KIRKLAND & ELLIS

KIRKLANDPEN
Private Equity Newsletter

March 8, 2017

Minimizing Exposure in Controlling Sponsor M&A Transactions

PENpoints

Understanding how a Delaware court will analyze a specific transaction allows PE sponsors to implement appropriate procedural safeguards and minimize litigation exposure.

A private equity firm with a "controlling"[1] interest in a portfolio company should be aware that a Delaware court will examine the board's conduct in connection with certain M&A transactions with a heightened level of judicial scrutiny.[2] Understanding how a Delaware court will analyze a specific transaction allows private equity sponsors to implement appropriate and achievable procedural safeguards for the benefit of minority stockholders and minimize litigation exposure, while avoiding excessive and unnecessary ones.

Courts have divided transactions involving targets with controlling stockholders into four primary categories that focus on the degree of conflict inherent in the transaction:

1. Third-Party Sale — Pro-rata consideration transaction. At one extreme is a standard private equity exit where the controlling stockholder sells its whole stake to an unaffiliated third-party buyer, receiving identical consideration as the minority stockholders.[3] Absent extreme circumstances, the business judgment rule will apply because the controller's sale of its stake for identical consideration creates maximum alignment of interest with the minority stockholders. Heightened scrutiny will only apply in cases where the controller forces an inopportune "fire sale" to address a crisis requiring immediate liquidity. And a recent case makes clear that the venture capital/private equity investment model, which is predicated on an exit after a certain investment period, does not by itself create a conflict if controlling financial sponsors pursue and achieve a sale for the same consideration as all other stockholders.

2. Squeeze/freeze-out transactions. At the other extreme is a transaction where a controlling stockholder seeks to acquire the shares it does not already own from the minority stockholders. This inherent conflict of interest generally results in the default "entire fairness" standard of review (which requires the controlling stockholder to prove that the price and process were fair, almost always resulting in a full trial).

However, in a landmark 2013 decision,[4] the Delaware Supreme Court endorsed a set of procedural protections which, if followed, offer a pathway for the transaction to be reviewed under the more deferential business judgment rule: (i) approval of the transaction by an independent special committee of the board, empowered to select its own legal and financial advisors and free to reject the controlling stockholder's offer, (ii) approval of the transaction by a fully informed and un-coerced majority-of-the-minority stockholders, and (iii) the special committee meeting its duty of care in negotiating a fair price for the minority.

A recent Delaware Chancery Court decision granting a controlling stockholder's motion to dismiss (without costly and time-consuming discovery or trial) empha-

INSIDE KIRKLANDPEN

1 The determination of whether a stockholder, such as a private equity fund, is "controlling" requires a nuanced analysis focusing on both the ownership percentage and exercise of actual control. See our *M&A Updates* from December 15, 2016, and October 30, 2014, for more information.

2 While these issues typically arise in public-target transactions, they can also arise in private-target deals if, for example, the transaction is not covered by a drag-along provision or if a drag-along doesn't exist.

3 See our October 30, 2014, *M&A Update* for more information.

4 *Kahn v. M&F Worldwide Corp.*

sizes the benefits of properly following this Delaware prescription. This recent decision also confirmed two other key principles that apply when a controller is pursuing a squeeze-out transaction — (i) the controller is free to reject a competing third-party offer even if the minority stockholders would be better off under the competing offer, and (ii) the legitimacy of a "minority discount" in pricing a squeeze-out transaction (i.e., a controller's offer can be reasonable and fair to the minority in certain cases even if the offer is made in the shadow of a higher offer from a third party because the controller already "owns" the control premium).

3. Third-Party Sale — Differential consideration transaction. Between the two extremes rests a third category where the controller is a seller along with the minority stockholders but receives different consideration for its stake. While Delaware has repeatedly accepted that a controller is legally permitted to receive a greater share of the consideration (a "control premium") when an unaffiliated third party acquires a controlled company, such a transaction will be reviewed under the more searching entire fairness standard unless certain procedural protections are implemented, because the controller is viewed as conflicted by competing with the minority stockholders for consideration.

Differential consideration can take one of two forms:

- The first is "disparate consideration," where the controller receives greater monetary consideration for its shares than the minority. While more common in the sale of dual class companies (such as where the controller's high-vote stock receives more than the low-vote public minority), a controller of a target with a single class might also seek greater per-share consideration for its control stake.
- The second kind of differential consideration is where the controller receives some additional benefit beyond simply incremental cash per share, such as a preferred interest with a significant liquidation preference, ownership of one of the target's key assets, beneficial contractual rights or elimination of a potential derivative suit against the controller.

The procedural protections required to gain business judgment review bear many similarities to the above Delaware test: approval by an independent special committee of the board, a non-waivable requirement for approval by a majority of the disinterested and fully informed stockholders, and the absence of threats or coercion.

4. Third-Party Sale — Continuing stake transactions. Also sitting between the two extremes is a fourth category where, in connection with the sale of a controlled company to an unaffiliated third party, all or a portion of the controller's stake is exchanged for debt or equity of the combined company. Rollover may occur because it is requested by the controlling stockholder or required by the third-party buyer. Historically, the Delaware courts have treated these transactions as hybrids, exhibiting elements of both a squeeze-out transaction (and the associated concern about the controller standing on both sides) and a differential consideration transaction (with concerns about competing for consideration and unique benefits).

Delaware courts have not provided clear guidance as to how much of the controller's stake needs to be "rolled over" for the transaction to be subject to heightened scrutiny, or whether conflicts arise if the rollover opportunity is in substitution for, rather than incremental to, a portion of the cash consideration the controller would have otherwise received. In one case that applied entire fairness review, the controller received a small continuing equity stake and a basket of other "unique benefits," leaving it unclear whether the small continuing stake alone would have triggered the entire fairness review. Some older cases show that, at least where the rollover includes a meaningful portion of the controller's pre-transaction stake, the court will require procedural protections (including an independent special committee and approval by a majority-of-the-minority stockholders) in order to preserve the benefits of the business judgment rule.[5]

* * * *

When a target company with a controlling stockholder engages in one of the above transactions, there is a tendency to assume that the transaction is intrinsically conflicted and that procedural protections that remove or isolate the controller (and its representative directors) are mandatory to avoid application of the more onerous entire fairness standard. However, "entire fairness … 'is not implicated solely because a company has a controlling stockholder.' Rather, entire fairness will govern only when 'the controller . . . engage[s] in a conflicted trans-

5 But note that in one ruling from the bench a Delaware judge suggested that business judgment would apply in a deal where, at the request of the buyer, an existing sponsor rolled over 25% of its equity in a take-private.

action.'"[6] The Delaware courts have outlined a variety of controller transactions so that dealmakers can, with the benefit of a nuanced analysis of the specific facts and circumstances at hand, properly match the appropriate procedural protections to the degree of inherent conflict and thereby minimize litigation exposure.

6 *GAMCO Asset Management v. iHeartMedia.*

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

Daniel E. Wolf, P.C.
www.kirkland.com/dwolf
+1 212-446-4884

Gilad Zohari
www.kirkland.com/gzohari
+1 212-909-3321

Revised Hart-Scott-Rodino Act Thresholds

The Federal Trade Commission recently announced increases to the Hart-Scott-Rodino ("HSR") Act filing thresholds.

Parties to an acquisition closing on or after February 27, 2017 must, subject to certain exemptions, file HSR forms when, as a result of an acquisition, the buyer will hold assets, voting securities, and/or non-corporate interests valued in excess of $80.8 million (the "Size-of-Transaction" test) and the transaction involves a buyer or seller with annual net sales or total assets valued at $16.2 million or more and $161.5 million or more, respectively (the "Size-of-Person" test). If the "Size of Transaction" exceeds $323.0 million, the "Size of Person" is, subject to certain exemptions, irrelevant and HSR forms must be submitted.

The chart below summarizes the 2016 and the new thresholds.

HSR Jurisdictional Test	2016 Thresholds	New 2017 Thresholds
Size-of-Transaction	$78.2 million $312.6 million	$80.8 million $323 million
Size-of-Person	$15.6 million $156.3 million	$16.2 million $161.5 million

Filing fees have not changed and apply to the new thresholds as follows:

Transaction Value	Filing Fee
Greater than $80.8 million but less than $161.5 million	$45,000
Greater than or equal to $161.5 million but less than $807.5 million	$125,000
$807.5 million or more	$280,000

The FTC also announced an increase in the maximum civil penalty amounts for HSR violations from $40,000 per day to $40,654 per day, effective January 24, 2017.

If you have any questions about the matters addressed in this *KirklandPEN,* please contact the following Kirkland authors or your regular Kirkland contact.

Ellen M. Jakovic
www.kirkland.com/ejakovic
+1 202-879-5915

Michael D. Thorpe
www.kirkland.com/mthorpe
+1 312-862-2194

Donna Alberts Peel
www.kirkland.com/dpeel
+1 312-862-2429

Kurt J. Wunderlich
kurt.wunderlich@kirkland.com
+1 312-862-4438

PENbriefs

New UK Ethical Reporting Regulations in Force April 2017

Two new "ethical compliance" reporting obligations — requiring UK employers with more than 250 employees to collect and report gender pay gap metrics, and large UK companies and limited liability partnerships to disclose invoice payment practices — are due to come into force in the UK in April 2017. While this is likely to be of most direct application to large UK companies, financial sponsors will have an interest in their UK portfolio groups' compliance with these new obligations. To learn more, see our recent *Alert.*

Trump Administration Releases National Trade Policy Agenda for 2017

On March 1, 2017, the Office of the U.S. Trade Representative released its National Trade Policy Agenda for 2017 describing the president's trade policy objectives, which includes pivoting away from multilateral trade negotiations and organizations. To learn more, see our recent *Alert.*

FTC Merger Remedy Study

On February 3, 2017, the Federal Trade Commission released a study evaluating the effectiveness of its merger remedies and proposing updated best practices for merging parties and divestiture buyers. The study, not surprisingly, confirmed that the FTC's merger remedy practices have been effective in maintaining or restoring competition, and as a result does not signal a significant departure from the FTC's merger remedy practices. To learn more, see our recent *Alert.*

German Insolvency Avoidance Action Reform and its Impact on Financial and Trade Creditors

The German *Bundestag* recently enacted a reform bill seeking to improve Germany's stringent insolvency avoidance action regime and incentivize work-outs between debtors and, among others, financial and trade creditors. The law seeks to raise the bar for assertion of avoidance claims on account of prepetition transactions, potentially providing creditors greater protection. To learn more, see our recent *Alert.*

Delaware Supreme Court Upholds Decision Applying *Corwin* Doctrine to Tender Offers

In its recent *Corwin* decision, the Delaware Supreme Court decided that the deferential business judgment rule should be the standard of review in post-closing damages cases in mergers (other than those subject to entire fairness review) that have been approved by a fully informed majority of disinterested stockholders. The Supreme Court recently affirmed a lower-court decision extending the *Corwin* doctrine to tender offers, providing dealmakers with confidence that choosing a tender offer structure, which may be favored by parties because of potential speed advantages, will not deprive the target board of the litigation benefits of a fully informed approval by stockholders. To learn more, see our recent *M&A Update.*

DOJ Obtains $600,000 Settlement for HSR Gun-Jumping Violations

The Hart-Scott-Rodino Act requires companies to refrain from completing a reportable transaction, including obtaining "beneficial ownership," during the HSR review period. In the Department of Justice's view, beneficial ownership may include "assuming the risk or potential benefit of changes in the value of the relevant assets and exercising control over day-to-day business decisions." The DOJ recently settled a case against a utility that acquired operational control over an electric generating plant before it acquired title to the plant. To learn more, see our recent *Alert.*

Second Circuit Removes Uncertainty Surrounding Out-of-Court Restructurings

The U.S. Court of Appeals for the Second Circuit vacated and remanded a controversial district court decision that had created uncertainty as to whether a bond issuer could legally engage in a consensual out-of-court restructuring with creditors that could have a negative impact on recoveries of non-consenting creditors. The decision brought case law back in line with historic market practice, relieving recent uncertainty in the corporate debt market. To learn more, see our recent *Alert.*

M&A and Classified Government Contracts: U.S. Defense Department Issues New Guidance

The U.S. Department of Defense recently updated its security rules for government contractors holding facility security clearances and their corporate parents. These rules include requirements to mitigate risks that may arise out of foreign control of such companies, which could include operational and governance restrictions. To learn more, see our recent *Alert.*

Voting Standards Are Not That Standard

The question of whether shareholder approval was obtained or a director elected is subject to overlapping provisions of state law and the company's organizational documents (and occasionally federal law and stock exchange rules) that can be confusing and lead to mistakes. The real-world impact of mistakes can be significant. In addition to raising potential questions about the validity of a corporate action if the wrong standard is applied, inaccurate disclosure about the voting standard may also give rise to disclosure-related litigation claims. To learn more, see our recent *M&A Update.*

Russia Sanctions Developments Highlight Need for Active Compliance Efforts

Recent expansion of sanctions against entities and individuals subject to sanctions against Russia highlight the need for continuous, active monitoring for compliance with U.S. sanctions developments by U.S. companies and non-U.S. companies with a U.S. nexus (e.g., co-investors, management, partnerships, share-holders, suppliers or service providers). To learn more, see our recent *Alert.*

Advance Notice Bylaws in Light of Corvex/Williams — Displacing the Placeholder Nomination

Advance notice bylaws are a near universal feature of the organizational documents of public companies. A recent proxy contest launched by an activist investor who nominated "placeholder" candidates, to be replaced by more qualified persons after the stockholder vote, suggests that companies should modify existing advance notice bylaws to require director nominees to represent that they currently intend to serve as directors for the term for which they are standing for election. To learn more, see our recent *M&A Update.*

KirklandAIM Update

Recently in our *KirklandAIM* newsletter, which is directed toward Chief Compliance Officers and other compliance professionals, we discussed: the settlement of an SEC proceeding against a private equity sponsor relating to payment of accelerated monitoring fees and other practices (click here to access this edition of *KirklandAIM*); SEC changes to the investment adviser registration forms and rules regarding performance-related recordkeeping (click here to access this edition of *KirklandAIM*); passage by the House of Representatives of the Investment Advisers Modernization Act of 2016 (click here to access this edition of *KirklandAIM*); the announcement of the SEC's 2017 examination priorities, including continued enforcement focus on investment advisers (click here to access this edition of *KirklandAIM*); an SEC risk alert which cites frequent adviser deficiencies (click here to access this edition of *KirklandAIM*); an executive order setting out the new administration's core principles of financial regulation (click here to access this edition of *KirklandAIM*); and a CFTC aggregation rule that may implicate trading at controlled portfolio companies (click here to access this edition of *KirklandAIM*).

PENnotes

PEN News Conference Call Series

Kirkland has hosted a series of short PEN News conference calls covering topics most critical to private equity business professionals. The inaugural call addressed "The Future of Carried Interest," the second discussed "Gifting Your Carry: Estate Planning Under a New Administration" and the third covered "Minimizing Personal Liability of Directors and Officers of Insolvent Corporations."

"Going Public: My Adventures Inside the SEC and How to Prevent the Next Devastating Crisis" Book Launch
New York, NY, March 15, 2017
Washington, D.C., March 30, 2017

Please join us for Kirkland partner Norm Champ's book release, "Going Public: My Adventures Inside the SEC and How to Prevent the Next Devastating Crisis." The book chronicles his experiences as former Director of Investment Management at the SEC and sheds light on the regulatory process and government policymaking. Click here for more information.

Harvard Business School Club of New York "The Global Outlook for Private Equity Investing"
New York, NY, March 27, 2017

In partnership with Harvard Business School Club of New York, Kirkland will host this event, featuring Blackstone senior adviser and Harvard Business School professor John Dionne. The program will address the worldwide economy, emerging political and social trends, and the resulting effect on the global outlook for private equity investing. Click here for more information.

National Young Energy Professionals' Law Conference
New Orleans, LA, March 31-April 1, 2017

Designed primarily for energy attorneys under 40 years of age, this conference will provide young energy professionals with opportunities to network with their peers, provide significant hours of energy-related CLE and offer professional development training. Kirkland is a sponsor of the event. Click here for more information.

Kellogg Spark 2017: The Premier Student-run Private Equity and Venture Capital Conference
Evanston, IL, April 12, 2017

Kirkland is a platinum sponsor of Kellogg Spark 2017, which will offer an opportunity for professionals, academics, students and alumni to explore the challenging issues surrounding private equity and venture capital, as well as to network with other industry professionals. This year's event will feature Monique Woodard of 500 Startups and Liam Stewart of Macquarie Infrastructure Corporation as keynote speakers, in addition to a variety of panels and fireside chats. Click here for more information.

Institute for Energy Law Mergers, Acquisitions & Divestitures Conference
Houston, TX, May 18-19, 2017

Kirkland is a sponsor of the Center for American and International Law - Institute for Energy Law's annual Mergers, Acquisitions & Divestitures Conference. Kirkland partner Cody Carper will be a panelist on "Lessons Learned from Big Deals," which will explore lessons from the last 12 months of major deal making, from antitrust to regulatory hold-ups to major deal collapses to large deals that made it through. Click here for more information.

SuperReturn U.S. 2017
Boston, MA, June 12-15, 2017

SuperReturn U.S. 2017 will explore the trends and drivers of private equity and venture capital in North America, and provide networking opportunities within the global private equity community. Kirkland partner Norm Champ will be a panelist at the event. Click here for more information.

Private Equity Practice at Kirkland & Ellis

Beijing
Chicago
Hong Kong
Houston
London
Los Angeles
Munich
New York
Palo Alto
San Francisco
Shanghai
Washington, D.C.

Kirkland & Ellis' nearly 500 private equity attorneys handle leveraged buyouts, growth equity transactions, recapitalizations, going-private transactions and fund formations on behalf of more than 400 private equity firms and hedge funds around the world.

Kirkland has been widely recognized for its preeminent private equity practice. The Firm was named "Private Equity Group of the Year" in each of the last six years by *Law360* and was commended as being the most active private equity law firm of the last decade in *The PitchBook Decade Report*. U.S. News Media Group and Best Lawyers have ranked Kirkland as a Tier 1 law firm for Leveraged Buyouts and Private Equity Law for seven consecutive years and as a top-tier firm for Private Funds/Hedge Funds Law since 2012. The Firm was recognized as the #1 law firm for private equity in the 2017 Vault 100 rankings, and, in 2016, Private Equity International named the Firm "Law Firm of the Year in North America: Fund Formation" for the third year in a row.

In 2012-2016, Chambers and Partners ranked Kirkland as a Tier 1 law firm for Investment Funds in the United States, United Kingdom, Asia-Pacific and globally. The Firm was ranked as the #1 law firm for both Global and U.S. Buyouts by deal volume in Mergermarket's *League Tables of Legal Advisors to Global M&A for Full Year 2011-2016*, and has consistently received top rankings among law firms in Private Equity by The Legal 500, the Practical Law Company and IFLR, among others.

The Lawyer magazine has recognized Kirkland as one of its "Transatlantic Elite," having noted that the Firm is "leading the transatlantic market for the provision of top-end transactional services ... on the basis of a stellar client base, regular roles on top deals, market-leading finances and the cream of the legal market talent."

KIRKLANDPEN

KIRKLAND & ELLIS

EDITORS

Jack S. Levin, P.C.

Margaret A. Gibson, P.C.

Norbert B. Knapke II

SUBSCRIPTIONS

To subscribe to *KirklandPEN*, please email kirklandpen@kirkland.com +1 (312) 862-3356