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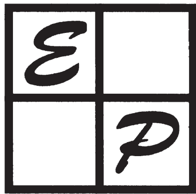

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The Merger Tarantella: Considerations in Post-Merger Corporate Governance

By Dave Meyers, a Partner of Troutman Sanders LLP

All experienced deal lawyers know that planning for and managing leadership succession after a merger often presents significant challenges to the target and acquiring companies, and to the board and management of the combined entity.[1] As Mr. Batts' article highlighted, the merger of Duke Energy and Progress Energy, and the subsequent post-merger management shake-up, illustrate some of the difficulties in ensuring stable governance after a merger.[2]

This article expands upon that notion and highlights several areas that lawyers and the management and boards of companies negotiating merger transactions might wish to consider while negotiations are ongoing. No plan for post-merger governance is foolproof. There will almost always be a dominant party that is able to dictate much of what happens post-merger. And, in the public company context, constantly shifting shareholder bases make forming dependable voting agreements difficult or impossible. These obstacles notwithstanding, taking post-merger governance into consideration as a part of merger negotiation will help make post-merger integration a smoother and more predictable process.

Board Composition

Prime among the considerations for post-merger governance is board composition. The smaller party often will have to agree to minority board representation. Still, an acquirer can make a post-merger board more effective by drawing on the combined talent of both parties. Preparing a new "board skills matrix"[3] is a good way to envision the composition of the likely post-merger board, and an effective method to determine where the board is wanting, and where certain skills are overrepresented.

[1] For an excellent review of these issues, see Ed Batts, "When Companies Combine: Object Lessons in Managing Leadership Succession," Deal Lawyers at 7 (November-December 2012).

[2] Despite the merger agreement providing that the Chief Executive Officer of Progress Energy would become the Chief Executive Officer of the combined company, immediately following the merger, the Progress Energy Chief Executive Officer was promptly fired as Chief Executive Officer of the combined company and replaced with the former Chief Executive Officer of Duke Energy. It was understood among both parties that installing the Progress Energy Chief Executive Officer as the Chief Executive Officer of the combined company was a central tenet of the deal. One former director called his ouster "one of the greatest corporate hijackings in U.S. business history."

[3] A "board skills matrix" is a chart listing directors on one axis, and skills and expertise on the other. Each director is rated on each skill.

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Similarly, the new combined board might pose independence problems. Parties should consider whether a potential board and its committees will comply with applicable SEC, exchange listing and proxy advisor independence requirements. In the case of a public company acquiring a private company, the parties should also consider fully vetting any members of the private company that may join the combined company's board to avoid background issues that may be inappropriate for public company service.

Industry-specific expertise is vital to effective governance. Where a merger is between two complementary parties (and not competitors), parties would do well to consider retaining key experts from each side if the intent of the merger is to allow the combined entity to compete in both arenas.

Finally, to better balance the board composition, parties should consider providing for one or more mutually elected new directors to be added to the combined company board. The acquired company may wish to bargain for a supermajority voting requirement requiring the affirmative vote of at least some of both parties' directors to ensure that it has a voice in such determinations.

Board Committees

Similar considerations apply to board committee membership. It is worth considering the makeup of the committees themselves, and to reshuffle membership where appropriate if, for example, a resulting committee would be unduly dominated by legacy acquirer members, or where a committee could benefit from particular expertise or required member independence. As noted above, parties must also consider the applicable SEC and exchange listing requirements.

Executives

Determining who is going to be in charge of the combined entity generally requires considerable negotiation; missteps in this process can lead to the failure of economically rational transactions. An interesting example was the failed hostile takeover of Vulcan Materials Company by rival Martin Marietta Materials, Inc. in 2011 and 2012.[4] As the two largest aggregates companies in the United States, Vulcan and Martin Marietta are often considered natural merger partners, including by their own management teams. For many years, Vulcan and Martin Marietta held periodic merger discussions. During the 2000s, Vulcan's Chief Executive Officer reached out on several occasions to Martin Marietta's management and expressed interest in talking about a friendly merger. Each of the companies' Chief Executive Officers, however, wanted to be the head of any combined company and thus the merger discussions never progressed.

In 2010, C. Howard Nye was promoted from Chief Operating Officer to President and Chief Executive Officer at Martin Marietta. Vulcan again approached Martin Marietta about a possible combination. Mr. Nye, though having no intention of relinquishing his position as Chief Executive Officer, believed in the success of a combined company. Mr. Nye also believed that he would become Chief Executive Officer of the combined company given the number of years Vulcan's Chief Executive Officer had served in such a role and his age. By December 2011, however, discussions had broken down and instead Martin Marietta launched a hostile takeover bid. Ultimately, the takeover attempt failed. In litigation over the hostile takeover, Chancellor Leo E. Strine, Jr. remarked, "[t]he primary reason why this combination doesn't seem to be getting going is because the managers on the boards don't agree on who should run it."[5] Vulcan spent $46 million fighting off Martin Marietta's hostile takeover attempt in 2011 and 2012.[6]

Other factors may also come into play when deciding who will run an acquired business. Recently, Shanghui International Holdings Ltd., China's largest meat processor, agreed to acquire Smithfield Foods, Inc., the largest pork producer in the United States.[7] Even though Smithfield was acquired in the transaction, Shuanghui stated that it would retain many Smithfield management members in their current roles

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[4] Chancellor Leo E. Strine, Jr. provided a fascinating summary of the issues surrounding who would run a combined company in his opinion with respect to the transaction at http://courts.delaware.gov/Opinions/Download.aspx?ID=172290.

[5] David Marcus, *Who Would Run a Combined Martin Marietta and Vulcan?*, The Deal, March 9, 2012, available at http://www.thedeal.com/magazine/ID/045167/2012/march-12-2012/who-would-run-a-combined-martin-mariettandashvulcan.php.

[6] Ryan Poe, *How Much Did it Cost to Defend Vulcan from a Takeover*?, Birmingham Bus. J., March 1, 2013, *available at* http://www.bizjournals.com/birmingham/news/2013/03/01/takeover-fight-was-costly-for-vulcan.html.

[7] Dana Mattioli *et al.*, *China Makes Biggest U.S. Play*, Wall St. J., May 30, 2013, *available at* http://online.wsj.com/article/SB10001424127887324412604578512722044165756.html.

and would keep the acquired business's headquarters in Smithfield, Virginia.[8] This decision appears to have been based upon the combined company's desire to retain goodwill based upon the Smithfield image and to soften criticism concerning the foreign takeover of a large U.S. business.

The compensation structures for executives that remain with the combined company, and the severance packages for executives who will leave post-merger, also are an important part of merger negotiations. These packages also can present post-merger governance problems or leverage, depending on one's point of view. For example, hard-to-swallow golden parachutes for target company executives can be an effective means of ensuring that a target retains some influence in the new or surviving entity. Such a strategy must be balanced against its risks: that aggressive negotiation of executive retention might threaten to overtake more important deal points, that shareholders might react negatively to packages that appear too generous, and that making decisions in deference to such packages might make a board uncomfortable that it is adequately fulfilling its fiduciary duties.

Regulatory Considerations

There may be regulatory considerations that go beyond general board composition. For example, in certain industries, the regulatory regime may dictate or at least strongly encourage that a board include members with certain expertise or backgrounds. Of course, retention of expert directors knowledgeable about the particular regulatory requirements of the industry in which the combined company operates is critical; this is an obvious fact in the case of a merger of companies from different industries. But even in a merger of competitors within an industry, it may be wise to retain such "experts" from both legacy entities. The benefits of doing so—such as increased access to key contacts within the industry and governmental regulators, as well as a deeper and broader pool of expertise and experience—are less obvious and quantifiable. But, even in lopsided acquisitions where the target is viewed merely as an asset addition, the acquirer would be wise to thoughtfully consider such intangible assets and how to make the most of them.

Similarly, where a statute applies to certain areas of the parties' business, post-combination governance structure itself may have an impact on how that business is conducted. The MillerCoors joint venture provides a good example.[9] MillerCoors is a joint venture of SABMiller plc and Molson Coors Brewing Company formed in 2008 to compete against Anheuser-Busch in the United States. SABMiller and Molson Coors each have a 50% voting interest in MillerCoors. The joint venture was formed with a ten-seat board, with five directors from each of SABMiller and Molson Coors. Molson Coors appointed the CEO and SABMiller appointed the CFO. Moreover, the joint venture agreement provided that each board member would continue to owe a fiduciary duty to his or her appointing entity and not to MillerCoors. If the MillerCoors board is deadlocked, the matter is referred to the CEOs of SABMiller and Molson Coors. If the CEOs are unable to agree, the matter is deemed to have not been approved by the board. After the creation of the joint venture, MillerCoors sought to terminate Ohio distributorship agreements for SABMiller and Molson Coors products that predated the joint venture. Ohio distributors brought suit to prevent termination of these agreements. Interpreting an Ohio statute that prohibited termination of distributorship contracts unless, among other things, an entity was a "successor manufacturer," the Sixth Circuit held that MillerCoors was not allowed to terminate the contracts. In so ruling, the court examined in detail the governance structure of MillerCoors. While the precise point of law in the case is not important for the purposes of this article, the case illustrates an important principle: Post-combination governance structures can have effects that extend well beyond obvious or expected areas.

Business considerations may well override—it is not clear, for example, that SABMiller and Molson Coors would have allowed this Ohio statute to dictate MillerCoors board composition and governance structure. Still, it is worth considering the ways in which governance decisions can hinder or enable the surviving or new entity's abilities to conduct its business.

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[8] Tiffany Hsu, *Pork Firm Smithfield Sold to China's Shuanghui for $7.1 Billion*, L.A. Times, May 29, 2013, *available at* http://articles.latimes.com/2013/may/29/business/la-fi-mo-smithfield-shuanghui-sale-20130529.

[9] Beverage Distributors, Inc. v. Miller Brewing Co., *et al.* (6th Cir. 2012), *available at* http://www.ca6.uscourts.gov/opinions.pdf/12a0266p-06.pdf.

Governance Structure

Finally, the parties should consider carefully the terms of the new or surviving entity's governance arrangements. Depending on the deal structure, this may present an opportunity to overhaul the governance structure of the combined company. Typical corporate governance considerations should be addressed—will there be a poison pill? A classified board? A Lead Director?

Conclusion

In sum, post-merger governance may be difficult to control, and may take a back seat to business considerations in merger negotiations. Even so, it is worth taking time to consider those governance issues that can be controlled or prescribed and to provide for a post-merger structure that will help ensure stability, especially during the often-difficult post-merger integration period.

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The In-House Perspective: Post Merger Governance

By Broc Romanek, Editor of DealLawyers.com and Deal Lawyers

Here is a collection of anecdotes from in-house colleagues who have lived through the process of mergers with other companies:

– One reason M&A transactions fail to maximize value is because there is not a good process to ensure the right top leadership at the combined entity. The controlling executive role (sometimes Chairman, sometimes CEO) typically goes to the company that paid the premium in the transaction. Or when there is no significant premium, control may be shared by an executive from each company.

  However, leadership at a predecessor company does not make an executive best qualified to lead the combined entity. The combined entity is always a "new" company. It may have a new global footprint and intertwining innovation/R&D processes, as well as changes in the product mix, customer base, shareholder base and capital structure/liquidity. Further, unique skills are needed to lead the combining entities through the complex integration phase.

  During integration, the business must operate well at the same time that work processes, facilities and teams are combined. Alignment of the work force to a "new company culture" and new goals is critical.

  Given these factors, I believe boards would produce the most value by using an objective process, which is not related to the transaction pricing, to ensure the strongest leadership for the new entity:

  1. First evaluating the skills and experience needed to run the new company based upon its unique characteristics and circumstances.
  2. Next working with search professionals to identify candidates who best fit those needs. *The search should extend to candidates from both companies and from outside.* An outside candidate might be best if the new company will have a significantly different profile or if neither CEO has deep experience in driving complex integrations. Boards should have the freedom to determine if the extra disruption that might flow from an outside party taking over would be offset by stronger skills that are uniquely valuable to the new company.

  All parties with a stake in the success of the combining companies (including shareholders, employees, customers and regulators) should want to ensure that the strongest leadership possible is at the helm of the new entity.

– In some deals, the letter of intent may comprehensive enough as to address post-merger board representation and retention of seller's management – but that is not the norm. When it is the case, the letter of intent may address (1) whether the seller will retain any post-closing representation on the board, and (2) if the buyer is to retain certain members of management, the letter of intent may condition closing of the deal on the buyer's ability to negotiate satisfactory employment agreements with those members of management.

– If you're the target, try to get as many management decisions as you can in writing during the negotiation stage as that is when you have leverage. Once the leverage is gone, you are at the whim of the buyer's fancy.

– In many deals, the management decisions often are part of a broad social issues memo that is part of integration planning and hammered out between the time the deal is announced and when it closes. It is hard to figure out sometimes whose bottom to kiss to keep your job. A new wave of office politics opens up and sometimes plays out in far flung locations.

– Who becomes board chair might be an important item in negotiating the deal. Or not. Sometimes it's a trade-off to keep the seller's chair as the new chair of the combined company in return for making the CEO of buyer the new CEO of the combined company.

– Negotiation of how management of the combined company will be structured typically is a sidebar conversation between the two CEOs – not a conversation before all the advisors on the deal as it co

be a very sensitive topic.

- Like many mergers—even if a deal is deemed to be a merger of equals/strategic combo—there is no doubt that the buyer is the stronger of the two companies and that its management team would be running the combined company.
- It is not uncommon for the non-disclosure agreement entered into at the outset prohibits the buyer from soliciting or hiring the seller's employees for some period – and that once there is a definitive merger agreement, there was mutual agreement between the buyer's and seller's CEOs as to the timing of the buyer approaching the seller's management and employees to discuss staying on or joining the company post-merger.
- In certain deals, the execution by the buyer of employment or consulting agreements with certain members of the seller's management team is made a condition of closing the deal, which can make things very difficult.
- Timing of senior management discussions can be fairly late in the game—driven primarily by legal considerations (*e.g.*, gun jumping typically is a driving consideration throughout). Factors may include respective skill sets and whether there are duplicative people resources and whether someone would be an asset to the combined company to fill a gap on the team either on a short-term or long-term basis, future plans (*e.g.*, another position, time off, retirement), geography, how much it would cost to bring us on board relative to other comp considerations.
- Surprisingly, in many cases, there is not a lot of force out and most members of the corporate secretarial and legal departments find a position in the combined company, with the exception normally being at the very top (e.g., general counsel and corporate secretary). However, often people don't want to move if the headquarters are located in different cities.
- It is possible that the seller's and buyer's executive compensation structure are not at all comparable because one pay structure (base, bonus opportunity, and benefits and CIC severance for senior officers) might be significantly above the other. So even if the buyer is interested in bringing certain officers on board, the buyer might not be able to afford what the officers are willing to "sell" themselves for.
- When it comes to selecting advisors for the combined company when the deal is closed, for the most part, they are not even on the board room's mind when the deal is negotiated or when the deal is pending. Rather, picking them for the combined company is just a function of the other personnel decisions – who then in turn decide what advisors to select going forward. Some might try to insist on using the same advisors they had before the deal, but it will depend on normal office politics as before.

<u>Activist Shareholders in the U.S.: A Changing Landscape</u>

By Stephen Arcano and Richard Grossman, Partners of Skadden, Arps, Slate, Meagher & Flom LLP

Shareholder activism in the U.S. has increased significantly over the past several years, with activist campaigns increasingly targeting well-known, larger market capitalization companies, such as Apple, Hess, Procter & Gamble and Sony. In 2013, the number, nature and degree of success of these campaigns has garnered the attention of boards of directors, shareholders and the media. While the continued level of success of activists is uncertain, and the longer-term impact of activism is unknown, at the moment shareholder activism is exerting considerable influence in the M&A and corporate governance arenas. In this evolving landscape, public company boards and their managements need to be aware that virtually any company is a potential target for shareholder activism.

<u>Key Factors Influencing the Current Paradigm</u>

Activism has become a viable and increasingly applied (arguably mainstream) tool for shareholders to seek to influence corporate policy. Several changes have occurred over the past few years that have contributed to the heightened—although not universal—success now being enjoyed by activism, including factors related to the activists, institutional investors and corporate defenses.

- <u>Greater financial firepower</u> —"dry powder"—has become available to activist shareholders, permitting them to make larger and more investments. This increased financial firepower derives to a significant extent from institutional investors that, in seeking "alpha" returns, have turned to activist investor funds as a legitimate alternative asset class.
- <u>New activist funds have emerged</u> on the scene, including so-called "Son of Activist" funds, or funds started by individuals who previously worked for—and learned their trade from—well-known, successful activists.
- <u>Activists have become more sophisticated</u> in selecting their platforms and more nuanced in approach, sometimes seeking incremental change and longer-term involvement with target companies rather than solely focusing on short-term gains. They also are running more professional campaigns than in prior years, hiring financial and legal advisors to perform in-depth analyses of target companies, providing written presentations to targets and investors, and seeking more qualified candidates to serve as nominees for the boards of directors of target companies.
- <u>Activists have been receiving greater support from traditional long equity investors.</u> Institutional investors that might not themselves agitate for change are increasingly willing to support activist campaigns rather than simply pursue the path of selling shares of companies they believe are underperforming. Supporting activists has largely lost the stigma that it had among traditional institutional investors, which once may have viewed activists as a disruptive influence acting contrary to the long-term interests of the company, but today view activist investors as a useful tool. In fact, some institutional shareholders are reportedly encouraging activists to agitate at underperforming companies in their portfolio.
- <u>There has been a significant increase in media attention to activist situations.</u> This media attention, often sympathetic to activist platforms, has become another important tool in the activist arsenal and is a low-cost way to pressure companies.
- <u>Large-cap companies have become more vulnerable.</u> By and large, they have lost their classified boards and shareholder rights plans, often a direct result of corporate governance activist initiatives. Accordingly, they are more exposed to rapid accumulations of shares and contests for board control.

<u>Expanding Activist Agenda</u>

The appearance of an activist has often been a catalyst for M&A or similar activity. One common activist tactic has been to press a target's board to consider strategic alternatives involving the company, including urging one or more actions, such as sale of the company or significant assets, enhancing dividends, and/or share buy backs, spin-offs or break-ups. Often this tactic has been perceived—and challenged—by targets

and others as pursuit of short-term, event-driven gain over longer-term sustained value creation, and this has been the core criticism of activist investors. Without abandoning pursuit of these alternatives in particular situations, some activist shareholders have expanded their agenda to encompass longer term objectives in other situations. Indeed, some have fashioned themselves as "operational activists" who claim they will roll-up their sleeves and help fix under-performing businesses.

Prudent Preparation: Some Key Steps

In view of the uptick in shareholder activism, public companies must remain vigilant to avoid being surprised by an activist accumulation and should be prepared in advance to deal with an activist approach.

- Stock watch programs; awareness of activists. Every public company should have a stock watch program to monitor the trading patterns of the company's shares, as well as to keep track of ownership reporting on SEC forms. Such a program can help spot unusual trading activity and determine which entities are accumulating stakes in the company. In conjunction with the stock watch program, companies and investor relations departments should be familiar with activist identities and aware of which activists have been active recently with companies in the same industry.

- Monitoring all other advance warning sources. The usual warning signs (13F, 13D, HSR filings and unusual trading volume) are often, but not always, the first indications that an activist investor has taken an interest in a company. Many times, the first indication that an activist is lurking is from the activist investor itself via a letter, a revelation made at an investor/activist conference, or attendance on a quarterly earnings call. It's important to remember that there are significant advantages to activists remaining undetected until they have amassed a significant stake in the company.

- Shareholder outreach—in advance. Companies need to maintain an effective, ongoing shareholder outreach program. The focus should be on where the company stands today and what management's strategy is for the future, especially as it relates to increasing short- and long-term shareholder value. Ongoing communications with significant shareholders in a manner compliant with Regulation FD help both to ensure that investors understand the company's story and to provide an important avenue for feedback regarding shareholder views. The strength of the relationship with shareholders and whether shareholders trust management can make all the difference in the world if an activist situation emerges. This trust cannot be built only after an activist shows interest in the company or after a proxy contest has been threatened. Keeping shareholders close, maintaining contact and assessing internal voting and investment processes of institutional investors will help keep shareholder support if an activist situation materializes.

- Comprehensive communications planning. Related to preparing for outreach, companies need to implement a comprehensive communications plan focused not only on significant institutional investors, but also on the broader market and analyst community. Today, successful defenses against activists are won or lost not with legal defenses, but largely on the success of the communications and investor relations plan. The company will have more credibility among its shareholders if it promotes its strategic plan well before a specific demand is made, as opposed to developing the plan in reaction to a demand from any activist.

- Advance formation of a team. Forming a team before an activist shareholder appears on the scene, comprised of key insider personnel and outside professionals, will serve two critical functions: (a) permitting the company to become educated about shareholder activism in all its facets (and there are many) in a calm atmosphere, and to engage in thoughtful planning regarding how to react should an activist shareholder situation arise, and (b) avoiding what can be costly mistakes (including through delay) in receiving critical, informed advice and making important decisions if and when an activist shareholder surfaces.

- Understand critical choices, critical duties and context. If a proposal from a shareholder activist is received, the target's board and management often will quickly be faced with important threshold decisions such as whether and, if so, in what manner to meet with and perhaps engage with the activist. Advance evaluation of what considerations may be relevant to those decisions (depending, of course, on the nature and specifics of the proposal) can be very valuable as often

tors and management, including understanding various contextual settings that might apply. For example: Is the proposal public? Is it accompanied by a proposed director election contest? How has the company been performing relative to its peers, operationally and on a stock valuation basis? Have shareholders been frustrated or unhappy with management? What is the make-up of the shareholder base? Equally valuable for the board and management is to have considered in advance both what their duties are—and are not—in the face of an activist initiative, and how the decisions they make in exercising their duties may play out. Given the pressures that activists often seek to apply in particular to the directors of a target company, it seems prudent to provide them with a clear day reminder that they are statutorily vested with the authority and obligation to manage the company.

While almost all public companies are potential targets of shareholder activism in today's world, with advance planning, they can reduce the risk of undetected activist accumulation and be prepared to analyze effectively and deal with shareholder activist proposals. Moreover, if a potential target company has been in dialogue with shareholders and market professionals articulating a credible plan for value creation, it may both reduce the risk of an activist campaign and better position itself to defend that plan if a campaign is launched.

Appraisal Rights: The Next Frontier in Deal Litigation?

By Daniel Wolf, Matthew Solum, Joshua Zachariah and David Feirstein of Kirkland & Ellis LLP

Appraisal, or dissenters', rights, long an M&A afterthought, have recently attracted more attention from dealmakers as a result of a number of largely unrelated factors. By way of brief review, appraisal rights are a statutory remedy available to objecting stockholders in certain extraordinary transactions. While the details vary by state (often meaningfully), in Delaware the most common application is in a cash-out merger (including a back-end merger following a tender offer), where dissenting stockholders can petition the Chancery Court for an independent determination of the "fair value" of their stake as an alternative to accepting the offered deal price.

The statute mandates that both the petitioning stockholder and the company comply with strict procedural requirements, and the process is usually expensive (often costing millions) and lengthy (often taking years). At the end of the proceedings, the court will determine the fair value of the subject shares (i.e., only those for which appraisal has been sought), with the awarded amount potentially being lower or higher than the deal price received by the balance of the stockholders.

While deal counsel have always addressed the theoretical applicability of appraisal rights where relevant, a number of developments in recent years have contributed to these rights becoming a potential new frontier in deal risk and litigation:

– Cash is King—With cash representing the deal currency (either alone or together with stock) in approximately 70% of domestic M&A transactions over the last few years, the deals in which appraisal rights apply have rebounded as a percentage of overall volume. In addition, in the 2011 *Wescor* decision, the Delaware court indicated that appraisal rights also would likely apply in cash/stock election mergers if the application of caps on the stock consideration mean that even shareholders who elect all-stock could be "required" to accept some cash as part of their merger consideration.

– Hedge Fund Activity and Deal Controversy—With a significant increase in capital available to hedge funds dedicated to activist, merger arbitrage and special situation activity and a seeming swell of deals attracting some form of stockholder opposition (*e.g.*, distressed sales, PE or management buyouts, etc.), appraisal rights have attracted attention as an interesting new opportunity to deploy capital within the scope of these investors' expertise. Moreover, appraisal actions represent a more targeted "investment" opportunity given that the potentially increased consideration only flows to those shareholders who participate in the action (*i.e.*, the benefits are not shared with the wider class of shareholders as is the case in generic deal litigation).

– Appraisal Rights "Arbitrage"—A little-noticed 2007 Delaware decision in *Transkaryotic* significantly increased the arbitrage opportunity available to appraisal rights "investors." Under the statute, holders may only seek appraisal if they do not vote in favor of the merger. It was thought by many that this requirement limited the remedy to stockholders who held their shares as of the record date (which long preceded the meeting and often even the preliminary proxy statement). Under this thinking, the opportunity to "buy into" an appraisal claim was often foreclosed to late-moving investors.

  In *Transkaryotic*, the court endorsed a technical focus on Cede & Co. (the national clearing house for stock, also known as DTC) as the record holder for appraisal purposes. The court essentially held that any beneficial holder through DTC, regardless of when it acquired its shares, could seek appraisal rights as long as the total number of shares for which appraisal was sought was less than the total "street name" shares either voted against or not voted on the merger. As a result, appraisal investors can delay their decision on whether to acquire a stake for purposes of pursuing an appraisal action right up to the date of the stockholders meeting, giving them an opportunity for trend visibility as fair value is measured by the courts as of the date of closing (while the deal price may have been struck under different market or industry conditions months before).

- Low Interest Rate Environment—Under Delaware law, shareholders are generally entitled to statutory interest on the appraisal award at a rate equal to the Fed discount rate plus 5% from the closing date until the award is actually paid.

  Importantly, under a statutory presumption, absent good cause (such as the stockholder pursuing the appraisal in bad faith) this interest is paid (compounded on a quarterly basis) regardless of the ultimate appraisal decision (*i.e.*, even if the court awards a per share amount less than the offered deal price). In today's ultra-low interest rate setting, the accumulating interest payments represent, if not an intriguing stand-alone investment opportunity, at least a meaningful offset to the extended period of illiquidity and litigation costs imposed on the dissenting shareholders for the duration of the proceedings. In fact, the mere threat of the mounting interest cost can coerce companies into considering unfavorable settlements with stockholders bent on pursuing an appraisal action.

- Active Valuation Exercise—In the seminal *Weinberger* case, the Delaware Supreme Court opined that appraisal valuation could be argued based on "any techniques or methods ... generally considered acceptable in the financial community."

  While synergies resulting from the merger are not taken into account, other elements of future and speculative value can be advanced and no minority or illiquidity discount is assessed. In fact, in two recent decisions, *Orchard* and *Synthes*, the courts indicated that any "control premium" involved in the valuation exercise (e.g., in a comparable public companies analysis) had to be shared pro rata by all stockholders, even in the face of a controlling majority stockholder. Much like we have seen in the context of general deal litigation, recent years have shown an increased degree of sophistication and skepticism in the valuation exercise central to the appraisal action, both from the petitioners and the courts.

  An example of this more searching court analysis was seen in the *Golden Telecom* appraisal case where the Supreme Court decisively rejected deference to the negotiated deal price as a "market-checked" fair value, and instead supported the Chancery Court having formed an independent view on fair value with sophisticated textbook-style analyses of expert opinions and positions on such variables as expected tax rates and equity risk premiums and betas used in calculating discount rates. Given the courts' flexible approach to valuation, and the increasing sophistication of petitioners, the potential for more significant premium awards (and possibly discounts) has emerged. To put the issue in perspective (and recognizing that appraisal cases taken to completion likely reflect an element of self-selection bias), some studies have shown that the median premia achieved in appraisal actions is not much below 100%, and awards occasionally are as high as 400%.

While anecdotal evidence suggests that the volume of thought and discussion about appraisal rights has increased significantly, it remains to be seen whether a meaningful flow of litigated appraisal actions will follow.

To the extent the pace increases, we expect that parties may begin to reassess the apportionment of risk around dissenters' rights. Closing conditions tied to the level of shares that assert appraisal rights are not common in the current deal market but may be reconsidered. Such conditions potentially impair deal certainty and create "hold up" value that can be exercised by a relatively small percentage of the outstanding shares. In addition, these conditions are of limited effectiveness in deals structured as tender offers. For deals heavily reliant on financing, dealmakers will need to at least consider the possibility of additional consideration being owed as a result of the appraisal process in creating a long-term and flexible "sources and uses" structure.

Although it is too early to predict whether we will see a true wave of appraisal cases, current market conditions and developments suggest that dissenters' rights may merit a reappraisal.

The Standard of Review in Going Private Transactions: Delaware's Long Awaited Clarification

By Philip Richter, David Shine & John Sorkin of Fried, Frank, Harris, Shriver & Jacobson LLP

Due to a jigsaw puzzle of judicial decisions, companies and controlling shareholders have had to deal with continuing uncertainty as to the standard of review that a Delaware court would apply to a going private transaction with a controlling shareholder. Without certainty as to the applicable standard of review, deal professionals have been left to structure key elements of these transactions based on intuition and "feel" for what will pass scrutiny under the circumstances. In late May, however, Chancellor Strine provided welcome clarity on this process in his decision in the *In re: MFW Shareholders Litigation* action.

The *MFW* case arose from the proposed acquisition of M&F Worldwide by its 43% shareholder, MacAndrews & Forbes. In making its initial proposal, the shareholder made clear that it expected the company to establish a special committee of M&F's independent directors, that it would not proceed with the transaction unless it was approved by a majority of M&F's minority shareholders and that it would not bypass the special committee (i.e., the committee had the authority to "just say no"). After negotiating with the special committee, the controlling shareholder raised its price by approximately 4%, ultimately agreeing to pay a 47% premium to M&F's price before announcement of the offer. Holders of 65% of the shares held by the minority shareholders voted to approve the transaction.

In the *MFW* decision, Chancellor Strine applied the business judgment rule, rather than the higher-scrutiny "entire fairness" standard, to his review of the transaction. In applying this lower-level scrutiny to the transaction, the Court granted the defendants' motion for summary judgment and dismissed the plaintiff shareholder claims.

In his decision, Chancellor Strine announced that the following six specific conditions would need to be met in order for the business judgment rule to apply to a controlling shareholder transaction: "(i) the controller conditions the procession of the transaction on the approval of both a special committee and a majority of the minority stockholders; (ii) the special committee is independent; (iii) the special committee is empowered to freely select its own advisors and to say no definitively; (iv) the special committee meets its duty of care; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority."

The clarity of Chancellor Strine's holding is refreshing. However, in the law of going private transactions, like in skydiving, an eye always needs to be kept on the horizon. First, the *MFW* decision has been appealed to the Delaware Supreme Court, and that Court could obviously take a different view. Second, since *MFW* did not involve a tender offer, the case does not decide whether a special committee recommendation is now required in order to obtain the benefits of the business judgment rule in the case of a tender offer structure. Chancellor Strine did not impose such a requirement in the context of a tender offer in his 2002 *In re Pure Resources* decision. Third, even if the "six point test" survives Supreme Court review, there is certain to continue to be litigation as to, among other things, the proper mandate that a special committee must have in these circumstances, whether the members of the special committee are appropriately independent, and whether the minority vote is fully informed.

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