Highlights from 2013 and Implications for 2014

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During 2013 shareholder activism continued to surge and impact corporate-decision making. The Delaware courts also handed down several significant rulings during the year. 2013's activist campaigns and court rulings are likely to influence M&A market participants in 2014 and beyond.

Shareholder Activism

While 2013 saw its share of traditional activism focused on corporate governance initiatives, the year is especially notable for the significant number of activist campaigns focused on creation of shareholder value both in the short-term (dividends, buybacks, spinoffs or sales) and the long-term (improved capital management, operational efficiencies, compensation arrangements, or board structure and membership). Several high profile activist situations in 2013, including campaigns against Apple, Microsoft, Pepsico and Air Products, proved that no company is too large or profitable to attract an activist investor. With activist funds having outperformed other investment models in 2013, and in turn, gaining greater access to capital, market participants of all sizes should be prepared for continued activist shareholder initiatives in 2014.

Companies and their advisors should be proactive and address anticipated activist situations by engaging in regular discussions with institutional and other influential shareholders. Activists have received increasingly positive reviews in the media, and have garnered institutional investors' support in many situations. However, institutional investors have also established enhanced internal capabilities for independently analyzing activist campaigns and will not necessarily agree with all strategies proposed by activists. Companies and advisors should also prepare themselves for activism by assessing and correcting potential operational, financial or structural vulnerabilities, monitoring their shareholder base to identify unusual trading activity, and working with advisors to prepare a strategy to respond to an activist investor should one arrive on the scene.

Regulation of Proxy Advisory Firms

As activists put forth more proposals for shareholder consideration each year, the influence of proxy advisory firms has grown. In 2013, the role of proxy advisory firms received increased attention.

The SEC held a roundtable discussion and solicited public comment related to the regulation of proxy advisory firms, and Nasdaq filed a rule-making petition urging the SEC to tackle this issue. These issues also received significant attention from a U.S. House subcommittee, the European Securities and Market Authority and the Canadian Securities Administrators. Regulators and commentators have also called increasingly for the repeal of previously granted no-action relief shielding investment advisors from liability if they vote in accordance with the recommendation of proxy advisory firms. We expect the increased domestic and international regulatory focus on proxy advisory firms to continue in 2014 with a view toward requiring that the methodologies used by proxy advisory firms be transparent to companies and their shareholders and that conflicts of interest are properly treated and disclosed.

Buyouts and the Majority of the Minority Condition

2013 brought a potentially game changing decision from the Delaware Chancery Court that also highlights the important role of an independent special committee in interested party transactions. The court in *In re MFW Shareholders Litigation* held that a controlling shareholder transaction subject to shareholder challenge will be reviewed under the deferential "business judgment rule" if the transaction was *both* negotiated and approved by an independent special committee of the board *and* included a non-waivable majority of the minority vote condition. Before *MFW*, while some courts had suggested the possibility of applying the business judgment rule to controlling shareholder transactions with both a special committee and a majority of the minority vote, controlling shareholder transactions were subject to the more stringent "entire fairness" standard. The case has been appealed to the Delaware Supreme Court and a ruling is expected in 2014. In the meantime, it remains to be seen whether companies will structure their transactions in accordance with *MFW* and conclude that the legal benefits of business judgment rule protection outweigh the execution risk posed by a non-waivable majority of the minority condition.

Both a special committee and a majority of the minority condition were used in the 2013 Dell Inc. buyout. The special committee in Dell negotiated significant rights to protect minority shareholders, including a go-shop and a majority of the minority condition. After a robust go shop process failed to yield a competing bid, the special committee leveraged the rights it had negotiated to increase the value offered by the buyout group in exchange for amending the majority of the minority condition to lower the vote threshold from a majority of the minority shares outstanding to a majority of the minority shares actually voted. Chancellor Strine, who was recently nominated to the Delaware Supreme Court, refused to second-guess the special committee and praised the board's process. The Dell buyout illustrates how a strong special committee can generate credibility with the courts and other constituents and succeed in obtaining additional value for shareholders.

Forum Selection Bylaws and Disclosure-Only Settlements

In 2013, the Delaware Chancery Court upheld the validity of, and many companies adopted, forum selection bylaws. Absent a forum selection bylaw, M&A litigation is often brought in federal court, Delaware and the state where the target is headquartered. By adopting a forum selection bylaw, companies can make Delaware not only the preferred forum for M&A litigation, but also the required forum, decreasing the costs and burden of defending against the same claims in multiple courts at the same time. A November 2013 Delaware Chancery Court decision, *Edgen Group Inc. v. Genoud*, provides however that forum selection clauses are not self-executing and action may need to be taken in the forums outside of Delaware where litigation is pending to request that those courts enforce the Delaware forum selection clause.

2013 also continued to see a significant amount of M&A litigation settled through the target's agreement to provide additional transaction-related disclosure and payment of plaintiffs' legal fees without any increase in deal price. However, in several instances in 2013, the Delaware Chancery Court expressed the view that these cases present an undue burden on companies that engage in M&A transactions, generally benefit only plaintiffs' counsel and do little to protect shareholder interests. In *In re Transatlantic Holdings Inc.*, Chancellor Strine rejected a proposed disclosure-only settlement and in *In re PAETEC Holding Corp. Shareholders Litigation*, Vice Chancellor Glasscock held that it is proper for the court to "scrutinize disclosure-only settlements, both substantively and to determine whether the plaintiffs' efforts have conferred a benefit on the class." Recently, in connection with a disclosure-only settlement related to the sale of Talbots Inc., Chancellor Strine observed that "the social utility of cases like this continuing to be resolved in this way is dubious."

The Delaware Chancery Court's criticism of disclosure-only settlements and the court's approval of forum selection bylaws may make plaintiffs' lawyers think twice before bringing cases in search of a quick payday. The court's views could also have the effect of making those M&A cases filed tougher to settle because plaintiffs' lawyers may seek to extract greater concessions or demand a monetary payment to settle in order to demonstrate that they added value and the litigation benefitted the shareholders.

Directors' Duty to Oversee Foreign Operations

Several Delaware Chancery Court decisions in 2013 highlighted the risks faced by Delaware companies with foreign operations. In *Rich v. Chong*, *In re Puda Coal, Inc. Stockholders Litigation* and *In Re China Agritech, Inc. Shareholder Derivative Litigation*, the court ruled against directors in cases involving the directors' duty to oversee operations in foreign countries, focusing on the companies' inadequate compliance functions in the face of obvious warning signs. The court in *Puda Coal* went on to note that in order for directors to discharge their duty of oversight, directors must regularly visit foreign operations, navigate the foreign language and culture in a manner that allows them to comply with their fiduciary duties and retain advisors that are equipped to maintain proper controls. Further evidence of the difficulties presented in overseeing foreign operations came from the failed Cooper Tires-Apollo merger. There, a labor strike by workers at a Cooper joint venture in China led in significant part to the failed $2.5 billion sale of Cooper Tires and Rubber Company to Apollo Tyres. As a result of the foreign joint venture's refusal to provide Cooper with information, Cooper was unable to timely file its quarterly financial statements, which were necessary for Apollo to provide to potential lenders for deal financing purposes. This played a large part in allowing Apollo to effectively exit a deal it seemed to come to regret entering into in the first place. We expect that these developments will lead to increased oversight of companies with significant foreign operations. In the M&A context, these cases illustrate for sellers the importance of managing and overseeing foreign operations, and for buyers, the substantial due diligence necessary and potential execution risk associated with targets with foreign operations.

Fairness Opinions

A May 2013 Delaware Chancery Court decision in *Koehler v. Netspend* left companies and financial advisors anxious that fairness opinions delivered in connection with M&A transactions could be subject to increased scrutiny. In *Netspend*, the court found that the plaintiffs had shown a likelihood of success on the merits that a board of directors would be held liable for breach of fiduciary duty because it approved a transaction based upon a "weak" fairness opinion. The court subsequently provided additional color on its *Netspend* decision in an October 2013 decision. In *In re BioClinica*, the court allayed some of the concerns caused by *Netspend* in noting that it was necessary to view the "weak" fairness opinion in *Netspend* in context, including the problems with certain valuation methodologies utilized in the fairness opinion and that the board did not conduct a market check even though the discounted cash flow analysis showed the company to be worth more than the sale price. Nonetheless, financial advisors and boards should be mindful that plaintiffs' attorneys and courts continue to scrutinize the various components of their fairness opinion analysis, particularly in the absence of a market check.

Back-End Mergers

In 2013, the Delaware legislature adopted new Section 251(h) of the Delaware General Corporation Law. Section 251(h) permits (with certain exceptions) parties to a merger agreement that contemplates a two-step acquisition (i.e, a tender offer followed by a second-step merger) to agree that the buyer may close the back-end merger without shareholder approval if the buyer acquires enough shares in the tender offer to approve the back-end merger. The number of shares required is a majority of the outstanding shares unless the certificate of incorporation requires a super-majority vote for approval of a merger. Previously, a buyer was not permitted to effect a back-end merger without shareholder approval unless the buyer acquired at least 90% of the outstanding shares in the tender offer.

This change will significantly reduce the importance of top-up options and subsequent offering periods, mechanisms previously used to ensure that a buyer would meet the 90% threshold. Moreover, in situations where a buyer is relying on third party financing to finance the acquisition, the virtually simultaneous closing of the front-end tender offer and the back-end merger will ease lenders' concerns (and likely reduce financing fees) caused by the lender not having a security interest in the assets of the target during any prolonged gap between the closing of the tender offer and consummation of the back-end merger.

Section 251(h) is not available in a transaction where the buyer is an "interested stockholder" (a holder of 15% or more of the target's shares). The calculation of whether a buyer is an "interested stockholder" is to be made under Section 203 of the Corporation Law (without giving effect to any of Section 203's exemptions) and is broadly defined to include any shares held by a stockholder that enters into a tender or support agreement with the buyer and any shares to be rolled over by management. Companies and advisors should also note that all mergers effectuated pursuant to Section 251(h) are subject to appraisal rights, including those that otherwise would not be, such as transactions in which the sole form of consideration is publicly traded stock.

Section 251(h) will have a significant impact on structuring and timing considerations for M&A transactions involving Delaware target companies. Already, Section 251(h) has been used in acquisitions of Steinway Musical Instruments and Onyx Pharmaceuticals. While a two-step acquisition may not always be the optimal transaction structure (such as in situations where the receipt of regulatory approvals between signing and closing is expected to take an extended period of time), Section 251(h) significantly reduces much of the burden and uncertainty traditionally associated with two-step transactions, making use of Section 251(h) a more attractive transaction structure for both buyers and sellers alike.

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