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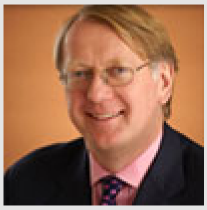

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The Hot Topic in United States M&A – *Corwin*

Introduction

The general question of corporate governance can be summarized, in the context of public companies, as three interrelated questions: who has decision-making authority; how are they constrained in the exercise of that authority; and how are they held accountable for that exercise? In this model, the U.S. approach to corporate governance has historically been very director-centric. In a U.S. public company, the board of directors has substantially more power than in any other major developed legal regime and is subject to fewer formal constraints on the exercise of that power. Not surprisingly, the U.S. approach to corporate governance has developed differently with respect to the means by which boards of directors are held accountable for their decisions. The U.S. market remains the most active with respect to the three leading structural mechanisms for holding boards of directors accountable: hostile takeovers, shareholder activism/proxy fights and, last but not least, direct shareholder litigation against boards of directors.

While the foregoing is true generally with respect to corporate governance, it is particularly true with respect to M&A. Almost all developed legal regimes recognize that "M&A is different" and apply distinct rules of corporate governance to the behavior of boards of directors of target companies in the context of M&A. The most well known model is the U.K. Takeover Code, from which the European Takeover Directive was heavily drawn and which also significantly influenced the takeover codes in other

Commonwealth countries. A central premise of the U.K. Takeover Code is “passivity”: it takes power away from the board of directors of a target company.

In the U.S., while the challenge created by corporate governance in the M&A environment has been recognized, the model of director-centric corporate governance has not been abandoned. Instead, the preexisting structures for holding boards of directors accountable are applied with greater force, in particular, judicial supervision of the conduct of boards of directors exercised through private litigation. As is well known and documented, the U.S. is home to substantially more M&A-related shareholder litigation that calls into question the behavior of the boards of directors of U.S. companies. In the context of M&A litigation, the Delaware courts have traditionally been reluctant to give effect to any principle of “stockholder ratification”. This has been based in part on a theoretical model, in which the Delaware courts have noted that directors have their own duties and that the mere fact a majority of the stockholders support a particular transaction does not speak to whether the directors have discharged their duties in proposing that transaction. In addition, the Delaware courts have been concerned by a conceptual problem with the principle of stockholder ratification, as applied in the M&A context. A stockholder vote on a proposed M&A transaction is a binary choice between the transaction, as negotiated by the board of directors, and no transaction at all. It is seldom the case that the stockholders have the ability to send the board of directors back to “try again”; accordingly, a vote by the stockholders to approve a particular transaction cannot as a substantive matter be viewed as the equivalent of stockholder agreement with the proposition that the transaction before them was properly negotiated by a careful and loyal board of directors.

From time to time, the Delaware courts have shown deference to the will of the stockholders. For example, outside the area of conflicted transactions, there is no known example of a Delaware court permanently enjoining a proposed M&A transaction as a result of alleged misbehavior by the board of directors of the target corporation other than in the context of a competing bid for the target company. However, over the last several years there have been three different series of decisions in the Delaware courts that, taken as a whole, seem to reflect a more significant judicial shift in approach to the U.S. director-centric model.

MFW

The first line of cases relates to a transaction in which a majority stockholder buys out the minority stockholders (a “squeeze out”). As a result of judicial concern regarding fair treatment of stockholders in squeeze out transactions, in the 1980s and early 1990s the Delaware courts developed the “entire fairness” standard of judicial review, under which, in a squeeze out, the controlling stockholder and the board of directors of the target company were subject to strict judicial scrutiny focused on whether the squeeze out involved a “fair process” and offered minority stockholders a “fair price”.

As a result of the entire fairness doctrine, squeeze out transactions in Delaware are particularly subject to litigation risk. Almost from its inception, controlling stockholders and their advisors sought to avoid the application of that doctrine through structuring techniques. This led to a series of decisions in the 2000s in which the Delaware courts commented on various alternative structures and evidenced increasing concern that substantive protections for minority stockholders should not depend on the legal structure used for a squeeze out. This process came to a head, and possibly to a conclusion, with the *MFW* litigation. In *MFW*, the Delaware courts held that a squeeze out, without regard to structure, would not be subject to the entire fairness standard of review, but would be subject to the more deferential business judgment rule standard of review, if, among other matters, the transaction was negotiated on behalf of the target company by a properly functioning special committee consisting of independent directors and was approved by a fully informed, uncoerced vote of minority shareholders representing a majority of the shares not held by the controlling stockholder (the so-called "majority of the minority vote"). *MFW* has now become the prevailing model for squeeze out transactions in Delaware.

It is worth noting at the outset that *MFW* is not a decision based on stockholder ratification. It is, instead, a decision about judicial standard of review. However, as a practical matter, the determination of the standard of review comes very close to compelling the conclusion on the merits: controlling stockholders routinely failed review under the entire fairness doctrine and routinely survived judicial review under the business judgment standard.

As noted earlier, the entire fairness doctrine had two components—fair process and fair price. One can see that the *MFW* standard itself meets the requirement of fair process, with the properly functioning special committee of independent directors and the majority of the minority vote together being a fair process. So what happened to the concern about fair price that originally led the Delaware courts to include that as a component as of the entire fairness doctrine? One could say that the Delaware courts simply decided not to worry about fair price. On the other hand, it might be the courts decided that approval by a majority of the minority vote should be regarded judicially as compelling evidence of fair price. If *MFW* were the only line of cases involved here, it would be hard to know what was motivating the Delaware courts. But *MFW* is not alone.

Deal Price in Appraisal Litigation

Under the Delaware corporation law, stockholders who vote against a merger are entitled to seek appraisal, i.e., to decline to receive the agreed merger consideration and instead to receive cash at a valuation of the target company determined by the Delaware Court of Chancery in an adversarial valuation proceeding known as an appraisal. The right to appraisal has been a feature of the Delaware corporation law for many decades, albeit rarely seen. Starting in the middle of the last decade, however, and accelerating through much of the current decade, there was a significant increase in the volume of appraisal demands, leading to a significant increase in the number of reported Delaware decisions on the appraisal statute, including the proper way of valuing Delaware target companies for purposes of appraisal.

The most recent Delaware decisions with respect to the proper valuation of a target company in appraisal proceedings have attached extraordinary weight to the agreed deal price itself. As one recent commentator put it, in the absence of some evidence of a conflicted transaction or self-dealing, at the moment in Delaware it is almost impossible to have an appraisal action reach a valuation of the target company greater than an agreed cash price.

As a matter of principle, there is much to like about the Delaware courts' focus on a deal price. If the purpose of an appraisal proceeding is to determine the fair value of the target company, what better evidence of value is there than an agreed transaction price negotiated at arm's length? From the perspective of the appraisal statute, however, heavy reliance on the deal price seems illogical. The purpose of the appraisal statute is to give a dissenting stockholder the right to argue for something other than, and presumably greater than, the deal price in the transaction against which the stockholder voted. It would be an overstatement to claim that an overwhelming presumption that the deal price equals appraised fair value eviscerates the appraisal statute, but it is certainly true that it substantially reduces the benefit of the appraisal statute to dissenting stockholders.

Why, after decades of jurisprudence relating to the proper methods for valuing companies in appraisal proceedings, did the Delaware courts adopt a rule attaching so much weight to the agreed deal price? One explanation that has been offered was a judicial attempt to crack down on abusive and expensive appraisal proceedings. Another explanation though, seems more consistent with *MFW*. Just as, in *MFW*, one can see the Delaware courts concluding that the fair price component of the entire fairness doctrine should be deemed to be met as a result of uncoerced stockholder approval of the transaction, one can see in the appraisal proceedings the Delaware courts deferring to the judgment of the stockholders (in the form of stockholder approval of an agreed transaction) as compelling evidence of fair value of the target company. But even *MFW* and the appraisal cases are not alone.

<u>Corwin</u>

The 2015 decision of the Delaware Supreme Court in *Corwin* is probably the most significant Delaware M&A decision in 15 years. While *MFW* and the appraisal cases referred to above can be seen as elaborations on existing doctrine, it is hard to categorize *Corwin* the same way. One can argue that *Corwin* involves a reversal of almost 30 years of Delaware doctrine regarding judicial review of actions by boards of target companies. At the very least, *Corwin* has compelled a deep reexamination of that doctrine.

Under the *Corwin* doctrine, the Delaware courts will apply the deferential business judgment rule standard of review to decisions of a board of directors of a target company if the relevant M&A transaction is approved by a fully informed, uncoerced vote of disinterested stockholders (other than in a squeeze out, in which *MFW* applies). The Delaware courts have already substantially elaborated on *Corwin* by expanding it to provide business judgment rule standard of review if a majority of the stockholders accepted a non-coercive tender offer and by explicitly acknowledging that *Corwin* is a substantial limitation on two iconic Delaware decisions from the 1980's: *Unocal*, dealing with takeover defenses, and *Revlon*, dealing with directors' responsibilities when selling a target company.

We have also seen cases in which the Delaware courts have declined to apply *Corwin.* It is clear the courts will over time develop a coherent theory of what constitutes coercion of stockholders. So far, in one decision, the court found a stockholder vote to be coerced by pre-transaction actions by the board that made the status quo ("no deal") alternative very unattractive to stockholders. In a second decision, the court did not apply *Corwin* to an M&A transaction in which a major stockholder received ancillary benefits (echoing *MFW*). No doubt there will be significant developments in this area.

Corwin has significantly changed M&A practice in the U.S., with deal professionals pushing more aggressively for stockholder votes by disinterested stockholders as well as better disclosure in proxy statements. *Corwin*'s impact on M&A stockholder litigation has been even more dramatic. In the time since *Corwin*, there has been a significant drop in U.S. M&A litigation alleging fiduciary duty claims and something of an increase in litigation claiming violations of the U.S. securities laws. Although correlation does not prove causation, the prevailing view of market professionals is that the shift in litigation is substantially attributable to *Corwin* and related decisions.

Corwin is not a doctrine of stockholder ratification but merely sets the standard of review applied by the Delaware courts. However, given that that standard of review tends to be outcome-determinative, the practical effect of *Corwin* is very similar to stockholder ratification.

Corwin represents a profound challenge to the U.S. model in M&A transactions. Historically, a key component to the process of holding target boards accountable in M&A transactions has been the combination of searching judicial scrutiny and private litigation as the vehicle for that scrutiny. By allowing business judgment rule deference, the Delaware courts are now saying that "M&A is not different—at least if the stockholders approve."

So what happened? One explanation is that *Corwin* is simply the latest effort by the Delaware courts to bring frivolous M&A litigation under control. This view links *Corwin* to the *Trulia* decision, in which the

Delaware courts signaled an increasing reluctance to accept disclosure-only settlements of M&A litigation and to the decisions upholding "forum selection" by laws. In this view of *Corwin*, the Delaware courts have taken control of M&A litigation by ensuring that litigation will be in Delaware courts and have substantially limited frivolous litigation through the combination of *Trulia* and *Corwin*.

There is another explanation, though, that is more consistent with *MFW* and the appraisal cases. As one judge said, "there is little utility in a judicial second-guessing of [a determination that a transaction is in the corporate best interest] by the owners of the entity." That principle reflects a substantial deviation from the Delaware historical view, as evidenced by the Delaware courts' reluctance to accept stockholder ratification as a defense to a claim for breach of fiduciary duty by directors. In the U.S. director-centric model, the Delaware courts historically have scrutinized the conduct of boards of directors to determine whether it met the standards of care, loyalty and good faith expected of boards of directors, not solely whether the M&A transactions they negotiated were in the best interests of stockholders. Moving to a model in which there is effectively no judicial scrutiny of directors' conduct with respect to a transaction so long as the stockholders approve that transaction by a fully informed and uncoerced stockholder vote is perilously close, in substance, to a world in which the primary legal responsibility of the target board is to ensure such a vote. That is much closer to the world of the U.K. Takeover Code than to the Delaware world of *Unocal* and *Revlon*.

This will be tested. The guiding principle of *Corwin* stands uneasily next to such decisions as *Airgas*, in which the Delaware courts have upheld takeover defenses notwithstanding fully informed and uncoerced votes by stockholders against the use of such defenses. As one commentator asked recently, "Can the Delaware courts sustain the position that the board is immune from scrutiny because of stockholder approval but is also immune from scrutiny if it ignores the stockholders?"

Stay tuned.