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A quarterly round-up of key M&A/PE developments

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A Focus in Delaware on Contract Interpretation Cases

The plethora of Delaware decisions that transformed Delaware law in recent years by narrowing the routes to successful challenge of directors' compliance with their fiduciary duties has now been supplanted by an abundance of contract interpretation decisions. These decisions emphasize the longstanding Delaware principles of freedom of contract and adherence to the precise terms of an agreement. They underscore the critical need for clarity in drafting, including with respect to standard language commonly used in agreements. As discussed further below, the decisions issued in the past quarter are instructive with respect to drafting issues relating to the following:

- ***Privileged Communications*** – *Shareholder Representative Services*, relating to the preservation, post-merger, of a seller's privilege with respect to pre-merger attorney-client communications;
- ***Earnouts*** – *Windy City v. TIAA*, suggesting the desirability of specifically covering all reasonably anticipated developments in connection with a complex earnout calculation;
- ***Damages*** – *Leaf Invenergy*, relating to the measure of damages when an agreement provides for payment of a specified amount upon the occurrence of a specified action without consent and the action is later taken without consent and the payment is not made; and
- ***Indemnification Notice*** – *NASDI Holdings*, relating to the interpretation of an indemnification notice deadline provision.

We also discuss *PLX Technology*, where the Delaware Supreme Court upheld a Chancery Court ruling that no damages flowed from a board's fiduciary breaches in a sale where the deal price likely exceeded the standalone value and no higher bidders emerged; and *Emulex v. Varjabedian*, where the U.S. Supreme Court declined to rule on whether a private right of action exists under Section 14(e) for deficient disclosure in tender offers.

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Merger Agreement Provisions Can Preserve the Sellers' Privilege With Respect to Pre-Merger Attorney-Client Communications (Such as Emails) Even If They Were Physically Transferred To the Buyer at Closing—Shareholder Representative Services v. RSI Holdco

In *Shareholder Representative Services LLC v. RSI Holdco, LLC* (Del. Ch. May 29, 2019), the Delaware Court of Chancery addressed the scope of merger agreement provisions that seek to preserve, post-closing, the pre-merger privilege of the sellers with respect to communications with legal counsel relating to the negotiation of the transaction so that the acquiror cannot use them in post-merger litigation against the sellers. The issue is most relevant in transactions involving private companies or going private deals where the privilege can remain with the sellers or be assigned to a sellers' representative. *Shareholder Representative Services* highlights that the express terms of a merger agreement are the key to ensuring post-closing preservation of the privilege for communications between the target's legal counsel and the target, its directors, officers and selling shareholders.

This issue was last addressed by the court in *Great Hill* (Del. Ch. 2013), where, post-closing, a buyer discovered pre-merger privileged emails between the selling shareholders and the target's legal counsel on the acquired company's computer systems. The court held in *Great Hill* that the acquiror could use the emails as evidence in post-closing litigation against the sellers because, in the merger, *all* assets and rights, including the privilege over pre-merger communications, passed to the surviving corporation. The court stated further, however, that "the answer to any [sellers] worried about facing this predicament in the future is to use their contractual freedom…to exclude from the transferred assets the attorney-client communications they wish to retain as their own." The court found in *Great Hill* that the sellers had *neither* (a) negotiated for language in the merger agreement preserving the right to assert privilege over the communications *nor* (b) had prevented the acquiror from taking actual possession of the pre-merger communications. Following *Great Hill*, many private company merger and stock purchase agreements have expressly provided for preservation of the selling shareholders' privilege with respect to pre-merger communications between the target and counsel.

In *Shareholder Representative Services*, the acquiror had obtained possession of approximately 1,200 emails between the target company and its legal counsel that were stored on the target's computers and email servers. About two years after the closing, the plaintiff (the sellers' representative) brought suit alleging that the acquiror had breached the merger agreement by failing to pay a "holdback" amount withheld from the purchase price to account for post-closing purchase price adjustments and indemnification claims. The acquiror sought to use the target's pre-merger emails as evidence in the litigation. The merger agreement included a typical post-*Great Hill* clause purporting to preserve the sellers' privilege with respect to pre-merger communications with counsel. The acquiror argued that the sellers had waived the privilege, however, because they had taken no action to prevent the acquiror from actually taking possession of the emails (such as by segregating or excising them pre-closing or demanding their return post-closing).

Vice Chancellor Kathaleen S. McCormick held that the merger agreement language, which plainly provided that the acquiror would not use or rely on any pre-merger privileged communications, was sufficient to preserve the privilege even though the emails had been physically delivered to the acquiror at the closing. The Vice Chancellor added that the waiver argument itself failed because the merger agreement also provided that the parties would "take the steps necessary to ensure that any privilege attaching as a result of [the target company's law firm] representing [the target company]…in connection with the [merger] shall survive the Closing…and be assigned to and controlled by [the selling shareholders' representative]." The court reasoned that the acquiror could not claim the benefit of any waiver of privilege to which it itself had contributed by breaching its specifically agreed obligation to take "steps" to preserve it.

Accordingly, sellers should ensure that a merger agreement expressly and clearly provides for (i) preserving, post-closing, the privilege attached to pre-merger communications, (ii) assigning control of that privilege (for example, to the selling stockholders' representative), (c) precluding the acquiror from using the privileged communications in post-closing litigation against the sellers, and (d) requiring the parties to take all steps necessary to ensure that the privilege remains in effect post-closing. In addition, sellers should consider deleting privileged communications from the company's email servers prior to closing or requesting their return after closing.

Court of Chancery Finds Earnout Calculation Provisions Ambiguous —Windy City v. TIAA

In *Windy City Investments Holdings, LLC. v. Teachers Insurance and Annuity Association of America* (May 31, 2019), the Delaware Court of Chancery found that the meaning of the earnout provisions disputed by the parties was ambiguous. As neither party provided "the only reasonable interpretation" of the provisions, the court rejected the defendant's motion to dismiss at the pleading stage. The case is another reminder of the challenges associated with drafting unambiguous earnout provisions given complexities relating to the underlying business and/or method of computation.

The transaction involved the purchase by TIAA of one of the Windy City's independent mutual funds and advisory firms (Nuveen). In addition to an initial purchase price payment of $6.25 billion, the parties agreed that Windy City could receive an earnout payment, based on Nuveen's "profitability," of between $45 million (if the specified floor targets were met) and $278 million (if the specified caps were met).

The agreement provides that:

- The earnout is based on performance benchmarks derived from Nuveen's "Cumulative Advisory Revenues" and "Net Flows" during the almost four year-long earnout period.
- Cumulative Advisory Revenues is defined as "the cumulative advisory revenues of the Subject Companies,… derived from all assets managed or distributed by the Subject Companies, provided that [it] shall (i) include only 50% of cumulative advisory revenues of the Subject Companies derived from assets that are advised by TIAA-CREF or products that are distributed through TIAA-CREF captive channels… and (ii) exclude all cumulative advisory revenues of the Subject Companies derived from general account assets of TIAA-CREF."
- Net Flows is defined as the excess of all additions to assets under management by the Subject Companies over withdrawals (subject to specified exclusions). However, it will (i) "include only 50% of assets added or withdrawn that are third-party assets advised by TIAA-CREF or third-party products distributed through TIAA-CREF captive channels and (ii) exclude all assets added or withdrawn that are general account assets of TIAA-CREF.
- The floor and cap amounts are adjusted (upward or downward, respectively) "in the event of acquisitions or dispositions" from non-TIAA affiliated parties. (As the court noted, the agreement does not provide for any adjustments in the event of acquisitions or dispositions between Nuveen and TIAA's affiliates.) If TIAA sells or disposes of all or substantially all of Nuveen's businesses or assets, the maximum earnout will be paid.
- TIAA agrees not to take "any action the intent of which is to reduce the Earn-out Amount."
- TIAA will provide Windy City with a written statement setting forth the relevant calculations; and Windy City can dispute the statement within 60 days. Each party will "cooperate with the other in all commercially reasonable respects in Seller's review of, and the resolution of any dispute with respect to" the earnout amount, "including by providing… reasonable access to relevant personnel (including its accountants), work papers and books and records related to the Subject Companies…."
- If a dispute over the earnout amount cannot be resolved, it will be submitted to an impartial "referee" for final resolution. However, with respect to any disputed contract terms, the parties must first seek judicial interpretation and the referee will be bound thereby when making the computation.

After the closing, TIAA began to market its funds through Nuveen's brand and distribution networks. Nuveen started to offer not only funds that it advised but also TIAA-advised funds. Through Nuveen's sales force and distribution, TIAA was able to generate "substantial" advisory revenues and net flows. TIAA's earnout statement to Windy City calculating the earnout gave 100% credit for Nuveen's advisory revenues and net flows generated from providing investment advisory services, 50% credit for revenues and flows on which TIAA or Nuveen served as sub-advisor to the other, and 50% credit for revenues and flows that were advised by Nuveen and distributed through TIAA's captive channel.

The parties' dispute centers on how to treat financial products that Nuveen distributed, but did not advise—that is, under the definitions of Cumulative Advisory Revenues and Net Flows, whether revenues or flows advised or managed solely by TIAA, but distributed through Nuveen, generate credit in the earnout calculations. Windy City believed that it receives 50% credit for all such gains, while TIAA believed that Windy City receives credit only where Nuveen advised on the financial products.

TIAA focused on the opening words of the definition—"Cumulative Advisory Revenues means the cumulative *advisory revenues* of the Subject Companies" (italics added). First, TIAA read these words to limit Cumulative Advisory Revenues to revenues derived from the Subject Companies' *advisory* work, not mere distribution. Second, TIAA construed "assets that are advised by [TIAA]," which generate 50% earnout credit, to refer to the industry practice of sub-advising arrangements, or joint advising by primary and secondary advisors, between TIAA and Nuveen. With respect to the first point, the court wrote: "This [interpretation] is intuitive for that particular phrase, but requires a strained reading of nearly everything else in the definition." That second point, the court stated, "demands extrinsic evidence and divergence from the plain meaning to read language giving Earn-out credit for Nuveen's distributions as actually referring to a niche class of 'wrap fee' products [and] inserts the concept of sub-advising into the definition's reference to assets advised by TIAA" (which is "problematic" because the term "sub-advising" was used elsewhere in the agreement but not in this definition).

Windy City focused instead on the language in the definition that stated that Cumulative Advisory Revenues are "derived from all assets that are managed *or distributed* by the Subject Companies" and that 50% credit is given for Cumulative Advisory Revenues "derived from assets that are advised by TIAA-CREF or products that are *distributed* through TIAA-CREF captive channels" (italics added). The court stated that Windy City's construction "brings more intuitive readings" of the phrases relating to "distribution," but Windy City "stretches the 'cumulative advisory revenues of the Subject Companies' language to mean something more like revenues that involve advising and some participation from the Subject Companies."

The court concluded that neither interpretation was "perfect," as both "require[d] the Court to minimize deliberately placed language or, in some cases, import extra-contractual concepts to reconcile that language." Because neither party provided "the only reasonable interpretation" of the agreement, the court rejected the motion to dismiss.

The court also refused to grant TIAA's motion to dismiss the plaintiff's claim for TIAA's breach of the agreement in connection with the disposition of certain businesses allegedly in a manner intended to improperly depress the earnout amount payable. Finally, based on the "broad" agreement language providing for the parties' "commercially reasonable cooperation" with respect to calculating the earnout, the court rejected TIAA's motion to dismiss the plaintiff's claim for access to books and records it had requested but not received in connection with the calculation.

Damages for Breach of a Required Payment is the Amount Not Paid Rather than the Actual Harm Caused—Leaf Invenergy v. Invenergy Renewables

In *Leaf Invenergy Company v. Invenergy Renewables LLC* (May 3, 2019), the Delaware Supreme Court reversed the Court of Chancery's award of nominal damages ($1) to an LLC member for the company's breach of the LLC agreement and instead awarded damages of $126.1 million. The decision underscores the ambiguity that can arise with respect to provisions that require consent of an LLC member (or, in the context of other entities, a partner or stockholder) for the company to take certain action unless the company pays the party a specified amount. The decision once more serves as a reminder of the need for clarity in the drafting of these provisions.

The Supreme Court held that the amount of damages from breach of a provision that requires payment of a specified amount is equal to the unpaid amount, and not the "actual harm" to the non-breaching party. The opinion suggests that this should always be the result where (a) an agreement unambiguously provides for payment of a specified amount upon the occurrence of a specified action without consent and (b) the action is later taken without consent and the payment is not made. (We note that, in the context of a provision that does not provide for payment of a specified amount, the approach the Court of Chancery took—that is, basing damages on the actual harm to the nonbreaching party—should be applicable.)

The decision highlights that drafters of agreements should seek to ensure clarity in provisions that require consent unless a specified payment is made. Care should be taken to clearly reflect the parties' intentions with respect to both (a) whether a failure to obtain consent triggers a payment obligation and (b) if so, and if the payment is not made, what the measure of damages would be—the unpaid amount or the actual harm.

Court of Chancery Decides Indemnification Case Based on the Word "But"—Drafting Points for Indemnification Provisions of a Purchase Agreement—NASDI Holdings v. North American Leasing

In *NASDI Holdings, LLC v. North American Leasing, Inc.* (Apr. 9, 2019), the Delaware Court of Chancery interpreted an indemnification notice deadline provision in a purchase agreement as not applying to the plaintiff's indemnification claim. The court therefore granted summary judgment to the plaintiff-seller on its claim that it was entitled to indemnification.

The decision, written by Vice Chancellor Kathaleen McCormick, is notable, first, as a reflection of the Vice Chancellor's views with respect to interpretation of certain words and phrases in indemnification provisions. Second, the decision serves as a reminder for drafters that apparently clear agreement language can be *un*clear in terms of its interrelationship with other provisions of the agreement–and that the drafting of a provision that relates to indemnification claims (such as, in *NASDI*, the indemnification claims notice provision) should be clear as to whether the provision covers claims relating to breaches of *representations and warranties*, or to breaches of *covenants*, or to *both*. Third, the decision appears to reflect that the court will tend not to stretch to interpret an agreement in favor of a party whose offending conduct led to the dispute—and, indeed, may stretch to interpret ambiguous language against such a party. (While the court characterized the agreement language at issue as "clear [and] unambiguous," in our view the language appears on its face to have been ambiguous.) Finally, as discussed further below, the opinion highlights the potentially ambiguous nature of the phrases "in any event," "but in any event," and "provided that"—and serves as a reminder to drafters that, even in the case of commonly used phrases, supplemental language may be necessary to clarify the meaning.

Background. In 2014, North American Leasing (the "Purchaser") acquired the demolition and site-redevelopment business (the "Company") of NASDI Holdings (the "Seller"). As part of the purchase, the Purchaser took control of the Company's ongoing construction projects, including work under a $20 million subcontract on the Bayonne Bridge between New York and New Jersey. The Company was required to obtain payment and performance surety bonds for the project. Moreover, the purchase agreement provided that, after the closing, the Seller was required to maintain those bonds, secured by a letter of credit. In exchange, the Purchaser agreed to indemnify the Seller for any losses incurred in connection with the bonds or the letter of credit. After the closing, in 2017, the Company "walked off the Bayonne Bridge job." As a result, the surety drew more than $20 million on the Seller's letter of credit. The Seller demanded indemnification from the Purchaser for the loss; the Purchaser refused; and the Seller brought this suit.

The purchase agreement provisions. The purchase agreement provides as follows:

- Section 9.3(a): To receive indemnification, an indemnitee must provide notice of a claim:

  > [1] within a reasonable time after such Indemnitee becomes aware of the existence of [the] potential Claim…, [2] but in any event before the later of the Termination Date [(March 16, 2016)] or the survival period provided in Section 9.5 with respect to [the] particular representation and warranty to which the matter applies….

- Section 7.7: The Seller will maintain the surety bonds and letter of credit until a specified date (defined as the "Bond Covenant Termination Date") or when the sureties are no longer required by the underlying projects.
- Section 9.2: The Purchaser will indemnify the Seller for seven types of "Losses." The fifth type of Loss, set forth in Section 9.2(e), is Losses relating to the surety bonds or the letter of credit.

The conflicting interpretations of the indemnification notice provision. The Purchaser argued that Section 9.3(a) means that *all claims* for indemnification must be made within a "reasonable time" and that *no claim* for indemnification (whether for breach of a representation or warranty or for breach of a covenant) may be made after the Termination Date (with the only exception to the Termination Date deadline being for a claim for breach of any representation and warranty for which the agreement provides a survival period beyond that date). As the loss under the letter of credit was not incurred until after the Termination Date, the claim was time-barred, according to the Purchaser. The Seller argued that Section 9.3(a) means that indemnification claims for breaches of *covenants* must be made within a "reasonable time" and claims for breaches of *representations and warranties* must be made by the Termination Date (unless the agreement provides a survival period beyond that date).

The court's interpretation based on the agreement language. The court agreed with the Seller's interpretation. The court characterized the language at issue as "clear [and] unambiguous." Although it is difficult to reach a firm conclusion without a review of the full language of the purchase agreement, we observe that, arguably, the "plain reading" of Section 9.3(a) is consistent with the Purchaser's interpretation—given that, in the provision, the drafter did not expressly distinguish between indemnification claims relating to breaches of representations and warranties as opposed to breaches of covenants. The court explained its conclusion in a discussion that focused on the difference between an "exception" versus a "qualification" to preceding text—and a view that the phrase "but in any event" in clause [2] of Section 9.3(a) reflects that clause [2] provides an *exception* to the "reasonable time" requirement of clause [1], while the phrase "in any event" (without the word "but") would have reflected instead a *qualification* to the "reasonable time" requirement. According to the court, clause [2] *excepted out* of the reasonable time requirement claims relating to breaches of representations and warranties—and, therefore, clause 1 applies to claims for breaches of covenants and clause 2 applies to claims for breaches of representations and warranties (with the result that the Termination Date deadline does not apply to breaches of covenants). If clause [2] were instead a *qualification*, according to the court, it would mean that all claims were subject to clause [1] and no claim could be made after the Termination Date (unless it related to a breach of a representation with a longer survival period).

The court's interpretation based on "the purpose of indemnification." The court wrote: "By zeroing in on the words 'in any event,' the [Purchaser] lose[s] sight of the purpose of the indemnification provisions as a whole. That purpose was to indemnify [the Seller] for seven types of 'Losses' set forth in Section 9.2" (the fifth one of which was Losses relating to the bonds or letter of credit). By interpreting clause [2] as terminating the Seller's right to indemnification relating to the letter of credit "before [the Purchaser's] obligation to maintain the Letter of Credit ceases, [the Seller] undermines the purpose of the indemnification provisions." The Vice Chancellor reasoned that the "structure" of the language in clause [2] "roughly parallels" the provisions of Section 9.5 which govern the survival of the representations and warranties. Under Section 9.5, the representations and warranties survive until the Termination Date, but with two exceptions: certain specified representations survive indefinitely and other specified representations survive for the full period of the applicable statutes of limitations plus 60 days. The Vice Chancellor observed: "The language of [clause [2] of the indemnification notice provision] ties to the default (the 'Termination Date') and the exceptions ('the survival period provided in Section 9.5')." She concluded: "In sum, the purpose of [clause 2] is to ensure that [the Seller is] able to notice indemnification claims relating to the representations and warranties for the life of those representations and warranties, not to cut short indemnification rights relating to the Letter of Credit."

Practice Points

- **Need for clarity in the drafting of agreements, including with respect to the interrelationship of provisions.** Although obvious, it cannot be emphasized enough that drafting must be as clear as possible. A common area of ambiguity is how separate agreement provisions interrelate with each other. As illustrated by *NASDI*, when a provision relates to "indemnification," the provision should be clear as to the extent to which it covers *all* indemnity claims (*i.e.*, for breaches of representations and warranties *and* breaches of covenants) and the extent to which it covers only claims for breaches of representations and warranties. Also, when a covenant includes provision for indemnification, it should be clear whether the *general* indemnification provisions (for example, with respect to notice requirements and deadlines) do or do not apply. The *NASDI* agreement provision at issue could have easily been clarified to mean what the court concluded it meant, by adding the following bolded language:

  [To receive indemnification, an indemnitee must provide notice of a claim] within a reasonable time after such Indemnitee becomes aware of the existence of [the] potential Claim…, but, **in the case of claims relating to breach of a representation or warranty, the notice must be provided** in any event before the later of the Termination Date or the survival period provided in Section 9.5 with respect to [the] particular representation and warranty to which the matter applies….

- **Clarity in drafting indemnification provisions.** We offer the following suggestions:

  - The drafting of indemnification provisions (and, when an indemnification claim arises, the notice of the claim) should be reviewed by litigators familiar with the transaction.

  - If there are particular areas of importance, concern or uncertainty, it can be useful to specify in the agreement, for the avoidance of doubt, how that issue would be handled. It can also be useful to provide hypothetical examples to illustrate how the parties intend certain provisions to operate.

  - An agreement should clearly specify with respect to any provisions relating to indemnification whether they apply to indemnification for breaches of representations and warranties, or to breaches of covenants, or to both. The time periods for survival of each representation and warranty and each covenant, and the notice period for each, should clearly reflect the business arrangement between the parties.

  - Of course, a party may decide to accept ambiguity in an agreement when it believes that it cannot achieve in negotiations clarity that would be in its favor.

- In *NASDI*, Vice Chancellor McCormick's interpretation of the indemnification provisions was based on her views that:

  - The word "but" generally indicates an *exception* to the text before it rather than a *qualification*. Thus, the phrase "in any event" generally indicates a *qualification* to the' text before it, while the phrase "*but* in any event" generally indicates an *exception*. (As discussed above, the court's holding in *NASDI* was based in large part on the court's interpretation of clause [2] of the notice indemnification provision (which began "but in any event") as constituting an *exception* to, rather than a *qualification* of, the "reasonable time" requirement in the first clause of the provision.)

  - The phrase "in any event" is more precise than "provided that." The court cited an article that (a) states that "using *provided that* is an imprecise way to signal the relationship between two conjoined contract provisions" and (b) recommends the use of *in any event* instead of *provided that* "to impose a limitation."

- **Parties should think through, and clearly and specifically address in the purchase agreement, which party will have what responsibility with respect to long-term or problematic ongoing projects (debts or other liabilities) of the acquired company.** For example, in *NASDI*, in lieu of the agreement that the Seller would maintain the surety bonds (and the Purchaser would indemnify the Seller for any losses under the bonds), the parties could have agreed that the Purchaser was required to provide substitute surety bonds, with the Seller released from liability. To the extent that bonds (or other liabilities) are not replaceable or otherwise transferable in a deal, possible alternatives would include (i) changes in the purchase price, (ii) back-to-back bonds or other financing (in other words, if the purchaser cannot be substituted for the seller, the purchaser would obtain mirror surety that would reimburse the seller if the seller has liability under its bonds), or (iii) as in *NASDI*, indemnification.

Court of Chancery Interprets LLC Agreement Transfer Provision Based on Use of the Word "Void" Rather than "Voidable"—Absalom v. Saint Gervais

In *Absalom Absalom Trust v. Saint Gervais LLC* (June 27, 2019), the Court of Chancery held that the transfer of an LLC interest that was prohibited under the LLC Agreement would have been subject to equitable defenses if the transfer restriction provision had stated that a prohibited transfer would be "*voidable*"—but that, in this case, no equitable defenses are available because the LLC Agreement provides that a prohibited transfer would be "*void*." The LLC Agreement provides that any disposition of an interest in the LLC without the written consent of the managers is "null and void." An LLC member had assigned her interest to the plaintiff without the managers' written consent. In this action, the plaintiff sought to inspect books and records of the LLC to investigate possible mismanagement by the managers. The managers argued that the plaintiff has no inspection right as he is not a member given that the transfer to him is void. The plaintiff argued that the LLC is estopped from asserting that the transfer is void given that the LLC had provided him with some books and records, had issued Schedule K-1 tax forms to him, and had referred to him as a member in some trial papers, all without reserving the right to contest his status as a member.

Vice Chancellor Tamika Montgomery-Reeves held that, based on the LLC Agreement language, the transfer is void and the plaintiff is not a member. The Vice Chancellor stated that equitable defenses can validate "voidable" acts but not "void" acts. While the transfer likely would have been only "voidable" (not "void") under the common law and thus would have been subject to equitable defenses, the "clear and unambiguous language" of the LLC Agreement "trumps the common law." She cited *CompoSecure L.L.C. v. CardUX, LLC* (2018), where the Delaware Supreme Court considered an LLC Agreement that defined "Restricted Activities" as "void and of no force or effect" and held that such acts were therefore "*ultra vires* and generally cannot be ratified." As the Supreme Court held in *CompoSecure*, she wrote, "by using the word 'void' in [the] LLC agreement, the parties to the agreement adopted the common law rule and foreclosed the application of equitable defenses."

Practice Points. (i) LLC managers generally should seek to define restricted activities as "void" (rather than "voidable") to limit the availability of equitable defenses. (ii) Where an LLC member agrees to transfer her LLC interest and there are restrictions in the LLC Agreement that may be applicable, the transferee may wish to seek a contractual commitment from the transferor that she will enforce any member rights that she retains and that are not available to the transferee. At the same time, an LLC may wish to specify in the LLC Agreement that, in the event of a prohibited transfer, the transferor cannot act on behalf of the transferee (for example, by sharing with the transferee information obtained in a books and records inspection).

Delaware Supreme Court Upholds Court of Chancery Ruling that No Damages Flowed from Fiduciary Breaches in a Sale Where the Deal Price Likely Exceeded the Standalone Value and No Higher Bidders Emerged—PLX Technology

In *In re PLX Technology Inc. Shareholders Litigation* (May 16, 2019), the Delaware Supreme Court affirmed the Delaware Court of Chancery's post-trial decision that an activist stockholder had aided and abetted a breach of fiduciary duties by the target company directors that was predicated on the board having succumbed to the stockholder's pressure to effect a quick sale of the company. (The Court of Chancery in addition had suggested, in *dicta*, that the target's financial advisor likely also had aided and abetted the breach.) Further, however, the Court of Chancery had held that the plaintiffs did not prove that damages had flowed from the breach. The Court of Chancery had reasoned that the deal price likely exceeded the standalone value and no higher bidders had emerged. Thus, Vice Chancellor Laster had entered judgment in favor of the defendant activist stockholder. On appeal, the plaintiffs contended that the Court of Chancery had erred in deciding the damages issue by importing from appraisal jurisprudence the principle of deference to the deal price. In a summary order, the Delaware Supreme Court affirmed the Court of Chancery's decision that "the plaintiff-appellants did not prove that they suffered damages." The Supreme Court expressly declined to address the defendant's arguments on cross-appeal that it had not aided and abetted any breaches of fiduciary duty. The Supreme Court wrote that its affirmance on the damages issue "suffices to affirm the judgment." See the Fried Frank Briefing (relating to the Oct. 16, 2019 Court of Chancery decision), *Series of Avoidable Missteps by an Activist Stockholder and the Target Board Led the Court of Chancery to Find Fiduciary Breaches and Stockholder Aiding and Abetting in Connection With the Sale of a Company.*

U.S. Supreme Court Does Not Rule on Whether There Is a Private Right of Action for Disclosure Failures in Tender Offers—Emulex v. Varjabedian

In *Emulex* v. *Varjabedian* (Apr. 23, 2019), following oral argument before the U.S. Supreme Court on the fundamental question whether a private right of action exists under Section 14(e) of the Securities Exchange Act for misstatements or omissions made in connection with tender offers, the Supreme Court issued a one-line *per curiam* order that dismissed the *writ of certiorari* on the basis that it had been "improvidently granted." The dismissal leaves open the questions (i) whether a private right of action exists under Section 14(e) and (ii) whether a claim based on false statements or omissions under Section 14(e)—whether by private plaintiffs (if a private right of action exists) or by the SEC (if a private right does not exist)—requires proof only of negligence (as was recently held by the Ninth Circuit) or also requires proof of scienter (*i.e.*, intentional wrongdoing) (as other Circuits historically have held).

Of note, it appeared at oral argument on April 15, 2019 that a majority of the Supreme Court justices were highly skeptical that there is an implied private right of action under Section 14(e). Speculation has been that the Court likely dismissed the case

because Emulex, prior to petitioning for rehearing before the Ninth Circuit, had not raised the issue of whether a private right of action exists under Section 14(e). Thus, the Court may agree to hear and decide in the future a case without that procedural complication. In the interim, defendants in Section 14(e) actions should be careful to make and preserve the argument that no implied private right of action exists under Section 14(e).

We note that Section 14(e) applies only to tender offers and not to mergers or other transactions not involving a tender offer. We also note that a private right of action has been recognized under Section 14(a), which is the provision that governs proxies.

Court of Chancery Observes that a Company's Positive Violation of Law (or a Consent Decree) Helps to Support Shareholder Caremark Claims — Facebook

In *In re Facebook, Inc. Section 220 Litigation* (May 30, 2019), the Delaware Court of Chancery held in favor of Facebook, Inc. shareholders who were seeking to review certain books and records of the company in connection with the 2016 Cambridge Analytica data breach. The shareholders were seeking inspection of the books and records to bolster breach of fiduciary duty claims that they made in pending derivative shareholder litigation. According to the court, the company knew as early as 2015 that Cambridge Analytica, a British political consulting firm, had misappropriated potentially millions of Facebook users' data, but the company "did not disclose this security breach to its users upon discovery or at any time thereafter" and users "first learned of the breach when they read or heard about it in the news" in 2018. The company's stock price then dropped 19% ("wiping out" $120 billion of shareholder wealth)—"one of the sharpest single-day market value declines in history," the court noted. Vice Chancellor Slights found that the shareholders had met their burden of proof of demonstrating a "credible basis" from which the court could infer that "mismanagement, waste or wrongdoing" occurred at the board level that permitted the data breaches to occur. The court observed that the "credible basis" standard applicable in a Section 220 action "imposes the lowest burden of proof known in our law," while a *Caremark* claim implicates a high burden of proof (including evidence of bad faith) and "is possibly the most difficult theory upon which a plaintiff might hope to win a judgment." The court emphasized that the decision in this Section 220 action involved no "merits assessment" of the *Caremark* claim.

The decision is of interest for the court's observation that a company's positive violation of law, a regulatory mandate or a consent decree, will bolster a *Caremark* claim by shareholders against the board. The court noted that, at the time of the data breach, the company was subject to a Consent Decree under which it had agreed (and so was "under a positive obligation to take specific steps") "to protect its users' private data." The court noted that Delaware courts generally view "stockholder allegations that a board failed to oversee the company's obligation to comply with positive law, or positive regulatory mandates, more favorably in the *Caremark* paradigm than allegations that a board failed to oversee the company's efforts generally to avoid business risk." By providing "some evidence" that the board failed to oversee Facebook's compliance with the Consent Decree resulting in unauthorized access to its users' private data and attendant consequences to the Company," the plaintiff-shareholders "sustained their minimal burden to demonstrate a credible basis of wrongdoing justifying the inspection of certain of the Company's books and records," the court wrote.

The court also rejected the company's "implicit suggestion" that the court could not decide the books and records issue without first deciding whether there was sufficient evidence to justify the *Caremark* claim. The low burden to justify a books and records request is not "altered" by the higher standard of proof applicable to a *Caremark* claim, the court stated.

Among the company actions that the court noted were the following: (i) The company discovered the Cambridge Analytica data breach in 2015 "but elected not conduct an audit concerning the scope of that breach." (ii) The company did not notify the FTC "or any other outside party of the massive intrusion into its users privacy data." The company provided the personal data of its users to many third parties, without informing its users that it was doing so (even though most of them had not given permission for their data to be shared) and without "monitor[ing] the behavior of these third parties" with respect to use of the data to which they were allowed access. (iii) The company's key executives told the Chief Security Officer not to provide certain information to the board about various issues relating to the company's alleged failures to comply with obligations imposed on it. (iv) Various governmental agency investigations uncovered improper policies and procedures at the company and likely violations of the Consent Decree.

New Regulatory Regime to Review Transactions Involving Foreign Information and Communications Technology Could Have Wide Reach

On May 15, 2019, President Donald Trump issued an "Executive Order on Securing the Information and Communications Technology and Services Supply Chain." The Order creates a new regulatory framework that the Department of Commerce (DOC) must implement by October 12, 2019. Once implemented, the DOC, in consultation with other federal agencies, will be able to block (or permit or permit subject to risk mitigation conditions) any type of transaction involving information and communications technology or related services (ICT) provided by a "foreign adversary" that poses an "undue" or "unacceptable" risk to the national security of the United States.

The Order states that it applies to transactions that "[were] initiated, [are] pending, or will be completed after [May 15, 2019]." It is unclear whether the implementing regulations will apply the Order to transactions initiated, pending or to be completed after that date but before the regulations are issued. The Order does not (and presumably the DOC regulations will) define which countries are "foreign adversaries" for these purposes.

While it is generally believed that the Order is focused on China (and, especially, on Huawei Technologies, the largest communications equipment company in the world), the broad language potentially covers a very wide range of transactions. Notably, the Order complements existing regulatory regimes established under the Export Administration Regulations (EAR) administered by the DOC and the foreign investment regime administered by the Committee on Foreign Investment in the United States (CFIUS). In fact, the EAR and CFIUS are both in the midst of rulemaking processes to implement statutory reforms aimed at strengthening regulatory controls with respect to China. Accordingly, the potential applicability of the Order,and its relationship to the EAR and CFIUS, should be taken into account in connection with foreign transactions involving ICT. While the Order permits the implementing regulations to provide various exclusions and licensing procedures that would narrow the scope of the required DOC reviews and prohibitions, the potential reach of the new regime could be quite broad given the widespread use in the U.S. of ICT equipment from China (including equipment made by U.S. subsidiaries of Chinese companies and equipment developed or manufactured by U.S. companies in China).

The Executive Order was issued pursuant to the International Emergency Economic Powers Act (IEEPA) and the National Emergencies Act. Significantly, the IEEPA creates potential civil and criminal liability for violations of regulations issued under its authority, and the regulations can expand those liabilities to those who "facilitate" or "cause" violations.

Fried Frank M&A/PE Briefings Issued this Quarter

(*Please click on the title to see the Briefing*)

- ***Delaware Supreme Court Reverses Chancery Court's Dismissal of Caremark Claim Alleging No Board Oversight of Regulatory Compliance*—Blue Bell.** *Marchand v. Barnhill* ("*Blue Bell*") (June 18, 2019) serves as a reminder that, while so-called "*Caremark* claims" are difficult to plead successfully, there *are* circumstances under which they may prevail. *Caremark* claims are claims that directors breached their fiduciary duty of loyalty by not making "a good faith effort to oversee the company's operations"—and, if successful, they can result in personal liability for directors. In *Blue Bell*, the plaintiff-stockholder brought suit against the directors of Blue Bell Creameries after an outbreak of listeria contamination in the company's ice cream led to the sickening and (in three cases) the death of consumers—as well as a recall of all of the Company's products, the shuttering of all of the Company's plants, and, ultimately, a liquidity crisis that led the company to accept a dilutive private equity deal. In the decision below, the Court of Chancery had dismissed the suit on the basis that the company's food safety operations were subject to a reasonable system of oversight through the extensive regulatory scheme to which the company was subject (which included inspections and reports by federal and state regulators). The Supreme Court overturned the dismissal, however, after finding that the facts alleged in the complaint indicated that *the board itself* had taken no action to assure a system for *board* oversight of food safety. Notably, in *Blue Bell*, the factual context was egregious in terms of both the board's alleged inattentiveness (for example, the board minutes reflected that the board never discussed anything about food safety, even in the midst of the unfolding listeria crisis) and the dire consequences thereof (*i.e.*, the deaths of consumers of the ice cream). Our Briefing analyzes the decision and offers related practice points.

- ***Another Nail in the Coffin for Arm's-Length Merger Appraisal Cases Without Fatal Process Flaws–Delaware Supreme Court Embraces the Merger-Price-Less-Synergies Approach for Determining "Fair Value"*—Aruba.** In *Verition v. Aruba* (April 16, 2019), the Delaware Supreme Court fully embraced the concept (which is statutorily mandated but historically has been mostly ignored) that, when the court relies on the deal price to determine appraised fair value, the value of expected merger synergies included in the deal price must be excluded from the fair value determination. While the Supreme Court's appraisal result in *Aruba* was higher than the Court of Chancery's result, it was still well below the merger price—thus, the dissenting stockholders still experienced a "loss" as a result of having exercised their appraisal rights rather than accepting the merger consideration. The deal-price-less-synergies approach can be expected to further accelerate the recent significant decline in appraisal petitions involving arm's-length mergers without a seriously flawed sale process. Our Briefing analyzes the decision and offers related practice points.

- ***Delaware Supreme Court Overturns the Court of Chancery's Finding that a Controller-Led Transaction Was MFW-Compliant "From the Outset" of Negotiations*—Olenik.** In *Olenik v. Lozinski* (Apr. 5, 2019), the Delaware Supreme Court undercut the suggestion made by the Court of Chancery (in its earlier decision in the case) that there could be considerable leeway for a controller-acquiror to engage in discussions with a target before determining whether or not to structure a transaction to be *MFW*-compliant. The *Olenik* parties had what the Court of Chancery characterized as "preliminary" and "exploratory" discussions for ten months before the buyer imposed the *MFW* conditions in its formal offer and the special committee was formed. The Supreme Court found, however, that those discussions had included "substantive economic negotiations" because the parties had "set the playing field" for the high and low ends of the deal pricing. The Supreme Court therefore held that *MFW* did *not* apply and reversed the lower court's pleading-stage dismissal of the case. The Supreme Court emphasized that the *MFW*-required conditions must be imposed "early in the process" and indicated that the appropriate time is "during the germination stage of the Special Committee process," which is "when advisors [are] being selected" and "due diligence [is] beginning" and "before there has been any economic horse trading." Our Briefing analyzes the decision and offers related practice points.

- ***SEC Proposes Updates to Reg. S-X Disclosure Rules for Acquisitions and Dispositions.*** The SEC issued a release on May 3, 2019 proposing updates to the financial statement disclosure requirements of Regulation S X relating to acquisitions and dispositions. The updates include changes to rules relating to acquired business financial statements; pro forma financial information; and pro forma financial information of smaller reporting companies. In addition, the SEC proposed special new rules for issuers that are subject to registration as investment companies under the Investment Company Act of 1940, a category that includes business development companies and REITs. The updates improve the quality of information provided to investors while reducing companies' compliance burdens, thereby increasing speed to market and timely access to capital.

  Our Briefing (which will be available on our website next week) discusses the key proposed updates, including the following:

  - Under the current rules, a transaction that would not be material to the business sometimes nevertheless trips "significance" tests and therefore requires the preparation of additional financial disclosure. This unintended consequence has resulted from the "investment test" being measured as a company's investment in an acquisition target divided by the acquiring company's total assets. The new investment test would change the denominator from total assets to worldwide market value of common equity, which aligns the test more closely with the target's economic significance to the acquiror's enterprise value.

  - Similarly, the "income test" under current rules relies on equity in the acquisition target's income from continuing operations (exclusive of amounts attributable to any noncontrolling interests) divided by such income of the acquiring company. For an acquiror with net income or loss having a relatively low absolute value, whether due to non-cash items or otherwise, the deemed significance of an acquisition can appear disproportionate. The proposed income test attempts to reduce these distortions by adding a second trigger relating to comparison of revenues.

  - Other proposed changes would raise certain disclosure thresholds and reduce the number of periods for which acquired business financial information must be presented. In addition, proposed changes to the "significance" tests for registered investment companies would focus on the effect on the acquiring company's investment portfolio (as opposed to a potential combination of investment and non-investment assets), would reduce distortion where volatility is high or where a large portion of the holdings do not produce investment income, and would employ sophisticated triggers in an effort to reduce anomalous results. The proposed changes also would reduce the number of years of audited financial statements required with respect to fund acquisitions and would replace registered investment companies' obligation to provide pro forma financial information with an obligation to provide a pro forma fee table, narrative disclosure about material differences in accounting policies and, in certain cases, disclosure about changes in the acquired fund's portfolio due to investment restrictions.

Fried Frank M&A/PE *Round-Up*

Fried Frank's M&A practice advises clients on some of the largest and most complex US and global deals, providing counsel to a full spectrum of companies on sophisticated transactions that are often multi-jurisdictional and, in some cases, transformational. With over eighty attorneys in four offices, our team has deep experience advising public and private companies, special committees, audit committees, and boards of directors in complex negotiated and contested situations, including negotiated mergers, hostile takeovers and takeover defense, proxy contests, financial adviser representations, and restructuring transactions.

This quarter, Fried Frank was recognized by The Deal's 2019 *Deal Awards* for advising on both **Financial Services Deal of the Year** for BB&T's merger with SunTrust Banks and **Technology, Media & Telecom Deal of the Year** for Walt Disney's acquisition of Twenty-First Century Fox's television and film assets

Highlights of our 2019 second quarter work include representations of:

Sinclair Broadcast Group

Counsel to **Sinclair Broadcast Group** in its US$10.6b definitive agreement to acquire the equity interests in 21 regional sports networks (RSNs) and Fox College Sports from the Walt Disney Corporation.

Spirit MTA REIT

Counsel to **Spirit MTA REIT** and its independent directors in the US$2.4 billion sale of the assets in the Company's Master Trust 2014 and three assets presently owned by Spirit Realty Capital, Inc. to Hospitality Properties Trust.

Goldman Sachs

Counsel to **Goldman Sachs** in its $US750 million cash acquisition of United Capital Financial Partners.

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