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C & J Energy Services and the Continued Erosion of *Revlon*

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Delaware law has long required target boards navigating change of control transactions to singularly focus on maximizing value for stockholders given the final stage nature of such deals. This charge, rooted in the seminal *Revlon* decision, does not require directors to follow a legally prescribed process. On the contrary, independent and non-conflicted directors are given wide latitude to run a reasonable process and have never been required to run a perfect one.

The Delaware Supreme Court's 2009 decision in *Lyondell* reaffirmed this central tenet, but went further in holding that "[i]nstead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, the inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price."[1] December's Supreme Court decision in *C & J Energy Services* goes even further in holding that a board is permitted "to pursue [a] transaction it reasonably views as most valuable to stockholders, so long as the transaction is subject to an effective market check under circumstances in which any bidder interested in paying more has a reasonable opportunity to do so."[2] By so holding, *C & J* reduced the minimum threshold of actions necessary to satisfy *Revlon* in most cases to what *Omnicare* already requires—an effective fiduciary out.[3] Indeed, *C & J* effectively holds that a majority independent board free of conflict can forego both a pre- and post-signing market check so long as potential interested suitors are not precluded from making a superior bid before closing.

Like *Netsmart*,[4] *El Paso*,[5] *Delphi*,[6] and others before them, the issue before the

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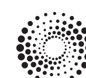

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Supreme Court in *C & J* was whether the target's stockholders should be deprived of the ability to decide for themselves whether to approve or reject the challenged deal, and the decision would be a relatively unremarkable one if it turned on the balancing of the equities like those cases did. But the *C & J* decision addressed the probability of success on the merits, and thus has broader doctrinal implications. Viewed in concert with other likely developments addressed below, *C & J* appears to be part of a larger movement to reduce the litigation risk borne by independent directors of Delaware corporations.

Background Facts

Atypical Transaction Structure

At a high level, *C & J* arose in the context of an anomalous transaction. The transacting parties, including C & J's board, the majority of which was independent and disinterested, approached the approximately $2.8 billion deal as an acquisition by C & J of a competing business. In the minds of the parties, C & J was the acquiror, and the target was the completions and productions services ("CPS") business of Nabors Industries, Ltd. Accordingly, "[b]oth parties agreed that … C & J's management team would manage the combined entity."[7] Likewise, the resulting entity "would then be renamed C & J Energy Services, Ltd., and be listed under C & J's current ticker, CJES, on the New York Stock Exchange."[8]

In many respects, the acquisition appeared relatively straightforward. But to attain approximately $200 million in tax benefits, the parties structured the deal as an inversion in which the resulting entity would need to be re-domiciled in Bermuda, and Nabors would need to own a majority of the new company.[9] Specifically, the parties agreed that Nabors would form a subsidiary into which it would place its CPS business and merge that subsidiary with C & J. As a result, C & J's former stockholders would own 47% of the combined entity, and their shares would be converted into common stock of the post-merger entity on a 1:1 basis in a tax-free transaction. Nabors would own the remaining 53%, and receive approximately $938 million in cash.

Recognizing that this unusual structure could convert it from being a buyer-in-fact to seller of control under Delaware law, C & J's counsel bargained for typical sell-side contractual protections in the merger agreement. Most notably, C & J secured a fiduciary out in the no-shop clause that would allow C & J to negotiate with interested third parties, and a fiduciary out generally enabling C & J to terminate the deal in favor of a superior proposal. C & J also negotiated a "modest" termination fee of approximately 2.27% of the deal value and a provision that would release C & J's CEO from his voting and support agreement if the board changed its recommendation.[10]

In addition to the customary sell-side deal protections, C & J bargained for synthetic control measures that would give former C & J stockholders a strong voice in the governance of the post-merger entity despite their minority position. In particular, C & J stockholders would have the right to designate four board members, including the Chairman. Likewise, for five years following the merger, C & J stockholders, as a collective block, would have veto power over major transactions and changes to the corporate governance documents of the company. C & J additionally bargained for Nabors to be subject to a five-year standstill period and for equal consideration in any sale of the company or its major assets. These contractual protections would prove critical to the Supreme Court's *Revlon* analysis.

Flaws in the Process

The evolution of the transaction and its structure enabled the plaintiff to argue that the C & J board was, in fact, unknowingly selling control of the company. The plaintiff predictably argued that there were several missteps in the "sale" process that prevented the board from satisfying *Revlon*.

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The Decisions

The Court of Chancery's Ruling

In its evaluation of the process, the Court of Chancery considered, and rejected, the defendants' analogy to *In re Plains Exploration & Production Company Stockholder Litigation*,[11] noting that although *Plains* permitted a single-bidder strategy, "[i]n order to justify not shopping the company or engaging in other techniques available to sellers, it is generally viewed as imperative that the board have impeccable knowledge of the value of the company that it is selling."[12] The Court concluded that in light of the unusual structure of this transaction, it could not be sure that the board satisfied the "impeccable knowledge" standard set forth in *Plains*.[13]

At bottom, the Court of Chancery seemingly—and understandably—was troubled by a threshold issue: the C & J board's apparent ignorance of the fact that in the eyes of the law C & J was the seller.[14] The Court made clear that it was "not suggesting any specific steps that the board needed to take," but held that "the fundamental underpinning—and lacking here—is a recognition of the sales process that this transaction involved."[15]

As a result, the Court of Chancery found that the plaintiff had shown a reasonable probability of success on the merits of a claim that the board breached its duty of care, though it noted that its finding was a close call and that it was willing to certify the decision to the Supreme Court for prompt interlocutory review.[16] On the balancing of the equities inquiry, and the question of whether the stockholders should have the chance to decide for themselves whether to accept the deal, the Court of Chancery observed that "[t]he answer, which is not a particularly satisfying one, is simply that they are entitled to having a sales process run when their company is being sold, and I don't believe that there was a sales process as that concept is commonly understood."[17]

For a remedy, the Court of Chancery looked to *Del Monte* for guidance, and issued a 30-day injunction during which the C & J board was ordered to shop the company.[18]

The Supreme Court's Opinion

The Supreme Court disagreed. First, as a semantic matter, it concluded that the Court of Chancery had applied the incorrect standard for a preliminary injunction motion.[19]

Second, and more substantively, the Supreme Court rejected the Court of Chancery's interpretation of what *Revlon* requires:

> **Here, the Court of Chancery seems to have believed that *Revlon* required C & J's board to conduct a pre-signing active solicitation process in order to satisfy its contextual fiduciary duties. It did so despite finding that C & J's board had no improper motive to sign a deal with Nabors and that the board was well-informed as to C & J's value, and despite the fact that [the company's CEO], one of C & J's largest stockholders, had a strong motive to maximize the value of his shares, and had no reason to do a deal just to secure his (unthreatened) management future. Not only that, but the employer of one of C & J's directors … was a private equity firm that owned 10% of C & J stock and was therefore unlikely to support a transaction that would compromise the value of its large equity position.[20]**

On these facts, the Supreme Court concluded that *Revlon* required nothing more than what the C & J directors did, which was to secure an effective fiduciary out and a suite of modest deal protections that ensured there "were no material barriers that would have prevented a rival bidder from making a superior offer."[21]

Interestingly, the Supreme Court in its *Revlon* analysis seemed unmoved by serious allegations of a conflict of interest on the part of C & J's financial advisor. The Court observed that the sell-side banker had previously advised the buyer and was given permission to provide financing for the deal.[22] The sell-side CEO and lead negotiator moreover testified that he "felt like [C & J's lead banker] was giving feedback to [the Nabors CEO]. So if [he] was negotiating with [the C & J banker], I was negotiating with [Nabors]."[23] Yet while the Court observed that the C & J CEO's "perception of needing to 'negotiate' with his

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own financial advisor gives color to the plaintiffs' allegation that the deal process fell short of the ideal," it otherwise made nothing of the issue and did not substantively address it.[24]

As to remedy, the Supreme Court again disagreed with the Court of Chancery, holding that "[t]o issue a mandatory injunction requiring a party to take affirmative action—such as to engage in the go-shop process the Court of Chancery required—the Court of Chancery must either hold a trial and make findings of fact, or base an injunction solely on undisputed facts."[25]

Lessons and Implications

Satisfying *Revlon* by Contract

In its procedural context, the Supreme Court's reluctance to enjoin the stockholder vote on the proposed transaction is hardly novel or surprising. Delaware courts have long been "modest about playing games with other people's money" when, as here, a "higher-priced alternative is not immediately available."[26] Notably, Delaware courts are loathe to enjoin deals in the absence of a topping bid on the basis of the balancing of equities even where a plaintiff has established a reasonable likelihood of success on the merits. By way of example, while then-Chancellor Strine found a likelihood of success on the merits of the plaintiffs' claims in *El Paso* that the target's banker and CEO harbored undisclosed conflicts, he nevertheless ruled that the "balance of harms counsel[ed] against a preliminary injunction" because there was "no other bid on the table and the stockholders of El Paso, as the seller, ha[d] a choice whether to turn down the Merger themselves."[27]

What makes *C & J* noteworthy, however, is the Supreme Court's expansive holding—in a rare reversal of the Court of Chancery in a preliminary injunction decision—that the plaintiffs had failed to establish a reasonable likelihood of success on the merits, despite ostensibly not consciously trying to conduct a sale or change of control process. As noted above, because the Court of Chancery found that C & J's directors viewed their company as the buyer and not the seller, it concluded that the directors had not done enough—had not done anything, in fact—to satisfy the obligations imposed by *Revlon*. The Court of Chancery also had nontrivial questions as to the directors' understanding of the company's value, and expressed concern about the testimony that the C & J board viewed its interactions with its own financial advisor as adversarial. In short, while C & J's legal advisors did a commendable job papering the deal as a sale transaction with modest deal protections, including a sell-side fiduciary out, that did not unreasonably preclude a topping bid, the Court of Chancery read *Revlon* as requiring the directors to approach their actions (or inactions) with the understanding that they were overseeing a final-stage transaction.

Since its high-water mark in 1985 with the vivid imagery invoked by the Delaware Supreme Court's *Revlon* decision,[28] the practical effect of the resulting doctrine has gradually waned. First, the Supreme Court walked back from its famed "auctioneers" metaphor by establishing that there is "no single blueprint" that a sell-side board must follow to satisfy *Revlon*.[29] Likewise, the Supreme Court long ago held that the *Revlon* doctrine requires target directors to run a reasonable process, not a perfect one. And in its much publicized *Lyondell* decision, the Supreme Court lowered the bar even further, asking whether the target directors "utterly failed to attempt to obtain the best sale price."[30]

C & J goes even further. The Supreme Court has now held that a majority independent board with shrewd legal advisors can satisfy *Revlon* unknowingly, simply by securing non-preclusive deal protections and an effective fiduciary out in a sufficiently public deal that allows for at least the appearance of a window shop.

Evading *Revlon* Altogether by Contract?

In a pregnant statement in passing, the Supreme Court in *C & J* assumed, without deciding, that *Revlon* applied to the atypical transaction at issue. In so doing, the Court avoided the interesting question of whether the protections secured by the C & J board, in the form of the governance structure of the post-transaction entity, took the deal outside the purview of *Revlon* altogether.

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The Court of Chancery has already endorsed the concept of synthetic control rights created by contract for the purpose of evaluating whether one is a controlling stockholder,[31] and this case could have served as the M&A analogue to that decision. As interesting as clarity on that front may have been, though, if the invocation of *Revlon* simply means that the board of the company deemed to be on the sell-side needs to obtain an effective fiduciary out, then it hardly seems worth the cost of contracting (for standard of review purposes) to try to allocate control of a post-merger entity by contract.

Putting Away the Blue Pencil

In a move presaged by his decision as Chancellor in *El Paso*[32] (and his decision as Vice Chancellor in *Toys "R" Us*[33] before that), Chief Justice Strine's *C & J* decision also rebuked the Court of Chancery's "blue-penciling" of negotiated merger agreements absent factual findings or undisputed facts. As a practical matter, the Court's holding that "blue-penciling" constitutes a mandatory injunction will put plaintiffs to a stark choice: forego a *Del Monte*-style remedy that permits (or requires) the target company to be shopped, or ask the court to make factual findings in an evidentiary hearing rather than arguing injunction motions on a paper record.

Conspicuously absent from the Supreme Court's decision, however, was any reference to the Court of Chancery's 2011 *Del Monte*[34] decision, despite the Court of Chancery in *C & J* having expressly referenced that decision in crafting its injunction. In *Del Monte*, the Court of Chancery permitted the target to re-shop the company in the wake of undisclosed conflicts that infected the sale process. But the *Del Monte* court crafted a traditional negative injunction (as opposed to a mandatory one), enjoining the parties from closing the deal for a time certain on the basis that the Court had no confidence the deal had been shopped (*i.e.*, not affirmatively ordering that the company to shop itself).

Conceivably, *C & J* might not change the result in *Del Monte*, where the Court concluded on the preliminary injunction record that there was a reasonable likelihood of success that the acquiror aided and abetted the target's breaches of duty, thereby permitting the conclusion that the acquiror's contract rights, in the form of deal protections, were no longer sacrosanct. By contrast, the Court of Chancery in *C & J* concluded that there was no basis for an aiding and abetting claim against Nabors, thereby leading the Supreme Court to question the basis for intruding on its contract rights.

The Broader Context

Stepping back, *C & J* may be fairly viewed as the latest manifestation of Delaware's director-centric model: if spearheaded by independent directors without questions of bad faith or conflict, business decisions—whether in the context of deal processes or otherwise—will be given the judicial deference that underscores Delaware's renowned corporate law. But the Delaware Supreme Court appears poised to go even further by reducing the litigation risk borne by independent directors of Delaware corporations. For example, the Supreme Court is likely to revisit the tension between Delaware's minimal "reasonable conceivability" pleading standard and the federal "plausibility" standard set forth by the United States Supreme Court in *Iqbal* and *Twombly*. Indeed, Chief Justice Strine, writing then as Chancellor, expressed concern "about reading *Central Mortgage* as a marked departure from Delaware's longstanding tradition of requiring that a plaintiff plead sufficient non-conclusory facts to support a pleading stage inference that a cause of action exists."[35] The Supreme Court also appears primed in the pending interlocutory appeals in the *Cornerstone* and *Zhongpin* cases to revisit whether independent directors can get the benefit of a 102(b)(7) defense at the pleadings stage.

In short, if *C & J* is any indication of a developing shift, then the litigation risk and exposure of independent directors appears to be dwindling, and independent directors will have more avenues to escape litigation at an earlier procedural stage.

NOTES

1. *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 244 (Del. 2009).

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2. *C & J Energy Servs., Inc. v. City of Miami Gen. Employees and Sanitation Employees Ret. Trust*, 2014 WL 7243153, at *10 (Del. Dec. 19, 2014) (hereinafter, the "Opinion" or "Op.").
3. *See Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 938 (Del. 2003).
4. *In re Netsmart Techs., Inc. S'holders Litig.*, 924 A.2d 171, 208 (Del. Ch. 2007).
5. *In re El Paso Corp. S'holder Litig.*, 41 A.3d 432, 450-451 (Del. Ch. 2012).
6. *In re Delphi Fin. Gr. S'holder Litig.*, 2012 WL 729232, at *2 (Del. Ch. Mar. 6, 2012).
7. Op. at *5.
8. *Id.* at *9.
9. "Because Nabors is a Bermuda-based company, C & J could avoid paying U.S. corporate taxes by merging into Nabors and re-domiciling in Bermuda. The tax benefits from structuring the transaction in this way are substantial—Citi estimated the savings as worth $200 million in net present value."*Id.* at *5.
10. *Id.* at *10.
11. 2013 WL 1909124 (Del. Ch. May 9, 2013).
12. *City of Miami Gen. Employees and Sanitation Employees Ret. Trust v. C & J Energy Servs., Inc.*, C.A. No. 9980-VCN, at 150 (Del. Ch. Nov. 24, 2014) (TRANSCRIPT) (hereinafter, the "Transcript" or "Tr.").
13. *Id.*
14. *Id.* at 149 ("Second, and this is the major problem that I have encountered with this case, it is not so clear that the board approached this transaction as a sale."); *id.* ("The C & J board did not approach this transaction as part of a sales effort. Indeed, if we go back to documents from very early on in the process, there is talk about the board unanimously approved the company's acquisition of Navy which was the name for the Nabors completion and production business.").
15. *Id.* at 152.
16. *Id.* at 142, 152, 155.
17. *Id.* at 153.
18. *Id.* at 154.
19. Op. at *13 ("In this case, although the Court of Chancery correctly identified the standard of review for a preliminary injunction, it misapplied that standard when it found that there was "a *plausible* showing of a likelihood of success on the merits as to a breach of the duty of care, and that goes to an absence of an effort to sell.").
20. *Id.* at *15 (footnotes omitted).
21. *Id.* at *16.
22. *Id.* at *4-5.
23. *Id.* at *5.
24. *Id.*
25. *Id.* at *17.
26. *Netsmart*, 924 A.2d at 208.
27. *El Paso*, 41 A.3d at 434, *see also id.* at 451 ("Given that the El Paso stockholders are well positioned to turn down the Kinder Morgan price if they do not like it, I am not persuaded that I should deprive them of the chance to make that decision for themselves."); *see also Delphi*, 2012 WL 729232, at *2 ("I find that the Plaintiffs have demonstrated a likelihood of success on the merits at least with respect to the allegations against [the controlling stockholder]. However, because the deal represents a large premium over market price, because damages are available as a remedy, and because no other potential purchaser has come forth or seems likely to come forth to match, let alone best, the … offer, I cannot find that the balance of the equities favors an injunction over letting the stockholders exercise their franchise, and allowing the Plaintiffs to pursue damages. Therefore, the Plaintiffs' request for a preliminary injunction is denied.").
28. *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1985) ("The duty of the board had thus changed from the preservation of *Revlon* as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit. This significantly altered the board's responsibilities under the *Unocal* standards. It no longer faced threats to corporate policy and effectiveness, or to the stockholders' interests, from a grossly inadequate bid. The whole question of defensive measures became moot. The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.").
29. *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989).
30. *Lyondell*, 970 A.2d at 244; *but see Chen v. Howard-Anderson*, 87 A.3d 648, 683-85 (Del. Ch. 2014) (clarifying that the "utterly failed to attempt" standard applies only to "conscious disregard" arguments of bad faith, and not other ways of establishing bad faith, most notably subjective bad faith (including conflicts of interest) and gross negligence).
31. *See Kalisman v. Friedman*, C.A. No. 8447-VCL, at 14 (Del. Ch. May 14, 2013) (TRANSCRIPT) ("One can easily construct contract rights that provide the equivalent of a control … position without needing the underlying equity ownership of the stock. … The equity ownership is a mitigating factor in terms of the potential misuse of control because it aligns the controller's economic incentives with those of the company as a whole."); *but see In re KKR Fin. Holdings LLC S'holder Litig.*, 101 A.3d 980, 994 (Del. Ch. 2014) ("At bottom, plaintiffs ask the Court to impose fiduciary obligations on

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a relatively nominal stockholder, not because of any coercive power that stockholder could wield over the board's ability to independently decide whether or not to approve the merger, but because of pre-existing contractual obligations with that stockholder that constrain the business or strategic options available to the corporation. Plaintiffs have cited no legal authority for that novel proposition, and I decline to create such a rule.").

32. *El Paso*, 41 A.3d at 449 ("Rather, the plaintiffs want an odd mixture of mandatory injunctive relief whereby I affirmatively permit El Paso to shop itself in parts or in whole . . ., in contravention of the no-shop provision of the Merger Agreement, and allow El Paso to terminate the Merger Agreement on grounds not permitted by the Merger Agreement and without paying the termination fee set forth in the Merger Agreement, but then to lift the injunction and then force Kinder Morgan to consummate the Merger 'if no superior transactions emerge.' That is not a traditional negative injunction that can be done without an evidentiary hearing or undisputed facts.") (footnote omitted).

33. *See In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, at 1022-23 (Del. Ch. 2005) (refusing to "blue-pencil" provisions in a merger agreement "before a trial has even been held," noting that "[t]o grant that sort of mandatory relief would … be inappropriate on disputed facts, and plaintiffs who seek such relief should move promptly, not for a preliminary injunction hearing, but for an expedited trial").

34. *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813 (Del. Ch. 2011).

35. *Winshall v. Viacom Int'l, Inc.*, 55 A.3d 629, 635 n.23 (Del. Ch. 2011).

A Harsh Reminder About the Danger of Pre-Closing Activities in M&A Transactions

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On November 7, 2014, the Department of Justice (DOJ) required particleboard competitors Flakeboard America Limited (Flakeboard) and SierraPine to pay $5 million in penalties and to institute a ten-year antitrust compliance program because of inappropriate pre-closing conduct.[2] DOJ's allegations centered on three things: (1) the parties' discussions and conduct relating to the planned closure of SierraPine's mill in Springfield, Oregon; (2) the movement of customers from the Springfield mill to Flakeboard; and (3) the sharing of SierraPine's customer and pricing information.

The Alleged "Gun Jumping"

The Hart-Scott-Rodino Act of 1976 (HSR Act),[3] if applicable, requires that transacting parties obey a mandatory pre-closing waiting period. This waiting period seeks to preserve competition between the parties while the antitrust enforcement agencies review the proposed transaction. If the merging parties prematurely transfer "operational control" of the target, they are subject to a fine of $16,000 for each day they are in violation of the HSR Act. In addition, the Sherman Act prohibits pre-closing coordination between competitors regarding price, output, or other restraints of trade.[4] Pre-closing violations of the HSR Act and Sherman Act are known as "gun jumping."

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