes in working capital between signing and closing, determined consistently with past practices. Any challenges on the basis of GAAP-compliance constituted claims for breach of the financial representations and warranties, which were precluded under a bar for post-closing damages.

The Language of the Purchase Agreement

The purchase agreement defined "Net Working Capital Amount" as the Company's current assets less current liabilities "solely to the extent such assets and liabilities are described and set forth on Schedule 1.4[f])." That schedule was the Company's June 30, 2015 balance sheet, which was also included in the financial statements covered by the financial statements representation. Prior to closing, Seller had to deliver a "Closing Payment Statement" to Buyer setting forth its good faith estimate of the Net Working Capital Amount. In the second stage of the true-up, Buyer had to deliver a "Closing Statement" to Seller within 90 days after Closing, including the Net Working Capital Amount and its estimate of the "Final

Purchase Price." Both the Closing Payment Statement and the Closing Statement had to be "prepared and determined from the books and records of the Company and its Subsidiaries and in accordance with [GAAP] applied on a consistent basis throughout the periods indicated and with the Agreed Principles."

The "Agreed Principles" provided as follows:

> "Working Capital . . . will be determined in a manner consistent with GAAP, consistently applied by [the Company] in preparation of the financial statements of the Business, as in effect on the Closing Date. To the extent not inconsistent with the foregoing, Working Capital . . . shall be based on the past practices and accounting principles, methodologies and policies applied by [the Company] and its subsidiaries and the Business (a) in the Ordinary Course of Business and (b) in the preparation of: (i) the balance sheet of the Company and its Subsidiaries for the year ended December 31, 2014 (adjusted to reflect the Business); and (ii) the Sample Calculation set forth on Schedule 1.4(f)."

In the Closing Statement, Buyer reflected the Net Working Capital Amount as negative $976.5 million, which was over $2 billion less than the targeted amount of $1.174 billion (the Target). Most of the deviations from the Target were due to changes in accounting methodology as opposed to changes in the Company's business between signing and closing. When the parties were unable to resolve their disagreement over the Net Working Capital Amount, Seller filed a court action seeking an order declaring Buyer's claims over the Net Working Capital Amount were claims for breaches of representations and warranties, which were barred under the purchase agreement. Disputes over the "Final Purchase Price" were to be determined by an independent auditor, acting as an expert and not an arbitrator, whose determinations were to be final, binding and non-appealable. Seller argued that Buyer could not circumvent a bar on post-closing damages under the purchase agreement (the Liability Bar) by running the issues through the independent auditor. Buyer maintained, in contrast, that the true-up was a process for resolving any disagreement over the calculation of the Final Purchase Price.

The Context of the Dispute

The court first looked to the context of the dispute and the terms of the entire contract. The acquisition of the Company was an attempt by Buyer and Seller to resolve ongoing cost overrun disputes in a collaboration to build nuclear reactors. Seller viewed the transaction as a "quitclaim," where it would hand over the Company for free, subject to post-closing adjustments with respect to the Net Working Capital Amount and other items, and potential upside payments. In light of a covenant requiring Seller to continue to run the Company in the ordinary course prior to closing, it was likely that required cash infusions to the business would result in a higher net working capital at closing. The court noted that the purchase agreement contained the unusual provision that Buyer's sole remedy for a breach by Seller of its representations and warranties was to refuse to close, and that the Liability Bar precluded Buyer from making any claims for monetary damages. Also unusually, Buyer had broad indemnification obligations. The purchase agreement also contemplated that various liability releases in favor of Buyer would be in full force and effect at closing. The court noted that "the crux of this deal was that [Seller] was done with the nuclear projects. It would get no profit for selling [the Company] - as of closing - the Liability Bar, indemnity and releases meant [Seller] would at least be rid of liability for the still-spiraling costs of the projects. . . ."

A Review of the Language in Light of the Purpose of Purchase Price Adjustments

The court then described the general purpose of purchase prices adjustments as accounting "for changes in a target's business between the signing and closing . . ." and that the most common interpretation of this change in working capital is that "the business being sold is run for the seller's benefit" until closing. The court noted that when the definition of "Net Working Capital" under the purchase agreement at issue was read in conjunction with the rest of the agreement, it required that the Company's historical accounting practices be used, and not a new assessment of whether these accounting practices complied with GAAP. The court noted that the Closing Payment Statement and the Closing Statement had to "be prepared and determined from the books and records of the Company and its Subsidiaries and in accordance with [GAAP] applied on a consistent basis throughout the periods indicated and with the Agreed Principles." The Accounting Principles required working capital calculations to be "determined in a manner consistent with GAAP, consistently applied by [the Company] in preparation of the financial statements of the Business, as in effect on the Closing Date . . . [and] based on the past practices and accounting principles, methodologies and policies applied by [the Company]." From this, the court distilled two conditions with which the Closing Payment Statement and the Closing Statement had to comply: "i) they must be prepared from [the Company's] books and records; and ii) they must use the same accounting approach as had been used in the past."

The court noted that its interpretation was reinforced by the way the representations and warranties and the true-up fit together. Seller represented that the financial statements it provided to Buyer were prepared in accordance with GAAP, and that working capital was defined as being determined on the basis of GAAP consistently applied in preparation of the Company's financial statements. It therefore made sense that the accounting approach for working capital be the same as the historical approach taken for the Company's financial statements. It would be difficult to measure changes in the business between signing and closing if the accounting approach were not the same. The court also noted that the role of the independent auditor provided further support for this conclusion. Its role, as an expert and not an arbitrator, was limited, and did not extend to resolution of whether Seller had breached its representations and warranties. The court further noted that Buyer's interpretation "renders the Liability Bar meaningless and eviscerates the basic bargain between these two sophisticated parties."

An Analysis of Precedent

The court analogized its decision to the decision in *OSI Systems Inc. v. Instrumentarium Corp.,* [1] and distinguished it from the decision on *Alliant Techsystems Inc., v. MidOcean Bushnell Holdings, L.P.*[2] In *OSI*, the buyer's closing statement had to be "prepared in accordance with the Transaction Accounting Principles applied consistently with their application in connection with the preparation of the Reference Statement of Working Capital and the Statement of Estimated Closing Modified Working Capital. . . ." "Transaction Accounting Principles" was defined as "U.S. GAAP; provided, however, that (i) with respect to any matter as to which there is more than one principle of U.S. GAAP, Transaction Accounting Principles means the principles of U.S. GAAP applied in the preparation of the Financial Statements. . . ." The *Chicago Bridge* court noted that in *OSI*, as in *Chicago Bridge*, there was a representation that the historical financials complied with GAAP, and the language for the working capital adjustment "did not establish a separate GAAP compliance test, but instead a consistency test: the adjustment was to be 'in accordance with the Transaction Accounting Principles *applied consistently with their application in connection* with the preparation of the [statements based on historical financials].'"

The *Chicago Bridge* court distinguished *Alliant* on the basis that in that case, "the definition of Net Working Capital was that it was a relevant set of assets less liabilities on a consolidated basis 'and calculated in accordance with GAAP and otherwise in a manner consistent with the practices and methodologies used in the preparation of the [benchmark financial statements] . . .' the chancellor found that the use of two separate 'and's created two separate tests. The first test was if the calculation complied with GAAP. The second test was if the calculations were 'otherwise' consistent with how the seller had prepared its financial statements."

Takeaways

Whether GAAP-compliance arguments can be raised in the purchase price adjustment process, versus being solely a matter for post-closing indemnities, can have material importance. In *Chicago Bridge*, there was no cap on the purchase price adjustment, and there were zero post-closing indemnities. Thus, the ability to raise a GAAP-compliance issue meant having an approximately $2 billion claim that would not otherwise have existed.

The court in *Chicago Bridge* identified two approaches: one, that can be called the "consistency test" and was present in *Chicago Bridge* and *OSI*, and the other, which can be called the "bifurcated test", was present in *Alliant.* Under the consistency test, the working capital calculation uses an accounting approach that is consistent with that used by the acquired company. A GAAP-compliance test is not undertaken in connection with the purchase price adjustment because it would not achieve the goal of measuring changes in the business between signing and closing. A GAAP-compliance test can only be raised as a claim for breach of representations and warranties.

The bifurcated test, on the other hand, involves an initial GAAP-compliance inquiry followed by a consistency inquiry. An initial inquiry is made into whether seller's historical accounting approach (on which the net working capital calculation is based) is in accordance with GAAP. If it is not, then the buyer can reject the historical approach and calculate net working capital in accordance with GAAP. If it is in accordance with GAAP, then the accounting approach for the net working capital calculations should be otherwise consistent with the seller's historical accounting approach.

Acquirors will typically want the bifurcated test because it gives them the option of introducing a GAAP-compliance challenge into the purchase price adjustment process if it is in their interest to do so. What sort of roadmap to obtaining the bifurcated test do the three cases provide? In *Chicago Bridge*, the Closing Payment Statement and the Closing Statement had to "be prepared and determined from the books and records of the Company and its Subsidiaries and in accordance with [GAAP] applied on a consistent basis throughout the periods indicated and with the Agreed Principles." But this expressly references GAAP. The court appears to have been heavily influenced by the factual context, and by the other provisions in the purchase agreement, such as the Liability Bar and the releases, and de-emphasized the words "in accordance with

GAAP." In *OSI*, the Transaction Accounting Principles were defined as "U.S. GAAP; provided, however, that (i) with respect to any matter as to which there is more than one principle of U.S. GAAP, Transaction Accounting Principles means the principles of U.S. GAAP applied in the preparation of the Financial Statements. . . . " The words "U.S. GAAP" seem to have been similarly de-emphasized in light of the overall structure of the purchase agreement. So acquirors would be advised to assume that unless the language clearly specifies a bifurcated test, it is likely to be interpreted as a consistency test. The language in *Alliant* worked, although that may have been a close call.

Sellers, on the other hand, may wish to include an express statement that the parties understand and agree that the working capital adjustment provisions cannot be used to resolve any claims regarding whether the historical financial statements comply with GAAP, and that any such claims can only be made as part of a claim for breach of representations and warranties.

»Read the ruling.

Return to Table of Contents

EMSI Acquisition, Inc. v. Contrarian Funds, LLC, 2017 WL 1732369 (Del. Ch. May 3, 2017)

When drafting fraud carve-outs, parties should specify whether the fraud to be covered is intended to be contractual or extra-contractual, and whose fraud is covered.

EMSI involved a motion to dismiss a claim for post-closing indemnification based on a target company's alleged fraudulent financial statement misrepresentations under a stock purchase agreement (the SPA). Plaintiff's right of recovery turned on whether the fraud carve-out language in the SPA exempted claims for fraudulent misrepresentations in the SPA made by company management from the limits on recovery for indemnification under the SPA. The court held that the SPA was ambiguous, and refused to grant the motion to dismiss. The decision builds on the analytical framework for fraud carve-out provisions set forth in *Abry Partners V, L.P. v. F&W Acquisition LLC,*[3], and provides further guidance on drafting pitfalls to avoid.

The *EMSI* decision involved the sale of a company (the Company) by several institutional investors and two Company officers (collectively, Sellers) to a private equity fund (Buyer). A forensic investigation conducted after closing revealed that the Company had manipulated its work-in-progress model, inflating volume and prices, accelerating revenue recognition and falsifying progress on ongoing projects, which led Buyer initially to bring a claim through the working capital adjustment process. The aggregate purchase price adjustment determined by a settlement auditor exceeded the amount placed in escrow. Buyer then brought a legal action to recover the shortfall in the purchase price adjustment, and to recover damages for the inflated price it paid as a result of the Company’s alleged fraud.

The SPA Language

The court noted that the SPA contained straightforward nonreliance language pursuant to which Buyer acknowledged that it was relying only on representations and warranties made under the SPA. The SPA, however, contained ambiguous and potentially contradictory language in the indemnification section, Article X. Section 10.2 set forth Sellers' indemnification obligations, including for breaches of representations and warranties such as the representations about the Company's financial statements in Article IV made by the Company (and not Sellers). Section 10.4 set forth various limitations, including the following language in Section 10.4(d):

> "Notwithstanding anything to the contrary in this Agreement . . . [t]he Buyer Indemnified Parties shall only be entitled to indemnification (i) with respect to Losses in respect of the representations and warranties (other than the Excluded Representations and the Specific Indemnity Items) to the extent of, and exclusively from, any then-remaining Escrow Funds. . . ."

Section 10.10(a) contained the following exclusive remedy language regarding breaches of representations, warranties and covenants:

> "From and after Closing (except . . . in the case of claims for fraud or willful or intentional misrepresentation), the sole and exclusive remedy of the Seller Indemnified Parties and the Buyer Indemnified Parties for any breach or inaccuracy, or alleged breach or inaccuracy, of any representation, warranty or covenant under, or for any other claims arising in connection with, any of the Transaction Documents . . . shall be indemnification in accordance with this Article X, subject to the limitation set forth herein. . . . "

Section 10.10(b) then carved out any claim based on fraud from this limitation:

> "Notwithstanding anything in this Agreement to the contrary (including . . . any limitations on remedies or recoveries . . .) nothing in this Agreement (or elsewhere) shall limit or restrict (i) any Indemnified Party's rights or ability to maintain or recover any amounts in connection with any action or claim based upon fraud in connection with the transactions contemplated hereby. . . ."

Buyer argued that Section 10.10(b) carved out fraudulent misrepresentations of Company management under Article IV of the SPA from the contractual limits on recovery. Defendants argued that the carve-out in Section 10.10(b) only applied to extra-contractual fraud, and that any claims for contractual fraud remained subject to the limitations under Article X.

The Abry Framework

In evaluating the parties' arguments, the court first reviewed the legal framework established for fraud carve-outs by the Chancery Court's decision in *Abry*. The *Abry* decision analyzed the type of fraud claims that could be waived, in light of Delaware's public policy against fraud. *Abry* involved the sale of shares of a company by one private equity fund to another. The stock purchase agreement at issue contained a broad nonreliance clause. The *Abry* court held that Delaware's public policy against fraud did not prevent buyers from contracting away their rights to bring claims based on extra-contractual representations through a clear nonreliance clause. With respect to representations and warranties under the stock purchase agreement, the *Abry* court held that parties could allocate the risk with respect to unintentional false statements of fact, but not intentional misrepresentations, because to do so would violate Delaware's public policy against fraud. A key point in both *Abry* and *EMSI* is that, as is typically the case in a stock purchase agreement, the allegedly fraudulent representations and warranties in both cases were made under the stock purchase agreement by the target company and not by the sellers. According to the *Abry* court, for a buyer to avoid the bargained-for-limits on its remedies, the sellers must have either known that the company's representations and warranties were false, or themselves lied to the buyer about a contractual representation and warranty. In other words, the sellers must have had an "illicit state of mind".

The Abry Framework Applied to EMSI

So how did the *EMSI* parties deal with the *Abry* framework? The *EMSI* court noted that the SPA contained both a specific nonreliance clause and a separation of the representations and warranties between Sellers and the Company, with the financial representation and warranty having been made only by the Company.

Sellers maintained that Section 10.10(a) preserved claims for "fraud or willful or intentional misrepresentation" within and subject to the contractual indemnification framework, and that Section 10.10(b) provided for a fraud exception with respect to extra-contractual representations. Sellers' interpretation of Section 10.10(a) was consistent with *Abry* because it addressed fraudulent misrepresentation made by officers of the Company, and not by Sellers. According to Sellers, given that Buyer's claims were based on fraudulent misrepresentation made by officers of the Company, they remained subject to the indemnification limits, including the cap, under the SPA.

Buyer rejected this argument, and maintained instead that Section 10.10(b) provided for a contractual exclusion from the indemnification limitations that was not present in *Abry*. Buyer argued that Section 10.10(b) expressly excluded from the indemnification limits any action or claim "based on fraud", regardless of whether the fraud was that of Sellers or that of the Company's officers. Thus, since Buyer's indemnification claim was based on the fraudulent misrepresentation of the Company's officers under the financial statements representation in the SPA, it was excluded from the indemnification limits.

The *EMSI* court noted that the SPA was ambiguous because the SPA contained "notwithstanding anything in this Agreement to the contrary" clauses in Sections 10.10(b) and 10.4(d) that appeared to override each other. The court found that it was at least reasonable to view the clause in Section 10.10(b) as overriding the clause in Section 10.4(d), as maintained by Buyer. Moreover, the very broad exclusion in Section 10.10(b) for "any action or claim based upon fraud" did not delineate between contractual fraud and extra-contractual fraud. The court found that both interpretations were plausible, and denied Sellers' motion to dismiss.

Takeaways

This case serves as a warning against liberal usage of "notwithstanding anything herein to the contrary" clauses, which can end up creating interpretive ambiguities, as it did in this case. One such ambiguity was whether the fraud carve-out could be interpreted as only carving out fraud for extra-contractual representations and warranties. Such an interpretation in *EMSI* seemed counterintuitive, given that the SPA also contained a nonreliance provision. But such ambiguities can still create leverage in litigation settlement discussions. A second ambiguity was whether the broad fraud carve-out for "any action or claim based on fraud" should be interpreted as applying to fraud by the company's management in addition to fraud by the sellers.

The lesson for both buyers and sellers is to proactively address these issues in the drafting, and avoid use of competing "notwithstanding anything herein to the contrary" clauses. Sellers should try to limit the fraud carve-out so that it is as narrow as possible. One way of doing that would be to argue against including any fraud carve-out language in the stock purchase agreement, and simply have buyer rely on the courts to apply Delaware's public policy exception should the requisite type of fraud occur. If that is not possible, sellers should try to ensure that fraud carve-out language applies to fraud of the sellers only, and not intentional misrepresentations by company management.

Buyers, on the other hand, will want to make the fraud carve-out as expansive as possible, so that it covers both contractual and extra-contractual fraud, and covers fraud of both the sellers and company management. As a related matter, it is now quite common for parties to include a definition of "fraud" in the acquisition agreement. Sellers will want a definition that tracks the elements of intentional, common law fraud as opposed to more expansive types of fraud, such as equitable fraud (which does not require proof of scienter) or negligent fraud. Buyers will want a broad definition of fraud that does not require scienter.

»Read the ruling.

Return to Table of Contents

Frederick Hsu Living Tr. v. ODN Holding Corp., 2017 WL 1437308 (Del. Ch. Apr. 14, 2017)

Selling company assets in order to generate funds to satisfy an obligation to redeem preferred stock may violate a board's fiduciary duties to residual claimants; fiduciary duties may require boards to commit an "efficient breach" of the redemption obligation.

In *Frederick Hsu Living Trust*, the Delaware Chancery Court refused to dismiss fiduciary duty claims against certain officers and directors of ODN Holding Corporation (the Company) and its controlling venture capital fund for improperly favoring the fund's interests, to the detriment of other stockholders, in connection with the sale of substantially all of the Company's businesses to generate cash to partially redeem preferred stock held by the fund.

The Facts

The fund, Oak Hill Capital Partners (Oak Hill), invested $150 million in the Company in 2008 in connection with the purchase of Series A Preferred Stock (the Preferred Stock). Following purchases of common stock of the Company in 2009, Oak Hill became the controlling stockholder, and had the right to designate three members of the Company's eight-member board of directors. The Preferred Stock contained a redemption right that was exercisable five years after the issuance date. The redemption right obligated the Company, following exercise by Oak Hill, to redeem the Preferred Stock for an amount equal to the original issue price plus declared and unpaid dividends. If the funds legally available for redemption were insufficient to cover the redemption price, the Company was obligated to redeem the maximum number of shares permissible. Thereafter, the Company was obligated to "take all reasonable actions (as determined by the [board] in good faith and consistent with its fiduciary duties) to generate, as promptly as practicable, sufficient legally available funds to redeem all outstanding shares of [Preferred Stock], including by way of incurrence of indebtedness, issuance of equity, sale of assets . . . or otherwise. . . . "

Prior to 2011, the Company engaged in a growth strategy, including through acquisitions. In 2011, after Oak Hill determined that it would have to exercise its redemption right in order to get its capital back, the Company changed its strategy and its management team. In 2012, the Company sold two of its four lines of business for $15.4 million. The sold businesses included two companies that had been purchased in 2007 for $46.5 million. In May 2012, the compensation committee of the board approved bonus agreements for the CEO and two other officers, which provided for payments if the Company achieved a "liquidity event", including redemption of at least $75 million of the Preferred Stock.

In August 2012, after the board had dropped to seven members, the board formed a special committee consisting of two nonmanagement directors unaffiliated with Oak Hill, which was tasked with evaluating alternatives for funding the redemptions and negotiating with Oak Hill. The Company's attempts to obtain a bank loan were unsuccessful. After some back and forth with Oak Hill, the special committee approved using $45 million of the Company's $50 million in funds to redeem a portion of the Preferred Stock, in return for an agreement by Oak Hill to forbear on any additional redemption payments until December 31, 2013, which forbearance was cancellable by Oak Hill on 30 days' notice. The court described this forbearance as largely illusory, given that Oak Hill could not compel the Company to make additional redemptions unless out of legally available funds, and it was unlikely such funds would become available before the end of the year.

In April 2014, the special committee approved the sale of another of the Company's businesses for $40 million. The board used the proceeds to redeem additional shares of Preferred Stock. In December 2014, the Company sold another portion of its remaining business, representing the majority of its remaining revenue, for $600,000, despite having paid $17 million for the business in 2010. In March 2016, Frederick Hsu, one of the founders of the Company, brought an action for breach of fiduciary duty by directors and certain officers, breach of fiduciary duty by Oak Hill, unlawful redemptions, and various other claims.

Legal Principles Applicable to Breach of Duty of Loyalty

After dismissing plaintiff's claims for unlawful redemptions because the Company had sufficient funds under Section 160 of the Delaware General Corporation Law to make the redemptions, the court considered plaintiff's breach of duty of loyalty claims.

The court held that in corporations with more than one class of stock, the directors' fiduciary duties run to the corporation and to "stockholders in the aggregate in their capacity as residual claimants, which means the undifferentiated equity as a collective, without regard to any special rights. . . . " The court noted that this is a presumptively long-term focus. However, that does not equate to a duty to ensure a corporation's perpetual existence, because there could be situations where continuing the corporation as a going concern could be value destroying.

The court noted that holders of preferred stock have rights that are generally contractual in nature. Citing *In re Trados Inc. S'holder Litig.*, the Court noted that preferred stockholders are owed fiduciary duties "only when they do not invoke their special contractual rights and rely on a right shared equally with the common stock."[4] The court noted that these principles apply, notwithstanding the contractual obligation of the Company to redeem the Preferred Stock.

The court noted that the "fiduciary status of directors does not give them Houdini-like powers to escape from valid contracts." According to the court, if directors breach their fiduciary duties when entering into a contract, it may be possible to invalidate the contract on fiduciary duty grounds. But that is not so where a corporation is already bound by a valid contract (like the redemption obligations of the Preferred Stock). The board still has to act consistent with its fiduciary duties when taking action under valid contracts. In such a situation, "there remains room for fiduciary discretion because of the doctrine of efficient breach."

Contractual Redemption Right Does Not Foreclose Fiduciary Duty Claims

Applying these principles to the situation under consideration, the court noted that the plaintiff was not relying on an efficient breach argument, because the divestitures took place before the redemption right contractually arose. The court noted that the complaint asserted that the board acted disloyally by selling off businesses to raise cash before the contractual redemption right was exercised, and that the divested businesses would have generated greater long-term return for the undifferentiated equity. Moreover, the redemption provisions expressly noted that the Company's obligation to generate sufficient cash to fund the redemption was subject to the board's fiduciary duties. The court noted that Oak Hill's contractual redemption right was not inconsistent with plaintiff's fiduciary duty claims.

Entire Fairness Is Standard of Review

The court then addressed the applicable standard of review. The court held that the allegations supported a reasonable inference that the directors acted to benefit Oak Hill, and thus entire fairness would apply. Of the nine directors who served on the board during the relevant period, the court found that the complaint adequately called into question the interests of seven of those directors, given that some were nominees of Oak Hill, one received a bonus that was tied to achieving $75 million in redemptions, and three outside directors took numerous steps that favored the interests of Oak Hill. Given that Oak Hill was a controlling stockholder, and used its power to its benefit in negotiations with the Company over the redemption right, use of a special committee, without the protection of a majority-of-the-minority vote, was not sufficient to change the standard of review from entire fairness to business judgment.

Allegations Supported Reasonable Inference of Lack of Entire Fairness

The court held that the allegations supported a reasonable inference that the decision to generate funds to pay off Oak Hill by pursuing a de facto liquidation of the Company was not entirely fair to the undifferentiated equity. The court found that the complaint supported a reasonable inference that it was not fair to the undifferentiated equity to change business strategy so as to stockpile cash to be available for the redemptions. According to the court, the Company could have continued to grow its business, redeemed the Preferred Stock over time, and generated returns for its common stockholders. According to the court, the complaint also supported a reasonable inference that the Company failed to obtain a fair price in the divestitures.

Takeaways

The decision is reminiscent of *In re Trados*, where a change of control transaction at the behest of the holders of preferred stock, who controlled the corporation, was similarly subject to an entire fairness standard of review. Both cases illustrate the risks to the board of pursuing exit transactions where the holders of common stock will receive little or no consideration.

Redemption provisions are a common feature of preferred stock instruments, particularly in private equity deals, and limit the down-side risk to the holders of the preferred stock. *Frederick Hsu Living Trust* highlights the risk that board action to generate funds to satisfy the redemption right may constitute a violation of the board's fiduciary duties. The risk of a duty of loyalty claim could be mitigated by providing in the terms of the preferred stock for a significant increase in the dividend rate following a failure of the corporation to redeem. The board would have to factor the economic implications of this in its assessment of whether it is in the best interests of the corporation and its residual claimants to sell assets to fund the redemption, or leave the preferred stock outstanding and accruing high dividends.

Another mitigation strategy would be to have the borrower be a limited liability company instead of a corporation. Board fiduciary duties can be substantially eliminated in limited liability companies, unlike in corporations.

Frederick Hsu Living Trust arguably also has some implications for drag-along rights, which, like redemption rights, are contractual rights that may be used to the benefit of controlling stockholders. In the wake of *In re Trados*, many practitioners advocated the use of drag-along rights as a way of avoiding *Trados*-like fiduciary duty actions. The theory is that if the stockholders have the contractual ability to force a sale of the corporation through a drag-along right, the decision whether to sell is made by the stockholders and not the board, and thus the board's fiduciary duties are not implicated. In *Frederick Hsu Living Trust*, Vice Chancellor Laster raised the possibility (in dictum) that a board may have a fiduciary duty to cause the corporation to breach its contractual obligations. Thus, to the extent that exercise of drag-along rights involves action by the corporation (as most drag-alongs do), *Frederick Hsu Living Trust* can be read as suggesting that boards may have a fiduciary duty to residual claimants to consider whether to cause the corporation not to comply with the drag-along procedures. Such an interpretation of a board's fiduciary duties would undermine the effectiveness of drag-alongs as solutions to the *Trados* problem.

A final point worth noting is that unlike the board in *In re Trados*, the board in *Frederick Hsu Living Trust* used a special committee as a procedural protection for the holders of common stock. The court in *Frederick Hsu Living Trust* noted that both an effective special committee and a majority-of-the-minority vote were required under the facts of the case in order to invoke the business judgment standard of review. A special committee on its own can have the more modest potential benefit of merely flipping the burden of proving lack of entire fairness to the plaintiff. A majority-of-the-minority vote will in many cases not be practicable, given that the holders of common stock can be expected to vote against any liquidation event that will result in them not receiving any consideration. As a result, it will generally not be possible to avoid an entire fairness standard of review in the types of situation presented by *In re Trados* and *Frederick Hsu Living Trust*.

»Read the ruling.

Return to Table of Contents

Buttonwood Tree Value Partners, L.P. v. R.L. Polk & Co., Inc., 2017 WL 3172722 (Del. Ch. July 24, 2017)

Actions of family members that acted as a controlling group, and directors allied with them, were subject to entire fairness review when the company they controlled conducted a self-tender offer in which tendering stockholders received less than nontendering stockholders received approximately two years later in a cash-out merger.

Buttonwood Tree Value Partners involved claims by minority stockholders against an alleged control group of family members and the directors representing them for breach of their fiduciary duties of care and loyalty in connection with a self-tender offer by RL Polk & Co. (the Company). Members of the Polk family, which controlled the Company since its founding in 1870, held more than 90 percent of the stock of the Company at the time the Company commenced a self-tender in March 2011 to purchase Company shares at $810 per share (the Self-Tender). In October 2012, fifteen months after the self-tender offer expired, the Company engaged a financial advisor to explore a sale. The Company was sold to IHS, Inc. (IHS) in June 2013 for $2,675 per share. The Company declared a special dividend of $240 per share and two extraordinary dividends of $25 per share in 2012 prior to the sale to IHS. The plaintiffs were minority stockholders that sold shares in the Self-Tender and, as a result, they argued, forwent extraordinary dividends amounting to more than one-third of the tender offer price they received, and merger consideration that was three times the Self-Tender price received. The Chancery Court ruled at the motion to dismiss stage that the claim relating to the members of the Polk family forming a control group could proceed at the pleading stage because it was reasonably conceivable that the Polk family controlled the Company and engineered and stood on both sides of the Self-Tender. As a result, the court would analyze the claim under the entire fairness standard and found that the complaint adequately pled facts alleging that the transaction was not entirely fair to the plaintiffs.

Background

The Company was a consumer marketing information company that collects and interprets data to help customers make informed decisions. Its assets included Carfax, Inc., a provider of vehicle history reports. The Company described itself as being minority held, although approximately nine percent of its outstanding shares of common stock were publicly held. The Company's board of directors (the board) included three members of the Polk family—Stephen Polk (the Company's chairman, CEO and president), Nancy K. Polk (Stephen Polk's sister-in-law) and Katherine Polk Osborne (Stephen Polk's niece) (together, the Polk Family Directors)—along with four other members who were not Polk family members (the Non-Polk Directors).

Starting in 2008, the board explored a number of strategic options for the Company beginning with a self-tender at $850 per share, a price that was supported by an oral fairness opinion delivered by Stout Risius Ross Inc. (SRR), a firm that renders valuation and financial opinions. The board eventually postponed this initial self-tender offer indefinitely as a result of economic uncertainties and the decline of the automotive industry. Following the 2008 self-tender postponement, the board explored a number of other possible corporate restructuring transactions, including a conversion of the Company to Subchapter S status and a short-form merger (examination of which was delegated to a committee of Non-Polk Directors). Throughout 2010 and 2011, the Company and its counsel, Honigman, Miller Schwartz & Cohn LLP (Honigman), undertook significant work related to these corporate restructuring transactions, which the plaintiffs allege were a ruse to justify the elimination of minority stockholders prior to a more lucrative sale to a third party, but ultimately did not enact any corporate restructuring. In December 2010, Honigman prepared and delivered a legal memorandum to the board regarding a potential sale of the Company.

At a March 9, 2011 board meeting, Stephen Polk informed the board that "the Polk family was no longer interested in pursuing a short-form merger" and that Company management was instead interested in buying back shares of minority stockholders and various Polk family members. The board engaged SRR, which first delivered an oral fairness opinion and then a written fairness opinion stating that the proposed price for the Self-Tender, $810 per share, was fair from a financial point of view. The court noted that the Company's stock traded in the $600 to $650 per share range prior to the Self-Tender. The Company launched the Self-Tender on March 31, 2011 with an expiration of May 16, 2011.

The disclosures in the offer to purchase (the Offer to Purchase) circulated in connection with the Self-Tender noted that the Polk Family "owned or controlled 485,377 shares representing 90.5 percent of the total number of shares outstanding at the time of the Self-Tender." The Offer to Purchase disclosed that Polk family stockholders intended to tender approximately 10,000 shares in total, but that they might tender more or fewer shares. The Offer to Purchase further stated that the board did not consider other strategic options, including a merger or consolidation of the Company, the sale or transfer of all or a substantial part of the Company's assets or a purchase of securities in a change of control transaction, as there were no firm offers for any such transaction. The Offer to Purchase stated that "the Polk family has not expressed interest in exploring any such transactions."

The plaintiffs' complaint included claims against (i) the Polk Family Directors and the other members of the Polk family who owned shares that were controlled by the Polk Family Directors, formed a part of the alleged control block, supported the Polk Family Directors or benefitted from their actions (the Polk Family Class), (ii) the Non-Polk Family Directors, (iii) the Company and other entities formed in connection with the structuring options the Company explored prior to the Self-Tender, and (iv) the Company's legal counsel and financial advisor for aiding and abetting. The claims against the Company and the other entities formed by the Company were dismissed at oral arguments. The court's decision addressed the claims with respect to the remaining defendant groups at the motion to dismiss stage. The claim against the Non-Polk Directors was dismissed because of a charter exculpatory provision and failure by the plaintiffs to adequately plead facts showing that the Non-Polk Directors were interested in the Self-Tender or not independent or acted in bad faith. The claims against the Company's legal counsel and financial advisor were likewise dismissed because the court did not find it reasonably conceivable that SRR or Honigman knowingly provided substantial assistance to any fiduciary's breach of duty. The claims against the Polk Family Class, however, were allowed to proceed and the transactions in question subjected to an entire fairness review.

Analysis of Claim Against Polk Family and Polk Family Directors

Citing *Kahn v. M&F Worldwide Corp.,* the court held that "[w]here a transaction involving self-dealing by a controlling stockholder is challenged, the applicable standard of judicial review is entire fairness."*5* The defendants have the burden of proving that the transaction was entirely fair to the minority stockholders. The court held that "it was reasonably conceivable that, through its 90 percent ownership stake, the Polk Family—including the Polk Family Directors—acted as a controlling stockholder such that entire fairness applies to [the] Self-Tender." In reaching that conclusion, the court first noted that "common familial relationships among holders of a majority of corporate voting power are not *per se* sufficient to establish a controlling group of stockholders." Here, however, there were a number of factors making it reasonably conceivable that the Polk Family acted as a controlling block. In addition to the three Polk family members serving on the board, the Offer to Purchase contained numerous references to the "Polk Family" as a single block and disclosed its shareholding as a collective block (i.e., 90.5 percent of the total number of shares outstanding). Most significant to the court was the allegation that Stephen Polk ended the discussions regarding the short-form merger the Company was exploring prior to the Self-Tender by informing the board that "the Polk Family was no longer interested in pursuing a short-form merger as a way to restructure the Company." Based on these facts, the court held that it was reasonably conceivable that the Polk Family Class and the Polk Directors "controlled the Company and engineered—and stood on both sides of—the Self-Tender." Accordingly, the entire fairness standard of review applied.

The court noted that the complaint alleged that the Polk Family Class and the Polk Directors set a price for the Self-Tender through the use of a financial advisor that also worked for members of the Polk Family (in connection with the aborted short-form merger). The complaint "further alleges that those who tendered forwent, as a result, extraordinary dividends amounting to over one-third of the sale price they received, together with merger consideration in an amount three times the Self-Tender price, within a period of around two years." The court held that these facts sufficiently alleged, at the pleading stage, that the transaction was not entirely fair to the plaintiffs. Accordingly, the court refused to dismiss the claims, including various disclosure-related claims, against the Polk Family Class and the Polk Directors.

Takeaways

Buttonwood Tree Value Partners reinforces that the actions of controlling stockholders and related directors may be later scrutinized under an entire fairness standard of review when a series of transactions results in significantly different valuation outcomes for minority stockholders.

There are several potential structural protections that do not appear to have been employed in this case. Application of entire fairness as the applicable standard of review, and the resulting inability of the defendants to have the case dismissed at the pleadings stage, turned on the plaintiffs making the requisite showing that the Polk Family Class acted as a control block. The court noted that common familial relationships does not *per se* establish a controlling group of stockholders. The Polk Family Class could have established procedures, perhaps through the use of family trusts, to ward against the conclusion that they functioned as a control block. They could also have been mindful of not making public disclosures that indicated that they functioned as a control block.

Another structural protection that does not appear to have been employed in connection with the Self-Tender is the use of a special committee of disinterested and independent directors with full authority to consider strategic alternatives, to employ legal counsel and financial advisors of its choice, and to negotiate at arms' length with the family stockholders. This is a bit surprising, given that the board appears to have formed a special committee in connection with consideration of a short form merger and converting the Company to Subchapter S status. Under *Kahn v. Lynch Comm'n Sys. Inc.,6* an effectively functioning special committee will flip the burden of proving lack of entire fairness to the plaintiffs. Under *Kahn v. M&F Worldwide Corp.*, both a special committee and a majority of the minority stockholder approval condition can result in business judgment as the applicable standard of review.

»Read the ruling.

Return to Table of Contents

Frechter v. Zier, 2017 WL 345142 (Del. Ch. Jan. 24, 2017)

Bylaw provisions of Delaware corporations requiring super-majority stockholder approval for removal of directors are invalid under Delaware law.

In *Frechter v. Zier*, the Court of Chancery found that a corporate bylaw provision that required a super-majority approval of the stockholders to remove a director was in violation of Section 141(k) of the DGCL.

On January 7, 2016, defendant Nutrisystem Inc., announced that it had amended its bylaws to delete a provision allowing for the removal of directors only for cause. The court noted that Nutrisystem was presumably responding to a recent decision by the Delaware Court of Chancery finding that removal "for cause" provisions in bylaws of Delaware corporations without classified boards or cumulative voting were prohibited by Section 141(k) of the DGCL.[7] Nutrisystem's amendment, however, left a provision in the bylaws requiring that a director may only be removed with the vote of 66-2/3 percent of the voting power of all of Nutrisystem's outstanding stock.

On February 24, 2016, the plaintiff, a stockholder of Nutrisystem, filed a class-action complaint against the company and its directors challenging the bylaw provision. In a decision on defendants' motion to dismiss and plaintiff's motion for summary judgment, the court reviewed the language of Section 141(k) of the DGCL, which provides that "[a]ny director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors. . . ." Based on the plain language of the statute, the court found the bylaw provision to be invalid.

The court then reviewed the defendants' contention that Section 141(k) is merely a permissive provision, in that it provides that holders of a majority of a company's shares "may" remove directors, but it does not prohibit bylaws from including a different requisite for director removal. Defendants pointed to other provisions of the DGCL which use "shall" or "must" language to argue that if there is a required vote for certain actions, the law uses mandatory language. The court disagreed with this reasoning, explaining that Section 141(k) provides that holders of a majority of shares may remove a director, but they are not required to do so; therefore mandatory language would not make sense. In addition, the court explained that the Nutrisystem bylaw does not allow holders of a majority of shares to remove directors, and is therefore inconsistent with the statute.

The court also noted the defendants' reading of Section 141(k) was inconsistent with the *VAALCO Energy* decision, where Vice Chancellor Laster found that language in Section 141(k) providing that directors "may" be removed for cause prohibited bylaws requiring cause for removal. Therefore, the language in Section 141(k) providing that directors "may" be removed by a majority vote similarly prohibits bylaws that require some other threshold for removal.

Takeaways

Given both *VAALCO Energy* and *Frechter*, companies are encouraged to review their bylaws to ensure they do not include impermissible provisions limiting the removal of directors for cause or requiring a supermajority vote. While *VAALCO Energy* related to legacy bylaw language that was not removed when the company in that case declassified its board[8] *Frechter* involved bylaw language that appears to have been intended as a form of take-over defense that was unrelated to any board classification.[9] *Frechter* provides clear guidance that this type of take-over defense is invalid. The *Frechter* court did not address whether it would have been valid if located in Nutrisystem's charter instead of its bylaws. Section 102(b)(4) of the DGCL, which permits charters to contain "[p]rovisions requiring for any corporate action, the vote of a larger portion of the stock or of any class or series thereof . . . than is required by this chapter", appears to authorize such an approach.

»Read the ruling.

Return to Table of Contents

Nguyen v. View, Inc., 2017 WL 2439074 (Del. Ch. June 6, 2017), reh'g denied, 2017 WL 3169051 (Del. Ch. July 26, 2017)

DGCL § 204 can only be used to ratify defective corporate actions, not corporate actions that stockholders have rejected.

In *Nguyen v. View*, the Court of Chancery determined that a corporation was not entitled to use Section 204 of the DGCL to ratify an action that the holder of a majority of the outstanding common stock was entitled to approve but deliberately declined to authorize and the corporation nonetheless decided to pursue.

The History

The plaintiff, Paul Nguyen, was the founder and former president, chief technology officer, and chairman of the board of directors of View Inc. In early 2009, he was terminated and removed as the chairman of the board. While disputes concerning his termination and removal were pending, View requested that Nguyen consent to a Series B round of financing for View. The financing would provide needed capital for the company, but would result in a significant diminishment of Nguyen's rights in the company, including eliminating his consent right to an amendment to the voting agreement that guaranteed his right to nominate one director and eliminating his right to approve any amendment to the certificate of incorporation which changed the number of authorized shares of common stock. During a mediation in September 2009, Nguyen and View reached a settlement of his termination claims, which settlement included Nguyen's consent to the Series B financing. The settlement agreement, however, importantly allowed either party to rescind the agreement within seven days of its execution.

Following the mediation, Nguyen reconsidered his decision to consent to the Series B financing, and, within the seven-day period, rescinded the settlement, thereby revoking his approval of the Series B financing. Before the seven-day period expired, however, View proceeded to close the Series B financing.

Over the next several years, while subsequent litigation regarding the effectiveness of Nguyen's rescission of the settlement and the revocation of his approval of the Series B financing were pending, View raised approximately an additional $500 million in Series C through F financings. In December 2015, an arbitrator found that Nguyen had properly rescinded the settlement and revoked his approval of the Series B financing, thereby rendering the Series B financing, as well as all of the subsequent financings, void and invalid. In addition, the voting agreement was reinstated, giving Nguyen the right to designate one member of the board.

The Series A investors attempted to salvage matters in early 2016 by converting their Series A shares into common stock, displacing Nguyen as majority common stockholder and causing the voting agreement to expire pursuant to its terms. In 2016, View then filed various certificates of correction and certificates of validation with the Delaware Secretary of State pursuant to DGCL Section 204 purporting to ratify the various defective charter amendments and other corporate acts. Of particular import to the case was View's attempt to ratify the Series B financing that the arbitrator had found void and invalid. Nguyen sued under DGCL Section 205 challenging the validity of the ratifications, and View brought a motion to dismiss Nguyen's claim.

The Court's Denial of View's Motion to Dismiss

In denying View's motion to dismiss, the court reviewed the legislative history of Section 204, explaining that its purpose was to provide a "safe harbor procedure" for corporations to validate acts that would otherwise be "void or voidable" due to a failure to comply with the applicable provisions of the DGCL or the corporation's organizational documents. The court explained that the express language of Section 204 requires that the defective corporate acts that a corporation purports to ratify must be within the corporation's power "at the time such act was purportedly taken." The court found that here, at the time of the acts that were sought to be ratified in 2016, Nguyen had class voting protections as the holder of the majority of the common stock and the right to appoint one member to the board. The ratifications therefore had to be assessed in light of that situation. The court explained that there is a difference between a failure of authorization, which is within the purview of Section 204, and a rejection of a corporate proposal, which is not. Nguyen expressly did not approve the transaction, his approval was required as the majority common stockholder and View proceeded with the Series B financing anyway. Therefore, Section 204 cannot be now used to ratify the actions at issue.

The court then considered View's argument that because the Series A holders had the right to convert their preferred stock into common prior to the Series B financing, the court should consider the attempt to ratify the Series B financing as if the conversion happened prior to the transaction, not years later as actually occurred. The court found that Section 204 cannot be used to backdate an act that occurred but that the corporation wishes had occurred as of an earlier date. In addition, the court could find no application of Section 204 or 205 by the Chancery Court or Supreme Court to a case where a corporation sought to use statutory ratification to alter the outcome of a stockholder vote.

Takeaways

There is frequently corporate clean-up that needs to be undertaken by private target companies prior to M&A transactions. The Court of Chancery has provided clear guidance that DGCL Section 204 cannot be used to ratify acts that stockholders have rejected.

»Read the ruling.

Return to Table of Contents

In re Appraisal of GoodCents Holdings, Inc., 2017 WL 2463665 (Del. Ch. June 7, 2017)

Drafters of preferred stock terms should ensure that liquidation preference provisions applicable to mergers are not inadvertently drafted as voting provisions.

The Court of Chancery held that holders of common stock were entitled to a pro rata share of the merger consideration, instead of it all going to the holders of preferred stock, because the merger did not trigger the liquidation preference of the preferred stock but merely provided the preferred stockholders with a class vote on the merger.

In re Appraisal of GoodCents Holdings Inc. involved an appraisal action by holders of common stock of GoodCents Holdings Inc. (the Company), stemming from a merger in which the merger proceeds of approximately $57 million was less than the preferred stock liquidation preference of approximately $73 million. Section B.6.a and B.6.b of the Company's certificate of incorporation provided that on a liquidation, dissolution or winding up of the Company, the Series 1 Cumulative Convertible Preferred Stock (the Preferred Stock) was entitled to a 1X liquidation preference plus declared or accrued and unpaid dividends. If assets available for distribution to stockholders were insufficient for this liquidation preference, the assets would be distributed to the holders of Preferred Stock on a pro rata basis.

While Sections B.6.a and B.6.b addressed a liquidation, dissolution or winding up of the Company, Section B.6.c addressed mergers. Section B.6.c of the Company's certificate of incorporation contained the following language:

> "Without the affirmative vote of the holders of a majority of the [Preferred Stock], the [Company] shall not . . . effect any merger or consolidation . . . unless the agreement or plan of merger . . . shall provide that the consideration payable to the stockholders of the [Company] . . . shall be distributed to the holders of capital stock of the [Company] in accordance with Sections B.6.a and B.6.b above."

The court interpreted Section B.6.c as composed of two clauses: (i) the first contains a prohibition on any merger or consolidation without the affirmative vote of the holders of a majority of the Preferred Stock; and (ii) the second provides that the class vote falls away if the merger agreement provides the holders of Preferred Stock with the liquidation preference described in Section B.6.a and B.6.b. The court therefore interpreted Section B.6.c as providing the Preferred Stock with a limited voting right in the event of mergers or consolidations, but not providing them with a liquidation preference. As a result, pursuant to the certificate of incorporation, the holders of preferred stock were not entitled to receive all of the merger consideration. Ruling in favor of the appraisal petitioners, the court held that the petitioners were entitled to their proportionate share of the fair value of the Company considering the preferred stock on an as-converted basis.

Takeways

The decision provides a reminder of the fact that the rights of holders of preferred stock are generally contractual in nature, as set forth in the certificate of incorporation (or certification of designations). Holders of preferred stock should carefully scrutinize the drafting to ensure that the language provides for the rights they intend.

»Read the ruling.

Return to Table of Contents

Le Norman Operating LLC v. Chalker Energy Partners III, LLC, 2017 WL 4366265 (Tex. App. Oct. 3, 2017)

Negotiating parties should seek to establish at the outset of negotiations the specific terms pursuant to which a binding contract may be established between the parties and should be mindful of the need to adhere to the restrictions of any bidding or negotiation process established between the parties in order to rely upon the requirements thereof when later determining whether a binding contract has been established.

Background and District Court Decision

Le Norman involved the sale of oil and gas interests located in the Texas panhandle. Chalker Energy Partners III, LLC (Chalker Energy) served as the agent of the sellers (the Sellers) who sought to sell these oil and gas interests through a bidding process. Following this bidding process and other negotiations, Le Norman Operating LLC (LNO) believed that it had entered into an agreement to purchase the oil and gas interests subject only to the execution of a final purchase and sale agreement (PSA); however, the Sellers ultimately sold the oil and gas interests at issue to an unrelated third party, Jones Energy. In the ensuing breach of contract suit filed by LNO, the trial court granted summary judgment for the

Sellers, finding that no contract had been formed by the advanced negotiations conducted between the Sellers and LNO. However, the Texas First Court of Appeals reversed the trial court as to this issue, finding that there was a genuine dispute of material fact as to whether LNO and the Sellers had entered into a binding agreement.

For the initial marketing process, the Sellers used a slide presentation regarding use of the virtual data room and two bid instruction letters (the Bid Documents) to govern the bidding process for the oil and gas interests they sought to sell, establishing the format in which bids should be submitted and the content that the bids should include (the Bid Form). The Bid Documents stated that once Chalker Energy received bids, each individual Seller would be given 24 hours to elect to sell their interests. Each bidder could then adjust its bid in response to the Sellers' elections, and Chalker Energy would negotiate a definitive purchase agreement with the winning bidder. Finally, each Seller would have 48 hours to decide whether to accept the terms of the purchase agreement.

The bidders were required to sign a confidentiality agreement with Chalker Energy (the Confidentiality Agreement) to obtain access to the data room and be able to participate in the bidding process. The Confidentiality Agreement stated, in relevant part, that:

> "The Parties hereto understand that unless and until a definitive agreement has been executed and delivered, no contract or agreement providing for a transaction between the Parties shall be deemed to exist and neither Party will be under any legal obligation of any kind whatsoever with respect to such transaction. . . . For purposes of this Agreement, the term 'definitive agreement' does not include an executed letter of intent or any other preliminary written agreement or offer, unless specifically so designated in writing and executed by both Parties."

Both LNO and Jones Energy submitted their bids by the deadline of November 5, 2012, emerging as the two highest bidders. The Sellers then extended the deadline to November 9, 2012, and asked both parties to increase their bids. LNO did so, and—as with the initial bid—followed all bid procedures and expressly referenced the bid instructions. Chalker Energy selected LNO's revised offer to present to the Sellers, but negotiations between the Sellers and LNO were ultimately unsuccessful and LNO informed Chalker Energy on November 14, 2012 that it would no longer pursue the transaction.

On November 19, 2012, the deal revived when LNO proposed new deal terms via email, including a revised purchase price, timeline and other terms, along with the statement that the final PSA would be similar to what LNO had returned in the initial round of negotiations. In doing so, LNO submitted its revised deal terms without using the Bid Form or making any reference to the bid procedure. Chalker Energy presented the emailed offer to the Sellers, giving them less than 24 hours to decide whether to accept the offer, which also violated the established bid procedure. On November 20, 2012, the Sellers elected to participate in the sale to LNO, and final negotiations on the PSA began. Chalker Energy represented to LNO that they would finalize the PSA after the Thanksgiving holiday, and told LNO that the Sellers were committed to sell "subject to a mutually agreeable PSA." While negotiations between LNO and Chalker Energy were ongoing, Jones Energy presented a new offer to Chalker Energy, which Chalker Energy in turn presented to the Sellers. On November 23, 2012, the Sellers elected to sell the assets to Jones Energy instead of LNO, and on November 28, 2012, the Sellers and Jones Energy finalized and executed their PSA and LNO learned about the deal between the Sellers and Jones Energy for the first time.

As a result of the transaction between the Sellers and Jones Energy, LNO filed a lawsuit against the Sellers alleging that the Sellers breached their agreement, formed through the email correspondence between such parties on November 19 through November 20, to sell the oil and gas interests to LNO. The Sellers responded by arguing that "the formal bid process, as set out in the Bid Documents and Confidentiality Agreement, controlled all of the relevant negotiations and, thus, a formalized PSA was necessary to create a contract that was binding on them." The Sellers also argued that the November 19 through November 20 emails could not form the basis for a binding contract under the Texas Uniform Electronic Transactions Act (UETA) because the parties did not explicitly agree to conduct business electronically and the Sellers' email correspondence "accepting" LNO's offer lacked an electronic signature. The trial court granted summary judgment for the Sellers, finding, among other things, that "[t]here was no meeting of the minds because any offer and acceptance was subject to the bid process rules," "[a] PSA was a condition precedent to contract formation," and the emails did not constitute a contract under UETA. LNO challenged these findings via appeal to the Texas Court of Appeals.

Texas Court of Appeals

Formation of the Contract

With respect to the formation of a contract, the Sellers argued that in the absence of an executed PSA, the Bid Documents and Confidentiality Agreement precluded the existence of a valid contract. LNO argued that there was a genuine issue of material fact regarding whether the alleged contract set out in the November 19–20 emails was actually subject to the bid process rules. The court agreed with LNO and reversed the trial court's summary judgment order as to contract formation.

In reaching this decision, the court looked to the behavior of the parties, along with the context and terms of the November 19–20 emails. The court noted that the November 19 offer did not conform to the format required by the Bid Documents and, unlike LNO's other offers, did not state that it was made in accordance with the bid procedures. Moreover, the court found that this email was sent "after the initial bid process had concluded and after the procedure set out in those documents failed to result in a sale of the Assets." Additionally, the deadlines in the November 19 offer contradicted the terms of the bid procedure—the offer was made after the deadline contemplated by the Bid Documents, and LNO requested an immediate response to its offer in contravention of the bid procedure. The court also emphasized that "the Sellers' own conduct in continuing to negotiate with LNO even after it deviated from the bid procedures . . . raises a fact question regarding whether the parties intended to enforce or rely upon the procedures set out in the Bid Documents during their November 19–20 negotiations." For example, Chalker Energy gave the Sellers less than 24 hours to respond to LNO's bid, and none of them objected.

The court also looked to the language of the Confidentiality Agreement in reaching its holding. While the Confidentiality Agreement did state that a letter of intent or preliminary agreement was not a "definitive agreement", it did not specify what actually would constitute a "definitive agreement". Thus, the court found that because "[t]he November 19-20 emails and written elections of the Sellers constitute a writing that sets out the assets to be sold, the purchase price, a closing day, and other key provisions . . . a fact issue exists as to whether the November 19–20 email chain and subsequent written elections were sufficient to constitute a 'definitive agreement' for the sale of the Assets." The court consequently concluded that the conduct of the parties and the language of the Confidentiality Agreement "constitute[d] at least some evidence that the parties agreed and had a meeting of the minds on the essential terms of the sale sufficient to create a contract, even if they left other provisions for later negotiation, and that both parties communicated consent to those essential terms."

Finally, the court distinguished *WTG Gas Processing, L.P. v. ConocoPhillips Company*.[10] That case involved a similar sales transaction, where ConocoPhillips sold a natural gas processing facility to another party, instead of selling it to WTG, who was in the process of negotiating a PSA. The parties in *WTG Gas* were subject to a bid procedure that was similar to the procedure at issue here—those bid procedure documents also included provisions stating that ConocoPhillips did not intend to be bound absent the execution of a PSA. The *WTG Gas* court ultimately found that the execution of a PSA was a condition precedent to contract formation. However, the *Le Norman* court distinguished *WTG Gas* by noting that (1) the parties in *WTG Gas* "stipulated that WTG's bid was made in accordance with ConocoPhillips's bid procedure, but LNO made no such concession here;" (2) in *WTG Gas*, the alleged contract was "an oral contract based on representations made during the course of a telephone call that occurred during on-going negotiations," while LNO's alleged contract was in writing; and (3) unlike in *WTG Gas*, nothing in the agreements at issue in *Le Norman* indicated that the execution of a PSA specifically was a condition precedent to contract formation. Moreover, in *WTG Gas*, "ConocoPhillips informed WTG throughout the negotiation process that it was still assessing other bids; it informed WTG periodically of the status of negotiations with the other party; and at one point it even referred to WTG as a 'good alternative' if the negotiations with the other party fell through." In contrast, the Sellers never informed LNO that they were also negotiating with Jones Energy, instead representing to LNO that they were "committed to sell" their assets to LNO. Therefore, the court determined that the behavior of ConocoPhillips was materially different from that of the Sellers, and that *WTG Gas* was distinguishable.

In sum, the court determined that LNO presented at least some evidence that (1) the Bid Documents and other bid procedures did not apply to the negotiations between the parties as of November 19, 2012, and (2) the November 19–20 emailed offer and acceptance was a "definitive agreement" within the meaning of the Confidentiality Agreement. The court accordingly held that the trial court erred in granting the Sellers' motion for summary judgment on contract formation grounds.

The Texas Uniform Electronic Transactions Act (UETA)

The UETA stipulates that a legal requirement of a writing can be satisfied with an electronic record, and a legal requirement of a signature can be satisfied by an electronic signature.[11] It only applies to "transactions between parties each of which has agreed to conduct transactions by electronic means." The UETA does not require an explicit agreement to conduct transactions by electronic means, but instead provides that "[w]hether the parties agree to conduct a transaction by electronic means is determined from the context and surrounding circumstances, including the parties' conduct."

Thus, the court again looked to the parties' conduct, finding that the parties consistently engaged in negotiations and other relevant business via electronic means. This conduct "constitute[d] at least some evidence that the parties agreed to conduct some of their transactions electronically." Additionally, the court found that "the emails that LNO alleges formed the basis of the agreement between the parties identified the sending parties in the 'from' line and contained names or signature blocks identifying the senders," which "raises at least a fact question regarding whether the emails were signed electronically." Therefore, the court held that there was evidence that the relevant emails were "signed" within the meaning of the UETA, that there was evidence that the parties had agreed to conduct transactions electronically, and that the trial court erred in granting the Sellers' motion for summary judgment on these bases.

Takeaways

Negotiating parties should be specific in confidentiality and other initial agreements when defining when the parties are to be bound and what will constitute a "definitive agreement" between the parties, so that a binding contract is not unintentionally created prior to the completion of negotiations. In this case, while the parties attempted to provide for a period of negotiation prior to the creation of a binding contract, the court found that the language used by the parties (e.g., that the Sellers' acceptance of LNO's offer was "subject to a mutually agreeable PSA") was not sufficiently definitive or specific, and that a fact issue existed as to whether the Sellers had (i) lost the protection of the more fulsome language and negotiation procedures included in a formal bid process when the bid process concluded and negotiations were later restarted outside of the original formal bid process and (ii) created a binding agreement by accepting the material contract terms proposed by LNO via the parties' email correspondence. Additionally, in assessing the relationship between the Sellers and LNO, the court looked to the conduct of the parties in addition to their writings in determining whether an enforceable contract had been formed, including the Sellers' operation outside the bounds of their established Bid Documents and their failure to inform LNO of the existence of renewed negotiations with Jones Energy. As a result, negotiating parties should be mindful of the need to establish at the outset of negotiations the process pursuant to which a binding contract may be created by the parties as well as the need to stay within the terms of any corresponding negotiating framework established by the parties in order to rely upon the protections thereof when later determining whether a binding contract exists.

»Read the ruling.

Return to Table of Contents

Conclusion

As they have been in prior years, Delaware and other courts were active in 2017 in providing important guidance for private company M&A. Decisions concern the drafting and negotiating process, takeover defenses, governance matters, and controlling stockholder fiduciary duties. Some of the cases provide important reminders with respect to old themes, and some shed new light on topics that arise in many deals. Practitioners would be well advised to take note of the lessons imparted by the decisions.

Brandon Hauver and Evan Leitch contributed to this article. Mr. Hauver is a graduate of Southern Methodist University Dedman School of Law and is employed at Arnold & Porter Kaye Scholer LLP's Denver office. Mr. Hauver is admitted only in Texas. He is not admitted to the practice of law in Colorado. Mr. Leitch is a graduate of the University of Iowa College of Law and is employed at Arnold & Porter Kaye Scholer LLP's Denver office. Mr. Leitch is admitted only in New York. He is not admitted to the practice of law in Colorado.

1 892 A.2d 1086 (Del. Ch. 2006)

2 2015 WL 1897659 (Del. Ch. Apr. 24, 2015)

3 891 A.2d 1032 (Del. Ch. 2006)

4 74 A.3d 17, 39-40 (Del. Ch. 2013)

5 88 A.3d 635, 642 (Del. 2014)

6 638 A.2d 1110 (Del. 1994)

7 See In re VAALCO Energy Inc. S'holder Litig., C.A. No. 11775-VCL (Del. Ch. Dec. 21, 2015). See also our summary of this decision located here.

8 As noted in our prior summary (referenced in footnote 9 above), the *Vaalco Energy* decision put public companies on notice of the risk of "hold up" law suits if they failed to address problematic legacy bylaw language following a board declassification.

9 Based on EDGAR filings, as a publicly traded company, Nutrisystem Inc. has never had a staggered board.

10 309 S.W.3d 635 (Tex. App.—Houston (14th Dist.) 2010)

11 Tex. Bus. & Com. Code Ann. § 322.007(c), (d) (West 2015)

About Arnold & Porter Kaye Scholer

Arnold & Porter Kaye Scholer is a 1,000+ lawyer firm with sophisticated litigation and transactional capabilities, renowned regulatory experience and market-leading multidisciplinary practices in the life sciences and financial services industries.

Our lawyers practice across more than 40 practice areas, including bankruptcy, corporate finance, intellectual property, litigation, real estate and tax, to help clients with complex needs stay ahead of the global market, anticipate opportunities and address issues that impact the very value of their businesses.

From 13 offices around the globe, we offer clients forward-looking, results-oriented solutions that resolve their US, international and cross-border legal needs.

Key Contacts

Nicholas O'Keefe

Partner, Silicon Valley
+1 650.319.4522

nicholas.okeefe@apks.com

Edward A. Deibert

Partner, San Francisco
+1 415.471.3149

edward.deibert@apks.com

Ronald R. Levine, II

Partner, Denver
+ 1 303.863.2335

ron.levine@apks.com

Michael J. Isaacs

Associate, Silicon Valley
+1 650.319.4526

michael.isaacs@apks.com

Alexa D. Jones

Associate, Denver
+1 303.863.2344

alexa.jones@apks.com

Brandon Hauver and Evan Leitch contributed to this compilation. Mr. Hauver is a graduate of Southern Methodist University Dedman School of Law and is employed at Arnold & Porter Kaye Scholer LLP's Denver office. Mr. Hauver is admitted only in Texas. He is not admitted to the practice of law in Colorado. Mr. Leitch is a graduate of the University of Iowa College of Law and is employed at Arnold & Porter Kaye Scholer LLP's Denver office. Mr. Leitch is admitted only in New York. He is not admitted to the practice of law in Colorado.

Brussels | Chicago | Denver | Frankfurt | Houston | London | Los Angeles | New York | San Francisco
Shanghai | Silicon Valley | Washington, DC | West Palm Beach

apks.com