Court of Chancery Issues Multiple Opinions Relevant to Transaction Planners

In the three days prior to Thanksgiving, the Court of Chancery issued seven written opinions and one oral ruling of importance to transaction planners. Although each opinion and ruling independently could be the subject of a detailed memorandum, in light of the multiple issues addressed by the Court in a compressed period, we provide below a short summary of each.

Injunction Requiring Market Check

City of Miami Gen. Emps' & Sanitation Emps' Ret. Trust v. C&J Energy Servs, Inc.

Plaintiff, a stockholder of C&J Energy, challenged the merger of C&J Energy and a subsidiary of Nabors Industries Ltd. holding Nabors' "completion and production services" assets. Following the transaction, the former C&J Energy stockholders would hold a bare minority of the stock of the surviving entity; however, management of C&J Energy prior to the transaction would manage the surviving entity and Nabors agreed to various limitations on its rights as a stockholder. Following a hearing on plaintiff's motion for a preliminary injunction, the Court held that plaintiff was entitled to an injunction based on its allegation that the C&J Energy board approached the transaction as an acquisition of the Nabors completion and production services business, as opposed to a sale of C&J Energy. The Court's injunction ordered that C&J Energy shop itself for 30 days and that Nabors not treat that shop as a breach of the restrictions in the merger agreement. This ruling is on expedited appeal to the Delaware Supreme Court.

Disparate Treatment of Bidders

In re Novell, Inc. Shareholder Litigation

This summary judgment opinion follows an earlier opinion declining to dismiss a post-closing claim that a majority-independent board acted in bad faith by treating bidders disparately during a sales process. Following discovery, the Court concluded that the directors' actions during the sales process were within the realm of reasonableness. In doing so, the Court reaffirmed that "Delaware law does not require a board to treat all bidders equally." Although the Court found some of the board's decisions "troubling" (*e.g.*, a delay in providing a bidder a draft nondisclosure agreement), it stated that such decisions were, at most, breaches of the duty of care shielded from monetary liability under Novell's exculpatory charter provision.

Mistake in Deal Consideration

In re TIBCO Software Inc. Stockholders Litigation

On a motion for preliminary injunction, the Court found it likely that both sides to a transaction believed the transaction would have an equity value of approximately \$4.244 billion; however, because of a mistaken capitalization table, the final per-share price aggregated to only approximately \$4.144 billion. The target board publicly disclosed the mistake, but did not seek to renegotiate the per-share price with the acquiror. Through its motion, plaintiff sought either reformation of the merger agreement or an injunction based on an alleged breach of fiduciary duty due to the board's failure to seek to renegotiate the per-share price. As to reformation, although the Court found it likely both sides believed the per-share price would amount to the \$4.244 billion equity value, it found that the agreement itself was always based on a specific per-share price, not an aggregate equity value, and denied the reformation claim. (In light of the Court's substantive ruling, it did not address whether the plaintiff actually had standing to seek reformation.) The Court did not address the merits of plaintiff's fiduciary duty claim because it concluded there was a lack of irreparable harm. However, the Court noted two "troubling aspects" of the record: the lack of precision during the process regarding the capitalization table and the failure to share with the board the source of the error after it was discovered and that the acquiror had relied on the incorrect capitalization table. In discussing the lack of irreparable harm, the Court noted that the exculpatory provision in TIBCO's charter does "not apply to aiders and abettors of breaches of fiduciary duties, including the duty of care."

Deal Protection Potentially Unreasonable
Aiding and Abetting Claim Against Buyer Dismissed

In re Comverge, Inc. Shareholders Litigation

This motion to dismiss opinion arose out of HIG's acquisition of Comverge. HIG previously executed a nondisclosure agreement with Comverge that, although prohibiting HIG from acquiring "any securities or assets" of Comverge for two years, permitted HIG to acquire Comverge securities "in the public markets as a public investor," including by engaging "in transactions with respect to . . . bank debt" of Comverge. After Comverge rejected HIG's $2.25 per share bid, HIG acquired certain of Comverge's outstanding debt at a premium to market, threatened to foreclose on that debt, and lowered its bid to $1.50 per share. The parties ultimately agreed to a price of $1.75 per share and a go-shop period. At signing, HIG provided Comverge a $12 million bridge loan in exchange for convertible notes. Plaintiffs alleged that the directors breached their fiduciary duties in the sale process, including by failing "to inform themselves before deciding not to bring suit against HIG for breach of the NDA" and for agreeing to preclusive deal protection measures, and that HIG aided and abetted those breaches. The Court dismissed claims regarding the board's decision not to sue HIG for breach of the NDA, observing that the NDA was ambiguous as to whether HIG's acquisition of Comverge's debt constituted a violation and the Board acted reasonably in deciding to focus on negotiating a go-shop period rather than risk such a lawsuit. As to the deal protection measures, the Court observed that the termination fee and expenses reimbursement would aggregate to at least 5.55% of equity value and 5.2% of enterprise value, which "tests the limits of what this Court has found to be within a reasonable range for termination fees," and suggested it might aggregate the cost an acquiror would absorb from the conversion of the bridge loan notes in addressing the termination fee. The Court therefore refused to dismiss claims that the deal protection measures were unreasonable and that the directors acted in bad faith in agreeing to them. The Court did, however, dismiss the aiding and abetting claims against HIG, observing that "arm's-length bargaining cannot give rise to aiding and abetting liability on the part of the acquirer."

Directors Not a Control Group

In re Sanchez Energy Derivative Litigation

This litigation involved the purchase of assets by Sanchez Energy from another entity controlled by two of Sanchez Energy's directors. Plaintiffs alleged those two directors were controlling stockholders of Sanchez Energy so that the transaction was subject to entire fairness review. To support their claim, Plaintiffs alleged that: the two directors collectively owned 21.5% of Sanchez Energy; Sanchez Energy was a shell company established by those directors solely to obtain access to the public equity markets; Sanchez Energy had no employees and no directly managed operations; those directors retained "firm control over operations and the Board"; and one of the directors was the president and CEO of Sanchez Energy and president of another company that provided management services to Sanchez Energy. Citing two recent opinions from the Court of Chancery, *In re KKR Financial Holdings LLC Shareholders Litigation* and *In re Crimson Exploration Inc. Stockholders Litigation*, the Court held such allegations did not support a reasonable inference that the two directors were controlling stockholders because they did not sufficiently allege that the two directors exercised "actual control" over the Sanchez Energy board.

CEO as Controlling Stockholder Despite Minority Stockholding

In re Zhongpin Inc. Stockholders Litigation

Only a day after *Sanchez Energy*, the Court of Chancery held, at the motion to dismiss stage, that plaintiffs adequately alleged the existence of a controlling stockholder. *Zhongpin* involved a going-private transaction in which the acquiror was CEO and chairman of the board of, and held a 17.3% equity position (rising to 26% when aggregated with rollover stockholders) in, the target. Plaintiffs alleged the acquiror was a controlling stockholder based on his control over the target's "business affairs." Relying on a 2003 decision of the Court of Chancery, *In re Cysive, Inc. Shareholders Litigation*, and without citing the recent *KKR, Crimson* or *Sanchez Energy* opinions, the Court focused on the acquiror's alleged control over the target, not on "actual control" over the target's board (as focused on in the more recent cases), and found plaintiffs adequately pled facts raising the inference that the acquiror could have been a controller of the target. It bears mentioning that in its 10-K, the target described the acquiror as "our controlling shareholder."

Post-Closing Indemnity Clawbacks

Cigna Health & Life Insurance Company v. Audax Health Solutions, Inc.

This opinion involves purely legal issues. An affiliate of UnitedHealth acquired Audax by merger. The merger agreement did not contemplate any escrow holdbacks but did contemplate that former Audax stockholders would indemnify the acquiror, up to the pro rata amount of the merger consideration they received, for breaches of Audax's representations and warranties. In order to obtain the merger consideration, the former Audax stockholders were required to sign a letter of transmittal (i) releasing any claims against UnitedHealth, (ii) agreeing to be bound by the indemnification provisions in the merger agreement and (iii) appointing SRS as stockholder representative. Cigna, a former Audax stockholder, alleged it should not be required to sign the letter of transmittal to obtain the merger consideration and that the indemnification obligations were invalid under Delaware law. The Court first held that, because the release obligation was not mentioned in the merger agreement, it was not supported by consideration and could not be a condition to receiving the merger consideration. As to the indemnity obligations, the Court issued a very narrow ruling that addressed only certain indemnity obligations in the merger agreement which were for indefinite length and covered the full merger price. The effect of such provisions, the Court stated, could render "the value of the merger consideration unknowable," which the Court viewed as contrary to Section 251 of the DGCL. The Court stated, however, that its opinion did not address (i) merger agreements in which a percentage of the consideration is placed in escrow to cover future indemnification claims, (ii) the general validity of post-closing price adjustments requiring direct repayment from the stockholders, or (iii) "whether such a price adjustment that covers all of the merger consideration may be permissible if time-limited, or whether an indefinite adjustment period as to some portion of the merger consideration would be valid." In this opinion, the Court did not address the challenge by Cigna to appointment of the stockholders representative via the letter of transmittal.

Fraud Claims After Privilege Transfer

Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP

In a prior opinion in this litigation, the Court of Chancery held that, absent contractual agreements to the contrary, the attorney-client privilege of a target company is transferred to the surviving corporation (and thus the acquiror) by way of merger. Armed with such privileged information, the purchaser of a corporation brought post-closing fraud claims against the pre-closing directors and officers of that corporation. In addition, the purchaser brought a post-closing indemnification claim and a claim for unjust enrichment against former stockholders of the corporation who were not alleged to have engaged in fraud. In an opinion on defendants' motion to dismiss, the Court declined to dismiss the fraud claims. The Court's treatment as to plaintiffs' claims for indemnification and unjust enrichment is notable. As to indemnification, the merger agreement provided that recourse to an escrow account would be the sole remedy, subject to a fraud carve out. Plaintiffs argued that, if they could prove fraud, they could seek indemnification on a joint and several basis from all stockholders, including innocent ones. Defendants argued that the fraud carve out simply meant that plaintiffs could seek "tort damages for fraud outside the limits of the indemnification provisions, but not unlimited indemnification from" innocent stockholders. Although the Court found that the defendants' reading of the merger agreement was "commercially reasonable," it declined to address the issue definitively at an early stage of litigation. As to unjust enrichment, the parties differed as to whether the agreed-to contractual indemnity regime precluded a remedy for unjust enrichment arising from fraud against innocent stockholders. Again, the Court declined to address the matter at an early stage of litigation.

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