The Future of LBOs

3:40 PM – 4:20 PM, April 17, 2024

Navigation by PE bidders of the fiduciary duties of directors/officers of target companies in buyouts

- Impact of the *Mindbody* decision on the PE playbook
- New fiduciary duty guidance for public companies in LBOs by PE sponsors

Leverage as the secret sauce for LBOs

- The evolution of the private credit ecosystem in the context of acquisition financing
- New regulatory focus on treating private credit more like banks ("systemically important financial institutions) and the impact on LBOs
- Creativity for bidders to build out the senior side of the capital structure – i.e., that which is senior to the equity

Building out the equity side of buyouts

- Evolution of building consortia and managing different levels of infrastructure and skillset
    - Role of sovereign wealth funds and impact on CFIUS/FDI
- Balancing speed and momentum of sales processes to allow for strong bids while preventing competitive advantage to consortium

Secondary market solutions as an alternative to sales of portfolio companies

- Forecasted decrease of portfolio company M&A activity leads to liquidity crisis
- Growing market for secondaries, NAV loans

Antitrust regulatory and the private equity business

- Recent developments on the DOJ and FTC antitrust divisions for US private equity strategy
- Litigation as a potential strategy for PE buyers against the US antitrust agencies and its impact on debt commitments

Other relevant reading:

- New Chancery Decision Highlights Need for Care in Crafting Shareholder Arrangements with Delaware Corporations, Ethan Klingsberg, Meredith Kotler, Victor Ma (freshfields.us)
- Sears and (the Limited Scope of) Controlling Stockholder Fiduciary Duties (harvard.edu)
- Trend in Delaware Merits Heightened Attention by Acquirors (harvard.edu)
- To Exculpate, or Not to Exculpate: Is It Even a Question? (harvard.edu)
- M&A Predictions and Guidance for 2023 (harvard.edu)
- In re BGC Partners: Maybe Entire Fairness Review Isn't So Bad After All (harvard.edu)
- DGCL Amendment Merits Amending Charters and Engagement with Institutional Shareholders (harvard.edu)
- Lessons from the Goldstein Opinion (harvard.edu)
- M&A Predictions for 2022 (harvard.edu)
- Poison Pills After Williams: Not Only for When Lightning Strikes (harvard.edu)

Harvard Law School Forum on Corporate Governance

Troubling Signs from Recent M&A Case Law

Posted by Ethan Klingsberg and Victor Ma, Freshfields Bruckhaus Deringer LLP, on Wednesday, February 17, 2021

Tags: **Delaware cases**, **Delaware law**, **Fiduciary duties**, **Leveraged acquisitions**, **Merger litigation**, **Mergers & acquisitions**, **Pension funds**, **Private equity**, **Shareholder suits**
More from: **Ethan Klingsberg**, **Victor Ma**, **Freshfields**

Editor's Note: **Ethan Klingsberg** is partner and **Victor Ma** is an associate at Freshfields Bruckhaus Deringer LLP. This post is based on their Freshfields memorandum, and is part of the **Delaware law series**; links to other posts in the series are available **here**.

Have we forgotten the lessons of the Delaware cases that arose from the heyday of big-ticket LBOs by private equity preceding the financial crisis of 2007-2008? And to the extent we have, who is bearing the cost, how are plaintiffs uncovering these recent deviations from best practices, and what is to be done?

In these cases from the mid-2000s, courts consistently viewed LBOs as transactions marred by the conflicts of target company executives. Notwithstanding the presence of supermajority independent boards at the target companies, the courts regularly denied motions to dismiss breach of fiduciary duty claims in connection with LBOs. The focus was the absence of safeguards to neutralize the interests of these executives in working for the financial sponsor buyer after the closing and in having access thereafter to, as one case from that era described it, “a second bite at the apple” when the private equity firm would inevitably flip or IPO the company. [1]

A number of useful protocols grew out of these cases from the 2000s. [2] But the 2000s are now a long time ago and a new generation of gatekeepers (lawyers, bankers, and independent directors, not to mention private equity professionals and their friends in senior management of target companies) for whom those cases may be distant memories at best, are now in prominent roles. In the second half of 2020, two of the most important M&A cases involved alleged missteps that adherence to the protocols arising from the 2000s would have prevented.

The first case involved a merger of equals rather than a private equity buyout, but the misstep is one on which the private equity cases of the 2000s repeatedly focused. In *City of Fort Myers General Employees’ Pension Fund v. Haley*, [3] a public company CEO, whom the board had designated as its lead negotiator for the merger, failed to disclose an extraordinary compensation package that representatives of the other merger party had told him he would receive at the combined company. The Delaware Supreme Court reversed the Court of Chancery’s dismissal of the fiduciary duty claim against the CEO, on the grounds that his compensation package was material information about which the CEO should have posted the board while he was serving as a key source of information for the board about this bet-the-company transaction. The high court also remanded the aiding and abetting claims against those who conveyed the news to the CEO about his post-closing compensation prospects.

A longer list of alleged blunders emerges from the Court of Chancery’s denial of the motion to dismiss fiduciary duty claims against the CEO/chairman and COO/CFO of the target company in connection with a $1.9 billion LBO in *In re MINDBODY, Inc., Stockholders Litigation.* [4] Here, the CEO/chairman allegedly:

- failed to inform his board about a series of contacts he had with the eventual private equity buyer—these contacts included discussions of his post-LBO compensation and equity return prospects;
- delayed informing his board about the initial takeover proposal from the private equity firm;

- provided the private equity firm with timing and informational advantages over other prospective bidders;
- prevented the company's financial advisor from reaching out to certain financial and strategic bidders;
- made statements about the company's prospects on an analyst call to manipulate the stock price downward and thereby facilitate negotiation of the buyout;
- ran a "go shop" process characterized by an abbreviated timeline and access to limited information in part due to his unavailability for management presentations while on vacation; and
- failed to disclose to the shareholders in advance of the merger vote that the company was outperforming market expectations—expectations that he had allegedly succeeded in tampering down to facilitate the sale process.

Meanwhile, the COO/CFO was allegedly "recklessly indifferent to" and facilitated some of these items and therefore the fiduciary duty claim against him survived the motion to dismiss as well.

Who bears the costs of these missteps?

The answer is the executive officers of the target company. In both *Mindbody* and *Haley*, some of the core claims for damages that survived the motions to dismiss were not against directors, but against officers, who, in contrast to directors, are not exculpated for actions taken in good faith. In *Mindbody*, Vice Chancellor McCormick used the gross negligence standard **[5]** (a less stringent standard than the "bad faith" standard necessary to establish a damages claim against a director) to assess the liability of the COO/CFO, as did Chancellor Bouchard in the recent *Baker Hughes* case. **[6]** Moreover, the Court of Chancery has acknowledged that there is an open question of whether a potentially lower standard than gross negligence may apply to determinations of an officer's personal liability in connection with a process to sell control of the company. The courts have historically used the "range of reasonableness" standard to determine a director's compliance with the *Revlon* duty to obtain the best price reasonably available when selling control of a company. **[7]** If this "range of reasonableness" standard were used to determine an officer's personal liability (as opposed to the gross negligence standard), then the court may open the door to an even higher risk of unexculpated post-closing liability for officers. Plaintiffs' lawyers are very focused right now on this risk for officers. Indeed, in a newly filed suit challenging a $3.5 billion LBO announced in December 2020, the plaintiff makes allegations similar to those in *Mindbody* and takes aim at the defendant founder expressly in his capacity as an officer of the target. **[8]**

How are the plaintiffs finding these bad facts and building their cases?

The answer is an aggressive use of the right of shareholders under Section 220 of the DGCL to access books and records of a Delaware corporation. The plaintiffs in *Mindbody* successfully used Section 220 demands to identify disconnects between what was in the board minutes and the defendant executives' positions that they had been taking direction from a well-informed board in an exemplary manner. This may have been an easy task in *Mindbody* because, according to the court, there was an absence of any board minutes to support the defendants' portrayals of the facts. Not only were there gaps in the minutes, it appears that the Section 220 demand, perhaps because of the weak minute-taking practices of the company, enabled the plaintiffs to get access to a load of informal electronic messages by the CEO/chairman and his team (including communications with bankers and private equity professionals) that contain what appear to be unhelpful expressions of his personal interests and that the court repeatedly quotes and finds persuasive. Back in 2007, then-Vice Chancellor Strine's opinion in *Netsmart* stressed the importance of having a disciplined approach to board minutes, where they are finalized in advance of announcing a merger and are sufficiently detailed to refute allegations of lapses in compliance with fiduciary duties. **[9]** This advice is now doubly important given the use of Section 220 demands as a vehicle to build out complaints in M&A cases.

What is to be done?

In sum, directors and especially officers need to adhere to protocols for best practices in connection with any process to sell the company. This vigilance is arguably even more warranted when private equity bidders are on the scene. Moreover, documentation of this adherence in a solid set of board minutes is critical. The basics for these protocols include:

- Officers should be updating and taking direction from the board, which should be involved and engaged regularly from the initial question of whether this is the right time to even explore a sale transaction.
- All material relationships and interests of directors and officers relating to the sale process and the bidder universe need to be aired before the full board from the commencement of the process and regularly revisited, and appropriate steps need to be taken to neutralize these conflicts.
- Due diligence processes and conveyance of information to bidders need to be supervised by advisors reporting to the board (and not by management acting on its own), and management should be chaperoned by these advisors in all of management's communications with the bidders, especially private equity bidders.
- Express permission from the board is necessary before any officer or director may commence communications with a bidder about personal post-closing arrangements and equity rollovers, the board must be informed of any deviations from this guideline, and these discussions should be sequenced to avoid any implication that they are part of the bargaining over the economics to shareholders.
- Internal forecasts should be prepared by management and presented to and endorsed by the board no later than the determination to commence a sale process, rather than a choreography where the forecasts appear to be playing catch up to match the valuations underlying the bids.
- Do not over-rely on a post-signing "go shop" as a means to satisfy the duty to obtain the best price reasonably available and, to the extent a go shop is part of the mix, be sure that the terms of the go shop do not render a superior proposal by a "go shop bidder" impractical.
- When asking shareholders to take action in connection with a merger, such as participating in a tender offer or voting to adopt a merger agreement, all material nonpublic information, even if it comes to light after the mailing of the tender offer documentation or proxy statement, must be disclosed to the shareholders in advance of the expiration date for the tender offer or the shareholders meeting.

These take-aways are the same as they were over a decade ago. The burden is on the gatekeepers to start paying attention again.

Endnotes

[1] *In re Netsmart Techs., Inc. S'holders Litig.*, 924 A.2d 171, 198 (Del. Ch. 2007) (internal quotation marks omitted).
(go back)

[2] Ethan Klingsberg, *The Need for Careful Choreography in LBOs*, M&A Lawyer (Apr. 2007).
(go back)

[3] 235 A.3d 702 (Del. 2020).
(go back)

[4] 2020 WL 5870084 (Del. Ch. Oct. 2, 2020).
(go back)

[5] *See In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 750 (Del. Ch. 2005), *aff'd*, 906 A.2d 27 (Del. 2006) (gross negligence requires a showing that the officer acted with "reckless indifference" or "without the bounds of reason").
(go back)

[6] *In re Baker Hughes Inc. Merger Litig.*, 2020 WL 6281427, at *15 n.149 (Del. Ch. Oct. 27, 2020).
(go back)

[7] *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 45 (Del. 1994).
(go back)

[8] *See Pullan v. Skonnard*, C.A. No. 2021-0043-PAF, Compl. ¶ 101.
(go back)

[9] *See Netsmart*, 924 A.2d at 187.
(go back)

Harvard Law School Forum on Corporate Governance

M&A Predictions and Guidance for 2024

Posted by Ethan Klingsberg, Freshfields Bruckhaus Deringer LLP, on Wednesday, January 31, 2024

Tags: antitrust and competition, M&A, private capital
More from: Ethan Klingsberg, Freshfields

Editor's Note: Ethan Klingsberg is a Partner at Freshfields Bruckhaus Deringer LLP. This post is based on his Freshfields **memorandum**. Related research from the Program on Corporate Governance includes **Are M&A Contract Clauses Value Relevant to Target and Bidder Shareholders?** (discussed on the Forum **here**) by John C. Coates, Darius Palia, and Ge Wu; and **The New Look of Deal Protection** (discussed on the Forum **here**) by Fernan Restrepo and Guhan Subramanian.

1. Cross-Border M&A – The era of migration transactions comes into full bloom.

Many companies listed outside the US would trade today at higher multiples to earnings and other applicable metrics if they were listed in the US and, even more so, if they could make it into the S&P 500 (which does not require that issuers be organized under the laws of a US state).

The result will be a continuation of these trends:

- **Exchange hopping.** Issuers listed outside the US will increasingly obtain a second listing in the US, and then migrate over to having the US listing as their primary listing and thereby take advantage of index eligibility that comes with this migration.
- **Using excess cash to arbitrage multiples.** US-listed companies will use their excess cash to buy targets outside the US. When those earnings become housed under a US-listed company, they will trade at the US-listed company's higher multiple. Even when paying a premium to the non-US listed entity's trading price, there will be room for a win/win for the US buyer and non-US target holders, especially if there are some synergies. Buying outside the US will mean digesting terms and takeover rules that are more target-favorable than in the US, as well as often having to undertake more acrobatics than the US M&A regimes require for acquiring 100% ownership. The trading multiple arbitrage will make the effort worth it.
- **Stock combinations to back into a US listing.** Stock for stock combinations (including mergers of equals) between US-listed and non-US listed companies will provide an efficient way to reap synergies and get that non-US company listed in the US with the multiple bump and index inclusion advantages.

2. Leveraged M&A – The secret sauce is coming together.

The secret sauce of any M&A boom in 2024 will be leverage. The key will not be interest rates, but the size of the debt checks that will be available. Many acquisition financing lenders that rely on syndicating their loans were left with "hung" debt in 2022 and we've been hearing for over a year now how that debt needs to be slowly syndicated at a loss before we can return to consistently large debt checks to support leveraged M&A by strategics and private equity.

In the meantime, private credit has stepped in to fill the void, but many strategic buyers and middle market private equity players are not fluent with how to use private credit to build out their pro forma capital structures in connection with leveraged acquisitions.

In 2024, family offices and sovereign wealth money will continue to help boost the equity checks for acquisitions, and bidders in 2024 will up their games on navigating the world of private credit and creating "mosaic" capital structures (i.e., with mezzanine and other investments between the common equity and the senior debt) to get to larger takeovers.

Moreover, 2024 will be the year when both (i) the competition from private credit pushes the syndicated bank loan market to reinvigorate and (ii) the competition and excessive dry powder within the private credit world pushes private credit funds to loosen up on the terms and size of their loans and other investments senior to the junior equity.

The beneficiaries of this trajectory in 2024 will be public company LBOs and leveraged M&A by strategics.

Sales of unlisted, private equity portfolio companies may not benefit. Although there are lots of pre-IPO portfolio companies held by private equity that are overdue for an exit, we will not necessarily see an explosion of these exits through either public listings or sales. The IPO market is still rough for companies that rely on growth forecasts over near-term profitability. In addition, the robust secondary liquidity market will serve as a welcome alternative to sales of portfolio companies. Private equity fund managers will frequently rely on NAV loans and other sources of secondary liquidity at the fund manager levels as the means for returning cash to their LPs, rather than forcing sales of their portfolio companies. We may even see fund managers start to merge because they believe that a combined fund manager with a larger, more robust package of portfolio companies will be better positioned to receive favorable NAV loans.

An important wildcard in this equation will be the US Financial Stability Oversight Council's proposed rules to rein in the activity of private credit funds. Such rules, if adopted during 2024, may present a headwind for prospects for leveraged M&A.

For a more analysis of what to expect from the private capital world, see **Freshfields Private Capital '10 for 24': 10 Things to Keep an Eye on in 2024**.

3. Regulatory – There is a path.

During what the antitrust bar now refers to as "the before times" (i.e., when Lina Khan was an academic and Jonathan Kanter was in private practice) whenever an antitrust expert would warn a board, "It is going to be very hard to get this merger approved by the antitrust agencies," the board would typically respond, "Then work hard!"

Then came this current era of bipartisan support for heightened antitrust enforcement in the US, alongside a European Commission and UK CMA that regularly vie to outdo each other in their fervor to create obstacles for M&A. Moreover, during the last two years, we witnessed the energetic development of foreign investment regulatory regimes in virtually every developed country. During this new era, boards have pivoted away from the view that any antitrust hurdle ought to be surmountable if advisors have the right work ethic. This current era has been characterized by board rooms that reek of intimidation by the nightmare of agreeing to sell their companies, being tied up for 18 months by interim operating covenants, and ending up as "damaged goods" without closings and with only the receipt of regulatory reverse termination fees.

2024 will be the year when the M&A world pivots once again by exhibiting confidence that we've figured out how to manage the fear of this nightmare:

- Bidders will regularly come prepared with detailed action plans and substantive analyses to proactively put to rest regulatory paranoia in target boardrooms.
- Target counsel will realistically assess risks by discussing not only the likelihood of an agency trying to block a merger, but also the dual likelihoods of prevailing against the regulators in court in the US and of being able to cut predictable settlement deals with the regulators outside the US.
- Merger agreements will contain more detailed undertakings that provide more comfort that there is a pathway to expediting processes with regulators.
- Parties will more aggressively and proactively deploy "fix it first" and "litigating the fix" approaches to minimize regulatory approval risks.

For more, see **10 Key Themes Global Antitrust and Foreign Investment in 2024**.

4. Dispersion breeds activism and now finally M&A.

As investors return to equity markets and cause continuing upticks in stock prices, all boats will not rise equally. Dispersion will make it easier for activists to identify those listed companies lagging their peers, and the activist attacks on these laggards will characterize 2024. The results will initially be changes in board and executive management composition and most likely operational and strategic shifts, including cost cutting and reallocation of capital. Pushing for sales of listed companies was not the preferred strategy of activists in 2023 (and indeed many activists launched campaigns to oppose sales of companies during the last year). Instead, the focus in 2023 was consistently on cost-cutting and margin improvement.

In 2024, as leveraged M&A picks up (see item 2 above), activists are going to pivot back to the days when they would regularly complement their pushes for operational reforms with threats that wholeco sales will be necessary if those reforms do not result in quick improvements to performance and shareholder returns.

5. Optimism in board rooms leads to hostile M&A.

Upticks in stock prices during 2024 will feed optimism in board rooms about standalone plans and that, in turn, will make resistance by target boards to takeover entreaties more common. At the same time, in the board rooms of bidders, directors will continue to feel pressure from investors to use their companies' excess cash and highly-priced equity to do accretive acquisitions wherever available. In addition, board room optimism leads to taking risks on allocating capital to acquisitions rather than the more conservative approach of share buybacks. The result is that we are going to have more companies committed to acquisition strategies in 2024, while at the same time we will have more of the companies on their lists of targets remain enthusiastic about their stand-alone prospects. The result will be a boon for unsolicited and hostile M&A. Many M&A advisors over the last several years have done very well nursing friendly combinations. There will be a premium for M&A advisors who are expert, from prior eras, on unsolicited M&A tactics.

Harvard Law School Forum on Corporate Governance

M&A Predictions and Guidance for 2023

Posted by Ethan Klingsberg, Freshfields Bruckhaus Deringer LLP, on Monday, January 23, 2023

Tags: **Antitrust**, **CFIUS**, **China**, **Institutional Shareholders**, **M&A**, **Middle East**
More from: **Ethan Klingsberg**, **Freshfields**

Editor's Note: **Ethan Klingsberg** is a Partner at Freshfields Bruckhaus Deringer LLP. This post is based on his Freshfields memorandum.

Tension between institutional shareholders and boards about strategic alternatives.

We are emerging from several consecutive years where both activist shareholders and boards have been able to regularly count on institutional shareholder support for all-cash sales of companies at premia to recent trading prices. We will be entering a different environment in 2023 – where long-term, institutional shareholders have acquired their shares over the last several years at prices that not only are significantly higher than prices that represent a healthy premium to *current* trading prices, but also far exceed the ranges where financial analyses of the newest internal, management forecasts are putting both intrinsic values and future stock prices.

Against this backdrop, we are not necessarily going to be able to rely on institutional shareholder enthusiasm for cash sales of companies just because the transactions satisfy the traditional criteria of meaningful premia to recent trading prices and falling within the ranges of intrinsic values and future stock prices derived from internal management forecasts. The uncertainty and downsides that will be characterizing the forecasts that managements present to boards at the outset of 2023 will be fueling this tension between the approaches of boards and the approaches of institutional shareholders to sales of companies in 2023.

These tensions between boards and their institutional shareholders over strategic alternatives may come as a surprise to many corporate clients. They will have run sale processes consistent with the latest guidance from Delaware Chancery decisions. In addition, many will have recently upped their games on shareholder engagement, "thinking like activists," improving their investor relations messaging, being more transparent about longer term targets (rather than managing the markets only from quarter to quarter or even from fiscal year to fiscal year) and making shareholder-friendly governance concessions in a tactically wise manner. Nevertheless, we need to prepare for battles in 2023 for shareholder approvals of negotiated sales of public companies for cash consideration.

We are going to be spending a lot more time in 2023 convincing ISS, among others, why cash mergers merit their support. We may even start trying to structure more transactions as tender offers to avoid ISS recommendations, although regulatory timelines will continue to push us toward one-step mergers. Get ready for this tension. Advisors' board presentations will show everything to be in order for a well-founded merger and then the chorus of objections emerge following the announcement.

Commodification of private equity and the adventures of reliance on direct lenders and on equity commitments from the Middle East and sovereign wealth funds.

The leveraged acquisition playbook for at least the outset of 2023 is going to be characterized by herding numerous direct lenders into leverage packages and negotiating supplemental equity commitments from the Middle East and sovereign wealth funds. The core private equity commitments are arguably commoditized at this point; it's the senior side of the capital structure and the supplemental equity that are going to require hard work.

Although the commitment papers from the direct lenders in 2023 may look similar to those from the commercial bank lenders that dominated much of 2022, the differences (and the additional burdens) will include the intensity of the diligence, the uncertainty of whether these lenders are "in" until much later in the game, and the sheer number of direct lender shops that may be needed to make this formula work given the relatively small checks each direct lender fund typically writes (due to the absence of follow-on syndication of their commitments). The big private equity bidders have internal teams that can coordinate this activity, but will middle market private equity buyers and strategic buyers in need of leverage have the wherewithal to shepherd all this in 2023?

Meanwhile, the importance of money from the Middle East and sovereign wealth funds to fill out equity checks from the core private equity players is going to require special focus on CFIUS (as will the fact that some of the US private equity funds receive significant capital from the Middle East and Asia) and making sure that the entities signing these commitments are not just unfunded vehicles.

Outmaneuvering antitrust regulators in 2023.

The playbook of the antitrust regulators is now clear: "Throw sand in the gears" – i.e., do everything possible to delay the transaction until the merger agreement's "outside date" hits and one of the parties decides that it would be better to pull the plug and receive or pay the reverse break-up fee than extend the outside date. (Given antitrust paranoia, it is fair to expect reverse break-up fee structures, for better or worse, to be pervasive in merger agreements in 2023 even in the face of strong antitrust undertakings by buyers).

In 2023, we will see merger parties better prepared to counter the regulators' strategy successfully. More M&A clients will adopt, from the outset of their merger discussions, clear strategies for:

- fix-it-first remedies,
- expediting responses to document and information requests from antitrust regulators,
- proactive management and leverage of the UK CMA-EC-FTC/DOJ triangle (as opposed to having these agencies leverage this triangle against us), and
- most importantly, engagement in litigation against those antitrust regulators that throw up roadblocks.

The "sand in the gears" strategy of the regulators will not work when clients get their act in order upfront on these items, and clients are now realizing this. Merger parties have learned the hard way that being reactive and planning on the fly plays into the "sand in the gears" strategy of the antitrust authorities, and that success is within reach by proactively managing timing risks (through expedited handling of requests and other process matters) and substantive risks (through fix-it-first) and, most importantly, by having a clear litigation action plan to ensure success.

In the past, boards, when considering a merger, would rather shutdown merger discussions than have to plan out in advance litigation strategies for obtaining antitrust clearance. That will change in 2023. The antitrust agencies have challenged merger parties to enhance their approaches to overcoming regulatory impediments, and the challenge will be accepted in 2023.

Reverse-CFIUS, CFIUS and foreign investment and national security regulations – the minefield expands.

The word from our colleagues in Washington is that the US government now wants to figure out how to regulate or at least start monitoring closely not only inbound foreign investment (CFIUS) and the sale and licensing of sensitive technology and other key resources (OFAC; export control), but also outbound investment generally. The objective of this "reverse CFIUS" idea is not to restrict cash outflows (e.g., China has plenty of cash), but to regulate and monitor the spread of US legitimacy, managerial know-how and other intangible benefits to a foreign company that come from having, say, a name-brand US private equity house or a marquee US brand in its stockholder profile. This regime has yet to be promulgated but it is coming in 2023. Who knows what kinds of reciprocal restrictions (on investing in the US) other countries will impose on their local sources of capital as a response? As one China-born CEO of a US-based public company put it to me in December: The US and other western governments want to borrow ideas from the Chinese government.

Meanwhile, the scope of CFIUS and non-US foreign investment and national security regimes continues to expand on a monthly basis. Many merger parties in 2023 are going to underestimate the magnitude of the effort necessary to figure out not only all the foreign investment clearances required but also their impacts on timing and substantive execution risk. There will be embarrassments and frustrations in 2023 on this front.

Leveraged spin-offs – the default choice for separation transactions in 2023.

Investors will never let go of their push for portfolio rationalization and separation out of non-core assets. Leveraged spins are going to be one of the alternatives of choice in 2023 for addressing this objective.

Even with prices obtainable in straight divestiture sales and carve-out IPOs way down during the initial months of 2023, there will always be the spin-off alternative if the non-core asset in question is sufficient to float on its own, even as a small cap.

Investors will continue to love tax-free spin-offs because they permit the shareholders to retain both upside opportunity and liquidity in the SpinCo and because most SpinCo's will be able to navigate the tax restrictions to position themselves to be sold quickly at a premium when markets eventually become frothy again in the coming years. Meanwhile, despite limited debt markets, leverage-lite is still usually available to put on the SpinCo and enable the parent to keep the cash proceeds to boost the core business that remains behind.

Mergers of Equals – Will boards be heroic in 2023?

Here's where the difference between what "should" happen and what "will" happen may differ in 2023. If you are a director looking at management's outlook for the next 15 months, there's a good chance that you are thinking, "I don't want to be a director of an underperformer for 2023." One solution is to find a complementary company facing similar challenges, determine if there are some attractive revenue and cost synergies, whether antitrust clearance is doable, whether the two corporate cultures are compatible, and, if these boxes can all be checked, then do an all-stock merger based on a fair, relative valuation. That often means an at-market exchange ratio, but may mean something slightly different after further analysis of trading multiples. In any event, the key to such an all-stock merger-of-equals transaction is not any premium to market trading prices in the exchange ratio, but the value generation for shareholders from the synergies and multiple potential bumps.

Yet, it takes heroic boards and management teams to get these deals done. Why? Because, by definition, 50% of the directors and executives from the two companies are going to be out of a job or in less glamorous positions at the combined company by the day after closing. These are the deals that "should" be happening in 2023 and many directors know it. Whether they "will" happen remains to be seen. To the extent they do not happen, we will start to see more dispersion among the underperformers in 2023 and those directors and executives at companies performing poorly relative to peers in the tough times of 2023 will be prime personal targets for activists and will wish they had been cheerleaders for an accretive merger of equals even if it meant not having a personal role at the combined company after closing.

Freshfields

December 21, 2023 | 10 minutes read

Freshfields Private Capital “10 for 24”: 10 Things to Keep an Eye on in 2024


Timothy Clark
Partner


Allison Liff
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Partner

+9 more...

As we approach the end of 2023, the Freshfields Private Capital team took some time to pause and collect our thoughts about trends and issues for the year ahead. Here are the topics on our minds when we aren't focused on year-end closings and wrapping gifts.

AI is Coming To PE

Prognostications around artificial intelligence range from wish casting to dystopian warnings. The truth is that even those at the forefront of AI development can't be sure exactly what it will look like in the coming years. That said, it is safe to assume that if there is some way to leverage the power of AI to increase the efficiencies, and reduce the cost, of business operations – and there probably will be soon, if they aren’t here already – private capital will be at the vanguard of AI adoption, largely through the introduction of AI across their portfolio of companies. Private capital firms are well positioned for this role because many of them have the scale, know-how and internal and external resources needed to navigate the privacy, data security and other regulatory and business issues that AI presents. But cost efficiencies can come at a cost of jobs, which has long been the public relations monkey on private capital’s back.

Secondaries are Here to Stay (and Growing)

Predicting that the secondaries market will be strong in 2024 is a little like saying the sun will rise tomorrow. What is new about this success story is that there are reasons to believe that secondary transaction activity can reach even new highs in the new year. First, secondary fundraising, which has been unable to keep pace with deal flow, should get a nice boost from the recent batch of strong returns from recent vintage GP-led continuation fund transactions, which should translate into more capital being available to fund secondary deals. Second, in the context of what is still a sluggish M&A and IPO exit market, more private capital managers will likely look to secondary liquidity solutions, such as preferred equity deals and NAV loans, to manage to the DPI (distribution to paid-in capital) expectations of their investors.

Asset Management Consolidation

A combination of market factors, including a sluggish fundraising market (which itself is a product of a sluggish exit market), and mega fund managers vacuuming up available LP dry powder, has contributed to an increasingly bifurcated private capital industry: private capital managers who are big and getting bigger, on the one hand, and the rest of the private capital manager community looking for ways to grow and remain relevant, on the other. This environment has become a ripe one for private capital asset management M&A, with larger players using their substantial balance sheets and franchise resources to acquire stakes or outright control of other manager businesses. In the last twelve months, we have seen a continued flurry of manager combinations, including private equity houses acquiring secondary and infrastructure businesses and multi-channel asset managers reorganizing their product verticals so that they look at real assets on a more integrated basis. As private capital investors continue this expansion of product verticals, the universe of potential investors in any given asset is necessarily changing, bringing new competitive dynamics into a marketplace that has remained strong and is expected to get even stronger over the next year.

Private Credit Strategies and Market Participants Are Converging

Over the course of the past year, the leveraged finance market has seen the continued growth of private credit as a source of financing to fill the gap where the broadly syndicated loan (BSL) market has not been available. The private credit market now constitutes around $1.5 trillion in assets under management, which is comparable to the BSL market. While this growth has been widely reported, a more nuanced aspect of this growth is the convergence of formerly disparate private credit strategies and market participants.

For one, there has been an increase in “capital solutions” focused private credit funds moving into acquisition financing and other “performing” parts of the credit market. As the Freshfields’ **Private Credit and Capital Solutions** team highlighted in a recent chapter for the **GRR Americas Restructuring Review**, historically the private credit universe might generally be divided into two parts: (1) direct lending to performing credits where the direct lender is providing an alternative to the BSL market to support M&A and other strategic activity and (2) “bespoke” capital solutions whereby the credit fund is providing financing for companies that may be more challenging to finance in the BSL due to any number of factors, including stress in a particular industry or sector, litigation overhang and geographic issues. Credit funds lending into the latter would typically be compensated for the inherent additional risk in those types of financings, allowing them to achieve targeted returns in excess of 10% per annum. The recent rise in interest rates has brought more credit funds, which may have previously been confined to the “capital solutions” space, to participate in the “performing market”, while still achieving their targeted returns.

In addition, while credit funds have dominated the private credit arena, investment banks are making a push to compete for business by either forming or expanding private credit strategies within the bank. Colloquially referred to by some in the industry as “back to lending”, doing so allows the investment banks to leverage their own client relationships and name brand appeal so as not to lose transactions to credit fund competitors. While the banks are subject to regulations, including leveraged-lending guidelines, the current lending environment in the leverage finance market is one of generally lower leverage (and larger equity checks in the context of acquisition financings). Interestingly, various lending guidelines and regulatory overlay may focus the private credit arms of banks on the par financing market, which will only add to an increasingly competitive market in that space.

Needless to say, the private credit market – both in terms of direct lending and more opportunistic capital solutions – remains a dynamic and ever-growing component of asset managers’ general private capital strategy.

“Relationship Lending” for Private Equity in a Distressed Environment

Prior to the global financial crisis (GFS), private credit funds were often seen as lenders of last resort that a private equity sponsor would only turn to should the BSL market be unavailable. Rightly or wrongly, from the borrower’s perspective there was a perception that these players acted more like vulture funds ready to spring any default into an opportunity to take the keys from the current owners. Fast forward to 2023 and credit funds increasingly are first ports of call for even the largest of private equity backed acquisitions since the private credit universe can provide certainty of pricing, speed of deal execution and an additional capital partner to support the portfolio company throughout a deal lifecycle.

Private equity sponsors and other borrowers should remain focused on their relationships with private credit lenders. While in the par performing space, providers of private credit have positioned themselves as good long-term partners to borrowers, this perception of private credit as relationship lenders may be tested once the next distress cycle and/or upcoming maturity walls hit. Anecdotally, we frequently see credit funds as (within reason) willing capital providers to help carry a relevant portfolio company through a rough patch, which is consistent with the fact credit funds generally aim to hold a credit investment through maturity and view their investment akin to the equity sponsor, albeit at a different level in the capital structure. In addition, private credit providers (including capital solutions oriented funds) are quite nimble and seek out opportunities to propose bespoke solutions across the capital structure in both the performing and stressed spaces, including debt-like preferred equity (whether for ratings purposes, to address regulatory concerns or otherwise to address leverage concerns), paid-in-kind or zero-coupon instruments (to address cash flow concerns) and other structured financial products. A number of these solutions are not available from banks or otherwise in the BSL market (whether as a result of the regulatory overlay, what CLOs behind the BSL market can hold, or otherwise), thereby adding to the attractiveness of the private credit market for private equity backed and other borrowers. Nevertheless, if there is a sustained increase in defaults and bankruptcies – which as of late there has been in the middle market - it will be interesting to monitor how private credit responds.

Acquisition Financing Sources and Structures Continue to Diversify

Rate increases and other market shifts in 2022/2023 have given rise to new players entering the acquisition financing space in a meaningful way. What used to be a playbook where everyone knew the rules and financing gaps were filled by traditional syndicated lending is now a puzzle board taking in pieces of different sizes and shapes. Credit funds, sovereign wealth, pension funds, family offices and others have stepped in to fill the financing void created by the inability to access traditional lending sources. New players have stepped in with equity and debt checks and combinations of both, resulting in more complex post-close private company capital structures than those we were accustomed to in a traditional LBO world. While this trend initially took hold in the context of smaller and middle market deals, complex debt and equity financing structures with multiple players are gaining traction in the context of larger deals and we expect that trend to continue in 2024. As a result, we expect to continue to see an increase in the complexity of post-close cap tables and investors and acquirors' portfolios themselves will increasingly include a mosaic of different types of investments and securities.

The SEC's New Private Funds Rules May Be a Regulatory Bridge Too Far

It is no secret that the private capital sponsors are not pleased with the SEC's recently enacted **New Private Funds Rules** (even though the final rules were somewhat less problematic from the industry's perspective than the originally proposed rules). What is surprising is that, other than the SEC itself, there were no real constituencies that were pushing for the new rules in the first place; many institutional LPs are still shaking their heads about this rule-making exercise and are fretting about how they will manage the firehose of information that will be coming their way soon thanks to the new rules. The fate of the new rules is now before the Fifth Circuit, which will decide whether this is a case of administrative overreach. In the meantime, private capital firms and their investors are preparing themselves for the information superhighway and compliance costs that the SEC has mandated for the private funds industry.

FSOC Targets Private Capital

Among regulatory issues facing private capital in 2024, compliance with the SEC rules (in whatever form they survive) could prove to be little more than an afterthought – at least for larger firms. In November, the **Financial Stability Oversight Council released a new framework** for designating nonbank financial companies as “systemically important financial institutions” or “SIFIs” and made no effort to hide that private capital firms are an intended target. Because the SIFI designation triggers Federal Reserve regulation and oversight and can lead to bank-like capital requirements, leverage limits, and investment restrictions, such a move against private capital would be a game-changer; not surprisingly, **industry trade groups** are **preparing for a fight**.

FSOC’s announcement came near the end of a year when both **US regulators** (Fed and SEC) and **international bodies** (Financial Stability Board) have said they’re looking closely at levels of bank lending to hedge and private equity funds – and may start using supervisory tools to impose limits. Even Congress has entered the fray, with Senate Banking Committee Chair Sherrod Brown recently **demanding an explanation** of how the Fed, OCC, and FDIC are monitoring “private credit risk to the banking sector and our financial system.” It’s too soon to tell where this all leads, but one thing is clear – the regulatory landscape for private capital looks poised to become more complicated, and potentially riskier, in the coming year.

Increased Antitrust Scrutiny of Private Equity Roll-Ups

FTC Chair Lina Khan wants to put "the market on notice that [the FTC] will scrutinize roll-up schemes," and the US antitrust agencies recently announced several such policies. Roll-up strategies can be used by any company but is often a tool in the PE toolbox.

- On December 18, the FTC and DOJ issued new merger guidelines. Guideline 8 addresses roll-up strategies, explaining that firms engaging "in an anticompetitive pattern or strategy of multiple acquisitions in the same or related business lines” may violate Section 7 of the Clayton Act.
- In November 2022, **the FTC issued a policy statement** describing conduct it considers an “unfair method of competition" in violation of FTC Act Section 5. The policy statement identifies roll-up transactions specifically, subjecting to Section 5 scrutiny any “series of [transactions] that tend to bring about the harms that the antitrust laws were designed to prevent, but individually may not have violated the antitrust laws.”

This policy shift is exemplified by **the FTC's recent suit against PE firm Welsh, Carson, Anderson, and Stowe** ("Welsh Carson") and U.S. Anesthesia Partners ("USAP"). Among other things, the FTC alleged Welsh Carson and USAP violated Clayton Act Section 7 through a string of serial acquisitions which allegedly lessened competition among anesthesiology services in Texas. The complaint also asserts that defendants’ “roll-up” strategy represented an “unfair method of competition” under Section 5 of the FTC Act. Although this challenge is pending, it is clear the US antitrust agencies are increasing their focus on PE roll-up strategies and taking a critical view toward series of PE acquisitions concentrated within a single sector or related sectors.

Antitrust Agencies' Focus on Interlocking Directorates

The FTC and DOJ similarly reinvigorated **their enforcement of Clayton Act Section 8's prohibition of interlocking directorates**, targeting PE fund ownership overlaps. Section 8 prohibits directors or officers from simultaneously serving "as a director or officer in any two [competing] corporations . . . so that the elimination of competition by agreement between them would constitute a violation of any of the antitrust laws[.]” Traditionally, Section 8 applied only to corporations, but in its recent suit against Quantum Energy Partners ("Quantum") and EQT Corporation ("EQT"), the FTC applied Section 8 to limited partnerships and limited liability corporations. In that case, the FTC alleged Quantum's right to a seat on the EQT board would violate Section 8 because EQT competes directly with a Quantum portfolio company in the production and sale of natural gas. To settle the FTC's Section 8 claims and close the underlying transaction, the parties agreed to an extensive settlement, which required, among other things, for Quantum to sell its minority holding in EQT, for the parties to unwind a pre-existing joint venture, and for the parties to submit regular compliance reports. Moving forward, private equity firms can expect agencies to enforce Section 8 increasingly and should conduct regular audits of board appointments across all corporate and non-corporate relationships, including those of their portfolio companies.

Freshfields

March 7, 2024 | 4 minutes read

FTC Hosts Workshop on Private Equity in Healthcare


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On March 5, 2024, the U.S. Federal Trade Commission ("FTC") hosted a workshop "aimed at examining the role of private equity ("PE") investment in healthcare markets." During the workshop, the FTC and the Department of Justice, Antitrust Division ("DOJ") (collectively, the "agencies) along with the Department of Health and Human Services ("HHS"), and Centers for Medicare & Medicaid Services ("CMS"), addressed their increasing concern about the effects of PE investment in healthcare. The workshop coincided with the FTC's announcement of a "cross-government" inquiry on the "impact of corporate greed in healthcare," in coordination with DOJ and HHS. This inquiry requests public comment on healthcare deals driven by private payers, PE funds, or other alternative asset managers that may harm patients' health or safety.

Stakeholders expressed concern that private investment into healthcare markets incentivizes cost minimizing and profit maximizing strategies resulting in decreased quality of care and worsening conditions for healthcare workers. To address this, the agencies focused on their enforcement authority, including increased scrutiny of PE roll-up strategies and prohibitions on interlocking directorates. While these are not new enforcement priorities, the agencies' heightened focus is a warning to PE buyers and targets in the space.

Perceived Harms from Private Investment in Healthcare

The agencies' concerns about decreased quality of care fall into two categories: (i) harm from excessive cost cutting, and (ii) harm from prioritizing profit over patient care.

With respect to results from cost minimization, stakeholders specifically highlighted poorer conditions for physicians (e.g., longer hours, higher patient-to-staff ratios), declining patient care (e.g., longer wait times, delays to treatment, and less time with a physician), decreased hospital resources (e.g., shortages of basic drugs and supplies, outdated technology), and safety concerns (e.g., facilities operating below industry standards for safety compliance). As evidence, panelists pointed to increased patient falls, surgical site infections, and transfer rates at PE-owned hospitals.

With respect to profit maximization, the agencies' view the PE business model as incentivizing PE investors to raise product and service prices, reduce availability of care, and retain profits rather than reinvesting those profits into the medical facility or practice. This, in conjunction with a drive to decrease costs, lowers patient care and healthcare employment conditions.

FTC and DOJ Focus on Private Investment in Healthcare

The Chair of the FTC, Lina Khan, and the Associate Attorney General for the DOJ's Antitrust Division, Jonathan Kanter, each emphasized the agencies' interest in restricting, where applicable, PE's involvement in healthcare markets. They focused on two emerging enforcement priorities– increased scrutiny of serial acquisitions, or private equity "roll-ups," and the prohibition against interlocking directorates in Clayton Act Section 8.

- **Serial Acquisitions or Roll-ups.** The agencies stated they would scrutinize PE transactions in healthcare through an increased focus on serial acquisitions that may not individually be reportable or raise competitive harm. This is already apparent in recently released 2023 Merger Guidelines (Guidelines) (for more on the Guidelines, see our analysis here). In the Guidelines, the agencies note that "[a] firm that engages in an anticompetitive pattern or strategy of multiple acquisitions in the same or related business lines may violate Section 7 [of the Clayton Act]." The agencies have been focused on roll-up strategies in various markets and have recently acted on this theory against Welsh, Carson, Anderson & Stowe ("Welsh Carson"), where the FTC alleged, among other things, that Welsh Carson, through its subsidiary U.S. Anesthesia Partners ("USAP") entered into a series of transactions to consolidate anesthesiology practices in Texas in violation of Section 7 of the Clayton Act.
- **Interlocking Directorates.** The agencies also stated they will use the prohibition against interlocking directorates under Clayton Act Section 8 as a tool to regulate PE healthcare investments. Section 8 prohibits serving as a director or officer on the board of two corporations that compete. The agencies have recently expanded their interpretation of Section 8 to apply to both corporations and LLCs and LPs, and they have used this new interpretation to enforce against interlocking directorates in the PE space.

In addition, the agencies will continue to investigate PE healthcare investments with more traditional theories of harm, including whether such investments significantly increase concentration in highly concentrated markets or would eliminate substantial head-to-head competition.

Cross-governmental Coordination

At the workshop, regulators at all levels – including the FTC, DOJ, HHS, CMS, and state attorneys general ("AGs") – reinforced their commitment to protect against the alleged harm from PE healthcare investments. Although the FTC and DOJ are the lead enforcers of federal antitrust laws and state AGs already play an active role in merger enforcement, HHS and CMS affirmed their role in healthcare enforcement by coordinating with the traditional merger enforcement agencies in a cross-government enforcement effort consistent with the Biden Administrations 2021 Executive Order on a whole-of-government approach to antitrust.

By way of example, state AGs are scrutinizing PE healthcare investments through state healthcare regulatory regimes. The Rhode Island AG enforced the state's Hospital Conversion Act (RIGL §23-17.14) to add conditions to a PE firm's acquisition of two local hospitals. The PE firm was required to transfer $80 million into escrow, to be returned to the firm if it met certain conditions (e.g., ensure payment of operating expenses and guarantee capital improvements). Additionally, Colorado's AG recently reached an agreement with USAP to settle allegations that USAP, owned partially by Welsh Carson, acquired multiple anesthesiology practices in the Denver area, driving up prices for anesthesiology services for patients and insurers.

The workshop and joint inquiry demonstrate that enforcers at the federal and state level are focused on the impact of PE healthcare investments. Collaboration among these entities in their enforcement efforts will mean greater scrutiny of PE investments in the healthcare space and potentially longer review processes.

If you have any questions, please reach out to your contacts in Freshfields' US antitrust team or Jamillia Ferris, Meghan Rissmiller, and Jan Rybnicek.

Freshfields

February 26, 2024 | 1 minute read

New Chancery Decision Highlights Need for Care in Crafting Shareholder Arrangements with Delaware Corporations

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A new [133-page opinion by the Delaware Court of Chancery] highlights risks to the enforceability of agreements between Delaware corporations and one or more shareholders where the agreements focus on internal affairs and governance. The primary risk is that these agreements may infringe on the broad rights reserved for boards of directors under the Delaware General Corporation Law.

The Court held that a number of provisions in the shareholders agreement in question, including pre-approval (veto) rights of the shareholder and rights of the shareholder over the composition of the board and committees, were unenforceable. This opinion has implications for many common scenarios including:

- Arrangements by founders, strategic investors, financial sponsors, venture investors, and others to ensure they have minority protections, negative control, or exclusive control when investing in Delaware corporations. Clients often enter into these arrangements pre-IPO, at the IPO, or as part of PIPE investments after the IPO.
- Settlement agreements with activists that are conditioned on undertakings by the corporation to ensure the activist that its designee(s) will occupy one or more board seats for a specified period.
- Efforts by corporations to reject stockholder proposals (including those made pursuant to SEC Rule 14a-8) on the grounds that they envision changes that would conflict with Delaware corporate law's board-centric approach as detailed extensively in this new opinion.

The decision may be appealed, and new legislation may be adopted by the Delaware General Assembly at some point to address this outcome. Thus, it is worth consulting with us on this issue early and often.

In the meantime, consideration should be given to:

- using alternative entities, such as LLCs and LPs, which will not suffer from these constraints if the LLC and partnership documentation are drafted properly; and
- enshrining governance and internal affairs provisions appropriately in certificates of incorporation and certificates of

designations of preferred stock where practical – taking into account that there are limits to the ability to use these avenues and that creative approaches to drafting, structuring and implementation may be necessary.

In short, a thoughtful approach to shareholder governance arrangements is merited going forward.

Harvard Law School Forum on Corporate Governance

Poison Pills After *Williams*: Not Only for When Lightning Strikes

Posted by Ethan Klingsberg, Paul Tiger, and Elizabeth Bieber, Freshfields Bruckhaus Deringer LLP, on Sunday, March 21, 2021

Tags: Antitakeover, Delaware cases, Delaware law, Hostile takeover, Index funds, Institutional Investors, Merger litigation, Poison pills, Takeover defenses
More from: Elizabeth Bieber, Ethan Klingsberg, Paul Tiger, Victor Ma, Freshfields

Editor's Note: Ethan Klingsberg and **Paul Tiger** are partners and **Elizabeth K. Bieber** is counsel at Freshfields Bruckhaus Deringer LLP. This post is based on a Freshfields memorandum by Mr. Klingsberg, Mr. Tiger, Ms. Bieber, and **Victor Ma**, and is part of the **Delaware law series**; links to other posts in the series are available **here**. Related research from the Program on Corporate Governance includes **Toward a Constitutional Review of the Poison Pill** by Lucian Bebchuk and Robert J. Jackson, Jr. (discussed on the Forum **here**).

The board of The Williams Companies ("Williams"), in March 2020, became the only board among the S&P 500 companies to respond to the volatility of the pandemic by adopting a shareholder rights plan (also known as a poison pill). [1] On February 26, 2021, Vice Chancellor McCormick of the Delaware Court of Chancery enjoined the Williams poison pill in her post-trial opinion in *The Williams Companies Stockholder Litigation*. [2] Vice Chancellor McCormick's thorough opinion about the extraordinary pill adopted by the Williams board is worth reflecting upon from the perspective of over three decades of poison pill litigation.

Background and key terms of the Williams pill

The Williams board adopted the shareholder rights plan with a one-year term when the Williams stock price was hitting an all-time low, although the company's market cap remained above $10 billion and there were no indications of hostile actors in the stockholder profile or on the takeover front. The pill provided that if an "acquiring person" were to either "beneficially own" more than 5% of Williams stock or commence a tender offer to increase its beneficial ownership in excess of 5%, then the acquiring person would be subject to the massive dilution that results from the triggering of a poison pill. Pills adopted by other companies to protect their NOLs from being unwound by a change of control under the federal tax laws have had thresholds in the 5% range. But, as the Court observed, a pill with a threshold as low as 5% is otherwise virtually unheard of. The Williams board wanted to be different.

The definition of "beneficial ownership" in the Williams pill expanded the definition beyond that employed by Section 13(d) of the Exchange Act, and included ownership arising from synthetic interests, including cash-settled derivatives, which do not carry either voting rights or the right to influence how any shares are voted. Moreover, these derivatives, by definition, would not be diluted by the triggering of the pill since they are just synthetic economic interests. Although practitioners have increasingly gravitated toward this definition of beneficial ownership, the courts, in dicta in transcripts of oral rulings, have previously expressed skepticism about the enforceability of this expanded definition of beneficial ownership.

In addition, the Williams pill aggregated the ownership levels of those persons who were deemed to be "acting in concert." The definition of "acting in concert" went beyond the express-agreement approach used in the federal securities laws. The definition in the Williams pill captured actions that constitute conscious parallel conduct (sometimes known as a "wolfpack provision") and included a "daisy-chain" concept that potentially would aggregate actions of unrelated third parties (including those who might not be known to each other). As with the expanded definition of beneficial ownership, the expansion of the definition of "acting in concert" has become more popular with practitioners over the last several years despite sentiments of skepticism in dicta in transcripts of oral rulings.

In addition, the Williams pill carved out "passive investors" from qualifying as "acquiring persons" that could trigger the pill, but the definition of "passive investor" was more restrictive than the definition used in federal securities laws and included language that would arguably exclude any opinionated stockholder. The Court noted that even ordinary course governance oversight by index fund investors like BlackRock, State Street, and Vanguard would put these investors at risk of failing to qualify as passive investors under the Williams pill.

The Court's analysis

To evaluate the validity of the Williams pill under Delaware law, the Court of Chancery employed the established two-pronged test from *Unocal Corporation v. Mesa Petroleum Co.*: **[3]** (i) whether "reasonable grounds for believing that a danger to corporate policy and effectiveness existed" and (ii) whether the defensive measure was "reasonable in relation to the threat posed." **[4]**

On the first prong—whether a legitimate threat existed—the Court analyzed three possible threats put forward by the defendant directors during their testimony: (i) the general threat of stockholder activism; (ii) the threat of an activist pursuing a short-term agenda and causing a disruption in the company; and (iii) the ability of a stockholder to quickly accumulate large amounts of Williams stock undetected (a "lightning-strike attack").

The Court held that the first two threats were not cognizable because the board was not aware of any ongoing activist activity at the company. The Court found that what was really behind the directors' references to these "threats" was a desire to insulate the board from risks of stockholder pressure and proxy contests. The Court noted that these types of considerations run contrary to basic tenets of Delaware corporate law. For example, in response to the threat of a proxy contest, directors may not justify their actions on the basis that "stockholders would vote erroneously out of ignorance or mistaken belief." **[5]**

The Court did not definitively answer whether the third threat—a lightning-strike attack—could pose a legitimate threat, but, for purposes of the analysis, assumed that it fulfilled the first prong of the *Unocal* test. In particular, the Court left open the question of whether it would be legitimate to use the mechanic of a pill to force stockholders to avoid taking advantage of the loopholes and delays available under the federal securities law regimes for reporting beneficial ownership of accumulations.

On the second prong—whether the pill was reasonable in relation to the threat posed—the Court ruled that the Williams pill was not a proportional response and thus enjoined the pill. This determination of a lack of proportionality was based upon the effect on Williams stockholders of the key terms discussed above, when taken together in the aggregate:

i. the "off-market" 5% trigger;
ii. the expansive definition of "beneficial ownership" that captured synthetic interests;
iii. the broad definition of "acting in concert" that included parallel conduct in the absence of an agreement or understanding, as well as a daisy-chain concept; and
iv. the narrow definition of "passive investor" that potentially excluded categories of holders not commonly considered to be activists.

Takeaways for companies considering adoption of a poison pill in the wake of *Williams*

Advance preparation

The Court's findings were prefaced by the troubling conclusion that "the lawyer-drafted documents to which one would typically look for a statement of a board's purpose—e.g., board resolutions, board minutes, company disclosures—do not reflect the Board's actual intent." **[6]** Indeed, the formal record at Williams, as written up by counsel, cited to all the traditional justifications for adoption of a pill, especially prevention of accumulation of control—whether negative control or exclusive control—without paying an appropriate premium. But the testimony of the directors, although "unadorned and refreshingly candid," veered far from the guidance of over three decades of case law to justify this pill primarily on the principal that "*all* stockholder efforts to change or influence corporate direction constitute a threat to the corporation," which rationale, of course, "runs directly contrary to the ideological underpinnings of Delaware law." **[7]** Importantly, the Court did not attempt to limit prior holdings that a board is acting properly when adopting a pill in response to overt threats by an activist to acquire and exercise negative control without paying an appropriate premium.

This case underscores the importance of regular sessions with the board to educate directors about acceptable and unacceptable rationales for the adoption of pills. These sessions are best held when the board is not currently contemplating the actual adoption of a pill.

Identification of a threat and the future of "clear day" pills

The Court criticized the board for acting on hypothetical threats, rather than cognizable threats. This may leave practitioners with the mistaken impression that the adoption of a pill on a "clear day"—when no hostile actor is on the scene—is problematic. This would be an erroneous takeaway. Indeed, some practitioners believe it is preferable to adopt a pill on a clear day because this context may minimize the risk that the directors' motives will be characterized as entrenchment.

This new case does nothing to overturn long-standing case law that the adoption of a pill by the board of a widely held company with a single class of common stock satisfies the first prong of *Unocal* due to the ability of a third party to accumulate control of such a company without paying a premium to all stockholders. Where the Williams board stumbled was not by acting in the absence of an overt threat. The Williams board lost because the 5% threshold may be too low to justify a nexus to the prevention of a third party from acquiring control without paying a premium and because the testimony of the directors focused on shutting down all outside influence by stockholders, rather than safeguarding control. The *Williams* case is not the death knell of "clear day" pills, especially for small cap companies.

"War time" pills

The pill in *Williams* was not a "war time" pill. There was no hostile takeover proposal or tender offer and there was no activist accumulating stock. Rather, there was a company with a market cap of over $10 billion and a board concerned about intense stock market and economic volatility and the risk of pressure from stockholders. In this situation, the primary consequences that the board had to endure as a result of its adoption of off-market terms of questionable enforceability were limited to: (i) the receipt of a large number of "withhold" votes at the annual meeting and (ii) the distraction and cost of a litigation challenge that required directors to be subjected to discovery and testimony. In the meantime (nearly 11 months), the Williams board had the protection of an extraordinarily strong shareholder rights plan. By contrast, when responding to an actual hostile takeover attempt or an aggressive activist accumulating stock, litigation moves much faster and the plaintiffs (which typically include the hostile actor and its supporters) are more aggressive. In such a scenario, it is advisable to go with a "war time" pill—*i.e.*, a pill with litigation-tested terms on beneficial ownership, trigger threshold, and acting in concert—so that there is no doubt that control will be properly safeguarded. In such a situation, there is no margin for error or distraction.

Endnotes

[1] For an analysis of the modest uptick in the adoption of pills, mostly by small cap companies, during the early months of the pandemic, see **this post**.
(go back)

[2] 2021 WL 754593 (Del. Ch. Feb. 26, 2021).
(go back)

[3] 493 A.2d 946 (Del. 1986).
(go back)

4 *Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1152 (Del. 1990).
(go back)

5 2021 WL 754593, at *2.
(go back)

6 *Id.* at *23.
(go back)

7 *Id.* at *26, *30.
(go back)

Harvard Law School Forum on Corporate Governance

M&A Predictions for 2022

Posted by Ethan Klingsberg, Freshfields Bruckhaus Deringer LLP, on Monday, February 7, 2022

Tags: **Covenants**, **International governance**, **Merger litigation**, **Mergers & acquisitions**, **Securities regulation**, **SPACs**, **Special purpose vehicles**
More from: **Ethan Klingsberg**, **Freshfields**

Editor's Note: **Ethan Klingsberg** is partner at Freshfields Bruckhaus Deringer LLP. This post is based on his Freshfields memorandum.

As the 2022 pipeline continues to flow, here's a quick preview of where the tensions, action and hot spots will be in M&A this year, together with explanations of why this will be the case.

Regulatory covenant litigation. Case law on the enforceability of "hell or high water" and other regulatory covenants is sparse. The existing decisions all involve relatively blatant violations—e.g., the failure to submit a document expressly requested by the antitrust or foreign investment regulator or other examples of intentional "foot dragging." There have been cases involving nuanced situations where the buyer purported to be acting in good faith to obtain regulatory clearances, while the target/seller was fretting that the drop-dead date was rapidly approaching and that the buyer had to make more draconian concessions more quickly to obtain clearance in time to permit a closing before the drop-dead date; but those cases all settled. Entering 2022, when you combine the number of actual or near "hell or high water" undertakings to which buyers signed up over the last year with the increasing aggressiveness and unpredictability of antitrust and foreign investment authorities in the UK, Europe and the US, the result is a combination that is likely to make 2022 the year of regulatory covenant litigation.

Regulatory headwinds will not stop merger agreements from being signed up, but they will change deal terms. Now that everybody has had time to calm down after being outraged by reports about the breadth and assertive reach of the UK CMA and the views of officials in charge of the US and European agencies, the focus of clients has turned to how to navigate the new terrain. We will not see dealmaking dry up, even M&A by so-called dominant players or those seeking to consolidate within a sector will proceed, but we will see "fix it first" approaches more regularly in 2022 and, in anticipation of (or at least in response to) the litigation referenced in the preceding bullet, we will see a lot more nuance and detail in what merger agreements require of buyers and when—much more than in your generic "hell or high water" or reasonable best efforts undertakings. Reverse termination fees will remain part of the equation but there is a limit to how much comfort they will provide boards of sellers and targets. The real action in 2022 will be in the details of regulatory covenants.

Interim operating covenants as trip wires. Again, the antitrust and foreign investment regulators are the culprits. Due to the regulatory environment, we are going to have periods between sign and close that more routinely extend well beyond one year and even beyond 18 months. That's a lot of time for targets to comply with interim operating covenants and for buyers to experience some remorse that they've agreed to a misguided trade. Expect lots of scrutiny in 2022 of whether there's been a failed closing condition arising from breach of an interim operating covenant. The Delaware Supreme Court's *Maps Hotel* decision in December 2021 provided useful guidance for both buyers and targets on how to position a party for a win in interim operating covenant litigation, but left enough wiggle room on issues of what "unreasonably withholding consent," "ordinary course (without a "consistent with past practice" modifier) and "in all material respects" mean that interim operating covenants, in an environment where it takes well over a year to get to closing, will be a ripe area for disputes.

Supply chain issues will mean more M&A. Two ways that supply chain problems will add momentum to M&A in 2022. First, corporations will decide that, even if the margins of the key players in their supply chain are unattractive, the benefits of certainty and stability that arise from vertical integration make acquisitions of supply chain actors worthwhile. Second, optimism among buyers about the prospects for the eventual elimination of supply chain downsides is going to be a potential source for juicing their M&A models with another "synergy" type upside that is not reflected in a target's recent performance and may not be included in a target's projected performance either.

De-SPACs—the dealmakers' gift that keeps giving. De-SPAC transactions have been a corporate lawyer's dream—PIPEs, IPO disclosure, corporate and securities law complexities, and a big M&A deal all rolled into one—but the fun is going to continue in 2022 even after 2021's de-SPACs are consummated and the pipeline of new SPAC IPOs slows to a trickle. The recently de-SPACed companies have lots of long-term upside, but many of them are slow out of the gate and therefore prime targets for shareholder activism, guidance misses, management missteps, accounting restatements, and material weaknesses in internal controls. Moreover, relative to those that went public through IPOs and direct listings in 2021, hardly any of 2021's class of de-SPACed companies have dual class capital structures to insulate themselves from the rough waters of public company life in 2022. The year will see a disproportionate number of de-SPACed companies lose their footing and be taken private by financial sponsors and more mature strategic players, and the institutional investor universe will largely help catalyze these transactions. The only force going in the other direction to give these companies more time to remain publicly traded will be the underwater status of many of their large PIPE investments and the unwillingness of some of these PIPE investors to cut their losses and move on.

COVID work conditions—accelerating the pace of dealmaking to extremes and challenging the sustainability of the people-centric businesses, including investment banks, pr firms, proxy advisory firms and, most of all, big law firms, that drive the dealmaking; and there's no going back. It is no coincidence that M&A has been off the charts during these work-from-anywhere-but-the-office times. Clients love the hyper-efficiency that comes with the near-complete deterioration of the personal-life/work-life divider and being able to skip many of the time-consuming formalities that would typically accompany a significant M&A transaction, especially in the cross-border context. That's why we are probably never going back to the pre-COVID style of work, even when COVID itself is neutralized. If you had told any experienced M&A hand that you would be doing major cross-border US M&A opposite old-line Asian and European companies without any in-person meetings, they would have called you an amateur—but that's where we are now and it's full steam ahead. In addition to record dealmaking metrics, the consequence of the hyper-efficiency of work-from-anywhere-all-the-time is a material adverse impact on the mental health of the lawyers, bankers and other deal professionals. Twelve consecutive hours of remote work is a lot more brutal on one's mental health than 12 hours in a conference room with peers. We're going to need to take care of one another on a number of levels to keep up with this pace and under these conditions in 2022.

In sum, while 2022 will be an active year for M&A, it's not going to be an easy one. Complexities, hurdles and messy situations are going to abound, while the urgency and press for excellence and efficiency that continues to characterize M&A will not let up.

Harvard Law School Forum on Corporate Governance

Lessons from the Goldstein Opinion

Posted by Ethan Klingsberg, Meredith Kotler, and Victor Ma, Freshfields Bruckhaus Deringer LLP, on Saturday, July 16, 2022

Tags: **Books and records**, **Delaware cases**, **Delaware law**, **DGCL Section 220**, **Discovery**, **Merger litigation**, **Mergers & acquisitions**, **Securities litigation**
More from: **Ethan Klingsberg**, **Meredith Kotler**, **Victor Ma**, **Freshfields**

Editor's Note: **Ethan Klingsberg** and **Meredith Kotler** are partners and **Victor Ma** is an associate at Freshfields Bruckhaus Deringer LLP. This post is based on their Freshfields memorandum, and is part of the **Delaware law series**; links to other posts in the series are available **here**. Related research from the Program on Corporate Governance includes **Are M&A Contract Clauses Value Relevant to Target and Bidder Shareholders?** by John C. Coates, Darius Palia, and Ge Wu (discussed on the Forum **here**); and **The New Look of Deal Protection** by Fernan Restrepo and Guhan Subramanian (discussed on the Forum **here**).

Vice Chancellor Laster's recent opinion in ***Goldstein v. Denner*** provides a useful reminder of the importance of documenting board meetings, updates, and communications in formal corporate board documents, as they will likely later be part of the record on any motion to dismiss in a direct or derivative action. This reminder is especially important when a sale of the company or other material determination by the board may be in the company's future.

As is increasingly common, the *Goldstein* plaintiffs' claims for breaches of fiduciary duty relating to a sale of the company were preceded by a Section 220 "books and records" demand through which the plaintiffs obtained not only board minutes and presentations to the board, but also certain electronic communications by officers, directors, and the target's financial advisor relating to the sale process. Whenever these documents failed to reflect that the board had received certain communications or considered certain subject matter, the Court held that it was required—at least at the pleading stage—to credit the plaintiffs' assertions that these communications and deliberations had failed to occur. In addition, at one point, the Court pointed to gaps and contradictions between the electronic communications versus the minutes, and drew the inference—again at the pleading stage—that the relevant narrative provided in the minutes was untrue.

Comprehensive minutes, coupled with equally comprehensive (and consistent) disclosure in a merger proxy statement or recommendation statement on Schedule 14D-9, may well be the best defense for target company boards and officers against the risk from Section 220 demands and post-closing "sale process" claims by plaintiffs. The merger proxy statement and recommendation statement on Schedule 14D-9, which are distributed to the stockholders after the merger agreement has been signed and announced, are not the places to start to fill in gaps in the minutes. Moreover, a board is much more likely to be able to exclude electronic communications from a Section 220 demand's production, and to limit a Section 220 demand's production to only minutes and the formal board packages, if the minutes are comprehensive.

Inevitably, there will be important communications and activities relating to a sale process that occur outside board meetings. We strongly advise covering the substance of such communications and activities through addendums to board minutes, or through reporting at a board meeting that is memorialized in the minutes. This approach should cut off the need for plaintiffs to have access to electronic communications to satisfy their Section 220 demand. Moreover, this approach helps to assure a consistent and comprehensive narrative for the sale process in one place—the board minutes.

The Goldstein Case

In the *Goldstein* case, Vice Chancellor Laster denied the motion to dismiss fiduciary duty claims against four of the five directors of a target company that sold itself for cash in a single-bidder process. It is not news that many of the types of behaviors alleged in *Goldstein*, if true, will constitute breaches of fiduciary duties. The Court ruled that the plaintiffs adequately alleged that, among other things:

- Two directors began the sale process without informing the rest of the board and without the board's authorization.
- One of these two directors (i) caused his activist hedge fund to accumulate a significant number of shares of the company's stock in the open market after the first, confidential approach from the buyer (and thereby traded on material non-public information) without informing or obtaining permission from the board, (ii) initially manipulated the sale process, without the knowledge of the full board, so that the sale would not occur until after his fund's short-swing profit disgorgement period (under Section 16 of the Securities Exchange Act) expired, and (iii) subsequently further manipulated the sale process, without the knowledge of the full board and to satisfy liquidity needs of his hedge fund, so that timing of the sale accelerated even though this acceleration resulted in a single-bidder process, precluded a number of strategic bidders from expressing interest due to risks of adverse tax consequences (arising from the spin-off of the target company years earlier) that would have ceased to apply if the sale process had been delayed, and impeded the ability to obtain the best price reasonably available.
- Two of the other directors were repeat "independent directors" who would regularly serve on boards at the request of the director from the activist hedge fund and manifested inclinations and motivations to act in the best interests of the hedge fund rather than the stockholders of the company.

The Court portrayed all of these items of alleged misconduct as rooted in conflicts of the directors in question and therefore held that, at least at the motion to dismiss phase, plaintiffs had pleaded a claim for which exculpation under Section 102(b)(7) of the Delaware General Corporation Law for actions taken in good faith would not be available.

In addition, the Vice Chancellor denied the motion to dismiss the fiduciary duty claims against the three officer defendants. Although we expect in the near future that amendments to Section 102(b)(7) will extend exculpation for actions taken in good faith to officers, such an extension would not have helped the officer defendants here because the claims against them were for alleged breaches of the duty of loyalty. The Court ruled that the plaintiffs had adequately alleged that, among other things:

- The chief executive officer and chief financial officer improperly adjusted the internal projections downwards to support the sale and ability of the financial advisor to deliver a fairness opinion.
- The chief legal officer prepared board minutes that made the sale process seem more proper than it was.

The defendants argued that the claims failed because of the availability of "cleansing" under the *Corwin* doctrine, which provides for dismissal of claims where the recommendation statement on Schedule 14D-9 contains adequate disclosure of all material information about the underlying allegations and a majority of the disinterested stockholders nonetheless tenders its shares. But the Court looked skeptically upon the disclosures in the Schedule 14D-9. The Court repeatedly held that the problem was not just that there was a gap in the breadth of the disclosure in the Schedule 14D-9. Rather, the Court observed that, more fundamentally, there were meaningful gaps in the board minutes' portrayal of the sale process and related communications, and therefore the Court permitted these gaps to be filled—at the pleading stage—with inferences in favor of plaintiffs, which in turn led the Court to conclude that material portions of the story of the sale process conveyed by the "Background of the Transaction" section of the Schedule 14D-9 were, for purposes of the motion to dismiss, inaccurate. In short, the defendants lost access to *Corwin* cleansing, in part, because the Court refused to give credence to a number of portrayals of material events and facts in the "Background of the Transaction" section because the minutes were silent about them.

The Vice Chancellor left the door wide open to the possibility, and even notes that there is evidence in the 628 documents (produced in response to the Section 220 demand) to support the view, that the plaintiffs' allegations are untrue. The full board may have been properly updated and reasonably and thoughtfully authorized all the alleged missteps by the specified directors and officers. The accumulation of shares by the director's activist hedge fund may have been known to and encouraged by the full board. The communications with the bidder and tactical decisions about the timing of the sale process may have been socialized with and deemed reasonable by the full board. The modifications to the projections may have been well-founded and understood by and supported by the full board. The gaps in the minutes may end up being filled entirely with evidence of exemplary conduct by the directors and officers once all the facts are on the table as a result of discovery and the potential for a trial that now follows.

For now, and given the continued use of Section 220 demands, we have been provided with yet another case study on the importance of a comprehensive set of minutes for a process to sell a publicly traded company for cash. In particular, this case study reminds us that minutes should contain all information that would be included in the Schedule 14D-9, and as such, drafters of these minutes should try to anticipate the kinds of information that would eventually be disclosed in that filing. In addition, key communications or events that occur outside of board meetings should be reported to the full board and reflected in board minutes—they can either be reported to the board during a meeting and subsequently memorialized in the minutes, or included in an addendum to the minutes—and such records, of course, should accurately reflect what actually happened and be consistent with any separate record of such communications (i.e., emails). Preparing board minutes in such a manner will limit the scope of documents that defendants may need to produce in response to a Section 220 demand, as all communications and events identified in the Schedule 14D-9 will be documented in the minutes. Beyond that, having robust board minutes will be valuable for any defendant filing a motion to dismiss a claim that follows a Section 220 demand.

Harvard Law School Forum on Corporate Governance

DGCL Amendment Merits Amending Charters and Engagement with Institutional Shareholders

Posted by Ethan Klingsberg and Oliver Board, Freshfields Bruckhaus Deringer LLP, on Sunday, September 4, 2022

Tags: Charter & bylaws, Delaware law, DGCL, Director liability, Institutional Investors, Liability standards, Management, Proxy advisors, Securities litigation, Shareholder suits
More from: Ethan Klingsberg, Oliver Board, Freshfields

Editor's Note: Ethan Klingsberg is partner and Oliver Board is counsel at Freshfields Bruckhaus Deringer LLP. This post is based on their Freshfields memorandum, and is part of the Delaware law series; links to other posts in the series are available here.

Amendments to the charters of Delaware corporations are advisable as a result of a new amendment, effective August 1, 2022, to the Delaware General Corporation Law (the DGCL) that permits the extension of exculpation rights to executive officers.

Delaware law has long permitted a corporation to include a provision in its certificate of incorporation that eliminates or limits the personal liability of *directors* for monetary damages arising from their breaches of fiduciary duty, subject to basic exceptions. Delaware has now amended Section 102(b)(7) to expand this exculpation right to be available to cover *executive officers* as well.

This amendment to the DGCL is a response to the increasing frequency of shareholder suits where the plaintiffs name executive officers, including general counsels, as defendants. Often these suits follow the closing of a sale of the corporation. It is not uncommon for such suits to include a claim that the general counsel breached his or her duty of disclosure in connection with the preparation of the merger proxy statement or Schedule 14D-9. Others have alleged that the general counsel engaged in conduct that impeded the fulfillment of the *Revlon* duty to seek the best price reasonably available when selling control of the corporation. In some of these cases, the courts have dismissed claims against some of the pre-closing directors, because they were exculpated under the corporation's charter, but allowed claims to proceed against the pre-closing officers, because, prior to this amendment to Section 102(b)(7), they could not be exculpated from personal liability in a similar manner.

The amendment to Section 102(b)(7) allows a corporation to protect against this perverse outcome by amending its charter to expand the exculpation provision (already contained in the charters of virtually every IPO-pipeline company and publicly traded company) to cover officers. Adoption of this charter amendment will require board and shareholder approvals.

For most corporations, the drafting of the amendment will be simple. All that is needed is insertion of a reference to "officers" in the existing exculpatory provision that covers directors. An illustrative form of this provision is as follows:

> To the fullest extent permitted by the DGCL, no director or officer of the Corporation shall be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director or officer, as applicable. No amendment or repeal of this provision shall adversely affect any right or protection of a director or officer of the Corporation hereunder in respect of any act or omission occurring prior to such amendment or repeal.

However, even with this change to Delaware's exculpation regime, officers will continue to have exposure in one circumstance where directors will remain protected. Officers will remain vulnerable to liability for "any action by or in the right of the corporation." In other words, the board (including in response to a shareholder demand) may still elect to sue officers and recover damages. Importantly, the ultimate determination of whether to bring such suits against officers will lie with the corporation's directors (and not the shareholders) so long as disabling conflicts do not taint all the directors.

The other standard exceptions to exculpation will apply equally to both directors and officers: for breaches of the duty of loyalty (i.e., where the director or officer acts for personal benefit rather than the good of the corporation), actions or omissions in bad faith, knowing violations of law, unlawful dividends and stock repurchases, and transactions from which the director or officers derives improper personal benefit.

The amendment to Section 102(b)(7) fixes a troubling imbalance in the DGCL that plaintiffs' lawyers have been exploiting to increase settlement value of suits that have little or no benefit to the corporation or its shareholders. Adoption of a simple charter amendment to take advantage of this fix will now allow officers to avoid liability to shareholder plaintiffs when acting in good faith, while preserving (1) the ability of shareholders to impose personal liability on directors and officers for breaches of the duty of loyalty and (2) the ability of boards, where appropriate (including following a shareholder demand in a derivative litigation), to bring damages claims against officers for misdeeds even if they were the result of good faith actions.

One open question is how institutional shareholders and proxy advisory firms will react to proposals to amend the charter in this manner. The answer, in the case of listed companies, may depend on:

- the other elements of the corporation's governance profile and the extent to which there may already be tension with shareholders over governance;
- the extent to which the corporation otherwise engages in best practices relating to its executive officers, including their compensation, diversity, and skillsets;
- the relationship between management and the shareholders, including the extent of shareholders' confidence in management's stand-alone plan and their assessment of recent performance;
- management's approach to shareholder engagement and its ability to articulate effectively in off-cycle meetings with shareholders in the coming months the rationale for putting forward this proposed charter amendment at the next annual meeting; and
- the effectiveness of the articulation of the rationale for this charter amendment in the proxy statement for the meeting at which the amendment will be voted on and in related solicitation conversations.

We believe that it would be sensible for institutional shareholders and proxy advisory firms to support these charter amendments at all companies due to their strong policy rationale and the meaningful limitations on exculpation of officers embedded in the amended statute. But we recognize that assuring that sensible minds will prevail may take some thoughtful and deliberate efforts on the part of corporations in their engagement with shareholders.

In sum, this new amendment to the DGCL is good news and presents an opportunity that all Delaware corporations ought to take advantage of by amending their charters by no later than their next annual shareholders meetings; but, while the drafting and rationale for these charter amendments is straightforward, there may be some additional work to do to assure that institutional shareholders and proxy advisory firms are on board.

Harvard Law School Forum on Corporate Governance

In re BGC Partners: Maybe Entire Fairness Review Isn't So Bad After All

Posted by Meredith Kotler, Ethan Klingsberg, and Marques Tracy, Freshfields Bruckhaus Deringer LLP, on Tuesday, October 4, 2022

Tags: **Business judgment rule**, **compliance**, **Controlling shareholders**, **Delaware law**, **Fairness review**, **Special committees**
More from: **Ethan Klingsberg**, **Marques Tracy**, **Meredith Kotler**, **Freshfields**

Editor's Note: **Ethan Klingsberg** and **Meredith Kotler** are partners and **Marques Tracy** is an associate at Freshfields Bruckhaus Deringer LLP. This post is based on their Freshfields memorandum and is part of the **Delaware law series**; links to other posts in the series are available **here**.

Eight years ago, the Delaware Supreme Court in *Kahn v. M&F Worldwide Corp. ("MFW"),* [1] affirmed then-Chancellor Strine's decision holding that the business judgment rule could apply to controlling stockholder mergers if certain necessary conditions were met. In articulating the new standard that the Supreme Court would ultimately adopt, the Chancellor expressed optimism that controlling stockholders would be more likely to start embracing the *ab initio* conditions if the presumption of the business judgment rule would be available.

While the lure of the business judgment rule is unquestionably appealing to many controlling stockholders, others remain unwilling to face the execution risks that can arise from a non-waivable majority-of-the-minority condition or to limit their flexibility at the outset of negotiations for an undefined period of time. Recent Court of Chancery decisions demonstrate that the Court will carefully review compliance with the *MFW* conditions and apply entire fairness if those conditions are not met. At the same time, the Court has also shown its willingness, most recently in *In re BGC Partners, Inc. Derivative Litigation*, [2] to find transactions entirely fair after trial where the evidence establishes a robust special committee process, and where the defendants have presented a strong record to support a fair price.

MFW and Application of the Business Judgment Rule

Where a controlling stockholder stands on both sides of a transaction, an agency problem arises, and under Delaware law, entire fairness review of the transaction is the default standard. As the Court of Chancery reminded us last year, however, "the common law of corporations recognizes that conflicted controller transactions may enhance firm value, and that the risk of litigation under the high bar of entire fairness may discourage such value-enhancing deals." [3] Acknowledgement of this risk led the Delaware Supreme Court in *MFW* to extend the business judgment rule to conflicted controlling stockholder transactions so long as the controlling stockholder commits *ab initio* to proceed only if the transaction is subject to both (1) the approval of an independent, adequately-empowered special committee that fulfills its duty of care, and (2) the uncoerced, informed vote of a majority of the minority stockholders.

The last few years have seen several decisions denying motions to dismiss where the Court found these two *MFW* requirements not met. [4] These include instances where (i) a special committee had paused negotiations then reactivated and approved the transaction, but the controlling stockholder had substantive negotiations with a minority shareholder in the interim; [5] (ii) minority shareholders objected to a special committee's terms, and the controlling stockholder negotiated better terms directly with the minority; [6] and (iii) there were inadequate disclosures to the minority before they approved the transaction. [7] These recent decisions make clear that conditioning a transaction on compliance with *MFW* is no guarantee that the business judgment rule will end up applying in a subsequent litigation.

In re BGC Partners

Given this uncertainty, should a controlling stockholder retain flexibility in the process and aim to satisfy entire fairness? As the Court of Chancery reinforced last month in *BGC Partners*, defendants can prevail at trial, even under the more exacting entire fairness standard. To do so, however, it is critical that the evidence at trial reflect a robust special committee process and a strong record supporting fair price.

After trial, the Court found for the defendants in an action challenging the fairness of BGC Partners’ acquisition of Berkeley Point Financial from an affiliate of Cantor Fitzgerald. BGC purchased the entity for $875 million and simultaneously invested $100 million in a Cantor affiliate’s mortgage-backed securities business. Plaintiffs alleged that Howard Lutnick—controlling stockholder of both BGC and Cantor—caused BGC to undertake a deal that benefitted him at the expense of BGC’s stockholders, and that the transaction was not entirely fair.

While the evidence showed that Lutnick initiated the deal, had a financial incentive to cause BGC to overpay, and overstepped in identifying advisors for the special committee, the Court nonetheless found that defendants’ trial evidence “carried the day.” In particular, the Court found that the special committee and its advisors were independent and that Lutnick sufficiently extracted himself from the committee deliberations after it was fully empowered. The Court also found that the one special committee member whose claims were not dismissed on summary judgment had pushed back when needed and “worked tirelessly” on the committee’s behalf. The Court further found that Berkeley Point was “a unique asset particularly appealing to BGC,” that the price the committee agreed to pay was in line with its financial advisor’s recommendation, and that the price fell within what the Court concluded to be in the range of fairness.

The Court noted “some defects in the process,” including Lutnick’s hand in selecting committee members and advisors, as well as the slow roll of information and the compressed time period for negotiations. It concluded, however, that the deal was not timed to benefit Cantor, and, in fact, the committee had ignored Lutnick’s efforts to drive the timeline, declining to complete the deal on any of the timelines he proposed. Also, at least a majority of the committee members were independent throughout the negotiations, and the committee spent substantial time poring over information, meeting at least nine times, and reviewing multiple presentations about Berkeley Point and Cantor’s CMBS business. The Court also found that the committee’s advisors were independent, its multiple diligence requests were met, and a deal was ultimately agreed to, following an arm’s length process, where the committee obtained its desired structure, a favorable price, and had extracted “consequential concessions.” The Court also concluded that the prices for both the Berkeley Point acquisition and the Cantor investment were fair, relying heavily on a fairness opinion, along with expert opinions and testimony from both sides.

BGC Partners fits neatly within a continuing line of cases, both before and after *MFW*, where the Court of Chancery found for defendants after trial when applying entire fairness. For example, in *In re Cysive, Inc. Shareholders Litigation*, **[8]** then-Vice Chancellor Strine found a controlling stockholder’s buyout of the company’s public float to be entirely fair. The Court noted that the decision to enter into the agreement was preceded by an active, aggressive search for a third-party buyer and included extensive market checks before and after execution. The Court also credited the work of the special committee, which was independent, devoted substantial time to its work, selected qualified, independent advisors, and bargained hard throughout the process. The Court further noted that the controlling stockholder had given the committee the leeway to fulfill its duties without any influence or coercion. Similarly, then-Chancellor Chandler in *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, **[9]** another pre-*MFW* decision, found a merger to be entirely fair even where the controlling stockholder allegedly used his position to negotiate an array of private benefits for himself that were not shared with the minority stockholders. In so doing, the Court found that the special committee was not coerced but, rather, its members were undisputedly independent, highly qualified, and had extensive experience in the hotel industry. The trial record also showed that the committee members understood their authority and duty to reject any unfair offer—which they exercised—and that they were thorough, deliberate, and negotiated at arm’s length over a nine-month period with two active bidders. The Court also considered extensive expert evidence presented by the parties and found that the defendants’ evidence of fair value was more convincing, persuasive, and thorough.

Even after *MFW* was decided, with the business judgment rule formally on the table, companies have still occasionally chosen to forgo that option and take their chances at trial with entire fairness review. On several occasions, defendants have prevailed. In 2017, Vice Chancellor Laster found that Sprint had engaged in "multiple instances of unfair dealing" in the first phase of the Sprint/Clearwire merger process. But after DISH intervened and a bidding war caused the price to increase from $2.97 to $5.00 per share, Vice Chancellor Laster found that the circumstances "changed the landscape so substantially as to render [those prior instances of unfair dealing] immaterial." **[10]** Earlier this year, former Vice Chancellor Slights found the Tesla/SolarCity transaction to be entirely fair after trial. There, the Tesla Board elected not to form a special committee but did condition the acquisition on a majority-of-the-minority vote. **[11]** The Court acknowledged that the process was "far from perfect," Musk was "more involved in the process than a conflicted fiduciary should be," and certain Board members' conflicts "were not completely neutralized." The Court nonetheless found for the defendants because the Board had "meaningfully vetted the Acquisition," Musk "did not stand in the way," and, critically, the preponderance of the evidence established that Tesla paid a fair price.

Takeaways

While the business judgment rule undoubtedly remains appealing to many controlling stockholders, there may be reasons why some may choose not to go down the *MFW* path and instead embrace entire fairness review:

- ***The risks of a majority-of-the-minority vote may be high.*** Subjecting a buyout to a non-waivable majority-of-the-minority condition *ab initio* presents significant execution risks that could make the transaction simply unappealing.
- ***Controlling stockholders may want to retain a level of flexibility in the negotiation process that is simply unavailable under the MFW approach.*** To satisfy *MFW*, the Court has made clear that, when a special committee is formed and empowered, the committee is to be the exclusive bargaining agent for the minority early on. But a controlling stockholder may prefer to have some flexibility in terms of the negotiation process. The process in *Dell* provides an example of a controlling stockholder's election to engage in direct negotiations with the minority. **[12]**

For those controlling shareholders who elect not to adhere to *MFW* and therefore choose to go the "entire fairness" route, the following lessons for the controlling shareholder and independent directors of the controlled company are important both during the negotiation process and during preparation for litigation:

- ***A good special committee process is critical.*** The *BGC Partners* decision, as well as other entire fairness decisions, underscore the importance of a qualified, independent special committee that is diligent, retains its own independent advisors, and is fully empowered to negotiate without influence from the controlling stockholder. The committee's process should be thorough, including meetings with and presentations from advisors, and should operate on its own timeline. The committee should be authorized to negotiate the best terms, extract meaningful concessions, reject offers that are unfair to the minority stockholders, and, if the controlling stockholder is open to being a seller and not just a buyer, entertain multiple bids. (The Tesla/Solar City transaction is likely an outlier for satisfying entire fairness without a special committee (although there was majority-of-the-minority approval).
- ***Powerful evidence on price is invaluable.*** One of the two prongs of the entire fairness test is "fair price." Although courts look to the other prong—"fair process" (typically satisfied by a good special committee process)—as an indicator of fair price, courts often rely significantly on traditional forms of valuation analysis when determining whether the transaction had a fair price. Thus, while it is not typical for a controlling stockholder to obtain a fairness opinion when buying out the minority holders, it is advisable for any controlling stockholder that is anticipating having to satisfy entire fairness to have internally done the math up front to determine that the price likely will fall within the range of financial fairness. Even more importantly, any special committee that is approving or recommending a transaction will first need to have adopted, after proper deliberations and receipt of advice from management and advisors, a reasonable set of internal forecasts and obtained a fairness opinion premised on a financial analysis that uses those forecasts. Moreover, when preparing for an entire fairness trial, amassing supporting evidence of fairness of price, including expert evidence, will be critical.
- ***The supporting evidence must be memorialized by the special committee.*** There should be a comprehensive record, including minutes and meeting materials, that memorialize details of the committee's process. Each of the committee's diligence requests should be documented, along with the information provided in response. The record should reflect that the committee's work was fully independent and unimpeded by any influence from the controlling

stockholder. Any analyses regarding price, throughout the negotiations and continuing through closing, should be memorialized and consistent with the ultimate fair price evidence presented at trial.

- ***Prevailing at trial or reaching a settlement remains a viable option.*** *BGC Partners* and several other decisions underscore that entire fairness can and has been demonstrated, particularly where the trial record shows a robust, independent process and a fair price. And, short of trial, numerous transactions that have not embraced *MFW* have settled for amounts that controlling stockholders and their insurers have found reasonable.

Endnotes

[1] 88 A.3d 635 (Del. 2014).
(go back)

[2] 2022 WL 3581641 (Del. Ch. Aug. 19, 2022).
(go back)

[3] *Ligos v. Isramco, Inc.*, 2021 WL 3870679, at *1 (Del. Ch. Aug. 31, 2021).
(go back)

[4] *See, e.g.*, *In re HomeFed Corp. Stockholder Litig.*, 2020 WL 3960335 (Del. Ch. July 13, 2020); *In re Dell Techs. Inc. Class V Stockholders Litig.*, 2020 WL 3096748 (Del. Ch. June 11, 2020); *Ligos v. Isramco, Inc.*, 2021 WL 3870679.
(go back)

[5] *HomeFed*, 2020 WL 3960335, at *4.
(go back)

[6] *Dell*, 2020 WL 3096748, at *2.
(go back)

[7] *Ligos*, 2021 WL 3870679, at *8.
(go back)

[8] 836 A.2d 531 (Del. Ch. 2003).
(go back)

[9] 2011 WL 227634 (Del. Ch. Jan. 14, 2011).
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[10] *ACP Master, Ltd. v. Sprint Corp.*, 2017 WL 3421142, at *20 (Del. Ch. July 21, 2017).
(go back)

[11] *In re Tesla Motors, Inc. Stockholder Litig.*, 2022 WL 1237185, at *2 (Del. Ch. Apr. 27, 2022).
(go back)

[12] *Dell*, 2020 WL 3096748, at *2.
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Harvard Law School Forum on Corporate Governance

M&A Predictions and Guidance for 2023

Posted by Ethan Klingsberg, Freshfields Bruckhaus Deringer LLP, on Monday, January 23, 2023

Tags: **Antitrust**, **CFIUS**, **China**, **Institutional Shareholders**, **M&A**, **Middle East**
More from: **Ethan Klingsberg**, **Freshfields**

Editor's Note: **Ethan Klingsberg** is a Partner at Freshfields Bruckhaus Deringer LLP. This post is based on his Freshfields memorandum.

Tension between institutional shareholders and boards about strategic alternatives.

We are emerging from several consecutive years where both activist shareholders and boards have been able to regularly count on institutional shareholder support for all-cash sales of companies at premia to recent trading prices. We will be entering a different environment in 2023 – where long-term, institutional shareholders have acquired their shares over the last several years at prices that not only are significantly higher than prices that represent a healthy premium to *current* trading prices, but also far exceed the ranges where financial analyses of the newest internal, management forecasts are putting both intrinsic values and future stock prices.

Against this backdrop, we are not necessarily going to be able to rely on institutional shareholder enthusiasm for cash sales of companies just because the transactions satisfy the traditional criteria of meaningful premia to recent trading prices and falling within the ranges of intrinsic values and future stock prices derived from internal management forecasts. The uncertainty and downsides that will be characterizing the forecasts that managements present to boards at the outset of 2023 will be fueling this tension between the approaches of boards and the approaches of institutional shareholders to sales of companies in 2023.

These tensions between boards and their institutional shareholders over strategic alternatives may come as a surprise to many corporate clients. They will have run sale processes consistent with the latest guidance from Delaware Chancery decisions. In addition, many will have recently upped their games on shareholder engagement, "thinking like activists," improving their investor relations messaging, being more transparent about longer term targets (rather than managing the markets only from quarter to quarter or even from fiscal year to fiscal year) and making shareholder-friendly governance concessions in a tactically wise manner. Nevertheless, we need to prepare for battles in 2023 for shareholder approvals of negotiated sales of public companies for cash consideration.

We are going to be spending a lot more time in 2023 convincing ISS, among others, why cash mergers merit their support. We may even start trying to structure more transactions as tender offers to avoid ISS recommendations, although regulatory timelines will continue to push us toward one-step mergers. Get ready for this tension. Advisors' board presentations will show everything to be in order for a well-founded merger and then the chorus of objections emerge following the announcement.

Commodification of private equity and the adventures of reliance on direct lenders and on equity commitments from the Middle East and sovereign wealth funds.

The leveraged acquisition playbook for at least the outset of 2023 is going to be characterized by herding numerous direct lenders into leverage packages and negotiating supplemental equity commitments from the Middle East and sovereign wealth funds. The core private equity commitments are arguably commoditized at this point; it's the senior side of the capital structure and the supplemental equity that are going to require hard work.

Although the commitment papers from the direct lenders in 2023 may look similar to those from the commercial bank lenders that dominated much of 2022, the differences (and the additional burdens) will include the intensity of the diligence, the uncertainty of whether these lenders are "in" until much later in the game, and the sheer number of direct lender shops that may be needed to make this formula work given the relatively small checks each direct lender fund typically writes (due to the absence of follow-on syndication of their commitments). The big private equity bidders have internal teams that can coordinate this activity, but will middle market private equity buyers and strategic buyers in need of leverage have the wherewithal to shepherd all this in 2023?

Meanwhile, the importance of money from the Middle East and sovereign wealth funds to fill out equity checks from the core private equity players is going to require special focus on CFIUS (as will the fact that some of the US private equity funds receive significant capital from the Middle East and Asia) and making sure that the entities signing these commitments are not just unfunded vehicles.

Outmaneuvering antitrust regulators in 2023.

The playbook of the antitrust regulators is now clear: "Throw sand in the gears" – i.e., do everything possible to delay the transaction until the merger agreement's "outside date" hits and one of the parties decides that it would be better to pull the plug and receive or pay the reverse break-up fee than extend the outside date. (Given antitrust paranoia, it is fair to expect reverse break-up fee structures, for better or worse, to be pervasive in merger agreements in 2023 even in the face of strong antitrust undertakings by buyers).

In 2023, we will see merger parties better prepared to counter the regulators' strategy successfully. More M&A clients will adopt, from the outset of their merger discussions, clear strategies for:

- fix-it-first remedies,
- expediting responses to document and information requests from antitrust regulators,
- proactive management and leverage of the UK CMA-EC-FTC/DOJ triangle (as opposed to having these agencies leverage this triangle against us), and
- most importantly, engagement in litigation against those antitrust regulators that throw up roadblocks.

The "sand in the gears" strategy of the regulators will not work when clients get their act in order upfront on these items, and clients are now realizing this. Merger parties have learned the hard way that being reactive and planning on the fly plays into the "sand in the gears" strategy of the antitrust authorities, and that success is within reach by proactively managing timing risks (through expedited handling of requests and other process matters) and substantive risks (through fix-it-first) and, most importantly, by having a clear litigation action plan to ensure success.

In the past, boards, when considering a merger, would rather shutdown merger discussions than have to plan out in advance litigation strategies for obtaining antitrust clearance. That will change in 2023. The antitrust agencies have challenged merger parties to enhance their approaches to overcoming regulatory impediments, and the challenge will be accepted in 2023.

Reverse-CFIUS, CFIUS and foreign investment and national security regulations – the minefield expands.

The word from our colleagues in Washington is that the US government now wants to figure out how to regulate or at least start monitoring closely not only inbound foreign investment (CFIUS) and the sale and licensing of sensitive technology and other key resources (OFAC; export control), but also outbound investment generally. The objective of this "reverse CFIUS" idea is not to restrict cash outflows (e.g., China has plenty of cash), but to regulate and monitor the spread of US legitimacy, managerial know-how and other intangible benefits to a foreign company that come from having, say, a name-brand US private equity house or a marquee US brand in its stockholder profile. This regime has yet to be promulgated but it is coming in 2023. Who knows what kinds of reciprocal restrictions (on investing in the US) other countries will impose on their local sources of capital as a response? As one China-born CEO of a US-based public company put it to me in December: The US and other western governments want to borrow ideas from the Chinese government.

Meanwhile, the scope of CFIUS and non-US foreign investment and national security regimes continues to expand on a monthly basis. Many merger parties in 2023 are going to underestimate the magnitude of the effort necessary to figure out not only all the foreign investment clearances required but also their impacts on timing and substantive execution risk. There will be embarrassments and frustrations in 2023 on this front.

Leveraged spin-offs – the default choice for separation transactions in 2023.

Investors will never let go of their push for portfolio rationalization and separation out of non-core assets. Leveraged spins are going to be one of the alternatives of choice in 2023 for addressing this objective.

Even with prices obtainable in straight divestiture sales and carve-out IPOs way down during the initial months of 2023, there will always be the spin-off alternative if the non-core asset in question is sufficient to float on its own, even as a small cap.

Investors will continue to love tax-free spin-offs because they permit the shareholders to retain both upside opportunity and liquidity in the SpinCo and because most SpinCo's will be able to navigate the tax restrictions to position themselves to be sold quickly at a premium when markets eventually become frothy again in the coming years. Meanwhile, despite limited debt markets, leverage-lite is still usually available to put on the SpinCo and enable the parent to keep the cash proceeds to boost the core business that remains behind.

Mergers of Equals – Will boards be heroic in 2023?

Here's where the difference between what "should" happen and what "will" happen may differ in 2023. If you are a director looking at management's outlook for the next 15 months, there's a good chance that you are thinking, "I don't want to be a director of an underperformer for 2023." One solution is to find a complementary company facing similar challenges, determine if there are some attractive revenue and cost synergies, whether antitrust clearance is doable, whether the two corporate cultures are compatible, and, if these boxes can all be checked, then do an all-stock merger based on a fair, relative valuation. That often means an at-market exchange ratio, but may mean something slightly different after further analysis of trading multiples. In any event, the key to such an all-stock merger-of-equals transaction is not any premium to market trading prices in the exchange ratio, but the value generation for shareholders from the synergies and multiple potential bumps.

Yet, it takes heroic boards and management teams to get these deals done. Why? Because, by definition, 50% of the directors and executives from the two companies are going to be out of a job or in less glamorous positions at the combined company by the day after closing. These are the deals that "should" be happening in 2023 and many directors know it. Whether they "will" happen remains to be seen. To the extent they do not happen, we will start to see more dispersion among the underperformers in 2023 and those directors and executives at companies performing poorly relative to peers in the tough times of 2023 will be prime personal targets for activists and will wish they had been cheerleaders for an accretive merger of equals even if it meant not having a personal role at the combined company after closing.

Harvard Law School Forum on Corporate Governance

To Exculpate, or Not to Exculpate: Is It Even a Question?

Posted by Ethan Klingsberg, Pamela Marcogliese, and Elizabeth Bieber, Freshfields Bruckhaus Deringer LLP, on Wednesday, March 8, 2023

Tags: Delaware articles, Delaware cases, Delaware law, DGCL, DGCL Section 102, Duty of care, exculpation provision, Proxy voting
More from: Elizabeth Bieber, Ethan Klingsberg, George Ter-Gevondian, Pamela Marcogliese, Freshfields

Editor's Note: Ethan Klingsberg and **Pamela Marcogliese** are Partners, and **Elizabeth Bieber** is Counsel at Freshfields Bruckhaus Deringer LLP. This post is based on a Freshfields memorandum by Mr. Klingsberg, Ms. Marcogliese, Ms. Bieber and **George Ter-Gevondian** and is part of the **Delaware law series**; links to other posts in the series are available **here**. Related research from the Program on Corporate Governance includes **Monetary Liability for Breach of Duty of Care?** (discussed on the Forum **here**) by Holger Spamann.

Toward the end of last summer, **the Delaware General Corporation Law (DGCL) was amended** to permit companies to exculpate officers for breaches of their duty of care. This amendment permits officers to benefit from Section 102(b)(7) of the DGCL, in most instances, in the same way that this valuable section has long insulated directors from liability for actions taken in good faith. However, the catch is that this new right of officers to exculpation will take effect if, and only if, the charter of the company in question provides explicitly for this right. This means a charter amendment and, therefore, a shareholder vote will be required.

Approximately six months following the amendment of Section 102(b)(7), we have not changed our view: we believe the benefits of exculpation are significant and, at most companies, worth the costs of pursuing shareholder approval of a charter amendment. The market data from companies with off-cycle meetings within the last six months supports this view.

As a practical matter, extending exculpation to officers has the potential to reduce both the volume and scope of lawsuits alleging breaches of fiduciary duties by officers. This, in turn, reduces the indemnification burden on companies since such lawsuits are now more likely to be resolved earlier in the progression of the lawsuit (on a motion to dismiss, for example) or at lower cost of settlement. As a result, companies may see reduced D&O insurance premiums. Companies may also experience less quantifiable benefits, such as avoiding or truncating negative press cycles attendant to such lawsuits. However, companies should be aware that extending exculpation to officers will not insulate these officers from derivative lawsuits (i.e., a lawsuit by the board, on behalf of the corporation) against officers.

How Are the Votes Faring?

Between August 10, 2022 and February 23, 2023, 15 companies have held votes to amend their charters to update the exculpation provision to include officers. The voting results and ISS recommendation for each are below.

Company Name*	Meeting Date	ISS Recom.	% of Votes Cast (incl. abstentions)	% of Outstanding Shares	Result**
SWK Holdings Corporation	8/10/22	For	91.9	85.7	Pass
Avid Bioservices, Inc.	10/18/22	For	97.5	74.2	Pass
Fox Corporation	11/3/22	For	99.7	87.4	Pass
VMware, Inc.	11/4/22	For	99.1	82.6	Pass
Team, Inc.	11/8/22	For	92.9	51.1	Fail
Akoustis Technologies, Inc.	11/10/22	For	88.3	37.2	Fail
Axos Financial, Inc.	11/10/22	For	98.9	77.2	Pass
The Southern Banc Company, Inc.	11/16/22	Against	–	–	Not Disclosed
TSR, Inc.	11/30/22	For	98.5	54.6	Fail
Matrix Service Company	12/5/22	For	84.6	60.6	Pass
Guidewire Software, Inc.	12/20/22	For	81	70.5	Pass
CENAQ Energy Corp.	1/4/23	Against	91	71.8	Pass
The Duckhorn Portfolio, Inc.	1/20/23	For	96.3	88.3	Pass
Northern Technologies International Corporation	1/20/23	For	88.4	50.1	Pass
Liquidity Services, Inc.	2/23/23	For	92.7	80.9	Pass

*Source: ISS
** Voting standard for each vote was based on percentage of the shares outstanding, except for Guidewire Software, which measured votes cast.

Proxy advisory firm support: Of the 15 companies, ISS recommended FOR the proposals at all companies except for two companies. Both of the AGAINST recommendations involved unusual facts. The first of these two companies did not release a proxy statement (or disclose results) and ISS recommended against all proposals on the ballot. The other was holding a meeting to vote on its de-SPAC transaction, which ISS opposed along with every other proposal on the agenda for the meeting. For the remaining 13 companies, ISS recommended FOR the exculpation amendment proposal each time. This group that garnered ISS endorsements for their exculpation amendment proposals included companies with less than perfect records on governance and even some where ISS was recommending against the company's director nominees and/or say-on-pay proposals.

ISS notes in its voting guidelines, which it finalized in late November 2022, that it will recommend votes on a case-by-case basis on proposals for officer exculpation, taking into account the stated rationale for the vote. This final policy represents a change from the proposed proxy voting guidelines initially published in early November 2022, where ISS proposed having a policy generally to recommend a vote for the proposals. ISS' policy change reflects input from investors between the proposed and final guidelines. But practically speaking, absent other very significant issues unrelated to the proposal, ISS's practice to date indicates that the proxy advisory firm will be supportive of officer exculpation proposals.

Glass Lewis's voting recommendations are less accessible, but its proxy voting guidelines provide that they will make a recommendation on these proposals on a case-by-case basis (Glass Lewis states that the firm expects to recommend against these proposals unless there is a compelling rationale and the provision is reasonable). Given the high level of support to date, it does not appear that Glass Lewis recommendations against such proposals, if any, have had a significant negative impact on these votes.

Pass or Fail? Three of the 14 disclosed votes failed, when measured using the required voting standard set forth in the company's charter – a percentage of outstanding shares. However, two of these votes received majority support as a percentage of outstanding shares but nonetheless failed because the charter required a supermajority of the outstanding shares to pass. However, votes as a percentage of outstanding shares do not capture true voting sentiment, as many companies have a significant number of shareholders that do not vote. To determine how popular the proposals are with voting shareholders, we have reviewed the voting results as a percentage of votes cast, including abstentions. Under this threshold, every vote received supermajority support, with the lowest support at 81% of the votes cast, and 10 of the 14 disclosed votes receiving support of greater than 90% of the votes cast.

Future votes: An additional seven companies have filed definitive proxy statements that include upcoming votes to amend their charters to provide for officer exculpation. ISS has already released its recommendations for six of these companies. Four of the six received FOR recommendations, while two received AGAINST recommendations. One AGAINST recommendation was in connection with approval of a de-SPAC transaction, which is consistent with its recommendations on this proposal in de-SPAC contexts (as described above) and the other was at a company where all of the directors up for election received withhold recommendations. However, consistent with its prior practices noted above, for one of the upcoming votes, ISS made a FOR recommendation despite recommending withhold votes for five directors for unrelated reasons, including members of the compensation committee and the chair of the governance committee. We expect that many more proposals for exculpation will occur in this proxy season and receive ISS support.

Institutional investors: Institutional investors have not waded into policymaking on the subject, but the high levels of support for the votes suggest that there is significant institutional support for these proposals.

Considerations for Companies Evaluating Charter Amendments

Procedural point: As companies plan for their proxy filings, companies that seek votes on charter amendments should remember that the inclusion of a vote on a charter amendment will trigger the need for a preliminary proxy filing. As a result, companies will need to adjust their internal proxy timelines to accommodate the earlier filing requirement.

Supermajority provisions: As noted above, vote failures tended to occur at companies that had supermajority requirements to amend the relevant charter provisions. Companies with supermajority provisions should review past voting records to determine whether the average voting turnout would be sufficient to pass the charter amendment. If historical records do not favor passage, consider early season discussions with the company's proxy solicitor and counsel about shareholder engagement and disclosure considerations that would improve supportive turn-out.

Litigation: Two companies, Snap, which adopted the charter amendment by written consent, and Fox, which held a vote, have been sued in Delaware Chancery Court in connection with the vote to amend their charter to allow for officer exculpation. These companies have capital structures that include "no vote" shares and held votes that did not provide an opportunity for the "no vote" shares to vote. Plaintiffs claim that Section 242(b)(2) of the DGCL requires separate class votes on charter amendments that adversely affect the powers or rights of stockholders of a class and that therefore a separate class vote of the "no vote" shares was required to approve these charter amendments that limit the claims that stockholders may assert against officers. The claims against Snap and Fox are aggressive because there is no disproportionate treatment of any class or series of shares that arises from an exculpation amendment. Given the dearth of Section 242(b)(2) case law, these two cases are worth watching by all companies with dual or multi-class capital structures. Plaintiffs have now moved for summary judgment in each of the cases and briefing is ongoing.

Takeaways

With the number of lawsuits against directors and officers increasing, there is a significant benefit to seeking to provide the same legal protections to officers as provided to directors under the charter, particularly for the CEO as a dual officer and director. Early voting patterns are favorable, with shareholders overwhelmingly supporting the proposals and proxy advisory firms generally supportive of these proposals. As a result, we continue to recommend that Delaware corporations, particularly those with only one class and series of stock, seek a vote to amend their charter at their next annual meeting to provide for officer exculpation.

Harvard Law School Forum on Corporate Governance

Trend in Delaware Merits Heightened Attention by Acquirors

Posted by Ethan Klingsberg & Victor Ma, Freshfields Bruckhaus Deringer LLP, on Wednesday, September 6, 2023

Tags: acquirors, Delaware articles, Delaware cases, Delaware Court of Chancery, Delaware law, Fiduciary duties, Mergers & acquisitions
More from: Ethan Klingsberg, Victor Ma, Freshfields

Editor's Note: Ethan Klingsberg is a Partner and **Victor Ma** is an Associate at Freshfields Bruckhaus Deringer LLP. This post is based on their Freshfields memorandum, and is part of the **Delaware law series**; links to other posts in the series are available **here**. Related research from the Program on Corporate Governance includes **Are M&A Contract Clauses Value Relevant to Target and Bidder Shareholders?** (discussed on the Forum **here**) by John C. Coates, Darius Palia, and Ge Wu; and **The New Look of Deal Protection** (discussed on the Forum **here**) by Fernan Restrepo and Guhan Subramanian.

A trio of recent, high-profile M&A cases in the Delaware Court of Chancery merit special attention by M&A acquirors. In each of these cases, the Court highlighted the liability of the third-party acquiror of a publicly listed target company for aiding and abetting breaches of fiduciary duties by the target board and executives. [1]

Historically, successful "aiding and abetting" claims have been limited to the advisors of target companies and affiliates of a director. [2] However, there are a number of reasons why asserting aiding and abetting claims against third-party buyers may now be attractive for plaintiffs in light of these recent cases:

- An aider and abettor will have joint and several liability for the underlying fiduciary duty breach by the target board or executive team in a sale process. This means another deep pocket from which to obtain funds and have leverage in settlement discussions. The Delaware Court of Chancery will often determine damages by looking to the difference between what the aggregate merger consideration would have been, but for the breach of duty, and the actual merger consideration. Under this approach, the aggregate damages can be in the hundreds of millions of dollars and therefore having multiple deep pockets to draw from is of real value to the plaintiffs.
- In the case of breaches of the duty of care (such as a shortfall in the performance of *Revlon* duties to obtain the best price reasonably available in a sale process), many claims for damages against target company directors and officers are nullified by the applicability of the right to exculpation as permitted by Section 102(b)(7) of the Delaware General Corporation Law. [3] But claims against an aiding and abetting third-party buyer are not entitled to any such exculpation.
- As an aiding and abetting defendant, the acquiror becomes subject to potentially enhanced discovery of internal documents and depositions. It is even possible that the acquiror's own stockholders will start to pursue books and records demands and even derivative claims against the acquiror's board relating to the aiding and abetting activity. These risks provide further leverage for the plaintiffs to induce an early settlement payment directly from the acquiror.
- Troublingly, the standard insurance policies of many strategic acquirors—especially those that are publicly listed—may not currently cover these aiding and abetting liability risks. This vulnerability may further induce these acquirors to settle quickly rather than fight an aiding and abetting claim.

How Does an Acquiror Become Liable for Aiding and Abetting a Target Board's Breach?

In the three recent cases, the Court identified what it considered to be a slew of missteps by target officers and directors in their sale processes that indicated questionable loyalties and indifference to the best interests of the stockholders. But what turned this problematic conduct by target fiduciaries into "aiding and abetting" violations by the third-party acquirors were (i) the acquirors' knowledge that these missteps by the personnel at the target companies constituted acts of disloyalty or at least deviations from practices designed to obtain the best price reasonably available, and (ii) despite this knowledge, the decision by the acquirors to participate in inducing and/or exploiting these missteps. As the Court highlighted, a "potential acquirer's right 'to seek the lowest possible price through arms' length negotiations with the target board' is not unlimited." **[4]**

Thus, for example in the *Columbia Pipeline* case, the Court found, after trial, that the two target company executives leading the sale process who breached their fiduciary duties:

- conveyed to the strategic acquiror that the target was eager to sell,
- implied to the acquiror that they were personally seeking a quick sale to trigger their change in control benefits,
- reassured the acquiror that the process would not be competitive,
- never mentioned to the acquiror that the acquiror's maneuvers to undermine the competitiveness of the process were in violation of the acquiror's standstill undertakings,
- provided the acquiror with due diligence access on an accelerated timeline not available to any other bidder,
- were unduly receptive to proposals to decrease the proposed merger consideration,
- extended the acquiror's exclusivity despite the existence of competitive inbound inquiries, and
- never countered a last-minute price drop.

The Court found further that the acquiror advocated for the target executives to take these actions while the acquiror understood that these actions would constitute deviations from these executives' duties of loyalty and *Revlon* duties to obtain the best price reasonably available.

The Court in *Columbia Pipeline* found additional violations of fiduciary duties by the target board arising from the failure to disclose these missteps properly in the "Background" section of the proxy statement. The Court then examined these duty of disclosure violations on the part of the target board in the context of the acquiror's knowledge of these omissions along with the merger agreement's provision of a right for the acquiror to review and comment on the proxy statement. The result was a Court finding that the faulty proxy statement disclosure constituted yet another basis for aiding and abetting liability on the part of the acquiror.

In the *Presidio* case, the Court denied a motion to dismiss aiding and abetting claims against a private equity acquiror because, according to the Court, the complaint portrayed a reasonable inference of (i) favoritism of the acquiror that would constitute breaches of fiduciary duties on the target side and (ii) the acquiror's understanding that such favoritism constituted such a breach while nonetheless exploiting and attempting to keep secret its knowledge of this favoritism.

In the *Mindbody* case, the Court did not formally find an aiding and abetting violation by the private equity acquiror due to a technical pleading shortfall by plaintiffs' counsel, but dicta by the Court in *Columbia Pipeline* called out the finding of surreptitious communications between the target company CEO and the private equity acquiror in *Mindbody* as an instructive example of the components of an aiding and abetting violation by an acquiror—*i.e.*, the Court focused on what it considered to be instances of (i) fiduciary duty missteps in the form of favoritism of a specific private equity bidder by a CEO "uniquely smitten" with this private equity bidder and (ii) exploitation by that private equity bidder of these missteps by the smitten target CEO in a manner that appeared to amount to the acquiror's "participat[ing] knowingly in a sell-side breach." **[5]**

Aiding and abetting a breach of a fiduciary duty is in fact a well-established doctrine in Delaware. As a formal matter, it consists of two elements: first, an underlying breach of fiduciary duty by a director or officer of the target company and second, knowing participation in such breach by the third-party acquiror. [6]

The second prong (knowing participation), which the Delaware Court of Chancery has noted as the "most critical element for an aiding-and-abetting claim," consists of two further elements: knowledge and culpable participation (in each case, of the underlying breach). [7] Knowledge can be actual or constructive knowledge. As explained by Vice Chancellor Laster in *Columbia Pipeline*, the plaintiff, to establish culpable participation, is required to show that the third-party buyer "create[d], exacerbate[d], or exploit[ed] the sell-side breach" of fiduciary duty. [8]

In sum, a plaintiff must show the following elements to succeed on an aiding and abetting claim against a third-party buyer:

1. Underlying breach of fiduciary duty on the sell-side,
2. The buyer had actual or constructive knowledge of the breach, and
3. The buyer created, exacerbated, or exploited the breach.

In contrast to these three recent cases, there are many more Delaware cases where the Court of Chancery dismissed aiding and abetting claims against third-party buyers and bidders. [9] Indeed, *Columbia Pipeline* affirmed that aiding and abetting liability for a third-party buyer remains a very high bar—since knowing participation is difficult to plead, let alone prove. Well-advised acquirors should be able to avoid aiding and abetting risks despite their attractiveness to plaintiffs.

What Should Acquirors Do?

First, acquirors need to be on the lookout for acts of unwarranted favoritism or actions that are indicative of questionable loyalties on the part of the representatives of the target. Questions that bidders and their advisors ought to be asking themselves regularly during sale processes include:

- Do we believe that we are receiving meaningfully preferential access to due diligence materials relative to the other bidders—either in the substance of the material or the timing of the access?
- Are we receiving inside information about the sales process that would appear to undermine the competitiveness of the process and that we do not believe is being shared with the other bidders?
- Is the target looking the other way when we engage in repeated or blatant violations of our standstill or no-teaming undertakings?
- Are any executives from the target company engaging in discussions with us about plans for a post-closing role at the company or an individual side deal?
- Were we told that the sale process would abide by certain guidelines and protocols (such as prohibitions on unsupervised contacts with management) that are turning out not to be consistently followed?
- Are we receiving valuable information about how to prevail in the sale process through informal text messages and "offline calls" from target personnel rather than through formal sales process communications and channels?

The most effective way to ensure that these red flags do not give rise to aiding and abetting exposure (and, just as importantly, to mitigate the risk that consummation of the merger will result in the acquisition of a target rife with exposures for pre-closing fiduciary duty breaches) is for the bidder to insist on a quick, good faith confirmation that the target board is aware of and signed off on the developments in question combined with a sense check that business rationales exist for such developments. After the bidder obtains this real-time, good faith confirmation, the bidder's decision to exploit such developments shifts from potential fodder for an aiding and abetting claim to being a tactically smart move by the bidder.

The beautiful characteristic of *Revlon* duties is that the sell-side "directors are generally free to select the path to value maximization, so long as they choose a reasonable route to get there." [10] As an outsider, no third-party bidder knows what actions would reasonably be in the best interests of the target stockholders. Ignoring standstill violations may be a perfectly reasonable way for the target board to obtain the best value for stockholders in a sale process. But when there are red flags that would make a sophisticated M&A player metaphorically scratch her head and question how that act could be linked to fulfilling *Revlon*, then it is best to find out first about where the target board stands before proceeding to exploit the questionable actions by the target company's representatives.

One practice note that comes out of the *Columbia Pipeline* opinion is the disdain that the Court has for one-on-one consultations with target directors, as opposed to an actual meeting of the board or a committee, for ensuring compliance with the duties of care and loyalty. If a bidder wants to ensure that problematic activity by the target CEO is not problematic, then it is best not to settle for a message from a target executive along the lines of, "Oh, I spoke one-on-one with a couple of directors and they're fine." Better to insist on confirmation that a board or committee meeting has determined that all's in order. In addition, although asking to see the target's board minutes for the sale process is a step too far for a bidder, asking the target's outside counsel to confirm that the target board's understandings of certain elements of the sale process have been memorialized in the minutes (and that these minutes have been completed before the merger agreement is announced) is reasonable and advisable.

Second, even if there were missteps leading up to the signing of the merger agreement, the *Corwin* doctrine provides one final opportunity for the parties to come clean and obtain "cleansing" through disclosure of material missteps. A failure to take advantage of *Corwin* cleansing by having the "Background" section of the proxy statement disclose material missteps not only constitutes a missed opportunity to erase the fiduciary duty breaches, but such failure also may serve, as was the case in *Columbia Pipeline*, as another basis for an aiding and abetting claim. In *Columbia Pipeline*, the Court viewed awareness by acquiror personnel of various omissions in the proxy statement as the basis for finding that the acquiror aided and abetted breaches of target's duty of disclosure. Best practice is to ensure that all representatives of the buyer who played a material role in the interactions with the target carefully review the "Background" section of the proxy statement and understand the costs for the acquiror of material omissions, even if the omitted disclosure may be awkward to insert into the "Background" section.

Finally, acquiror deal teams in their internal post-transaction reviews should be circumspect about gloating about their successful navigation of the sale process. Discussion of how personal relationships were leveraged and missteps by the target team were exploited can be turned by plaintiffs' lawyers into foundations for aiding and abetting claims. Indeed, the internal post-closing presentation by the acquiror team in *Columbia Pipeline* about the ways they were able to have such "strong success" in the sale process was repeatedly relied upon by the Court to support its finding of aiding and abetting liability on the part of the buyer.

Endnotes

[1] *In re Columbia Pipeline Gp., Inc., Merger Litig.*, 2023 WL 4307699 (Del. Ch. June 30, 2023); *In re Mindbody, Inc., S'holder Litig.*, 2023 WL 2518149 (Del. Ch. Mar. 15, 2023); *Firefighters' Pension Sys. of Kans. City, Mo. Tr. v. Presidio, Inc.*, 251 A.3d 212, 286 (Del. Ch. 2021).
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[2] *See, e.g., New Enter. Assocs. 14, L.P. v. Rich*, 295 A.3d 520 (Del. Ch. 2023); *Morrison v. Berry*, 2020 WL 2843514 (Del. Ch. June 1, 2020).
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[3] Breaches of the duty of loyalty are not entitled to exculpation. *See 8 Del. C.* § 102(b)(7).
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[4] 2023 WL 4307699, at *64 (quoting *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813, 837 (Del. Ch. 2011)).
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[5] *Id.* at *66.
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[6] *Malpiede v. Townson*, 780 A.2d 1075, 1096 (Del. 2001).
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[7] 2023 WL 4307699, at *62.
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[8] *Id.* at *68.
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[9] *E.g.*, *Jacobs v. Meghji, 2020 WL 5951410*, at *8 (Del. Ch. Oct. 8, 2020); *In re Xura, Inc. S'holder Litig.*, 2019 WL 3063599, at *3 (Del. Ch. July 12, 2019); *In re Hansen Med., Inc. S'holders Litig.*, 2018 WL 3025525, at *12 (Del. Ch. June 18, 2018).
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[10] *In re Answers Corp. S'holders Litig.*, 2011 WL 1366780, at *3 (Del. Ch. Apr. 11, 2011) (quoting *In re Dollar Thrifty S'holder Litig.*, 2010 WL 5648895, at *17 (Del. Ch. Sept. 8, 2010)).
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Harvard Law School Forum on Corporate Governance

Sears and (the Limited Scope of) Controlling Stockholder Fiduciary Duties

Posted by Ethan Klingsberg, Meredith Kotler, and Victor Ma, Freshfields Bruckhaus Deringer LLP, on Tuesday, March 12, 2024

Tags: Delaware Court of Chancery, Fiduciary duties, Sears, stockholders
More from: Ethan Klingsberg, Meredith Kotler, Victor Ma, Freshfields

Editor's Note: Ethan Klingsberg and Meredith Kotler are Partners, and Victor Ma is an Associate at Freshfields Bruckhaus Deringer LLP. This post is based on their Freshfields memorandum and is part of the Delaware Law series; links to other posts in the series are available here. Related research from the Program on Corporate Governance includes Independent Directors and Controlling Shareholders (discussed on the Forum here) by Lucian Bebchuk and Assaf Hamdani.

The recent post-trial opinion by the Delaware Court of Chancery in *In re Sears Hometown and Outlet Stores, Inc. Stockholder Litigation* [1] puts controlling stockholders on notice that they must be mindful of their fiduciary duties to the Delaware corporations they control not only when they are engaging in transactions between themselves and these corporations, but also when selling and voting shares of these corporations.[2] Before having an alarmist reaction that every decision by a controller on whether or not to dispose of its shares or how to vote its shares may trigger a lawsuit on behalf of the minority stockholders, it is worth drilling down on this idea of fiduciary duties of a controller outside the context of a transaction or arrangement where the controller is receiving a unique or non-ratable benefit that is not available to the minority stockholders.

First, there are no fiduciary duties on the part of a controlling stockholder when the controlling stockholder is refusing to sell its shares or is voting against a change to the status quo. In contrast to a director, who has a duty to take reasonable actions to pursue the best interests of the corporation at all times, a controlling stockholder has the absolute right to "just say no" to changes to the status quo.[3] A controlling stockholder never has an affirmative obligation to sell or vote in favor of a change even if the sale or change would be in the best interests of the corporation or the minority stockholders.[4]

Second, if a controller is seeking to change the status quo without giving rise to a non-ratable benefit for the controller, then the applicable duties are of a "do no harm on purpose or recklessly" nature – specifically, a duty not to harm the corporation or its minority stockholders either intentionally or through grossly negligent action.[5] *Sears* sets forth three prongs for testing whether this duty has been satisfied:

1. *Legitimate objective*. Did the controller act in good faith for a legitimate objective (i.e., an objective that the controller believed in good faith would be in the best interests of the corporation and the minority holders)?
2. *Reasonable basis for changing the status quo.* Did the controller have a reasonable basis for believing that its action was necessary to pursue this legitimate objective?
3. *Reasonable means for achieving the objective.* Did the controller select reasonable means to achieve this legitimate objective?[6]

In *Sears*, Vice Chancellor Laster applied this framework to steps that the controlling stockholder, who held more than 50% of the Company's stock (the "Controlling Stockholder"), took to impede the board's proposed plan to liquidate a business segment of *Sears* Hometown and Outlet Stores, Inc. (the "Company").[7] A special committee of the board of the

Company favored the liquidation plan, but the Controlling Stockholder, as characterized by the Court, "thought liquidating [the segment] would destroy value."[8] The Court relates further that, after failing to convince the special committee that the liquidation plan was contrary to the best interests of the Company, the Controlling Stockholder took action by written consent, in his capacity as a majority stockholder, (i) to adopt a new bylaw amendment to impose procedural hurdles (a requirement for two supermajority board votes that were 30 days apart) to impede the adoption by the board of the liquidation plan and (ii) removed two of the directors on the special committee whom the controller believed to be the "most insistent on the liquidation plan" (collectively, the "Actions").[9]

The Court held that even though the Actions did not give rise to any non-ratable benefit to the Controlling Stockholder, these Actions still had to comply with fiduciary duties applicable to actions by a controller that change the status quo.[10] After trial, Vice Chancellor Laster found that the Actions did not violate the fiduciary duties of the controller because the Controlling Stockholder had satisfied each of the three prongs of the applicable fiduciary duty test:

1. The Controlling Stockholder had believed in good faith, based on study and experience, that the liquidation plan would be value-destructive to the Company (i.e., a good faith, legitimate objective).
2. The Controlling Stockholder had identified this threat and the Actions after a good faith, reasonable investigation of the intentions of the special committee and their disregard for the adverse consequences for the Company and the stockholders arising from the proposed liquidation plan (i.e., a reasonable basis for taking action).
3. The Actions were within the "range of reasonableness" for achieving the legitimate objective. The Court viewed the Actions as "drastic but necessary" to achieve the objective, and observed that the Actions were more restrained than alternatives, such as requiring board unanimity for a liquidation and broader changes to the composition of the board.[11]

Key Takeaways

How Hard Is It for Controllers to Satisfy the Sears Framework?

On its face, the *Sears* framework for compliance by controllers with fiduciary duties when they are changing the status quo without receiving a non-ratable benefit for themselves seems relatively easy to satisfy. In these scenarios, any rationally acting, sophisticated controlling stockholder should not have a problem satisfying the first two prongs, which basically amount to having a good faith intention to benefit this corporation which the controller has a vested interest to benefit by virtue of the controller's equity investment.

The third prong – whether the actions by the controller are within the range of reasonableness – echoes the Court's *Revlon* standard for testing whether a fiduciary has taken steps that are within the "range of reasonableness" for obtaining the best price available when selling the corporation for cash consideration. Historically, Delaware Courts have provided a relatively wide berth for fiduciaries to act and still be within the "range of reasonableness" in the context of Revlon and its progeny, and the Court in *Sears* does not appear to be intent on deviating from that trend.[12]

Will Dismissal on the Pleadings Be Available to Controllers Defending Future Sears Claims?

Even if compliance with the *Sears* framework is not burdensome, a pressing question coming out of *Sears*, which is a post-trial opinion, is how fiduciary duty claims brought against a controlling stockholder under this framework will be handled on a motion to dismiss. It would be problematic if every disposition or vote of shares by a controller in a manner that arguably changed the status quo (a potentially elastic concept) were to trigger a risk of a purported class action claim on behalf of the minority stockholders that could not be dismissed on the pleadings.

The Court of Chancery has granted and denied motions to dismiss *Revlon* claims in the past,[13] but, given the lack of case law, it is not clear how it will approach a *Sears* claim at the motion to dismiss stage. On the one hand, *Sears* involves some fact-based inquiries (which the Court may punt to trial) and controlling stockholders are not subject to monetary liability exculpation under Section 102(b)(7) of the Delaware General Corporation Law (and exculpated claims are generally dismissed); but, on the other hand, the bar to fulfilling fiduciary duties under *Sears* is not particularly high.

What Should Controlling Stockholders Do in Light of Sears?

We do not view the *Sears* opinion, by itself, as cause for a seismic shift in how controlling stockholders should interact with their respective companies and minority stockholders. In the wake of this opinion and the risk of heightened attention to scenarios where controllers are merely selling or voting and not even receiving a non-ratable benefit, we are currently advising controllers to adhere to the following protocols:

- *Internal recordkeeping and documentation.* Disciplined recordkeeping and document creation have been, and still are, critical factors to managing litigation risk. Controlling stockholders contemplating sales and votes to change the status quo should ensure that there is a robust paper trail to support their consistent, good faith pursuit of their "legitimate objectives" and "reasonable bases for taking the actions" (i.e., the first two prongs). If a controller is taking stockholder action by written consent, we are advising that the recitals to the consent clearly document the controlling stockholder's rationale, as well as supporting factual understandings, for adopting the resolutions.
- *Board materials.* Board minutes and other board-level materials remain key to defeating a motion to dismiss. Plaintiffs typically build their complaints using documents produced by a company in response to a demand for books and records under Section 220 of the Delaware General Corporation Law, which typically is confined to board-level materials including board minutes. Those documents will essentially serve as the evidentiary record for a defendant for purposes of a motion to dismiss, and therefore detailed board minutes about the controlling stockholder's legitimate objective and reasonable basis for its actions can help establish for the Court that the controlling stockholder fulfilled its fiduciary duties, without having to go through the costly exercise of discovery. One way for the controller to ensure that such details make it into the board and committee minutes is for the controller to meaningfully engage at formal board and committee meetings (including by arranging to attend for portions of meetings as an invited attendee if the controller does not have a representative on the board or committee). As part of this engagement with the board or committee, the controller would go on record at these meetings with explanations of and analytical support for the controller's concerns with the status quo of the corporation, and even provide the board or committee with written materials supporting the controller's good faith understanding of why changes to the status quo would be in the best interests of the corporation and the stockholders generally.
- *Less drastic means.* If a controlling stockholder decides to vote or sell its stock to change the status quo, keep in mind that, even though the "range of reasonableness" test provides a degree of deference to the controlling stockholder, the Court does not grant a controlling stockholder a blank check. If it is practicable to use less drastic means to achieve the controller's objective, then consider doing just that.

Endnotes

[1] — A.3d —, 2024 WL 262322 (Del. Ch. Jan. 24, 2024). The case is currently subject to a motion for reargument (and, eventually, a possible appeal to the Delaware Supreme Court). For Vice Chancellor Laster's personal commentary, dated February 19, 2024, about his opinion in this case, see https://www.linkedin.com/pulse/dispatch-from-tampa-sears-mundane-stockholder-votes-travis-laster-0mcle/.
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[2] *Id*. at *23
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[3] *See id.* ("A controlling stockholder owes fiduciary duties when exercising stockholder powers, but not the same duties a director owes.")
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[4] *Id*. at *25–26.
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[5] *Id*. at *1.
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[6] *Id*. at *30.
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[7] The *Sears* case discusses, among other things, whether the Controlling Stockholder's eventual buyout of the Company, which was not conditioned on a majority of the minority vote, was entirely fair. See id. at *37. This post does not discuss this aspect of the *Sears* opinion.
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[8] *Id*. at *13.
(go back)

[9] *Id*. at *1.
(go back)

[10] *Id*. at *27.
(go back)

[11] *Id*. at *31–34.
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[12] *See, e.g., Lyondell Chem. Co. v. Ryan,* 970 A.2d 235, 242–44 (Del. 2009); *In re Plains Exploration & Prod. Co. S'holder Litig*., 2013 WL 1909124, at *5–7 (Del. Ch. May 9, 2013); *In re Smurfit-Stone Container Corp. S'holder Litig*., 2011 WL 2028076, at *16–24 (Del. Ch. May 20, 2011); *In re Lear Corp. S'holder Litig*., 926 A.2d 94, 97–98, 117–22 (Del. Ch. 2007).
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[13] *See, e.g., In re Mindbody, Inc., S'holders Litig.*, 2020 WL 5870084 (Del. Ch. Oct. 2, 2020) (denying a motion to dismiss with respect to a Revlon claim); *Rudd v. Brown*, 2020 WL 5494526 (Del. Ch. Sept. 11, 2020) (granting a motion to dismiss with respect to a *Revlon* claim).
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