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Delaware Rundown: What You Missed In Q3

By **Chelsea Naso**

Law360 (October 5, 2018, 4:27 PM EDT) -- During the third quarter of 2018, the Delaware judiciary weighed in on an alleged hostile takeover, appraisal rights and the business judgment rule, while seeing a battle erupt over a failed media merger.

Here, Law360 outlines some of the biggest mergers and acquisitions-related developments in Delaware from the three-month span that lawyers need to know.

Deal Makers Offered Further Clarity on MFW

The Chancery Court in July weighed in on where the line is between early discussions and actually deal negotiations, offering further clarity on when the business judgement rule, which was established by Kahn v. M&F Worldwide Corp., will apply.

Vice Chancellor Joseph Slights rejected an Earthstone Energy Inc. shareholder Nicholas Olenik's challenge to the company's acquisition of Bold Energy III LLC, ruling that the transaction was properly structured so as to offer the protection of the business judgment rule.

"Under the business judgement rule standard of review, the court will not second-guess the decisions of corporate fiduciaries unless the Transaction is so inexplicable as to constitute waste," said Vice Chancellor Slights.

"Olenik has not expressly pled waste and the complaint does not plead facts from which the court can reasonably conceive that waste occurred here. Accordingly, the complaint must be dismissed," the vice chancellor continued.

The ruling helps clarify that just because there are early deal discussions between potentially conflicted parties, it doesn't mean the deal can't comply with the business judgement rule.

"After MFW and its progeny, questions arose regarding its scope and the difference between 'negotiations' and 'preliminary discussions.' Earthstone is interesting and notable because often you see the CEO or other top-level management, who may or may not be conflicted or have relationships with the controlling shareholder, start 'exploratory' discussions regarding strategic planning even before true merger negotiations begin," said Elizabeth Sloan, a Ballard Spahr LLP partner.

It shows that if the deal parties take the required precautions — like setting up a special committee — before formal negotiations kick off, the process can be viewed as an arm's-length one by the courts.

"It's a recognition of the reality that there is going to be some level of discussion before the special committee is formed. But so long as the special committee is formed at the time formal negotiations are beginning and the special committee has control over the process, that's what matters in getting the business judgment rule," said James J. Beha II, a Morrison & Foerster LLP partner.

Olenik alleged that the deal, announced in November 2016, essentially bailed out EnCap's investment in cash-strapped oil and gas development company Bold at the expense of Earthstone shareholders, who'd only get a 39 percent stake of the combined company without any upside benefits but with the bulk of the risks.

According to the complaint, EnCap and affiliated funds were both a controlling shareholder of oil and gas exploration company Earthstone, with a 41 percent stake, and owned roughly 96 percent of the outstanding equity of Bold, which was burning through millions in cash due to the dramatic drop in energy commodity prices that started in 2014.

Olenik alleged EnCap worked with Earthstone Chairman and CEO Frank Lodzinski to hammer together a merger deal without informing the rest of Earthstone's board. He claimed the committee the board formed to investigate the deal was neither independent nor well-functioning, consisting of two board members who had been appointed to the board by EnCap and had financial ties to the firm and Lodzinski.

Vice Chancellor Slights, however, said Lodzinski's discussions with EnCap and Bold were "entirely exploratory" in nature and that the actual negotiation of the merger terms took place between Bold and the board committee.

"And this special committee was no doormat. It was actively engaged in the process, called its own shots and interfaced directly with management and its legal and financial advisers throughout the negotiations," he said, saying the members' appointments and alleged financial ties were insufficient to impeach their independence.

The case is Nicholas Olenik v. Frank A. Lodzinski et al., case number 2017-0441, in the Delaware Court of Chancery.

Investors Again Shown Appraisals Can Cut Both Ways

Two separate appraisal cases served as the latest reminder that appraisal actions can also result in a reduced deal price for challenging shareholders.

In July, Chancellor Andre G. Bouchard went with an adjusted deal price for a challenge to Solera Holdings Inc.'s $6.5 billion sale to Vista Equity Partners LP, cutting 3.4 percent from the per-share price for synergies arising from the deal.

Chancellor Bouchard said the company's sales process "delivered for Solera stockholders the value obtainable in a bona-fide, arm's-length transaction, and provides the most reliable evidence of fair value."

"It's another case showing shareholders seeking appraisal face a real risk that they are going to get less money at the end of the day than if they just accept the merger price," Beha said.

That warning to shareholders was followed by yet another. An August reargument of an appraisal of AOL Inc.'s $4.4 billion takeover by Verizon Communications Inc. saw Vice Chancellor Sam Glasscock III erase another 3.3 percent from the deal value for the dissenting shareholders.

During reargument, the court caught an incorrect court calculation of the present value of AOL's future cash flows, Vice Chancellor Glasscock acknowledged in a letter opinion.

The decisions marked the latest in a series of decisions by the Chancery Court's ongoing absorption of state Supreme Court rulings last year that "heavily endorsed the application of market efficiency principles" in deciding lawsuits by investors challenging merger consideration and seeking court appraisal instead.

The Aug. 15 decision, which implied a $4.01 billion equity value for AOL, followed Vice Chancellor Glasscock's February post-trial ruling that **trimmed** AOL's appraised value by 2.6 percent from the $50-per-share amount paid by Verizon.

An incorrect court calculation of the present value of AOL's future cash flows, caught by the court after motions for reargument, led to the second step down, the vice chancellor acknowledged in a letter opinion.

As a result, stockholders who argued under Delaware's appraisal statute for a $68.98 per share, or 28 percent, higher merger payout could come up 5.8 percent short, at $47.08 per share, of the amount originally paid by Verizon

"No DCF analysis, used to calculate the 'exact' value of a corporation, can be sufficiently rigorous that it will not permit a good faith argument that the value should be otherwise," Vice Chancellor Glasscock said. "This, I think, substantiates the wisdom of reliance on deal price, where appropriate; it also may explain the current popularity of motions for reargument."

The cases are In re: Appraisal of AOL Inc., case number CA-11204, in the Court of Chancery of the State of Delaware and In re: Appraisal of Solera Holdings Inc., case number 12080, in the Court of Chancery of the State of Delaware.

Court Weighs in on Hostile Takeover Protections

A ruling concerning a buyout offer that featured a controlling shareholder selling its stake to the company's rival showed that shareholders cannot rely on hostile takeover protections since the parties had not worked together.

Vice Chancellor Sam Glasscock III rejected a preliminary injunction to block a looming vote on the proposed $7 billion merger of drywall producer USG Corp. with rival Knauf KG, casting aside putative class claims that the transaction warranted hostile takeover positions.

In a ruling from the bench a day ahead of the vote, Vice Chancellor Glasscock said that although Berkshire Hathaway Inc. — USG's largest equity holder — conferred over several months with Knauf to discuss possible per-share terms for the deal, Berkshire's shares never moved in a hostile lockstep with

Knauf's.

As a result, Knauf's efforts to forge an alliance with Berkshire Hathaway, including meetings with CEO Warren E. Buffett, never triggered provisions of Delaware's corporation law intended to kick in in the event of coercive takeovers.

Those provisions include a required two-thirds approval vote from independent investors when an investor owning 15 percent or more of a company's stock attempts to acquire the business.

Knauf owns 10.6 percent of USG's stock, Berkshire Hathaway 30.1 percent. Had the two arranged to vote together, their conduct could have required additional prevote disclosures in addition to the higher vote hurdle.

Vice Chancellor Glasscock said in his ruling that Berkshire Hathaway's and Knauf's "interests were congruent, although not identical."

"Berkshire Hathaway made no secret of the fact that it wanted to exit its position in the company [USG]. Knauf wanted to buy the company," he said.

In two complaints that were later consolidated, shareholders Kevin D. Anderson and Susan Fitzgerald alleged that the two companies exerted sustained pressure on USG's board to accept an underpriced sale, with the current $44-per-share proposal well below prior USG estimates that the company was worth up to $51 per share.

That pressure included a successful fight to oust four USG shareholders, Anderson and Fitzgerald alleged.

The vice chancellor noted the director proxy fight while reviewing the history of the dispute. He said, however, that Buffett's company also wanted USG to go at the highest achievable price, while Knauf was motivated to hold the acquisition cost down.

Vice Chancellor Glasscock said he provided a ruling from the bench because of the looming stockholder vote, but said he would have preferred to issue a written opinion on the "Section 203" dispute, a reference to the Delaware Code section involved. Delaware enacted the measure in response to the hostile takeover boom of the late 1980s, he said.

The case is In re: USG Corporation Stockholder Litigation, case number 2018-0602, in the Court of Chancery of the State of Delaware.

Court Mulls Who to Blame in Media Cos.' Failed Merger

Two media companies started in Delaware Chancery Court in August, each looking for the court to help pin the blame on the other for the demise of their $3.9 billion tie-up amid regulatory pushback.

Tribune Media Co. in August announced it had ended its planned combination with Sinclair Broadcast Group Inc. and sued its former acquirer for mangling the review process with "unnecessarily aggressive and protracted negotiations" with regulators.

The deal termination and lawsuit came after the Federal Communications Commission voted

unanimously last month to ask an administrative judge to review whether Sinclair obscured that it would effectively retain control of three divested stations through a since-withdrawn proposal that would have seen Sinclair sell two of its stations to Cunningham Broadcast Corp. and spin off a major Tribune station to another entity.

Trouble with the FCC has rocked the deal's standing at the U.S. Department of Justice, which was on track to approve the deal before FCC Chairman Ajit Pai indicated it would refer the deal for administrative review, a source told Law360 in July.

According to Tribune, the difficulty with the FCC is of Sinclair's own making and marks a breach of its agreement to use its reasonable best efforts to obtain regulatory approval, which includes divesting stations as required by regulators.

Sinclair fired back, arguing that it was still working to save the deal even after the FCC referred it for an administrative review and that Tribune is the one that broke their merger agreement by giving up.

In Sinclair's counterclaims and an answer to Tribune's suit, the media company slams its former target for providing a "revisionist history" that aims to shift responsibility for the deal's failure away from Tribune.

The case is Tribune Media Co. v. Sinclair Broadcasting Group, case number 2018-0593, in the Court of Chancery of the State of Delaware.

--Additional reporting by Jeff Montgomery, Matthew Perlman and Rick Archer. Editing by Katherine Rautenberg.

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