Client Alert

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Delaware Supreme Court Endorses Change of Control Subject Only to a Post-Signing Passive "Market Check" and Overturns Chancery Court-Ordered Go-Shop

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On December 19, the Delaware Supreme Court overturned a Delaware Chancery Court decision that imposed a mandatory obligation on a target company to solicit alternative transactions for 30 days despite a prohibition against such solicitation in the merger agreement. The Supreme Court decision affirmed both a board's flexibility under *Revlon* to fashion a reasonable sale process and the court's reluctance to "blue-pencil" a negotiated agreement. *C&J Energy Services, Inc. v. City of Miami General Employees' and Sanitation Employees' Retirement Trust*, Del. Supreme Court, Dec. 19, 2014, available here.

BACKGROUND

On June 25, 2014, C&J Energy Services, Inc. and Nabors Industries, Inc. agreed to a merger of C&J with a division of Nabors, creating a new company to be owned 47% by former C&J stockholders and 53% by Nabors. C&J also agreed to pay $938 million to Nabors as additional consideration. C&J was the putative acquirer, but Nabors would be the majority shareholder of the surviving company to qualify the transaction for inversion tax status. Despite Nabors' majority shareholding, the merger agreement provided that C&J management would run the new company and that four C&J directors would join, and comprise a majority of, the new company's board of directors, for at least five years. Additional post-closing protections for the C&J minority shareholders included supermajority shareholder votes for specified corporate transactions, standstill and transfer restrictions on the part of Nabors, and a requirement that all stockholders receive pro rata consideration in any sale of the new company.

Although C&J was nominally the buyer, the merger agreement prohibited C&J from soliciting alternative transactions and included a fiduciary out provision allowing C&J to respond to unsolicited bids and to terminate the merger agreement to accept a superior proposal, subject to paying a "modest" 2.27% termination fee. C&J's CEO signed a voting agreement that terminated if the board changed its recommendation or otherwise exercised its fiduciary out, and the merger agreement contained other typical deal protection provisions such as limited matching rights and notification and information rights regarding potential topping bids.

CHANCERY COURT INJUNCTION

The Chancery Court found that the C&J directors appeared to have approached the transaction as an acquisition of the Nabors division, rather than a change of control of C&J, and to have not otherwise tried to sell or shop C&J. The court also observed that the C&J board did not seem to have "impeccable" knowledge of the Nabors division, although it did have adequate knowledge of the value of C&J. In considering the independence of C&J's directors, the court noted that serving on the new company's board by itself was not disqualifying but said the five-year minimum term for those directors was "unique" and "raises concerns." Overall, the court found that the plaintiffs had made a "plausible" showing that the directors had breached their duty of care by failing to exert efforts to sell the company.

On the other hand, the court also noted that, in the five months following the announcement of the transaction, no other bidders for C&J had come forward, and that there was no basis in the record for any breach of duty of loyalty claims. The court also stated that adequate disclosure had been made to the C&J stockholders.

Nonetheless, the court concluded that the shareholders "are entitled to have a sales process run when their company is being sold…." The court ordered C&J (acting through its directors who had not been designated to be directors of the new company) to solicit alternative acquisition proposals for a 30-day period (calculated in part to avoid extending past the drop-dead date under the merger agreement) and ordered as well that such solicitation would not be deemed a violation of the no-shop restrictions of the merger agreement. The court further enjoined C&J from holding its stockholder meeting until it had complied with the order.

SUPREME COURT REVERSAL

The Delaware Supreme Court reversed the Chancery Court decision.

Sale Process. While noting the *Revlon* maxim that, in a change of control transaction, "the duty of the board … [is] the maximization of the company's value at a sale for the stockholders' benefit,"[1] the Court also reiterated its view that "there is no single blueprint" for fulfilling *Revlon* duties. In particular, "*Revlon* does not require a board to set aside its own view of what is best for the corporation's stockholders and run an auction whenever the board approves a change of control transaction." Rather, the Court noted that a board may "pursue the transaction it reasonably views as most valuable to stockholders, so long as the transaction is subject to an effective market check…." The market check must give other bidders a "fair opportunity to present a higher-value alternative" and give the target board the flexibility to accept the higher-value deal, but need not involve a pre-announcement market check or an active solicitation of alternative proposals post-announcement.

The Court noted that the Chancery Court had determined that the board members had no conflicts of interest and were otherwise well-informed as to C&J's value.[2] The Court rejected the Chancery Court's requirement that the C&J board have an "impeccable" knowledge of C&J's value informed by active shopping of the company. The Court also noted that the C&J CEO and another significant stockholder that had a board representative each owned approximately 10% of C&J's stock and thus had no incentive to harm the value of the C&J shares. The

[1] The Court, citing timing exigencies and the fact that this was a case of first impression, assumed that *Revlon* applied because Nabors would acquire a majority of the new company's shares and declined to address whether the minority protections provided in connection with the merger might otherwise avoid *Revlon*'s application.

[2] The fact that the C&J CEO would run the surviving company and benefit from an enhanced employment agreement negotiated after the principal merger terms were struck was noted but not deemed to be a breach of the duty of loyalty or a certain conflict of interest. While the CEO's focus on his compensation "cast[] shade on his motivations," the Court noted that the merger was not the only way for the CEO to improve his compensation, that there was no threat to his tenure, that he held a strong interest in maximizing the value of his C&J shares, and "[m]ost important" that the board had held numerous meetings and communicated closely with the CEO throughout the process. Similarly, the fact that certain target directors would remain as directors of the surviving company was not deemed to constitute a conflict.

Court observed that the C&J board appeared to have been aware of the implications of providing majority control of the new company to Nabors, citing the minority protections that the board had obtained in the merger agreement.

Finding that the deal protections in the merger agreement imposed no material barriers to a rival bidder, the Court concluded that the availability of a “passive” market check under the merger agreement was sufficient, at least where, as here, there was “more than adequate time” for a bidder to emerge. Stating that “people seem to forget that *Revlon* was largely about a board’s resistance to a particular bidder and its subsequent attempts to prevent market forces from surfacing the highest bid,” the Court observed that here, in contrast, no competing bids had emerged in the several months since the agreement was signed.

The Court also noted that it was “contextually relevant” that the C&J stockholders would have a “fair chance” to evaluate the transaction, given the stockholder vote requirement, and that the Chancery Court had found that the stockholders were adequately informed.

Mandatory Injunction. The Court also criticized the Chancery Court’s use of a mandatory injunction that affirmatively required C&J to engage in a go-shop process. The Court distinguished the use of such an injunction from the more traditional use of a preliminary injunction to preserve the status quo for some period, saying that a party should be “stripp[ed] … of bargained-for benefits” while being held to other contractual obligations only if it was “fairly required to do so” because the party “had, for example, aided and abetted a breach of fiduciary duty.” In any case, such an injunction should be issued only after a trial with findings of fact or on the basis of undisputed facts and not on the basis of a preliminary record with factual disputes. Importantly, the Court noted that the C&J stockholders could avoid the harm sought to be addressed by the injunction by simply voting down the transaction.

The Court concluded that “where no rival bidder has emerged to complain that it was not given a fair opportunity to bid, and where there is no reason to believe that stockholders are not adequately informed or will be coerced into accepting the transaction …, the Court of Chancery should be reluctant to take the decision out of their hands.”

CONCLUSIONS

- Under Delaware law, a board has substantial discretion to fashion a reasonable deal process that it deems most beneficial when pursuing a sale or other change in control.
- In appropriate circumstances, a board can decide to rely upon a post-signing passive market check, without an active market check either before or after signing, where the deal protection provisions do not prevent a rival bidder from making a superior offer. The Court’s position should support companies electing for appropriate reasons to pursue a single-bidder strategy.
- Delaware courts should be reluctant to rewrite negotiated provisions of a merger agreement (i.e., “blue-pencil”) without undisputed facts (or a finding of facts after trial) and a showing of a “fair” requirement, such as where the other party had aided and abetted a breach of fiduciary duties.

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