Application of Heightened Scrutiny in the Context of Settlement with an Activist—Ebix

The Delaware courts generally apply the heightened scrutiny standard under *Unocal* to a review of challenged board actions that have been taken in response to a perceived threat that relates to corporate control. Under *Unocal*, the board has the burden of demonstrating that it reasonably perceived a threat, and that its response was neither preclusive nor draconian and was reasonable in relation to the threat. In *In re Ebix, Inc.* (Jan. 15, 2016), the Chancery Court:

- **Reviewed under *Unocal* defensive bylaw amendments adopted by the company.** The court reviewed under *Unocal* the Ebix board’s adoption of defensive bylaw amendments because they were first considered by the board immediately after an activist’s approach—even though they were not adopted until after the activist was no longer an immediate threat because the company had entered into a settlement agreement with the activist that included standstill and voting provisions.

- **Did not review a settlement agreement with the activist (that included standstill and voting provisions) under *Unocal*.** The court did not apply *Unocal*, however, to the board’s decision to enter into the settlement agreement, notwithstanding the clearly defensive effect of the standstill and voting provisions.

**Key Points**

- **Application of Unocal review to the bylaw amendments: Reminder that defensive actions will generally be reviewed under the *Unocal* standard of heightened scrutiny.** The court’s review of the bylaw amendments under the heightened scrutiny of *Unocal* is consistent with the court’s longstanding approach in applying *Unocal* to actions taken by a board as a defensive response to a perceived threat that relates to corporate control. The court considered the bylaw amendments (which restricted shareholder rights to call, and to elect directors at, special meetings) to be a defensive response by Ebix because they (i) were first considered within days after an activist had expressed its intention to launch a proxy contest and (ii) had “clear defensive value.” *Ebix* thus serves as a reminder of the general applicability of *Unocal* to defensive responses—even when, as in *Ebix*, the response is not to an immediate or imminent threat but is to a potential future threat. In *Ebix*, even though the activist was bound under the standstill and voting provisions of the settlement agreement at the time the Ebix board adopted the bylaw amendments, the court applied *Unocal* on the basis that the activist posed a potential future threat because the standstill would expire in two years.
Refusal to apply Unocal review to the settlement agreement: If Ebix is followed, standstill provisions in a settlement agreement with an activist will not invoke heightened scrutiny of the settlement agreement under Unocal—even when there is a clear defensive effect in eliminating the threat of the activist. While acknowledging that the defensive aspect of the Ebix settlement agreement “conceivably” could lead to Unocal review, the court concluded that it would be “counter-intuitive” that a settlement agreement providing for the “giving up of seats” and the relinquishment of a degree of control to an insurgent stockholder should be viewed as a defensive measure. The court considered the standstill and voting provisions to have only an “ancillary” or “collateral” effect. We note that the court’s conclusion in Ebix may be viewed as at odds with the Delaware courts’ (including the Supreme Court’s) prior decisions holding that deal protection provisions in a merger agreement are to be tested under Unocal even if there is no existing competing bid. (The court’s conclusion in Ebix is consistent, however, with its recent trend of rejecting the application of heightened scrutiny, and applying instead business judgment rule deference, to directors’ decisions whenever possible.)

Result with respect to settlement agreement may depend on the facts and circumstances. It remains to be seen how broadly the court’s holding with respect to the settlement agreement will be applied. While the court did not explicitly address the issue in Ebix, the reasoning in the opinion appears to suggest that there could be some point at which the defensive protections included in a settlement agreement (considered in the context of the external factors confronting the board, such as interest in the company by activists) would so outweigh the concessions to the activist that a court might infer that the directors were motivated primarily by defensive concerns, triggering review of the settlement agreement under Unocal.

Background

Activist investor Barrington Capital threatened a proxy contest to nominate and elect a number of Ebix, Inc. directors. Within days thereafter, Ebix prepared, and the board considered, a package of defense-related bylaw provisions—including provisions permitting the board to delay special shareholder meetings for up to 120 days and, under certain circumstances, to prevent the election of directors at special meetings. Soon thereafter, Ebix and Barrington entered into a director nomination settlement agreement under which Ebix agreed to nominate and support two Barrington nominees and Barrington agreed to standstill and voting provisions for a two-year period. After the parties had entered into the settlement agreement, the board adopted the bylaw amendments. Shareholders brought suit, claiming that the directors had breached their fiduciary duties, on the basis that the bylaws, and also the settlement agreement (because of the standstill and voting provisions), were “entrenchment devices.”

At the motion to dismiss stage of the litigation on these claims, Vice Chancellor Noble reviewed the board’s decision to adopt the bylaw amendments under Unocal and refused to dismiss the bylaw-related claims. The Vice Chancellor rejected the plaintiffs’ argument that Unocal should apply also to the board’s decision to enter into the settlement agreement, however, and instead applied the business judgment rule and dismissed the settlement agreement-related claims.
Practice Points

- **Consider the extent of the defensive aspects of a settlement agreement.** Because the court viewed the defensive effect of the standstill and voting provisions in the settlement agreement as “ancillary” to the essential nature of the agreement, and viewed the essential nature of the agreement as a relinquishment of a degree of control to an insurgent stockholder, the court did not apply *Unocal* review to the settlement agreement. A board should evaluate the extent of the defensive effects of a settlement agreement, so that restraints on potential control changes would not be regarded by the court as defining the primary nature of the agreement. As noted, the result in *Ebix* with respect to the settlement agreement may be viewed as inconsistent with the Delaware courts’ longstanding approach of reviewing deal protection provisions included in a merger agreement under *Unocal*, although they are clearly not the primary purpose of the merger agreement. We note further, however, and emphasize, that in our view, even if *Unocal* were to be held to apply to a settlement agreement that removed an activist as a threat to control of the company, the courts could well view the settlement agreement as a reasonable response in avoiding the cost and burden of a contest with the activist. Once a court concludes that the directors’ response to a threat was reasonable, business judgment rule deference then applies.

- **Reminder of the court’s skepticism of defensive provisions that affect the stockholder franchise.** As long noted, the court disfavors actions that restrict the basic right of stockholders to vote. In *Ebix*, the Vice Chancellor characterized the numerous bylaw amendments as generally “achieving little more than making shareholder action more cumbersome [or] inconvenient.” However, the court viewed the amendments that permitted the board to delay special shareholder meetings for 120 days and, in effect, to prevent the election of directors other than at annual meetings, as having “clear defensive value.” The Vice Chancellor noted that the court had applied *Unocal* in other cases to special meeting delay periods of *less than* 120 days.

- **Another context in which “knowing your activist” is important.** *Ebix* provides another example of why it is important that a company that has been approached by an activist understand the particular nature, history and modus operandi of that activist. In *Ebix*, when the court inferred from the pled facts that the board could have been responding to a perceived threat when it adopted the bylaw amendments even though at the time of adoption Barrington was already bound by a two-year standstill, the court noted Barrington’s “known future capacity for re-initiating dissident behavior.” The opinion thus suggests that, when applying *Unocal* to defensive action taken after an activist has entered into a standstill of some duration, the court might apply a lower burden for establishing the reasonableness of the action if the activist has a reputation for only *short-term* interest in its targeted companies. (We note that a lower burden might also be applied if other activists have a reputation for following that activist’s approaches with approaches of their own, or if other activists in fact are surrounding the target.)

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