Fried Frank
M&A/PE QUARTERLY
A quarterly roundup of key M&A/PE developments
1st Quarter 2016

Reminder that Entire Fairness Framework Generally Applies to Commercial Arrangements Between a Corporation and its Controller, Even If Approved by an Independent Board Committee—In re EZCORP

When the board of a Delaware corporation has established—and follows—specific policies and procedures for approval of related party agreements, the directors should be mindful that a related party agreement, if challenged, would nonetheless be subject to the court's "entire fairness" framework of review.

In re EZCORP Inc. Consulting Agreement Derivative Litigation (Jan. 25, 2016) serves as a reminder that the court generally will review claims alleging fiduciary breach relating to agreements between a corporation and its controller under the "entire fairness" framework (rather than the more deferential business judgment rule). This will be the case even for agreements that relate to business transactions other than a squeeze-out merger and even when the agreements have been approved by independent and disinterested

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directors through a board-established process for the consideration of related party transactions. While not the subject of the decision, *EZCORP* also serves as a reminder that, in the context of initial public offerings and spin-offs, proper advance planning should significantly reduce or even eliminate any breach of fiduciary duty issues with respect to agreements between the newco (*i.e.*, the corporation that will become public) and its controller.

Background

In *EZCORP*, the plaintiff-stockholder challenged a series of consulting agreements between EZCORP Inc. and affiliates of its controlling stockholder, contending that they were "not legitimate contracts for services but rather a means by which [the controller] extracted a non-ratable cash return from EZCORP." The audit committee of the EZCORP board had approved the agreements. The plaintiff claimed that the committee directors had rubber-stamped the agreements "to preserve their cozy positions" (including significant pay) as directors of EZCORP and of other companies affiliated with the controller. Vice Chancellor J. Travis Laster held that the "entire fairness" framework would apply to the court's review of the challenged agreements.

Key Points

- **"Entire fairness" framework applies to commercial agreements (not only merger agreements) with a controller.** The "entire fairness" framework generally applies to the court's review of any transaction between a corporation and its controller in which the controller extracts a benefit not available to the minority stockholders on a pro rata basis. This standard applies not only to transformative transactions with a controller (such as a merger), but also to consulting, compensation, service, license, or other business transaction agreements between a corporation and its controller.

- **Procedures for approval of controller transactions by an independent committee have significant advantages, but will not prevent application of the "entire fairness" framework.** A corporation will be meaningfully advantaged by establishing and utilizing clear procedures for negotiating and approving controller transactions (*e.g.*, through an independent conflicts, related-party transactions, audit, or other special committee, as discussed below). Indeed, the establishment and use of such procedures are necessary for good corporate governance, important to a company's public stockholder base, and critical in connection with the defense of any related shareholder litigation. However, these procedures will not prevent a controller transaction, if challenged, from being reviewed by the court under the entire fairness framework—even though, under that framework, board and/or stockholder ratification can result in a shift in the burden of proof or a shift to the business judgment rule standard of review, as described below.

- **Advance planning for related party commercial arrangements in the context of IPOs and spin-offs.** Although not the situation in *EZCORP*, the decision serves as a reminder that protective planning can avoid review of controller arrangements entered into in the context of an initial public offering or spin-off. If a company is going to effect an IPO or a spin-off, the newco (*i.e.*, the company that will go public or be spun-off) should consider putting into place *in advance* of the IPO or spin-off any commercial arrangements it intends to enter into with the controller. If these arrangements are properly disclosed in connection with the IPO or spin-off, they will not be subject to later review (unless they are amended or modified), as they would be pre-existing stockholder-approved agreements. In addition, to the extent the newco may want to enter into agreements with the controller *after* the IPO or spin-off, the company should consider including in the charter of the newco (before the IPO or spin-off) a process for approval of related party transactions. If the approval process to be utilized is properly disclosed, those arrangements should pass judicial muster so long as the process specified in the charter is closely followed and the terms of the agreement are fully disclosed. The impact of these arrangements on the value of the IPO or spin-off would have to be evaluated.

"Entire fairness" framework. In connection with an agreement under which a controller or its affiliates receive a non-ratable return from the corporation, the "entire fairness" framework of review would apply as follows:

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- ***Defendants' burden to prove fairness.*** The defendants have the burden of proving that (i) the process was fair—for example, that the agreement was approved by independent and disinterested directors after full consideration, based on their reasoned view of what would be in the best interests of the company; and (ii) the economic terms of the agreement were fair—for example, the amount paid and other terms reflected what would have been standard or reasonable if the agreement had been entered into with a non-affiliated third party.

- ***Shift of burden to plaintiffs.*** If *either* a fully authorized and effectively functioning committee of independent and disinterested directors, *or* a majority of the minority stockholders in a fully informed vote, approved the agreement, then the burden would shift to the plaintiffs to prove that the transaction was unfair as to price or process.

- ***Change to business judgment rule review.*** If the agreement satisfies the prerequisites established in the Delaware Supreme Court's 2014 *MFW* decision for review of controller transactions under the business judgment rule—*i.e.*, from the outset, the agreement was subject to approval by a fully authorized and effectively functioning committee of independent and disinterested directors *and* by a majority of the minority stockholders in a fully informed vote, and both approvals were obtained— then the deferential business judgment rule should apply. (As shareholder agreements with a controller are not generally subject to a shareholder vote, it is rare that a shareholder vote is sought and the *MFW* prerequisites satisfied in this context.)

Benefits of established process for approving related party transactions. Regardless of the judicial standard applied to review related party agreements, established policies and procedures for a fair and reasonable process nonetheless offer the following potential advantages:

- increased confidence of the unaffiliated stockholders' that conflict situations will be dealt with in a manner that provides reasonable protection of their interests;

- avoiding a negative response by proxy advisory firms; and

- as noted, a shift in the burden of proof to the plaintiffs to prove unfairness of the agreement if the procedures include approval by a committee of independent and disinterested directors or by the unaffiliated stockholders.

Court's rationale. The Vice Chancellor outlined different ways that controllers can attempt to obtain non-ratable benefits from a company—including (i) "cash flow tunneling," where the controller "removes a portion of the current year's cash flow, but does not affect the remaining stock of long-term productive assets"; (ii) "asset tunneling," where the controller transfers "major long-term (tangible and intangible) assets" to or from the company, often not at market value; and (iii) "equity tunneling," in which the controller "increases [its] share of the firm's value, at the expense of minority shareholders, but does not directly change the firm's productive assets or cash flows." The Vice Chancellor reasoned that, as the court has been consistent in applying entire fairness review in cases involving "equity tunneling" (*e.g.*, going private transactions), heightened scrutiny should apply also to the other forms of potential value extraction so that a controller will not be encouraged to utilize one method over another based on the judicial standard of review that would apply.

Factual context supported reasonable inference of unfairness. The Vice Chancellor concluded, at the pleading stage of litigation, that the plaintiff's complaint supported a reasonable inference that the challenged agreements were *not* entirely fair and represented a means by which the controller extracted a non-ratable return from EZCORP. Specifically:

- The court viewed six of the seven EZCORP directors as not independent and disinterested because of their ties to the controller.

- The court was influenced by the fact that, under EZCORP's dual-class capitalization structure, the controller owned 100% of the voting power but only a 5.5% economic stake—which, according to the court, created a disincentive for the company to pay dividends and a strong incentive for the controller to obtain returns through non-ratable direct transfers.

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- At least according to the plaintiff's pleadings:
  - the company's audit committee had ultimately terminated the contracts at issue in 2014, apparently based on a concern as to their validity;
  - in response to the committee's termination of the contracts, the controller replaced the directors on that committee;
  - the controller had a history of "retributive behavior" with respect to directors who he perceived to be disloyal to him;
  - the affiliated consulting company was thinly staffed, had no other publicly traded clients, and was not in a position to offer the services contracted for;
  - the consulting services were for advice relating to EZCORP's "business and long term strategic planning"—services that no peer firms obtained and as to which the consulting company had no expertise that EZCORP's experienced and highly compensated management itself did not already possess;
  - the company had a long history of entering into agreements with affiliates of the controller, involving significant payments (and sometimes overpayments);
  - the consulting company received significant compensation through the agreements--with the annual fee remaining the same even when EZCORP's income declined (with the result that the fee represented between 5% and 20% of EZCORP's net income); and
  - the company had not paid dividends and had consistently stated that it did not intend to pay dividends.

Possibility of appeal. The Vice Chancellor acknowledged that there are a small number of Delaware precedents involving consulting or compensation agreements with controllers—through which the controller extracted a non-ratable benefit, but that had been approved by a board or a duly empowered committee with an independent majority of outside directors—in which the entire fairness framework was *not* applied. However, after citing a long list of decisions that took the contrary view and applied entire fairness, the Vice Chancellor concluded that "the weight of authority" favored applying the entire fairness framework whenever there was a non-ratable benefit to the controller. The Vice Chancellor acknowledged that "[t]here is considerable tension between these lines of authority," and characterized the choice between them as "both fundamental and consequential" because "the scope of a controller's influence has implications for a range of legal doctrines" (including not only the substantive standard of review, but also, for example, demand futility, how the law treats a controller's take-private tender offer, and the degree to which stockholder approval can ratify or change the standard of review for a controlling stockholder transaction). The Vice Chancellor noted that the decisions that did *not* apply entire fairness relied primarily on the reasoning of the Delaware Supreme Court's 1984 *Aronson* decision. The Vice Chancellor characterized his conclusion that *Aronson* should be read as limited to the issue of demand futility (which was the subject of that case) as "the view of just one trial court judge" and stated that the issue ultimately can be resolved only by the Delaware Supreme Court.

On February 22, 2016, the Vice Chancellor denied EZCORP's request that the court certify interlocutory appeal to the Supreme Court. At that hearing, the Vice Chancellor commented that there is "an awful lot of law" that supports application of an entire fairness standard of review to agreements with a controller, but acknowledged that the Supreme Court may want to clarify the issue. Also at that hearing, the Vice Chancellor permitted the plaintiff stockholder to submit an amended complaint to add (to the breach of fiduciary duty claims already made against the company and its directors) breach of fiduciary duty claims against the controller and his affiliated companies. ■

*The Post-*Trulia *Landscape—Disclosure-Based Settlement Approved in Delaware*

On February 18, 2016, Chancellor Andre G. Bouchard approved a non-monetary M&A litigation settlement in *In re BTU International, Inc.*, finding that the settlement met the standards that the Chancellor recently articulated in *In re Trulia*.

As discussed in a prior Fried Frank M&A Briefing, in *Trulia* (decided in late January 2016), the Chancellor established a new regime for the court's consideration of proposed disclosure-based settlements of litigation challenging M&A transactions—after warnings from the court over the past year that it would be applying increasing scrutiny to these types of settlements, seeking to ensure that the supplemental disclosures received by the plaintiff-stockholders (*i.e.*, the "get") supported the releases provided to the defendants (*i.e.*, the "give").

In *Trulia*, the Chancellor stated that, going forward, the court, will no longer approve disclosure-only settlements unless (a) the supplemental disclosures are "plainly material" (*i.e.*, it is "not a close call" that they materially affect the total mix of information that stockholders would regard as relevant) *and* (b) the releases provided by the stockholder-plaintiffs are narrowly crafted (*i.e.*, cover only the disclosure claims made, as well as only those sale process and price claims that the record shows were sufficiently investigated in discovery and prosecuted).

In approving the *BTU* settlement, the Chancellor found that the settlement met the heightened scrutiny standards of *Trulia*. The *BTU* stockholder suit challenged BTU's 2015 all-stock $35 million merger with Amtech System Inc. The plaintiffs raised disclosure issues and alleged that BTU executives had breached their fiduciary duties by pursuing the merger when, at the last minute, after all other bids had been rejected, Amtech dropped its bid price below the then trading price of BTU's stock.

Key Points

- The court found the supplemental disclosures of the company's financial projections met the *Trulia* standard for "plainly material" disclosure.
- The court found the release, which did not cover "unknown claims," but which covered (a) disclosure claims and (b) fiduciary duty claims relating to the decision to enter into the merger, was sufficiently narrow to meet the *Trulia* standard (and, we note, still provided significant protection to the defendants as a practical matter).
- The court reiterated, and emphasized, "a preference" for mootness resolutions—even when a settlement agreement otherwise would meet the *Trulia* standards.

Supplemental disclosures in *BTU*. The Chancellor found that the supplemental disclosures of the company's financial projections were "plainly material." The proxy statement had not included any company projections. In the settlement, the company agreed to supplementally disclose three sets of projections: an initial set, which reflected BTU as a standalone company without restructuring; a revised set, which reflected a restructuring that management thought would be necessary if the proposed merger did not go through (these were the projections that had been used by the financial advisor in its DCF analysis); and a third set (without restructuring), which reflected expected synergies from the merger with Amtech.

The court reasoned that the projections provided stockholders "with a key input to the DCF analysis that [they] could not obtain from anywhere else"—namely, management's best estimates of the future free cash flows of the business. With that information, the Chancellor stated, stockholders could apply their own assumptions about discount rates, growth rates, and other inputs to the DCF analysis, "to test the validity of the conclusions [the financial advisor] reached in its standalone analysis." Further, the court reasoned that the revised projections—which demonstrated that the free cash flow estimates had been revised significantly downward—was "potentially genuine negative information for a stockholder to consider."

The court did not specifically address whether the other supplemental disclosures made were "plainly material" because it concluded that the projections alone met the standard. The other supplemental disclosures related to potential conflicts of interest of management and other indications of interest that had been received from third parties. Specifically the

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company had disclosed in the proxy statement that specified executives involved in the merger negotiations entered into agreements for post-closing employment with the surviving corporation. In the settlement, the company supplementally disclosed that these executives, at an early stage of the negotiations, had discussed "the possibility of continuing executive roles in the combined companies," although "no specific positions or terms of compensation were addressed"; and disclosed the general timing as to when these executives were involved in the merger negotiations and when they were involved in discussions relating to their possible future employment. In additions, the company had disclosed in the proxy statement that it had received only one other indication of interest for a transaction, which involved an all-cash deal, and that no bid was ultimately received from that party. In the settlement, the company supplementally disclosed that that indication of interest had a nominal stated value of $35 million based on BTU's then-reported net cash position (which had since declined). ($35 million was also the aggregate equity value of the indication of interest received from Amtech.)

Release in *BTU*. The Chancellor found that the release—which covered (a) disclosure claims and (b) fiduciary duty claims relating to the decision to enter into the merger—was sufficiently narrow.

The release initially agreed by the parties was a typical pre-*Trulia* broad release, covering all claims, including so-called "unknown claims." The parties revised the release in response to *Trulia*, narrowing it to exclude "unknown claims." "Released claims" were defined to include claims "related to any disclosures (or lack thereof) to BTU's stockholders concerning the Merger and any fiduciary duty claims concerning the decision to enter into the Merger…."

Court's emphasis on mootness process. The Chancellor's first comments in the *BTU* ruling were to reiterate that, in *Trulia*, the court had expressed "a preference" that disclosure issues in deal litigation be resolved in "an adversarial process, whether through actual litigation or in connection with a mootness fee application." The Chancellor stated that this "remains very true" and that both plaintiffs and defendants "would be wise to pursue the options enumerated in *Trulia* [(*i.e.*, mootness fee resolutions)] in the future…." The court commented that the *BTU* settlement pre-dated *Trulia* and concluded that "perhaps [this] explains why those preferred avenues were not pursued in this case." We note that, at the recent Tulane Corporate Law Institute conference (March 17, 2016), Chief Justice Leo E. Strine, Jr. of the Delaware Supreme Court also emphasized the courts' preference for mootness resolutions in pure disclosure cases.

A mootness process involves a company providing supplemental disclosures; the plaintiff stockholders *not* providing a formal release of claims; and, through an adversarial court proceeding, the parties litigating what fee (if any) is appropriate for plaintiffs' counsel for their having obtained disclosure that "moots" the disclosure claims made. While no stockholder release is obtained in a mootness resolution, the Chancellor commented in *Trulia* that, as a practical matter, stockholders would be unlikely to bring further actions after a mootness resolution is reached. Indeed, in light of the Delaware Supreme Court's recent decision in *Corwin v. KKR Financial*, a merger transaction otherwise subject to *Revlon* would be reviewed post-closing under the deferential business judgment rule (even if the directors were not independent) if the transaction was approved (*i.e.*, ratified) by a fully informed stockholder vote. Accordingly, the quality and completeness of the pre-closing disclosures have taken on even greater importance to ensure a "fully informed" vote.

Thoughts on *BTU*

- **Court's view of materiality of projections was not limited to the factual context.** The court found that disclosure of the projections was meaningful in *BTU* in part because two of the sets showed that management had significantly revised its expectations downward just before the merger. However, the court's discussion appears to indicate that its view of the materiality of the projections was based primarily on the fact that disclosure of the previously omitted projections permitted stockholders to reach their own conclusions about the various inputs to the bankers' DCF analysis (such as discount rate, growth rate, etc.).

- **Release that was obtained, although "narrow," provided the most critical protection.** While the release obtained was not the broad "intergalactic" release typical in the past, it is to be noted that, in the "narrow" form that was acceptable under *Trulia*, the release provided what generally would be considered the most critical

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part of the protection that pre-*Trulia* broad releases provided. In any case in which there are not serious concerns about the sale process or price, a release that, as in *BTU*, covers claims "relating to the decision to enter the merger" (even though it does not include so-called "unknown claims") should provide a significant level of protection as a practical matter.

- **Distinguishing *BTU*.** The court noted that it "bears mentioning" that the BTU settlement was "not purely about disclosures," as the company also agreed to provide notice to the counterparties to nondisclosure agreements that contained standstill obligations that were still effective, stating that the company would not interpret the agreements to prevent a private request for waiver of the standstill. As a result, previously potentially interested parties that had signed NDAs could make a competing bid. (None of them then requested a waiver or made a bid.) Although apparently not providing substantial support for the court's ultimate ruling, conceivably *BTU* could be distinguished in the future from a purely disclosure-based settlement.

Thoughts on the Post-*Trulia* Landscape

- **There are already fewer M&A suits in Delaware.** The general consensus has been that the volume of complaints challenging public company M&A transactions filed in Delaware is already down since *Trulia*. In addition to the effect of *Trulia*, as we have discussed in prior Briefings, suits challenging third-party, arm's-length M&A transactions are now more unlikely in any event because of other Delaware decisions issued over the past couple of years that have evidenced a clear trend of increasing deference to the decisions of independent directors and early dismissal of claims against them, as well as, within the framework of exculpation provisions, findings of personal liability in only the rarest of circumstances. (We note that cases that present serious breach of fiduciary duty claims, or claims challenging related-party or controlling stockholder transactions, likely will not be affected by *Trulia*.)

- **Remains to be seen whether more "nuisance" M&A suits will be brought outside Delaware.** It remains to be seen whether more M&A suits will be brought in jurisdictions other than Delaware, where the courts may be less averse to the historical disclosure-only settlement. The extent of the shift to other jurisdictions will depend on the extent to which other jurisdictions decide to follow Delaware's lead in disfavoring disclosure-only settlements. New York and a number of other jurisdictions already are on record that they will be applying heightened scrutiny to disclosure-only settlements. In addition, the extent of the shift to other jurisdictions will depend on the extent to which corporations decide to adopt Delaware-only forum selection bylaws.

- **Uncertain effect on adoption or elimination of Delaware forum selection bylaws.** After *Trulia*, when deciding whether to adopt, retain, or eliminate Delaware forum selection bylaws, a company may consider not only the benefit that non-M&A litigation in which the company may become involved (including, for example, derivative suits alleging misconduct or lack of oversight in connection with the company's ongoing operations) will be decided based on Delaware law as interpreted by Delaware courts, but also the extent to which, in the company's view:

    - "Nuisance"-type M&A suits in Delaware (*i.e.*, suits based on minor disclosure claims) are less likely to be brought than in the past;

    - other jurisdictions will follow Delaware's lead in trying to reduce nuisance-type M&A suits; and

    - the company's circumstances make it more (or less) likely that an M&A suit brought against it would include serious (rather than nuisance-type) claims—for example, a company without a controller, with an independent board, and with confidence that it would be able to conduct a valid sale process, may not view obtaining a broad release in settlement of litigation as a particularly important objective (especially if a release of fiduciary duty claims becomes reasonably obtainable under *Trulia*, as discussed above).

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It is also to be noted that there is a question as to what standard of judicial review would apply to a company's decision to waive Delaware forum selection bylaws during the pendency of litigation.

- **Possibly more investigation of claims in discovery.** We commented in a previous Briefing that plaintiffs' counsel may seek to adapt to develop new strategies after *Trulia*, with the goal that routine M&A suits would continue to be viable in Delaware. We note, as one example, that, with a somewhat more vigorous investigation of sale process claims during discovery than has been conducted in the past, plaintiffs' counsel might assert that a release of (at least "known") fiduciary duty claims would then be supportable under *Trulia*. *Trulia* held that a release must be crafted narrowly so as to include, in addition to disclosure claims, only those fiduciary duty sale process claims *that the record shows were sufficiently investigated* (through discovery) and prosecuted. It remains to be seen what will constitute "sufficient" investigation. As discussed above, a release of fiduciary duty claims (even without including so-called "unknown" claims) would generally provide defendants with the most critical part of the protection that pre-*Trulia* broad releases provided.

- **Possibly more frequent consideration of "mootness" resolutions in Delaware.** As discussed above, the court explicitly suggested in the *Trulia* opinion that litigants in M&A suits consider resolution of disclosure-focused litigation through supplemental disclosures followed by a "mootness fee" proceeding. While these proceedings may well become more prevalent in cases based on minor disclosure claims and in which the supplemental disclosures may not meet the "plainly material" standard of *Trulia*, it remains to be seen to what extent the court's exhortations will lead parties to pursue the mootness process in lieu of settlement when it is likely that the supplemental disclosures do meet the *Trulia* standard.

- **Effect on disclosures.** A new focus for initial disclosure will be those areas that the court, when considering disclosure-based settlements in the future, adjudicates as meeting the "plainly material" standard of *Trulia*. As noted, in *BTU*, the approved supplemental disclosures related to free cash flow projections and potential conflicts of interest of management. In another settlement approved by the court since *Trulia* (*Haverhill v. Kerley*, Feb. 9, 2016), the approved supplemental disclosures also related to potential conflicts of interest (of bankers, management, directors, and a significant stockholder). As noted, in light of the Delaware Supreme Court's recent *KKR Financial* decision, a transaction not involving entire fairness is subject to business judgment rule review post-closing if the transaction was approved by a "fully informed" stockholder vote. Accordingly, the quality and completeness of the pre-closing disclosures have taken on even greater importance as part of ensuring a "fully informed" vote.

For further discussion of *Trulia* and related decisions, please see the Fried Frank M&A Briefing, *Delaware's Effort to Reduce Wasteful M&A Litigation—Should Companies Adopt Delaware Forum Selection Bylaws After Trulia?* (Feb. 9, 2016); and the Fried Frank M&A Quarterly (3rd Quarter 2015), *Releases Likely to Narrow in M&A Litigation When Court Deems Settlement to Offer Only "Peppercorn" of Value*—Aeroflex, Riverbed and Aruba Networks, both of which are available on the Fried Frank website. ■

Reminder to Directors of What Not To Do When Hiring or Firing a Senior Executive—Amalgamated v. Yahoo

In *Amalgamated Bank v. Yahoo! Inc*. (Feb. 2, 2016), the Delaware Court of Chancery granted a books and records request, under Section 220 of the Delaware statute, to Amalgamated Bank (a shareholder of Yahoo). The court found that Amalgamated had a valid purpose in pursuing additional discovery relating to possible mismanagement by Yahoo's CEO (Marissa Mayer), compensation committee, and board of directors in connection with Yahoo's hiring and subsequent firing of a Chief Operating Officer.

In the post-trial ruling, Vice Chancellor Laster found that Amalgamated had proven, by a preponderance of the evidence, facts that provided a "credible basis" to suspect the possibility that actions taken by Mayer, the committee and the board could constitute unexculpated breaches of their fiduciary duties or waste. Yahoo has appealed the ruling.

The facts recited by the court provide a blueprint for how a compensation committee should *not* act when hiring or firing a senior executive. The court's discussion underscores the importance of director's not deferring to management, but exercising their own independent business judgment, when considering executive hiring, firing, and compensation matters.

Background

Soon after she became CEO of Yahoo, Mayer spoke with Henrique de Castro (a former colleague of hers at Google) about his becoming her number two executive at Yahoo. The Yahoo board's compensation committee approved de Castro's hiring on the terms negotiated by Mayer. After de Castro's allegedly poor performance on the job, just fourteen months after he started, Yahoo decided to terminate his employment. The termination was without cause, triggering almost $60 million in severance payable to him under the agreements Mayer had negotiated with him. Most of that amount consisted of the value of equity awards that were accelerated on a termination of his employment without cause (with the value significantly positively affected by an increase in Yahoo's stock—from about $15 to $40—during the fourteen months he was employed, due to Yahoo's investment in Alibaba Group). The payout would have been only about $1 million if the termination of his employment had been for cause (primarily because the vesting of the equity awards would not have been accelerated).

Key Points

- **It is to be noted that the court will rarely find liability for directors' lack of due care in hiring or firing an executive.** It is rare that a court will impose liability on independent directors lack of due care (even if knowing or intentional) in their decision-making process regarding an executive's being hired or terminated. Based on a corporation's exculpation provision in its charter, directors' negligent or even grossly negligent conduct would not generally give rise to personal liability. Liability could arise only for breach of the duty of loyalty or the obligation to act in good faith. It was suggested in the Court of Chancery's 2005 *Walt Disney* decision (which was quoted in *Amalgamated*) that, in the context of board decisions on compensation, liability arises when the court regards the directors as having "failed to exercise *any* business judgment and to make *any* good faith attempt to fulfill their fiduciary duties."

- **The decision serves as a reminder of the proactive role a committee and board should take in the area of executive compensation.** The court characterized the Yahoo directors' involvement in the hiring and firing of the COO as apparently "tangential and episodic". The directors seemed to have "accepted [the CEO]'s statements uncritically" and "mindlessly swallow[ed] information," according to the court. While the committee met to consider changes that Mayer made to the original offer terms, the court emphasized that the committee "discussed the issue[s] as Mayer had framed [them]" (and by so doing, failed to recognize that Mayer made incorrect statements and that the committee lacked relevant information). "Although there may be instances in which a board may

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act with deference to corporate officers' judgments, executive compensation is not one of those instances. The board must exercise its own business judgment [in this area]," the Vice Chancellor stated. The board's "ostrich-like conduct" led the court to conclude that there was a "credible basis to suspect wrongdoing involving potential breaches of fiduciary duty [and] reason to suspect waste."

Practice Points

- **Problems the court identified in Yahoo's process in hiring its COO.** The major problems that the court identified in the compensation committee's and board's process in deciding to hire de Castro were that the CEO, in negotiating the arrangements:

  - did not provide the committee or the board with sufficient detail of the proposed arrangements (including, until just before the committee's approval, even the identity of the person to be hired);

  - misstated certain of the offer terms when describing them to the committee;

  - did not provide any materials to the committee or the board other than the offer letter draft and an oral summary of the material terms provided by outside legal counsel;

  - did not provide any financial analysis of the arrangements, with the important result, according to the court, that the description the board received "did not capture the implication of accelerated vesting for various termination scenarios" (such as termination with cause or without cause, and after employment for different lengths of time); and

  - after the committee had approved the original offer terms, failed to update the committee when certain terms later changed that "materially increased [the] compensation package"—including (i) changing the "tail period" from six months to twelve months—*i.e.*, the total portion of the Performance Stock Options and incentive RSUs that could vest on an accelerated basis was limited to the number which would have vested in the twelve month (rather than six month) "tail period" following termination of employment—but incorrectly stating to the committee that the tail period had always been twelve months; and, (ii) without any discussion at all with the committee, eliminating the time-weighted schedule for accelerated vesting for the Make-Whole RSUs and providing instead that 100% of the unvested portion of the award would accelerate if the company terminated de Castro without cause.

- **Problems the court identified in Yahoo's process in firing its COO**. The major problems the court identified in the committee's and board's process in deciding to terminate de Castro's employment were that:

  - the committee never met in person or by phone to discuss the reasons for de Castro's termination, and instead simply acted "through a quick email exchange of written consents" to approve the CEO's decision to terminate his employment), apparently "rubberstamp[ing] what [the CEO] had done," without "ask[ing] any questions at all";

  - there was no evidence that the committee ever evaluated whether it could or should terminate de Castro's employment for cause (which would have resulted in far less of a payout to de Castro than the without cause termination proposed by the CEO); and

  - the committee never evaluated, nor was provided with a calculation of, the severance benefits that de Castro would receive on termination of his employment (with or without cause).

Reminder to Directors (continues on next page)

- **Unusual nature of the process.** We note the unusual nature of a board process in which the director's consider the hiring of an executive without having received an accurate summary of the material terms of the compensation arrangements, and consider termination of an executive without the benefit of financial analysis that or not demonstrates the range of possible costs to the corporation depending on whether the executive is terminated and whether the termination is with or without cause.

- **Tables produced by the court**. De Castro's compensation package included a base salary, an annual bonus target, and a signing bonus, as well as three types of equity awards: Incentive RSUs, Performance Stock Options, and Make-Whole RSUs. Each type of equity award had its own vesting schedule and the extent of the accelerated vesting of the awards in various termination scenarios was determined by the "tail period" and/or the "specified percentage" of the awards. The court itself produced the following tables (which illustrated the complexity of the COO's compensation package), suggesting that the committee and the board should have had this information when considering the hiring and firing of the COO:

    - Table 1: Illustration of the effect of the vesting schedules under the terms in the original offer letter, with hypothetical termination dates to illustrate the direction and the magnitude of the vesting.

    - Table 2: Comparison of the effective percentages of equity awards that de Castro would receive using the accelerated vesting as structured in the original offer letter (as shown in Table 1), with the effective percentages using the accelerated vesting as structured in the final offer letter, and with hypothetical termination dates "to illustrate the direction and the magnitude" of the changes. The court noted that the Table showed that Mayer's changes substantially increased the percentage of the equity awards that de Castro would receive for an early termination.

    - Table 3: Comparison of the different categories of value conveyed to de Castro under the original offer letter versus the final offer letter, based on hypothetical termination dates.

    - Table 4: Comparison of the original offer letter and the final offer letter by focusing on the amount of target compensation that de Castro would receive from accelerated vesting.

    - Table 5: Reflection of the total dollar amounts de Castro would receive as severance. The court noted that the table showed that Mayer's changes from the initial offer letter to the final letter resulted in payouts that made earlier termination without cause dramatically more favorable to de Castro. Separately, the court noted that Mayer had explained to the committee that she did not view changes that increased the compensation in the event of termination without cause as problematic because it would always "be under her and the Board's control" whether to terminate de Castro without cause. ■

Delaware Decisions Provide Important Drafting Reminders for:

- *Term Sheets*
- *Preferred Stock Redemptions*
- *Stockholder Written Consents*
- *Anti-Reliance Provisions*
- *Indemnification*

Terms Sheets—*SIGA v. PharmAthene*

The Delaware Supreme Court's decision in *SIGA* (Dec. 23, 2015) has meaningfully increased the legal risk, at least in Delaware, associated with utilizing a term sheet or letter of intent. Although *SIGA* involved certain unusual facts, and more typical situations may therefore be distinguishable, the court's award of expectation damages for breach of the obligation to negotiate underscores the importance of clarity in a term sheet or letter of intent with respect to whether there is a binding obligation to negotiate in good faith and, if so, what the scope of that obligation is.

In *SIGA*, the Supreme Court:

- *not unexpectedly*, enforced a contractual obligation to negotiate in good faith a definitive license agreement consistent with the terms set forth in a term sheet—even though the term sheet was labeled as "non-binding" and there had been a dramatic change in the underlying economic circumstances of the deal; and
- *in a new development*, which increases the risk associated with utilizing a term sheet with an obligation to negotiate in good faith, established that there is a now a real potential in Delaware (unlike most other jurisdictions) for the recovery of expectation damages (*i.e.*, damages based on lost profits) for breach of an obligation to negotiate in good faith.

The following practice points should be kept in mind with respect to term sheets:

- **Consider whether to utilize a term sheet.** Parties should consider carefully, based on the legal risk and the particular business and other circumstances, whether to: (i) proceed with a term sheet, together with an express good faith obligation to negotiate a definitive agreement; (ii) proceed with a term sheet, and specifically disclaim any obligation to negotiate a definitive agreement, specifying that the term sheet is not binding and is subject to the negotiation and execution of a definitive agreement; or (iii) dispense with an term sheet, and proceed directly to negotiation of a definitive agreement.
- **Be clear whether there is an obligation to negotiate an agreement.** If the parties determine to proceed with a term sheet, they should ensure that they have expressly and clearly (a) provided that there is a binding obligation on the parties to negotiate in good faith a definitive agreement consistent with the terms of the term sheet, or (b) disclaimed any obligation to negotiate in good faith.
- **Specify the standards for any due diligence condition.** If a term sheet is labeled as "subject to due diligence," the parties should be clear (a) whether the effect of a party's dissatisfaction with the results of due diligence would be (i) termination of the obligation to negotiate in good faith or, instead, (ii) the obligation to negotiate

Delaware Decisions Provide Important Drafting Reminders (continues on next page)

would continue but the requirement that the terms must be consistent with the term sheet would terminate, and (b) whether dissatisfaction with due diligence would be in the party's sole discretion or would be based on material inconsistency with information already provided (or some other standard).

- **Consider the effect of possible changes.** In the context of a term sheet with an obligation to negotiate in good faith, particularly if the parties expect that there are likely to be changes in the underlying economic circumstances of the proposed transaction between the negotiation of the term sheet and of the definitive agreement, the parties may wish to consider whether to specify future events or circumstances that would trigger a specified change in the terms of the term sheet, a right to re- negotiate the terms of the term sheet, or a right to terminate the obligation to negotiate.

- **Consider whether to seek a limitation on damages.** A party may wish to try to negotiate to limit the damages in the event of a breach of the obligation to negotiate. The parties could agree that only reliance damages would be available. Alternatively, the parties could specify that expectation damages would not be available or would be subject to a cap.

- **Issue of a non-Delaware choice of law**. As noted, in most other jurisdictions (including New York and California), expectation damages generally are not awarded for breach of an obligation to negotiate a term sheet. Based on *SIGA*, other commentators have suggested that parties provide in a term sheet for a governing law other than Delaware. In our view, in most cases, focusing on the potential for expectation damages in Delaware in the event of a breach of an obligation to negotiate is likely to be "the tail wagging the dog," and the potential for expectation damages is better addressed by an agreement to limit damages as discussed in the preceding bullet point.

For further discussion, please see the Fried Frank M&A Briefing, *A Change in Delaware in the Consequences of Willful Breach of an Obligation to Negotiate an Agreement in Good Faith* (Jan. 19, 2016), and the Fried Frank Private Equity Briefing, *Practice Points for Term Sheets, Letters of Intent, and Undertakings to Negotiate in Good Faith* (Feb. 8, 2016), available on the Fried Frank website.

Redemptions of Preferred Stock—*TCV v. Trading Screen*

The Delaware Court of Chancery's *Trading Screen* decision (March 27, 2015) is currently on appeal to the Delaware Supreme Court. The issue is whether the common law requirement that preferred stock redemptions be made only out of "funds legally available" imposes any restriction beyond that imposed by the statutory requirement that a company make redemptions only out of statutory "surplus" (*i.e.*, net assets over capital). In *Trading Screen*, the Chancery Court held that the "funds legally available" requirement does impose a further requirement—specifically, that payment of the redemption would not render the company unable to continue as an ongoing business able to pay its debts as they come due. Resolution of the issue awaits the Supreme Court decision.

As a separate matter, an important practical point arising out of the Chancery Court decision relates to the drafting of preferred stock mandatory redemption provisions. In *Trading Screen*, the court refused to enforce the payment of penalty interest that arose on a "default" by the company of a mandatory redemption. The court reasoned that the company's failure to effect the mandatory redemption was not a "default" because the company did not have funds legally available for the redemption (and so was not legally required to make the redemption). Therefore, if rights are triggered when a company does not make a full redemption after the occurrence of a mandatory redemption trigger event—such as the accrual of a penalty interest rate, or rights to receive additional shares or other economic benefits, to elect directors, or to initiate or control a sale process—the drafting should reflect that those rights do not arise based on a "*default* by the company," but arise based on a "*nonpayment* by the company of the full redemption amount for any reason."

Delaware Decisions Provide Important Drafting Reminders (continues on next page)

For further discussion, including alternative transaction structures that could make the "legally available funds" restriction on redemption of preferred stock inapplicable, please see the Fried Frank M&A Quarterly (1st Q 2015), Increased Risk for Preferred Stockholders in Ensuring Mandatory Redemptions, available on the Fried Frank website.

Stockholder written consents—*Elite Horse Investments v. T3 Motion*

The Delaware Court of Chancery's transcript ruling in *Elite Horse* (Jan. 23, 2015) indicates that, when action by written consent of stockholders is authorized, the written consents may be vulnerable to attack if the consents are not signed and dated in a particular way. The Delaware statute (DGCL §228(c)) provides that "[e]very written consent shall bear the date of signature of each stockholder or member who signs the consent ...." Often, as was the case in *Elite Horse*, the date appears on the first stockholder consent, and the signature page states that execution is effective "as of the date first written above." While ultimately determining that the stockholder consents were valid for other reasons, the court noted that the company had raised a legitimate issue. Therefore, stockholders delivering written consents should ensure that the date appears next to each stockholder's signature.

Indemnification—*Prairie Capital v. Double E*

In *Prairie Capital* (Nov. 24, 2015), the Delaware Court of Chancery provided important guidance with respect to a buyer's ability to make post-closing fraud claims against a portfolio company's executives and its private equity fund sellers. The decision serves as a reminder that a typical non-reliance provision in a sale agreement (*i.e.*, a statement that the buyer has not relied on statements made or information provided outside the agreement) will bar the buyer from bringing post-closing fraud claims based on extra-contractual information—even if the agreement excluded fraud claims from the provision stating that indemnification would be the exclusive remedy and even if the extra-contractual information provided was indeed fraudulent. If the anti-reliance provision is effective, the only fraud claim that would be viable would be for fraud intrinsic in the contract—that is, for an intentional misrepresentation or omission in the representations and warranties.

In *Prairie Capital*, the buyer had conditioned its offer on the portfolio company's meeting certain sales targets. The company allegedly falsified its books and records and lied to the buyer in order to make it appear that the sales targets had been met. Notwithstanding the egregious factual context, at the pleading stage, the court ruled that, based on the non-reliance provision in the sale agreement, the buyer could bring a fraud claim only to the extent that it was based on a breach of a representation and warranty set forth in the agreement. Although most of the fraud claims were not dismissed, the court's disposition of each claim was based on a detailed review of the representations in the agreement to determine whether, by their terms and the dates as of which they spoke, they covered the alleged fraudulent conduct. In addition, the court confirmed that the private equity funds could be held accountable for the company's misrepresentations.

Further, in *FdG Logistics v. A&R Logistics* (Feb. 23, 2016), the Court of Chancery held that an anti-reliance provision in a merger agreement is not effective if it is drafted solely "from the point of view" of the seller rather than the buyer. For an anti-reliance provision to be effective in barring a fraud claim, it must be formulated as a statement *of the buyer.*

Based on *Prairie Capital* and *FdG*, parties should consider the following drafting points:

- **Drafting of anti-reliance provision.** The anti-reliance provision in a sale agreement should be drafted as a statement of the buyer—in effect, a promise by the buyer that it has not relied on anything extrinsic to the contract itself. Although the court ruled in *Prairie Capital* that the effectiveness of a non-reliance provision will not depend on the use of "magic words," previously judicially endorsed formulations should be employed to avoid the issues that arose in *Prairie Capital*. Issues relating to the effectiveness of a non-reliance provision should

Delaware Decisions Provide Important Drafting Reminders (continues on next page)

be mitigated if, as the court has previously required, the provision includes (i) words specifically stating that the buyer has not relied on extra-contractual statements; and (ii) a specific reference to non-reliance not only on misrepresentations but also on "omissions or the concealment of material information."

- **Separate, specific representation and warranty to cover any particularly sensitive information**. In any case in which the truth of certain specific information is particularly key to the buyer's determination to enter into the transaction (such as, in *Prairie Capital*, the target company's having met the March sales target), a buyer should consider whether it could better ensure that the information is precisely covered if that information is the subject of a separate representation (without the qualifications, dates or other limitations applicable to a broader representation).

- **Fraud claims will not be subject to the limitations on indemnification set forth in the sale agreement**. It should be kept in mind that, to the extent a buyer can bring a fraud claim for a misrepresentation of the seller, the claim will not be subject to the caps, deductibles, baskets, timeframes or procedural restrictions set forth by the parties in the sale agreement with respect to indemnification for breaches of representations.

- **Consider including a "double fraud carve-out."** In response to the court's interpretation in *Prairie Capital* of the fraud carve-out clause in the exclusive remedy provision, a buyer could consider seeking to include a fraud carve-out not only in the exclusive remedy provision but also in the non-reliance provision. The double carve-out would make it clear that the parties intend not only to eliminate indemnification as the exclusive remedy for a fraud claim, but also to override the non-reliance provision's bar to extra-contractual fraud claims.

- **Indemnification claim should cover the specific claim**. Consistent with the court's trend in recent years, in *Prairie Capital*, the court rejected the concept of a "placeholder" indemnification claim—*i.e.*, the court rejected a claim that was supported by allegations in the pleadings but had not been described in the indemnification notice provided under the agreement. Buyers making indemnification claims should provide specific support in the indemnification notice and not rely on being able to make more specific allegations later in the litigation pleadings.

- **Seller's response when projections become inaccurate**. Although not the situation present in *Prairie Capital*, the decision serves as a reminder that, even when fraudulent conduct is not at issue, during what can be an extended sale process, the selling parties may come to have knowledge that the projections provided to the buyer at an earlier stage have become inaccurate. *Prairie Capital* underscores the importance of careful consideration as to the appropriate timing, form, and extent of disclosure to the buyer of this type of development.

- **Other agreement provisions that might mitigate the risk associated with post-closing fraud claims**. We note that post-closing fraud claims span a continuum—from those that are made by a buyer who (as alleged in *Prairie Capital*) was "duped" into agreeing to a transaction based on false representations that were apparently knowingly made, to those made by a buyer who simply has "buyer's remorse" and bases fraud claims on representations that turned out to have been false but were possibly only negligently or even innocently made. Sellers seeking to mitigate the risk of post-closing fraud claims might consider (to the extent permissible under state law) seeking to contractually limit the persons and entities against which any claims (including fraud claims) could be made. In addition, sellers might consider seeking to provide for recovery of its fees and expenses incurred in defending a fraud claim unless the buyer prevails in the litigation.

For further discussion and additional practice points arising from the decision, please see the Fried Frank Private Equity Briefing, Chancery Court Provides Guidance on Post-Closing Fraud Claims by Buyer of Portfolio Company *(Jan. 4, 2016), available on the Fried Frank website.* ■

ISS and Glass Lewis Policy Updates for 2016 Proxy Season

The following summarizes the updates to the voting policies of proxy advisors Institutional Shareholder Services Inc. (ISS), effective as of February 1, 2016, and Glass Lewis, effective as of January 1, 2016.

Director Overboarding.

- Starting with the 2017 proxy season, both ISS and Glass Lewis will recommend against directors who sit on more than five public company boards (as opposed to the current six-board cap). During the 2016 proxy season, if a director serves on more than five public company boards, each of ISS and Glass Lewis will simply note that fact in its report. (ISS commented that the one-year grace period will allow companies and directors to plan for the change in policy.)

- ISS has retained its existing policy of recommending against a CEO of a public company who sits as a director on the board of more than two public companies (excluding the CEO's own company). Glass Lewis has adopted this same policy beginning with the 2017 proxy season, and, for the 2016 season, will simply note such directors in its report.

Unilateral Board Adoption of Bylaws or Charter Amendments

- In 2014, ISS instituted a policy of recommending against directors if the board, without shareholder approval, amends the company's bylaws or charter in a manner that "materially diminishes shareholders' rights." In the latest update, ISS (noting that investors may have different expectations for the governance documents of public issuers as opposed to those of IPO companies) has implemented a separate methodology with respect to IPO companies. The factors that will be considered in the IPO context include the provision's impact on the ability to change the governance structure in the future (*e.g.*, limitations on shareholder's rights, or supermajority voting requirements, to amend the charter and bylaws) and whether there is a classified board, as well as mitigating factors such as a public commitment to put the provision to a shareholder vote within three years of the IPO.

- Under the 2014 policy, ISS has considered these unilateral amendments in subsequent years' recommendations until the actions are reversed or submitted to a shareholder vote. In the update, ISS indicated that, unless the adverse provision is reversed or submitted to a shareholder vote, it will vote on a case-by-case basis on director nominees in subsequent years.

Conflicting Management and Shareholder Proposals

- Rule 14a-8 under the Securities Exchange Act of 1934 allows shareholders meeting certain stock ownership requirements to submit proposals for inclusion in a company's proxy materials. There are certain exclusions, including Rule 14a-8(i)(9), which allows an issuer to exclude a shareholder proposal that "directly conflicts" with a management proposal. After considerable controversy as to the meaning of this exclusion, in October 2015, the SEC Staff clarified that a conflict will be found to exist only "if a reasonable shareholder could not logically vote in favor of both proposals." Given uncertainties relating to this new standard, and because of the increased burden on companies of proving to the SEC Staff that a conflict exists that meets the new standard, some companies may choose to place management proposals alongside similar shareholder proposals in the 2016 season (rather than trying to exclude the shareholder proposal). For further discussion, please see the Fried Frank M&A Briefing, *Change in SEC's Longstanding Approach to Exclusion of 'Conflicting' Shareholder Proxy Proposals Creates Uncertainty* (Nov. 16, 2015), available on the Fried Frank website.

ISS and Glass Lewis Policy Updates (continues on next page)

- ISS has not provided guidance on how it will evaluate competing shareholder and management proposals.
- Glass Lewis' 2016 policy establishes a framework of factors that it will consider when evaluating competing management and shareholder proposals, including the following:
    - The nature of the underlying issue,
    - The benefit to shareholders from implementation of the proposal,
    - The materiality of the differences between the terms of the shareholder proposal and of the management proposal,
    - The appropriateness of the provisions in the context of a company's shareholder base, corporate structure, and other relevant circumstances, and
    - A company's overall governance profile and, specifically, its responsiveness to shareholders as evidenced by the company's response to previous shareholder proposals and its adoption of progressive shareholder rights provisions.

Exclusive Forum Provisions

- Glass Lewis has in the past automatically recommended a vote against the chairman of a nominating and governance committee that has adopted an exclusive forum provision (*i.e.*, a provision in a company's charter or bylaws that limits a shareholder's choice of legal venue to a specified jurisdiction). Glass Lewis is continuing this policy, but, similar to ISS's policy, has refined its approach to distinguish between an established company and an IPO company. When an exclusive forum provision is included in an IPO company's governing documents, Glass Lewis, in determining its recommendation, will consider the provision, on balance, in conjunction with other provisions that Glass Lewis believes might unduly limit shareholder rights (such as supermajority voting requirements, a classified board, or a fee-shifting bylaw).

Compensation Disclosures by Externally Managed Issuers

- Currently under ISS policy, insufficient disclosure regarding compensation arrangements for executives by externally managed issuers (EMIs) is not considered a "problematic pay practice." However, investors responding to the 2015–2016 ISS policy survey supported a change to this policy. Going forward, when an EMI provides a say-on-pay proposal, insufficient disclosure, which precludes a "reasonable assessment" of the EMI's compensation practices for executives, will be the basis for an adverse recommendation from ISS on the say-on-pay proposal.

Nominating and Governance Committee Chair

- Glass Lewis's policy for the 2016 proxy season seeks to hold the chair of a nominating and governance committee responsible for director effectiveness and refreshment. Glass Lewis may recommend against the committee chair if the ""board's failure to ensure the board has directors with relevant experience, either through periodic assessment or board refreshment, has contributed to the company's poor performance." The policy does not provide guidance or specify factors that could lead to such a conclusion. When determining whether to recommend a vote against the committee chair, Glass Lewis will continue to consider, among other factor, whether there are fewer than five or more than twenty directors on the board, and whether a director received more than a 50% against vote in the prior year and the director was not removed and the concern raised with respect to the director was not addressed.

ISS and Glass Lewis Policy Updates (continues on next page)

Evaluation of Proxy Access Nominees

- ISS's guidelines have provided in the past that ISS will consider the same factors to evaluate shareholder nominees to the board as are used to evaluate directors in contested elections. The 2016 guidelines provide ISS with "additional analytical latitude" in evaluating shareholder nominees. ISS may consider any "relevant" factors, including those that are specific to the company (such as relative company performance, board track record and responsiveness, governance profile, board composition, and any controversies); factors specific to the nominee(s) (such as the nominators' rationale, any critique of the incumbent directors or of management, and the nominees' qualifications)' and/or factors relating to the nature of the election (such as whether the number of nominees excess the number of available seats and the voting standards for the election of directors).

Proxy Access Bylaws

- ISS issued FAQs, with guidance as to the factors ISS will consider when determining whether to recommend a vote against directors after the company has adopted its own version of a proxy access bylaw in response to a majority-supported shareholder proposal. The factors ISS will consider are:
  - Whether the major points of the shareholder proposal were implemented;
  - Whether the company adopted provisions not contained in the shareholder proposal that unnecessarily restrict use of a proxy access right;
  - Whether the bylaw contains material restrictions that are more stringent than those included in the shareholder proposal, including (i) ownership thresholds above 3%, (ii) ownership duration requirements longer than 3 years; (iii) aggregation limits below 20 shareholders; or (iv) a cap on the number of nominees below 20% of the board; and
  - Whether the bylaw includes provisions that ISS considers to be "especially problematic" (*i.e.*, as effectively nullifying the proxy access right) or "potentially problematic.. The *"especially problematic"* provisions are: (i) aggregation limits that count individual funds within a mutual fund family as separate shareholders and (ii) a requirement that company shares be held after the annual meeting. The *"potentially problematic"* provisions are (especially when used in combination): (1) prohibitions on resubmission of failed nominees in subsequent years; (2) restrictions on third-party compensation of proxy access nominees; (3) restrictions on the use of proxy access and proxy contest procedures for the same meeting; (4) terms as to how long and when an elected shareholder nominee will count towards the maximum number of proxy access nominees; and (5) terms as to when the right will be fully implemented and accessible to qualifying shareholders. (It remains to be seen to when and to what extent each of these provisions, individually or in combination, will be considered to be problematic.)

Shareholder Proposals on Equity Holding Periods for Executives

- ISS has clarified its policy with respect to shareholder proposals requiring that senior executives retain portions of their shares acquired through compensation plans. Under the revised policy, ISS will recommend case-by-case on such shareholder proposals, taking into account:
  - The percentage/ratio of net shares required to be retained;
  - The time period required to retain the shares;
  - Whether the company has equity retention, holding periods, or stock ownership requirements and the robustness of such requirements;

ISS and Glass Lewis Policy Updates (continues on next page)

- Whether the company has any other compensation policies aimed at mitigating executive risk taking;
- Executives' actual stock ownership and the degree to which it meets or exceeds the thresholds in the proposal; and
- Problematic pay practices, current and past, which may demonstrate a short-term versus long-term focus.

The changes are intended to clarify the factors used in ISS' analysis and to eliminate the need for a separate policy tied to specific retention ratios (*e.g.*, 75% of net shares). ■

M&A Notes

Proposed Legislation Would Direct SEC to Amend 13D Rules

Legislation has been introduced in Congress that, if adopted, would direct the SEC to amend the reporting rules under Section 13(d) of the Securities Exchange Act.

SEC Rule 13D requires a filing and disclosure after acquisition of beneficial ownership of 5% or more of a company's common stock. However, currently, the filing and disclosure need not be made until ten days after the 5% threshold is crossed, and there is no limitation on further purchases during the ten-day filing window period. The proposed amendments would reduce the filing window to *two business days* after the 5% threshold is crossed. The Dodd-Frank law authorized the SEC to shorten the Schedule 13D filing window, and the SEC has been considering the issue for some time but has not taken action.

The amendments would also require public reporting of significant "short" positions; and include in the definition of "beneficial ownership" the possession of a pecuniary interest in the security (apparently without regard to whether the holder has voting or dispositive power over the security, which is the standard currently). The proposed changes would affect activists, who have been able to use the ten-day filing window and the narrow definition of beneficial ownership to acquire large equity stakes without the knowledge of the target company or the public.

CII Encourages Sunset Provisions for Dual Class Stock

On March 23, 2016, the members of the Council for Institutional Investors (CII) adopted a new policy opposing dual class capital structures. The new policy states that, upon going public, a company "should have a 'one share, one vote' structure," and that CII "expects" and "encourages" that companies going public without a single class structure will "commit to their adoption over a reasonably limited period through sunset mechanisms."

Notwithstanding the successes of the "good governance" movement in recent years, in the case of companies going public in initial public offerings or spin-offs (where corporate governance arrangements can be established without the vote of public stockholders), the newly public companies have emerged with strong defensive profiles—at times including a dual class capital structure. The structure (utilized in 15.5% of the IPOs in 2015) typically involves a low-vote-per-share class of common stock being sold to the public, with a high-vote-per-share class of common stock being retained by the founders and early investors so that they can retain voting control even when they no longer own a majority equity interest in the company.

Notably, the new CII policy, while continuing CII's opposition to dual class structures (and other defensive provisions), does not call for prohibition of these provisions through stock exchange or other rules, nor for boycott of the initial public offerings of companies with these provisions in their charters (as CII, CalPERS and others have done in the past). Rather, the policy, entitled "Expectations for Newly Public Companies," appears to acknowledge the likely continued prevalence of dual cap structures and other defensive provisions in IPO and spin-off companies, and expressly acknowledges (while not ascribing to) the argument that defensive needs are most pronounced at the earliest stages of development as a public company.

We note that ISS's policy is that it generally recommends that shareholders vote against a dual class structure unless the company can demonstrate a "compelling rationale." ■

Private Equity Notes

Proposed Rule Change to Govern Broker-Dealers Solely Engaged in Raising Capital for Private Funds

The SEC is expected to adopt soon a proposed FINRA rule change that would permit "capital acquisition brokers" to elect to be governed under a new rule set. The proposed change is a response to industry concerns that the full FINRA rule set should not apply to broker-dealers that limit their business to raising capital for private funds (or other issuers of unregistered securities) and M&A advisory activities. The relief from the current FINRA regulatory framework that would be provided would be more significant for sponsors of 3(c)(7) funds than 3(c)(1) funds.

Fund sponsors should consult with legal counsel with respect to their eligibility for registration as a CAB; an evaluation of the associated benefits, costs, and risks (which will vary significantly firm to firm); and the most effective way to register (including forming an affiliate as a new CAB or changing an existing FINRA membership to CAB status). For more information, see SEC Release No. 34-76675; File No. SR-FINRA-2015-054, available at http://www.sec.gov/rules/sro/finra/2015/34-76675.pdf.

SEC Effort to Challenge Nondisclosure of Fees to Affiliates Intensifies

As widely reported, the SEC has launched numerous enforcement actions against PE sponsors over the past two years for not disclosing arrangements that the SEC regarded as constituting conflicts of interest. The SEC's effort now appears to have intensified, with a $10.2 million settlement (announced in Nov. 2015) with Fenway Partners, two of its principals, a former principal, and its CFO. The action is significant in that it is the first challenge that relates to consulting services provided by an affiliate and paid for by fund assets or portfolio companies. The Fenway consulting arrangement replaced one in which the consulting fee paid was 80% offset against the advisory fee paid to the sponsor. This is also the first action that challenges incentive compensation paid to a PE firm's former employees on sale of a portfolio company. Because the employees had joined the affiliated consulting firm, the payments to them should have been disclosed as related party transactions, according to the SEC.

The SEC focus on disclosure of conflicts of interest—and the potential for substantial penalties and required disgorgement by firm personnel—underscores the need for legal counsel review of the structuring of fee arrangements; the consideration of when disclosure is (or may not be) curative of conflict of interest issues; the evaluation of the adequacy of disclosure; and the development of alternatives for addressing conflicts of interest. For more information, see *In the Matter of Fenway Partners*, SEC Release No. IA-4253, reported at Fed. Sec. Rep. ¶ 81,148.

SEC Challenge to Nondisclosure of Conflicts Relating to Insider Financing and Cross-Fund Investments

In another SEC action underscoring the importance of disclosure of potential and actual conflicts of interest, JH Partners was fined for failing to adequately disclose that it and certain of its principals loaned funds to portfolio companies and that it made a cross-fund investment. JHP and its principals provided interim financing to portfolio companies for working capital and other "urgent" cash needs, in some instances obtaining interests in the companies that were senior to the equity interests held by the funds. JHP also caused different funds to invest in the same portfolio companies at different priority levels, potentially favoring certain funds over others. In each case, according to the SEC, adequate disclosure of the action taken and the potential for conflicts of interest was not provided to, and in some cases required approval was not sought from, the fund advisory board or limited partners. In addition, the SEC charged that JHP funds exceeded concentration limits in the fund limited partnership agreements regarding any single investment.

The order highlights the importance of private equity fund managers' disclosing to partner advisory committees the potential for, and when appropriate obtaining advance approval of, investments that may result in potential conflicts of interest, including insider financing (often utilized to meet portfolio companies' interim financing needs) and obtaining different priorities in a portfolio company's capital structure or different valuations for funds' respective investments and cross-fund investments (often necessary to achieve balance across multiple funds with varying terms and investment periods). For more information, see *In the Matter of JH Partners, LLC*, SEC Release No. IA-4276.

SEC Sanctions Affiliated Investment Advisers for Misallocation of Funds

Two affiliated investment advisers settled SEC charges that they had wrongfully allocated more than $450,000 of consulting, legal and compliance-related expenses to the PE funds they manage. The SEC also charged the advisers with failing to have adopted written policies for preventing violations under the Advisers Act. The advisers reimbursed

Private Equity Notes (continues on next page)

the funds for the full amount of the alleged misallocation; agreed to cease and desist from future violations; and paid a civil penalty of $100,000.

The case highlights the importance of a review, with legal counsel, of a firm's written policies to ensure their efficacy in reducing the risk of violations, as well as their utility in a defensive context in response to SEC charges of violations. For more information, see *In the Matter of Cherokke Investment Partners, LLC and Cherokee Advisers, LLC*, SEC Rel. No. IA-4258, reported at Fed. Sec. Rep. ¶ 81,150.

SEC Questions Effectiveness of Outsourcing Compliance

The OCIE issued a Risk Alert relating to the increased prevalence of outsourcing of the compliance function, including the CCO role, by advisers and funds to unaffiliated third parties. An effective compliance programs requires the identification of risks in light of the firm's specific business operations, conflicts, risks, and other factors, and also must cover all relevant business activities. The Alert cautions that advisers and funds with outsourced CCOs should review their business practices in light of the risks noted in the Alert to determine whether their practices comport with the requirements of the Advisers Act.

Fund advisers and investment companies should ensure that, if the CCO role is outsourced, special attention is given to considering the CCO's resources and processes, as well as to ensuring that the adviser's particularized risks are identified and addressed and that all relevant business activities are covered. For more information, see SEC National Exam Program Risk Alert, *Examinations of Advisers and Funds That Outsource Their Chief Compliance Officers*, by the Office of Compliance Inspections and Examinations, Vol. V, Issue 1, Nov. 9, 2015, available at http://www.sec.gov/ocie/announcement/ocie-2015-risk-alert-cco-outsourcing.pdf.

SEC Emphasizes Risk Disclosures Must Reflect Current Market Conditions

In a recent Guidance Update, the SEC Staff emphasized that funds should "review their risk disclosures on an ongoing basis and consider whether these disclosures remain adequate in light of current conditions." The Staff highlighted the "dynamic, rather than static" nature of degree of risk, as it changes in response to market conditions, and that "different risks may be heightened or lessened at different points in time." The Staff wrote that fund advisers should monitor market conditions to assess the impact of changing conditions on the funds and the risks associated with the fund investments; assess their impact on fund risks; and assess whether fund risks have been adequately communicated to investors in light of current market conditions. If market conditions indicate changes to fund risk that are material to investors, updated communications to investors should disclose those risks. The Staff highlighted that fixed-income funds should consider risk disclosures in response to changes in market conditions relating to interest rate, liquidity, and duration risks; and that funds with investments in, or exposure to, Puerto Rico debt should consider (depending on the nature and significance of those investments) disclosing risks associated with the recent downgrades in ratings of Puerto Rico debt.

For more information, see IM Guidance Update 2016-02, Division of Investment Management, *Fund Disclosure Reflecting Risks Related to Current Market Conditions* (March 2016), available at https://www.sec.gov/investment/im-guidance-2016-02.pdf. ■

Fried Frank M&A/PE Briefings

In case you missed our distribution of any of the following Fried Frank Briefings in the first quarter of 2016, they are available on the Fried Frank website.

Fried Frank M&A Briefings (1st Q 2016):

- ***Delaware's Effort to Reduce Wasteful M&A Litigation—Should Companies Adopt Delaware Forum Selection Bylaws After* Trulia? (Feb. 9, 2016).** In *Trulia*, the Delaware Court of Chancery established that the most common disposition of M&A lawsuits—so-called disclosure-only settlements—will no longer be available, except in rare circumstances. In a strongly worded opinion, the Chancellor refused to approve the typical disclosure-only settlement proposed by the parties, and stated that the court will no longer approve disclosure-based settlements *unless* (a) the supplemental disclosure to be made is "plainly material" and (b) the release is narrowly crafted. We outline the practical implications of the decision, including the issues it raises in connection with a board's decision whether to adopt Delaware forum selection bylaws.

- ***Practice Points for Delaware Companies with Non-Classified Boards After Chancery Court's* Vaalco Energy *Decision* (Feb. 5, 2016).** The Court of Chancery held that *non-classified directors can be removed without cause*—irrespective of provisions in the charter or bylaws that purport to permit removal of directors only for cause. We offer practice points arising from *Vaalco* for companies with non-classified boards, including considerations with respect to amendment of, and disclosure relating to, existing director removal provisions.

- ***Application of Heightened Scrutiny in the Context of Settlement with an Activist*—Ebix (Feb. 3, 2016).** The Court of Chancery ruled that the standstill provisions of a settlement agreement with an activist that had threatened to launch a proxy contest would not invoke judicial review under the heightened scrutiny of *Unocal*. The court concluded that it would be "counter-intuitive" to apply *Unocal* to a director nomination settlement agreement, the essential purpose of which was to relinquish a degree of control to an insurgent stockholder. In this Briefing, we note that this result may be viewed as at odds with the Delaware courts' (including the Supreme Court's) precedent applying *Unocal* to the defensive provisions included in a merger agreement (notwithstanding that they are ancillary to the essential purpose of the merger agreement).

- ***A Change in Delaware in the Consequences of Willful Breach of an Obligation to Negotiate an Agreement in Good Faith*—SIGA v. PharmAthene (Jan. 19, 2016).** The Delaware Supreme Court decision in *SIGA* has meaningfully increased the risk associated with entering into an agreement to negotiate in good faith a definitive agreement based on a term sheet or letter of intent. Based on this decision, there is now a real potential for expectation damages in Delaware for breach of the obligation to negotiate. We discuss the case, the likely practical application by the courts, and practice points.

Fried Frank Private Equity Briefings (1st Q 2016):

- ***Court of Chancery Confirms Stockholder's Contractual Rights Do Not Establish Control, While Finding 26% Stockholder May Have Been a Controller*—Calesa v. American Capital (March 14, 2016).** The Court of Chancery found, at the pleading stage of litigation, that it was reasonably conceivable that a private equity firm that was a 26% stockholder was a controller. Importantly, the court based the determination on the affiliations between the directors and the private equity firm—and *not* on the private equity firm's equity ownership and significant contractual rights set forth in debt owned by the private equity firm. In this Briefing, we explain how the way that a non-majority stockholder's rights with respect to its equity and/or debt positions are crafted can affect the risk that it may be deemed a controller.

Fried Frank M&A/PE Briefings (continues on next page)

- ***Delaware Indemnification Rights for Former Officers and Directors*—Marino v. Patriot Rail (March 2, 2016).** The Court of Chancery confirmed that, under the Delaware statute, indemnification rights for officers and directors for actions that they take while in office (i) continue after they are no longer in office, (ii) do not cover actions they took after leaving office, and (iii) cannot be amended or eliminated retroactively—in each case, unless the source of the rights (*i.e.*, the certification of incorporation, bylaws or indemnification agreement) specifically provided otherwise at the time it was authorized or ratified. The fact situation underscores the importance to a buyer of providing appropriate protections with respect to a potential adverse outcome relating to material contingent liabilities of a target company (such as ongoing material litigation).

- ***Anti-Reliance Provision Will Be Effective (and Bar Fraud Claims Based on Extra-Contractual Statements) Only If Drafted as a Disclaimer by the Buyer*—FDG Logistics (Feb. 29, 2016).** The Court of Chancery held that an anti-reliance provision in a merger agreement is *not effective* if it is drafted "from the point of view" of the seller rather than the buyer. (If effective, a non-reliance provision will bar a buyer's post-closing fraud claims against selling stockholders that are based on information provided to the buyer in due diligence or otherwise outside the merger agreement.) The holding underscores the significant consequences that can follow from subtle differences in the drafting of certain private M&A agreement provisions. This Briefing provides examples of formulations of anti-reliance provisions that meet the judicial standards.

- ***Practice Points for Term Sheets, Letters of Intent, and Undertakings to Negotiate in Good Faith—Based on Delaware Supreme Court's* SIGA *Decision* (Feb. 8, 2016).** We discussed *SIGA* in an M&A Briefing dated Jan. 19, 2016 (noted above). Although *SIGA* involved certain unusual facts, and more typical situations may therefore be distinguishable, the real potential for expectation damages in Delaware for breach of the obligation to negotiate underscores the care that should be taken when relying on a term sheet or letter of intent. In this Briefing, we offer specific practice points.

- ***Court Refuses to Review Valuation When Agreement Provides for Valuation Firm's Determination to be Binding*—Peco v. Walnut (Jan. 6, 2016).** The Delaware Court of Chancery refused to review a valuation firm's determination of the value of an LLC's preferred units when the LLC agreement provided that the value as determined by an independent valuation firm would be binding on the parties. While *PECO* related to the valuation of LLC units in connection with the exercise of a put right, the decision presumably would apply more broadly—including to post-closing adjustments and other valuations. In this Briefing, we discuss the decision and offer practice points relating to agreements requiring valuations.

- ***Chancery Court Provides Guidance on Post-Closing Fraud Claims by Buyer of Portfolio Company*—Prairie Capital v. Double E (Jan. 4, 2016).** In this decision, relating to the sale of a portfolio company by one private equity firm to another, the Court of Chancery ruled (consistent with its 2006 *Abry* decision) that, based on the non-reliance provision in the sale agreement, the buyer could bring a fraud claim only to the extent that it was based on a breach of a representation and warranty set forth in the agreement. In this Briefing, we discuss how the representations and warranties in a sale agreement affect not only indemnity claims but also fraud claims and provide related practice points for buyers and sellers of portfolio companies. ■

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