Fried Frank

M&A/PE Quarterly

Fried Frank's quarterly roundup of key M&A/PE developments

Delaware Supreme Court Affirmance of Tesla *Makes Clear Entire Fairness Can be Satisfied Without Use of a Special Committee*

The Delaware Supreme Court, in *In re Tesla Motors, Inc. Stockholder Litigation* (June 6, 2023), unanimously affirmed the Court of Chancery's post-trial dismissal of claims by Tesla stockholders against Elon Musk in connection with Tesla's $2.6 billion acquisition of SolarCity, Inc. The plaintiffs, who sought damages of more than $13 billion, claimed that Musk, who was an executive and major stockholder in both companies, had caused Tesla to overpay for SolarCity—which allegedly benefitted Musk personally given that SolarCity, according to the plaintiffs, was insolvent.

The Tesla board did not utilize a special committee to consider and negotiate the transaction. The transaction was approved by the Tesla stockholders unaffiliated with Musk, however. The Supreme Court upheld the lower court's holding that, although the deal process was not perfect, Musk established that the price paid for SolarCity was entirely fair to Tesla's stockholders. (See **here** the Fried Frank M&A/PE Briefing on the Court of Chancery's decision: "Court of Chancery Reaches the Rare Conclusion that a Conflicted Transaction, with a Flawed Sale Process, Met the Entire Fairness Standard—*Tesla-SolarCity*," in the July 2022 *Fried Frank M&A/PE Quarterly*.)

The Delaware Supreme Court, in an opinion written by Justice Karen L. Valahura, held that the Court of Chancery erred in a portion of its entire fairness analysis, but that the error was not sufficient to require reversal given that there was substantial other evidence of the fairness of the transaction to Tesla and its stockholders.

Summer 2023 Content

Delaware Supreme Court Affirmance of Tesla *Makes Clear Entire Fairness Can be Satisfied Without Use of a Special Committee* *Page 1*

New State Laws Create Far-Reaching Risks for Investors with Foreign Investors *Page 4*

New Guidance on What Constitutes a Sale of "All or Substantially All" of a Company's Assets *Page 6*

Other Developments of interest *Page 9*

- Boards Should Consider Whether to Adopt Charter Amendment Opting Out of New DGCL Safe Harbor from Stockholder Vote Requirement on Sale of Mortgaged or Pledged Assets *Page 9*
- Court of Chancery Answers Unsettled Question: Stockholder Approval of Defensive Measures Does Not Result in Corwin Business Judgment Review *Page 10*
- Court of Chancery Holds a Flat Rep on Capitalization Means What It Says—and Permitted a PE Buyer to Terminate Its Merger Agreement Based on the Sellers' "Minor" Cap Table Misrepresentation *Page 10*
- Chancery Decision Highlights Risks of Returning Signed Signature Pages Without Checking To What They Are Being Attached *Page 11*
- Artificial Intelligence Creates Waves in Court *Page 11*
- U.S. Supreme Court Rules Parties Can Challenge Constitutionality of FTC and SEC Administrative Proceedings Before Agency Review is Complete *Page 12*
- New York Attorney General Proposes Novel, Sweeping Crypto Regulation *Page 12*
- Chancery Decision Interprets Earnout Trigger Event, Distinguishing Between a "New Agreement" and an "Amendment" *Page 13*
- DGCL Amendments Expected to be Enacted as of August 1, 2023 *Page 13*
- Anti-ESG Legislation Continues *Page 14*

Fried Frank M&A/PE Briefings Issued This Quarter *Page 15*

RoundUp: Second Quarter Highlights *Page 17*

Key Points

- **The entire fairness standard can be satisfied even if the deal process did not include an independent special committee of directors.** The Delaware Supreme Court stated that, although use of a special committee is considered "best practice" when a transaction involves a potential conflicted controller, its use is not a requirement for a finding, under the entire fairness standard of review, that the deal process was fair.

- Price may be the predominant consideration in an entire fairness determination. The Supreme Court reiterated that even a flawed process can result in a fair price. The Supreme Court stated that it was appropriate to defer to the Court of Chancery's determination that the price was fair to Tesla (i.e., was not an overpayment), particularly because the appellants' only argument at trial as to unfairness of the price to Tesla was based on their theory that SolarCity had been insolvent and therefore worth nothing at the time of the deal—and that theory had been "resoundingly rejected" by the Court of Chancery based on expert testimony that the lower court found convincing.

- The Court of Chancery erred by relying on certain market-based data—but the error was not significant enough to warrant reversal. The Supreme Court criticized the lower court for relying on the unaffected market price (just before announcement of the deal) to determine fairness of the deal price, when certain nonpublic information about SolarCity (relating to its liquidity problems) became known to the Tesla board during the five-month period between announcement and closing of the deal. Also, the Supreme Court criticized the lower court for not having explained, at least in a general sense, the weight it gave to the unaffected market stock price. The Supreme Court concluded, however, that these errors were not significant enough to warrant reversal, given substantial other evidence of fairness of the price (and the collapse of the plaintiffs' primary theory that SolarCity was insolvent at the time the price was agreed). In so holding, the Supreme Court rejected the argument a group of law professors made in *amici* briefs that characterized the lower court's analysis as reliance on "market evidence run amok," which, if affirmed, would disincentivize any board considering a conflicted transaction from utilizing the *MFW* procedural protections.

Discussion

Flaws in the deal process—including not utilizing a special committee—did not preclude a finding of entire fairness. The Supreme Court emphasized that, although Musk had more contact with the board than a conflicted fiduciary should have had, and although other directors also had conflicts that were not fully neutralized, "the Tesla board meaningfully vetted the acquisition, and [Musk] did not stand in its way." Critically, the board was led by a strong director who was "indisputably independent" of Musk; the board was advised by experienced, independent legal and financial advisors; and the transaction was "overwhelmingly" approved, in a fully informed vote, by a majority of the stockholders unaffiliated with Musk. The Supreme Court ruled that the lower court did not err in viewing these indicia of fairness of the deal process as outweighing the flaws in the process.

Use of a special committee is best practice in potential conflicted controller transactions. The Supreme Court noted that the price Tesla paid for not utilizing a special committee was having the transaction subjected to entire fairness review, which it characterized as "an expensive, risky, and heavy lift in the litigation arena." The Supreme Court pointed out that, notwithstanding that Musk may not have been

M&A/PE Partners

NEW YORK
Liza Andrews
Amber Banks
Adam B. Cohen
Andrew J. Colosimo
Warren S. de Wied
Steven Epstein
Christopher Ewan
Arthur Fleischer, Jr.*
David J. Greenwald
Erica Jaffe
Randi Lally
Thomas Lee
Mark H. Lucas
Scott B. Luftglass
Shant P. Manoukian
Philip Richter
Steven G. Scheinfeld
Robert C. Schwenkel**
David L. Shaw
Peter L. Simmons
Matthew V. Soran
Steven J. Steinman
Roy Tannenbaum
Gail Weinstein*
Maxwell Yim

WASHINGTON, D.C.
Bret T. Chrisope
Andrea Gede-Lange
Brian T. Mangino
P. Ryan Messier

LONDON
Ian Lopez
Andrew Rearick
James Renahan
Rachel Wolfenden

FRANKFURT
Dr. Christian Kleeberg
Dr. Juergen van Kann

**Senior Counsel*
***Of Counsel*

a controller, and that even if he was a controller the board may not have been influenced by him, and notwithstanding that the process apparently worked to accomplish a fair transaction for the stockholders, the litigation challenging the transaction spanned half a decade. In addition, the directors other than Musk had agreed to a $60 million insurance-funded settlement before trial (pursuant to which they were removed as defendants in the case).

We note that in another recent case, *Oracle* (May 12, 2023), the Court of Chancery held that a challenged transaction involving a potential conflicted controller, Larry Ellison, who, the court found, had the ability to control the transaction at issue but did not attempt to do so, was reviewable under the deferential business judgment rule rather than the stringent entire fairness standard. The case was dismissed at the pleading stage on that basis. The court emphasized in *Oracle* that Ellison had absented himself from the process and the unaffiliated stockholders had approved the transaction—both of which the court also found were the case in *Tesla*. The difference from *Tesla*, however, was that, in *Oracle*, an independent special committee was utilized and had functioned effectively to consider and negotiate the transaction. We note that it is only with *MFW*-type procedural protections in place (that is, requiring that the transaction be approved by an independent special committee and by the unaffiliated stockholders) that a challenge to a potential conflicted controller transaction might be dismissed at the early pleading stage of litigation.

There was substantial evidence of fairness of the deal process. The Supreme Court stressed that it was deferring to the Court of Chancery's "numerous unchallenged credibility and factual findings" that underpinned the lower court's determination that process flaws did not predominate or cause the process to be unfair or to "infect" the price. The Court of Chancery had emphasized that:

- The Tesla board did not appear to have been dominated by Musk—as the board had rejected certain of Musk's proposals with respect to the transaction, without "push back" from Musk; Musk did not engage in "threats, fits or fights"; and the director leading the negotiations for Tesla, and Tesla's financial advisor (Evercore), both were "unquestionably independent" of Musk.
- The evidence at trial substantiated that (i) the Tesla board's consideration of the acquisition was not for purpose of bailing out SolarCity, but was based on Musk's long-held strategic rationale for the combination, and (ii) the acquisition in fact had greatly benefitted Tesla.
- Evercore's ten-member team engaged in extensive due diligence and spent thousands of hours reviewing SolarCity's financial condition, performing analyses, and negotiating with SolarCity's financial advisor.
- The Tesla board lowered its offer price after completing due diligence and discovering that the extent of SolarCity's liquidity challenges was more severe than the board had known.

The Court of Chancery erred in relying on the unaffected stock price of the SolarCity shares to determine fairness of the price. The appellants challenged what they characterized as the lower court's "rote" and "almost exclusive" reliance on market-based data to establish fair price. They contended that the Court of Chancery based its ruling that the price was fair to Tesla stockholders almost entirely on the fact that the unaffected price of SolarCity's stock on the date the acquisition was announced ($21.19 per share, on June 21, 2016) was higher than the implied deal price ($20.35 per share, based on the merger exchange ratio agreed on November 21, 2016)—which led the Court of Chancery to conclude that no premium was paid and in fact that the deal price reflected a discount of $0.84 per share.

The appellants argued, first, that the June 21 stock price was unreliable due to material, non-public information relating to SolarCity's liquidity problems, which was unknown until later in the summer and in the fall of 2016 and thus was not factored into the June 21 market price; and, second, that the Court of Chancery's approach, if confirmed, would reduce the entire fairness analysis to the single question of whether a purchase price is sufficiently near the unaffected stock price. The *amici* brief submitted by a group of law professors supported the appellants on this issue, arguing that if the court "allow[s] a conflicted party to rely on little more than the pre-announcement transaction price to demonstrate the fairness in question, the party has little to gain from submitting to the procedural protections in *MFW*."

The Court of Chancery criticized the board for not explaining why the June 21 market stock price was reliable given the information that became known after that date; and for not explaining "at least in a general sense, the weight it gave to the June 21 stock price." The court acknowledged that "specific weighting of valuation methodologies takes on more significance in the appraisal context where the court is required to derive a single numerical estimate of fair value" rather than, in the case of an entire fairness analysis, a range of values where the price is deemed to be fair. The Supreme Court stated that, although the lower court's opinion reflected that it had *not* relied almost exclusively on the unaffected stock price, and in fact had relied on many factors, to determine the valuation of SolarCity, it would have "greatly aided" the reviewing court and the litigants if the lower court had provided "a more fulsome discussion of how [it] weighed the valuation evidence." The Supreme Court

stressed that, in any event, although the Court of Chancery erred in this portion of its analysis, there was "an array of valuation and fair price evidence" presented that supported the court's finding that the price Tesla paid was fair to its stockholders.

SolarCity was not insolvent. The Supreme Court deferred to the Court of Chancery's critical finding that, during the deal process, despite SolarCity's being "dangerously cash-strapped," the company was "solvent, valuable and never in danger of bankruptcy." The Court of Chancery had rejected the plaintiffs' expert testimony that SolarCity was insolvent based on the company's liquidity problems and the fact that its assets would be worthless in a liquidation context. The Court of Chancery found that the relevant analysis was, as Musk's expert argued, what the value was to SolarCity of the assets that were purchased and would be continuing (as opposed to being liquidated). The Court of Chancery also credited as evidence that SolarCity was not insolvent: Evercore's analysis and fairness opinion; the financial analysis by SolarCity's auditors at the time of the closing; Tesla's having booked in its financial statements an $89 million gain on the acquisition; and other financial testimony on SolarCity's cash flows and retained value.

Practice Points

Litigation strategy. Reliance on only one financial theory or valuation methodology typically presents significant risk as a litigation strategy. In *Tesla*, the Supreme Court indicated that the appellants' credibility, and their substantive case, were undermined by their having "placed their valuation case entirely in [one expert]'s hands"; that expert, "in turn, [having] relied exclusively on a single valuation theory" (*i.e.*, that SolarCity was insolvent); and that theory having been focused on just one financial factor (*i.e.*, that SolarCity's stock would be worthless in a liquidation context). The Supreme Court noted that, when the trial court "resoundingly rejected" the insolvency theory, "it undermined the credibility of [the appellants'] fair price case completely."

Valuation analysis and presentation. The Supreme Court indicated that an entire fairness analysis is best presented by setting forth "separately and expressly" the deal process conclusions and the deal price conclusions, followed by a "unitary determination of entire fairness in a separate section." Most importantly, the Supreme Court reaffirmed that a record demonstrating that "the negotiations were conducted at arm's-length, in good faith, with the advice of independent financial and legal advisors, led by an indisputably independent director," is evidence of a "fair process that led to a fair price."

Value of a special committee. In conflicted controller transactions, use of a special committee, combined with approval of a transaction by the stockholders unaffiliated with the controller, makes dismissal possible at the early pleading stage of litigation. We note that the court did not address in *Tesla* (nor in *Oracle*) whether, in a case involving a conflicted controller, the effective functioning of an independent special committee would "cleanse" a challenged transaction that did not require a stockholder vote and for which the approval of the unaffiliated stockholders was not obtained.

New State Laws Create Far-Reaching Risks for Investors with Foreign Investors

Citing national security concerns, over twenty U.S. states have recently enacted laws restricting foreign ownership of real property in the state. About a dozen other states currently have proposed such legislation. The laws generally are focused on restricting investment in certain real estate by persons and entities in nations viewed as being adversarial to the U.S. (including, or in many cases applying exclusively to, China).

These laws, in some cases, create significant uncertainty for, and may require certain actions by, U.S. public and private companies with non-U.S. investors, including managers of private investment funds that have non-U.S. passive financial investors. While the laws vary in their scope and effect, some appear to restrict even indirect investments in real estate (*i.e.*, investments in businesses that own real estate in the state) and apply even where the persons or entities in the specified foreign jurisdictions hold only small or indirect minority interests in the investor.

Florida's new law

The latest enactment of such legislation was by the State of Florida in May 2023. The law will be effective as of July 1, 2023, Also in May, the ACLU filed a lawsuit in federal court seeking an injunction against enforcement of the Florida law.

The law prohibits Chinese and Hong Kong investors from acquiring certain interests in real property in Florida; and requires that any such investments involving such investors that already exist be registered with the State by January 2024. The law appears to place the obligation to register such investments on the foreign investor, but their failure to register poten-

tially could result in forfeiture of the property to the state. Any investments made after July 1 in violation of the law will have to be divested. A *de minimis* exception is specified for new and existing investments, but it states that it is limited to situations where the interest is held through publicly registered securities. Thus, on its face, it seems that the law applies to investments in private companies involving even small, indirect interests by Chinese or Hong Kong investors, including through the ownership of interests in private investment funds managed by a U.S. adviser.

In addition, the law prohibits investors from Russia, North Korea, Cuba, Venezuela and Syria from acquiring any interest in agricultural land or real property that is within ten miles of any military installation (*i.e.*, any base, camp, post, station, yard or center under the jurisdiction of the U.S. Department of Defense encompasses at least ten contiguous acres) or any critical infrastructure facility (including, to the extent measures such as fences or barriers are employed that are designed to exclude unauthorized persons: chemical manufacturing activities, refineries, electrical power plants, water treatment facilities or wastewater treatment plants liquid natural gas terminals, telecommunications central switching offices, gas processing plants, and airports, seaports and spaceports).

The Florida law permits natural persons to acquire certain interest in real property that would otherwise be prohibited so long as the property is less than two acres, not within five miles of a military installation, and the person has specified types of U.S. immigration status. The law does not appear to prohibit lending activities. Also, it permits the acquisition of real property, that otherwise would be prohibited, through the enforcement of security interests or the collection of debts but the investor must divest the real property within three years.

Violation of the law can result in civil penalties, liens on and forfeiture of the property at issue. It is expected that Florida will issue clarifying rules and regulations, but not before the law goes into effect on July 1.

Other states' laws

In other cases, the laws enacted or proposed are more narrowly drawn. For example, the pending legislation in Texas and Washington would restrict investments in agricultural land by companies that are headquartered in, or are majority-owned by nationals of, China and certain other specified foreign nations.

Constitutionality issue

The constitutionality of these laws is uncertain, given federal jurisdiction over national security issues and the existing role of the Committee on Foreign Investment in the U.S. (CFIUS). (CFIUS has jurisdiction over real estate in proximity to specific airports, maritime ports, and military installations; and, in May 2023, a new rule was proposed that would add eight additional military sites in five states. See **here** the *Fried Frank International Trade and Investment Alert*, "CFIUS Proposes Expansion of Real Estate Rules to Cover Additional Military Installations.") Further, the Agricultural Foreign Investment Disclosure Act provides for the federal government to monitor foreign acquisitions and holdings in agricultural land. In addition, proposed federal legislation is pending (such as the FARM Act and the SOIL Act, both of which appear to enjoy bipartisan support) that would expand CFIUS's jurisdiction over certain acquisitions of agricultural land.

Practice points

U.S. and non-U.S. investors (including investment fund managers) should consider the potential applicability of these laws before acquiring U.S. real estate or making an investment in an entity that owns U.S. real estate, whether directly or through an M&A transaction.

- Such investors should consider whether their existing investments in U.S. real estate, or in entities that own U.S. real estate, are subject under these laws to a requirement that the investments now be registered with the state.

- Such investors that currently, directly or indirectly, hold, or that plan to so hold, real property interests in states with laws restricting foreign ownership of real property (especially if the applicable law has broad applicability and severe consequences for violations, such as divestiture of the property) should consider whether to redeem prohibited investors from their ownership structure, divest the real estate they own in the state at issue, or otherwise restructure their business to comply with such law or render it inapplicable.

New Guidance on What Constitutes a Sale of "All or Substantially All" of a Company's Assets

In *Altieri v. Alexy* (May 22, 2023), the Delaware Court of Chancery dismissed a lawsuit that challenged the sale by Mandiant, Inc. (the "Company") of its "crown jewel" division based on the Company's failure to obtain stockholder approval of the transaction. The plaintiff claimed that a vote was required, under DGCL Section 271, because the sale constituted a sale of "all or substantially all" of the Company's assets. The court determined that the sale did *not* constitute a sale of all or substantially all of the Company's assets and therefore a vote was not required. The decision is consistent with past precedent and breaks no new ground—but it is useful as a reminder of the facts-intensive and nuanced nature of the judicial analysis as to what constitutes a sale of all or substantially all of a company's assets, and provides helpful guidance as to the factors the court views as most critical in making the determination.

Key Points

- **Amplification of what constitutes a sale of "all or substantially all" of a company's assets.** There has been relatively sparse judicial development as to what constitutes a sale of all or substantially all the assets of a corporation. Previous cases have established that there are no bright line tests; and that the concept does not include *all* significant asset sales, but only those that, based on a combination of quantitative and qualitative factors, "strike at the heart of [the company's] corporate existence and purpose." Practitioners generally have considered judicial precedent as creating a significant degree of unpredictability on this issue.

- **Fundamental change in the type of business versus a significant change in how the business is operated.** In *Mandiant*, the Company's sale of its primary operating division altered the course of the Company's operations—changing the Company from a business focused primarily on cybersecurity detection and prevention services to a business providing only cybersecurity response services. The court emphasized that, notwithstanding the significant change in operations, both before and after the sale the Company was "a cybersecurity company." The critical factor for the court appeared to be that the Company, which had grown through regular acquisitions and dispositions of various businesses, was returning to a focus on what had been "a historical part of its business."

- **Issue arises in the non-public company context as well.** Cases on the issue whether a transaction constitutes a sale of all or substantially all the assets are relatively rare. The issue may arise, as in *Mandiant*, in the context of the requirement under DGCL Section 271 for a stockholder vote for a sale of all or substantially all of a company's assets. The issue also may arise in connection with a preferred stockholder's rights in a charter; other contractual rights of investors (such as a veto or consent right) or the company (such as a drag-along right) in a stockholders' agreement or LLC operating agreement; a lender's negative covenants under an indenture; or a financial advisor's engagement letter with respect to the types of transactions that trigger payment of advisory fees.

Background. In 2004, Kevin Mandia formed the Company to provide "incident response and consulting services" to companies that experience data security breaches (the "Old Mandiant Business"). The Old Mandiant Business pursued growth through mergers and acquisitions. In 2013, the Company combined with FireEye, Inc., which created products designed to detect and prevent cyberattacks (the "FireEye Business"). The Company then could both detect attacks and respond to them. In 2016, the Company acquired other businesses, such as one that gathered information about cyberhacker groups and one that provided security automation technology.

From 2016 to 2020, the Company was growing and the FireEye Business represented 62% of the Company's revenues. In 2021, however, the board projected that the FireEye Business would decline as a percentage of overall revenue (down to 42% in 2023). In June 2021, the Company sold the FireEye Business to Symphony Technology Group for $1.2 billion. The Company did not seek stockholder approval of the Sale. Mandia described the Sale as an opportunity to let the Company "concentrate exclusively on scaling [its] intelligence and frontline expertise"; and stated that the FireEye Business would fare better with STG as STG was focused on growing innovative market leaders in software and cybersecurity.

In reaction to the Sale, the Company's stock price dropped 17.62%. Analysts expressed concern about the Company's lower gross margin and stability absent the FireEye Business. In November 2021, a stockholder brought suit against the Company and the board, claiming that the Sale should be voided, and that the directors had breached their fiduciary duties as they had knowingly failed to put the Sale to a stockholder vote although it was a sale of all or substantially all of the Company's assets. Following briefing and oral argument, Chancellor Kathaleen St. J. McCormick found that the Sale was not a sale of all or substantially all of the Company's assets, and granted the defendants' motion to dismiss.

Discussion

DGCL Section 271. The statute does not provide any bright line test, mathematical formula, or other guidance as to what constitutes a sale of all or substantially all of a company's assets. Under the leading decision, *Gimbel v. Signal* (Ct. Ch. 1974), the determination depends on both "the quantitative and qualitative importance of the transaction at issue...." In *Mandiant*, the court reiterated that "[t]he purpose of the *Gimbel* analysis is to determine whether the transaction [at issue] struck at the heart of the corporate existence and purpose, in the sense that it involved the destruction of the means to accomplish the purpose or objects for the corporation was incorporated and actually performs."

The quantitative test. When evaluating the quantitative metrics of a sale, the court has looked at the overall effect on the corporation of the transaction, and has considered data points such as the percentage of overall revenue and the percentage of book value that the sold assets represented, as well as the contribution of the assets sold to overall EBITDA and future earnings potential. In *Mandiant*, the FireEye Business accounted for 62% and 57% of the Company's overall revenue in 2019 and 2020, respectively. At June 30, 2021, it represented about half of the Company's goodwill. Also, it had a strong social media presence relative to the Company's other offerings. These figures, the plaintiff contended, when paired with qualitative factors, were sufficient to satisfy the substantially-all test. The court noted that, in 2021, the board projected that the FireEye Business would decline as a percentage of overall revenue (to 48% and 42% in 2022 and 2023, respectively). The court also noted that, based on the Company's Form 10-Q for the quarter ended June 30, 2021, the Sale price represented roughly 38% of the Company's total assets as of December 2020 and June 2021. The court stated: "These percentages fall short of the substantially-all threshold from a quantitative perspective."

The qualitative test. When evaluating the qualitative metrics of a sale, the court considers whether the sale is "out of the ordinary" and "substantially affect[s] the existence and purpose of the corporation." The court focuses on "economic quality and, at most, on whether the transaction leaves the stockholders with an investment that in economic terms is qualitatively different...." The court held that the FireEye Business, while it was an "important aspect of Mandiant," did not affect the "existence and purpose" of the Company. The court emphasized that both before and after the sale the Company was a "cybersecurity company," even though the sale represented a significant alteration in the company's operations. The change, while "important...[, was] not so qualitatively significant as to strike a blow to [the Company]'s heart." The court viewed FireEye Business as an important part of the Company's corporate identity, but not at "the heart of its existence and purpose."

Review of precedential cases. Providing helpful clarity, the Chancellor explained how each of the cases the plaintiff cited (where the court found that there was a substantially-all sale) was distinguishable from the situation in *Mandiant*:

- ***Katz v. Bregman* (Ct. Ch. 1981)—shift from making steel drums to making plastic drums.** In *Katz*, the company sold a business line that represented 51% of the its assets, 45% of its sales revenue, and 52% of its pre-tax net operating income. The court's determination was not primarily based on these quantitative factors, however, but on qualitative factors. Qualitatively, the Chancellor stated in *Mandiant*, the sale in *Katz* constituted an effort by the company "to shift its overall business strategy by embarking on the manufacture of plastic drums that represented a radical departure from the company's historically successful line of business, namely steel drums." By contrast, the court wrote in *Mandiant*, the Sale by Mandiant "did not represent a stark departure from the Company's historic line of business." Rather, "[t]he Company was born from the fusion of FireEye with Old Mandiant, which focused on cybersecurity services. Mandiant had several businesses prior to the Sale, only one of which was the FireEye Business. The Sale was not qualitatively transformative for Mandiant."

- ***Winston v. Mandor* (Del. Ch. 1997)—shift from holding and managing real property to holding real estate-related securities and mortgages.** In this case, the issue arose with respect to a preferred stockholder's contractual right to convert shares into a new security if the company sold all or substantially all of its assets. The assets that were sold represented 60% of the company's net assets; and the sale shifted the company's primary business from holding real property to holding real estate-related securities. The Chancellor stated in *Mandiant* that, by contrast, the Sale by Mandiant did not "fundamentally change[] its core practice in the cybersecurity space[; and] [m]oreover,... the FireEye Business indisputably constituted far less... of the Company's net assets."

- ***Thorpe v. CERBCO* (Ct. Ch. 1995) and *B.S.F. v. Phila. Natl. Bank* (Del. 1964)—sale of the primary income producing asset**. In *Thorpe*, a pipeline service provider sold its subsidiary that provided pipelines services. The subsidiary constituted 68% of the company's assets and was the primary income generating segment of the company. Post-sale, the holding company was left with a substantial amount of cash, a small subsidiary that was about to be liquidated, and a single operating company that was minimally profitable. In *B.S.F.*, the issue arose out of a negative covenant

in a debenture (controlled by Pennsylvania law) which prohibited the sale of all or substantially all of the borrower's property. The company had sold a business that represented 75% of the company' assets and that was the company's only substantial income producing asset. The court wrote in *Mandiant* that, by contrast with these cases, the Sale by Mandiant, quantitatively, reflected metrics that were "much less compelling" and, qualitatively, differed in that Mandiant was not left "unable to generate income in FireEye's absence; indeed, the Company generated total revenues of approximately $121.97 million in the fiscal quarter following the Sale."

Similarity to *Hollinger*. The court found that the Sale by Mandiant was similar to the sale in *Hollinger v. Hollinger Intl.* (Ct. Ch. 2004). In *Hollinger*, the court found that the sale did *not* meet the substantially-all test. In that case, a global newspaper publishing company sold its crown jewel newspaper. The court emphasized that, post-sale it remained a newspaper company with profitable operating divisions. While the assets sold represented about 57% of the company's total asset value, they represented less than half the company's revenues during the prior three years, less than half the company's earnings and book value at the time of the sale, and a declining percentage of the company's EBITDA. In addition, post-sale, the remaining company would still be a profitable publishing company, with at least one highly valuable remaining division and at least two prestigious newspapers. Therefore, the *Hollinger* court concluded, "[w]hile important, the sale of the [division] does not strike a blow to the company's heart." In Mandiant, the Chancellor viewed the Sale similarly: "The FireEye Business was one part of the Company's corporate identity, but the Complaint does not support a reasonable inference that the FireEye Business was the 'heart' of the Company's existence and purpose."

Highly facts-intensive and nuanced inquiry. Practitioners have generally viewed cases on the issue of the substantially-all test as somewhat inconsistent and unpredictable. Indeed, one could imagine that the court could have viewed the *Mandiant* Sale the way it viewed the *Katz* sale—that is, as involving a "radical shift" from one line of business to another—and on that basis could have found the Sale sufficiently transformational to satisfy the substantially-all test. Or, conversely, in *Katz*, the court could have viewed the sale the way it viewed the *Mandiant* Sale—that is, as *not* sufficiently transformational to satisfy the substantially-all test on the basis that, both before and after the sale, the company was a drum manufacturing company, even though it had significantly changed its course of operations to make plastic drums rather than steel drums. The utility of the court's discussion in *Mandiant* is that it elucidates the facts-intensive and contextual analysis (beyond these semantic frameworks) that is required. Specifically, the decision highlights the kinds of qualitative factors that will be relevant—such as how different the business is post-transaction, how tied the sold assets were to the company's corporate identity, how important the sold assets were the company's ability to generate earnings and profits, whether the remaining business is one of the company's historical businesses, and so on.

Practice Points

- **Among the factors that should be considered when determining whether a sale meets the substantially-all test are the following:**
  - the percentage that the sold assets represent of the company's overall revenue (historic and projected); EBITDA and future earning potential; book value; and goodwill;
  - whether the sale was out of the ordinary or, instead, part of a regular course of business of acquisitions and dispositions;
  - whether the sale reflected a "radical departure" from the company's past line(s) of business; affected the "heart and soul" or "corporate identity" of the corporation; or "struck at the heart of the corporation's existence and purpose"—rather than simply representing an altered course (even if significant) in the company's operations;
  - the extent to which an investment in the post-sale company is significantly different from an investment in the company before the sale, and the extent to which a reasonable investor would have expected that the company would have viewed the assets as "sacrosanct"; and
  - among the most important considerations, whether the operating assets remaining post-sale constituted a substantial, viable, ongoing component of the company that could generate earnings and profits.

- See the article below relating to a new safe harbor from the DGCL Section 271 stockholder vote requirement, which is expected to be enacted soon and effective as of August 1, 2023: "Boards Should Consider Whether to Adopt Charter Amendment Opting Out of Safe Harbor from Stockholder Vote Requirement on Sale of Mortgaged or Pledged Assets."

Other Developments of Interest

Boards Should Consider Whether to Adopt Charter Amendment Opting Out of New DGCL Safe Harbor from Stockholder Vote Requirement on Sale of Mortgaged or Pledged Assets

There has long been uncertainty among practitioners as to whether there is an "insolvency exception" from DGCL Section 271's requirement for stockholder approval of a sale of all or substantially all the assets of a corporation—that is, whether there is an exception such that an insolvent corporation could sell all or substantially all of its assets without a stockholder vote. In *Stream TV Networks v. SeeCubic* (Del. 2022), the Delaware Supreme Court answered that question, holding that there is no insolvency exception to Section 271. In response, the Delaware legislature did not propose a general insolvency exception to Section 271, but has proposed amendments to DGCL Section 272 that would provide a safe harbor for selling, leasing or exchanging collateral assets that secure a mortgage or pledge without obtaining stockholder approval under Section 271.

Importantly, under the proposed amendment, if a corporation's charter requires stockholder approval for a sale of all or substantially all of the corporation's assets, that provision would not require a stockholder vote for a transaction permitted by amended Section 272(b) unless that provision expressly requires approval for such a transaction and first becomes effective after August 1, 2023. Thus, corporations should review their charters to determine if such an opt-out to Section 272(b) is desired (assuming that, as is expected, the proposed amendments to the DGCL are adopted). Any such determination should, of course, take into account the likelihood of the company's need for such an opt-out, the likely reaction of the company's stockholders to such a opt-out, and whether other companies are adopting such opt-outs.

Specifically:

- ***Existing DGCL Section 271*** provides that stockholder approval is required for a corporation's sale, lease or exchange of all or substantially all of its assets.
- ***Existing DGCL Section 272*** provides that stockholder approval is not required for the mortgage or pledge of a corporation's assets (unless the charter provides otherwise).
- ***New Section 272(b)(1)*** will clarify that stockholder approval is not required under Section 271 for a sale, lease or exchange of assets constituting collateral securing a mortgage or pledge—*if* the transaction is being effected through the secured party's exercise of its rights under the law governing the mortgage or pledge (or under other applicable law, such as Article 9 of the UCC, real property law, or other law) without the corporation's consent.
- ***New Section 272(b)(2)*** will provide that, alternatively, if a secured party is entitled to sell the collateral in such circumstances, but wishes not to, then the secured party and the corporation's board of directors can agree to an alternative transaction (*e.g.*, a strict foreclosure or sale to a third party), without obtaining stockholder approval under Section 271, *if* the value of the assets is less than or equal to the amount of the liability or obligation being reduced or eliminated as a result of the transaction (the "Value Asset Test").
- ***New Section 272(d)*** will provide that a charter provision—which first becomes effective after August 1, 2023—requiring stockholder approval of a sale, lease or exchange of assets will not apply to a sale, lease or exchange of assets that is permitted by Section 272(b) unless the charter expressly states that stockholder approval is required for transactions permitted by Section 272(b). Note that a charter provision that requires stockholder approval for "dispositions" of assets (*i.e.*, that extends beyond the "sale, lease and exchange" transactions to which the Section 271 stockholder approval requirement applies) may result in those transactions not receiving the benefit of the Section 272(b) safe harbor.

The Asset Value Test. With respect to the Asset Value Test, the amendment does prescribe a method of valuing the assets for such purpose. Section 272(b)(2) will provide that a transaction involving the payment of consideration to the corporation or its stockholders would not fail the Asset Value Test on that basis.

Injunction; Fiduciary Claims. New Section 272(c) will provide that, after a transaction is completed, the transaction cannot be invalidated for failure to satisfy the Asset Value Test if the transferee of the assets provided value therefor and acted in good faith. This Section also will provide, however, that a transaction may be enjoined before it is consummated. Nothing in the amendment precludes claims for monetary damages in connection with any sale, lease or exchange of assets—for example, derivative claims based on directors' or officers' fiduciary breaches. Section 272(c) will provide that the safe harbor under Section 272(b) does not change a director's or officer's fiduciary duties or the level of judicial scrutiny in connection with a sale, lease or exchange of assets. In addition, the amendment does not eliminate defenses that are generally available to directors and officers (such as exculpation under the charter for breaches of the duty of care, as

provided for under Section 102(b)(7); or protection based on good faith reliance on the corporation's books and records, officers, board committees and experts selected with reasonable care, as provided for under Section 141(e)).

The Chancellor, noting that value of the cap table issue (about $215 million, according to the plaintiff's complaint) was "minor" relative to the value of the deal, commented that the buyers seemingly could have protected themselves with respect to Marquez's claims simply by having entered into an escrow arrangement at closing that would have supplement the indemnity protections in the merger agreement. But, the court stated, apparently "the Buyers [did] not want the hassle"—and they were not required to do so. The Chancellor observed that the buyers had indicated that their business reason for backing out of the deal was "concern that Marquez himself posed reputational risks [for the company] post-closing"—an "ironic twist," the Chancellor commented, given that the buyers had "previously enjoyed a reputation as a reliable deal partner likely to provide a target with deal certainty." The Chancellor concluded, however, that ultimately, "it is not for this court to question the business wisdom of Buyers' decision to terminate."

The buyers had "negotiated for the ability to terminate if the capitalization representations were not accurate in all respects, and this decision enforces that right," the Chancellor stated. The court pointed to the negotiating history between the parties and noted that the sellers three times had tried to insert a materiality qualifier into the capitalization representation closing condition, but that each time the buyers had insisted that the representation should be brought down at closing as a flat representation.

Court of Chancery Answers Unsettled Question: Stockholder Approval of Defensive Measures Does Not Result in *Corwin* Business Judgment Review

In *In re Edgio, Inc. S'holders Litig.* (May 1, 2023), the Court of Chancery addressed the question—unsettled under Delaware law—whether a fully informed, uncoerced stockholder vote approving the adoption of defensive measures would, under *Corwin*, lead to review of a stockholder challenge seeking to enjoin such measures under the deferential business judgment review (which almost invariably leads to dismissal of claims challenging board action) when they otherwise would be subject to enhanced judicial scrutiny under the *Unocal* standard. Vice Chancellor Zurn held, at the pleading stage, that *Corwin* is inapplicable in the context of claims for post-closing injunctive relief under *Unocal*. The case related to certain transfer restrictions and voting commitments in a stockholders' agreement with a 35% stockholder, which the plaintiff alleged were defensive in nature by allegedly creating a 35% voting block. We note that the judgment is subject to appeal to the Delaware Supreme Court and that, based on a more fully developed trial record, the court may conclude not to enjoin the provisions. Pending ultimate resolution, the opinion provides important guidance for corporations with respect to negotiating transfer, voting and similar restrictions and requirements in agreements with major stockholders.

Court of Chancery Holds a Flat Rep on Capitalization Means What It Says—and Permitted a PE Buyer to Terminate Its Merger Agreement Based on the Sellers' "Minor" Cap Table Misrepresentation

HControl Hldgs. v. Antin Infrastruture (May 29, 2023) arose out of the merger agreement that private equity firm Antin Infrastructure Partners entered into in 2022 to acquire a group of privately held broadband companies ("OpticalTel") for $230 million plus an earnout arrangement. The merger agreement, as is common, contained a representation from the sellers that the capitalization of OpticalTel was as set forth on the capitalization table attached as an exhibit; and contained a bringdown provision requiring that the capitalization representation would be accurate *in all respects* at closing. The merger agreement also included a provision requiring the buyers to use best efforts to close.

After the merger agreement was announced, a former OpticalTel employee, Rafael Marquez, whom the court characterized as "a colorful character and a skilled shakedown artist," claimed to be a cofounder of OpticalTel and the owner of a 5% equity interest in OpticalTel. Marquez embarked on "a campaign of disruption to extract as much value from [the sellers] as possible," including by directly contacting the buyers' legal counsel, bankers and financing partner about his alleged ownership interest and the possibility of their being additional owners not reflected on the capitalization table. The buyer investigated Marquez's claim and attempted to settle with him, but his demands made settlement unachievable. Ultimately, the buyers provided notice to the sellers of a breach of the capitalization representation and sought to terminate the merger agreement.

Marquez's claim apparently was based on a 2004 software development agreement that provided him with "5% ownership of HControl Corporation to be distributed upon a liquidation event." The sellers argued that Marquez's interest was not an "equity security" that was required to be reflected on the cap table based on the definitions in the merger agreement. The court concluded that the software agreement provision was ambiguous, but that, based on extrinsic evidence, the sellers had the better argument—and the right granted to Marquez under the software agreement was a contingent

value right (CVR) (that is, a right to cash payment upon a liquidation event in the amount of 5% of the value of HControl Corporation). However, the court also concluded that a CVR was a security required to be reflected on the cap table, as the definition of "equity security" in the merger agreement included "phantom equity."

In a post-trial opinion, Chancellor Kathaleen St. J. McCormick ruled that, as the buyer had negotiated for a flat capitalization representation, even immaterial inaccuracies in the representation permitted the buyer to terminate the agreement. The court rejected the sellers' argument that the best efforts clause required the buyers to settle on Marquez's terms. The court wrote: "The best-efforts provision does not require Buyers to sacrifice their negotiated contractual rights to solve a breach. If that were the case, pre-signing diligence, a seller's representations and warranties, and specific closing conditions would be meaningless, as a buyer could be required to close over any breach that arose between signing and closing."

Chancery Decision Highlights Risks of Returning Signed Signature Pages Without Checking To What They Are Being Attached

In *Braga Investment & Advisory v. Yenni* (May 31, 2023), Braga invested $700,000 to acquire a 23.3% membership interest in Steven Feller P.E., LLC ("Newco"), as part of a transaction in which Newco acquired the business of Steve Feller P.E., PL. The Yenni Income Opportunities Fund, I (the "Fund") (which owned a majority of Newco's membership interests and became its managing member) and the Fund's managing partner, Musa Yenni ("Yenni"), had engineered the deal. During the course of due diligence, in 2015, Braga received an unsigned, proposed form of Newco's LLC operating agreement. Braga knew that the proposed operating agreement would be revised before the transaction's closing. Without ever asking to see the final operating agreement, Braga signed and returned a signature page to the proposed operating agreement it had earlier been provided. Braga also entered into a separate Co-Investment Agreement with the Fund, in which Braga acknowledged that it was a passive investor and gave the Fund an irrevocable power of attorney that allowed the Fund to vote Braga's equity interest in Newco.

Disputes later arose between Braga and the Fund, including, in 2019, with respect to a proposed amendment to the operating agreement in connection with a potential debt refinancing by Newco. In that process, Braga discerned that the operating agreement materially differed from the proposed form it had first received and signed in 2015. On May 31, 2019, Newco and its members adopted an amended operating agreement, with the Fund signing on behalf of Braga under the irrevocable power of attorney. Braga brought suit claiming that the Fund and Yetti fraudulently induced Braga to invest in Newco and that they breached the operating agreement by purporting to amend it twice without Braga's authorization. Braga sough rescission and a return of its original investment or, alternatively, damages and an order declaring that the form of operating agreement it had received in 2015 was Newco's valid and effecting operating agreement.

Vice Chancellor Fioravanti dismissed Braga's claims. The court found the defendants' conduct after closing "irresponsible, and perhaps worse" in several respects. "But," the court wrote, "this post-closing conduct does not establish that the 2015 OA was the Company's operating agreement, or that Defendants fraudulently induced Plaintiff to enter into the Co-Investment Agreement." The court emphasized that Braga actually knew that the 2015 form of proposed agreement "would be revised before closing and would not be the final operating agreement, yet it never asked to see the final version before executing and returning the signature pages to the agreement." Indeed, before Braga returned the signed signature page, Braga had received and paid, and discussed with Yenni, a bill for legal counsel for its work making revisions to the operating agreement. The court wrote: "Ultimately, Braga Investment's predicament is one of its own making and could easily have been avoided. The court will not unwind a transaction due to a sophisticated party's decision to sign an agreement without having read it."

Artificial Intelligence Creates Waves in Court

In one recent situation, a New York federal district court judge, Judge P. Kevin Castel, issued an order, against a plaintiff's attorney in a personal injury case, to show cause why he should not be sanctioned by the court for having cited in his brief in opposition to the defendant's motion to dismiss the case six non-existent cases that were generated by ChatGPT. The lawyer, who has been practicing for thirty years, submitted an affidavit to the court, stating that he had decided to consult ChapGPT to help supplement the legal research he had performed; and that ChatGPT had provided him with its legal sources and had assured him that its research was reliable. The lawyer attached to his affidavit the record of the queries he had presented to ChapGPT and ChatGPT's responses to him. For example, the lawyer asked ChatGPT: "Is *Varghese* a real case? What is your source? Are the other cases your provided fake?" And ChatGPT responded that the cases were not fake and could be found "in reputable legal databases such as LexisNexis and Westlaw." The lawyer told the court that he had never used ChatGPT for legal research before and was unaware of the possibility that its content could be false.

Following this incident, a Texas federal district judge, Judge Brantley Starr, issued a standing order requiring all lawyers

and pro se litigants to file certificates with their notice of appearance, attesting that either (i) "no portion of any filing will be drafted by generative artificial intelligence (such as ChatGPT, Harvey AI, or Google Bard)," or (ii) that "any language drafted by generative artificial intelligence will be checked for accuracy, using print reporters or traditional legal databases, by a human being." The judge wrote in the order that "[t]hese platforms are incredibly powerful and have many uses in the law: form divorces, discovery requests, suggested errors in documents, anticipated questions at oral argument. But legal briefing is not one of them." The judge explained that "[t]hese platforms, in the current states, are prone to hallucinations and bias"—"they make stuff up—even quotes and citations." Moreover, the judge noted, "these systems hold no allegiance to any client, the rule of law, or the laws and Constitution of the United States (or, as addressed above, the truth)." They are "[u]nbounded by any sense of duty, honor, or justice," and "act according to a computer code rather than conviction, based on programming rather than principle." The order further states that the court will strike any filing from a party who fails to file a certificate on the docket attesting that they had read the order and understand that they will be held responsible for the contents of any filing they sign and submit to the court, regardless of whether generative AI drafted any portion of it.

We note that the London-based law firm Allen & Overy has reported that, since late 2022, it has been testing the Harvey AI platform (a GPT-4-based software tailored for law firms and backed by an OpenAI-managed investment fund). Its lawyers are currently using Harvey for various aspects of legal work, including legal drafting, research, contract analysis, due diligence, litigation, and regulatory compliance—with lawyers validating what Harvey produces.

U.S. Supreme Court Rules Parties Can Challenge Constitutionality of FTC and SEC Administrative Proceedings Before Agency Review is Complete

In Axon Enterprises v. FTC, et al (April 14, 2023), the U.S. Supreme Court unanimously ruled that parties can challenge in federal court the constitutionality of administrative proceedings of the FTC and the SEC, without waiting for completion of the agency's review. The decision resolved a split between the Ninth and Fifth Circuits. The Ninth Circuit, in Axon, had affirmed the dismissal of Axon's claim that an FTC administrative proceeding is unconstitutional, reasoning that Congress had precluded the district court from hearing Axon's constitutionality arguments. The Fifth Circuit, in SEC, et al v. Cochran, had held that district courts have jurisdiction to hear constitutional claims prior to a final decision by the agency.

The Supreme Court did not rule on whether the proceedings at issue were constitutional, but removed the requirement that parties first must exhaust administrative processes before challenging the constitutionality of the proceedings. The decision thus facilitates such constitutionality challenges being made. As a result, the decision makes more likely further such challenges and, perhaps, ultimately a Supreme Court decision on the constitutionality of such proceedings.

New York Attorney General Proposes Novel, Sweeping Crypto Regulation

While U.S. federal agencies continue to try to sort out whether digital assets are or are not "securities" and which agency has primary jurisdiction to regulate them, states are becoming more active in considering the adoption of regulations that would fill the gap pending preemption by federal rules that may ultimately be adopted. On May 4, 2023, the New York Attorney General, Letitia James, proposed novel legislation with sweeping breadth. The proposed Crypto, Protection, Transparency and Oversight Act (CRPTO Act) would:

- bypass the ongoing debate about whether digital assets should be regulated as securities or commodities, and instead treat them as a class of their own;
- very broadly define digital assets and the "covered entities" subject to regulation (to include digital asset issuers, brokers, marketplaces, and investment advisers) and impose extensive new requirements and restrictions on the covered entities;
- treat all digital assets as financial instruments (even when their use is unrelated to speculative finance);
- impose extensive public disclosure requirements on digital asset issuers;
- (most unusually) impose reporting requirements on digital asset *customers* with respect to unauthorized transactions involving their digital assets; and
- impose extensive disclosure requirements on digital assets influencers and promoters.

Among the most notable provisions, the Act would:

- prohibit covered entities from operating in more than one of the following roles: issuer, broker, marketplace, or investment adviser;
- prohibit companies or individuals who perform any of the above roles from engaging in proprietary trading (similar to the Volcker Rule that prohibits banks from investing with their own accounts);
- require digital asset issuers to publish prospectuses containing material information about the issuer and the digital

assets being issued; and, if conducting business from New York, to file digital asset statements and make publicly available independently audited annual and quarterly financial statements (following which the company would be subject to the existing regulations allowing oversight by state financial regulators, including examination of the company's financial condition, business conduct, management policies, and regulatory compliance);
- apparently, subject the covered entities to New York's existing, expansive cybersecurity compliance requirements (including requirements to implement extensive cybersecurity policies, with specified governance and other controls, and regular testing and assessments);
- require that digital asset customers report to the state unauthorized transactions in their digital assets (such as through fraud, hacking or other theft)—with caps on the customer's liability for losses being eliminated if the report is not made within 60 days of the customer having become aware of the unauthorized transaction; and
- require that digital assets influencers and promoters disclose their ownership interest in and compensation received in connection with the digital asset being promoted, as well as other personal information such as their wallet address (which is generally well-guarded information as it can provide access to a record of the person's cryptocurrency transactions on public blockchains) and their educational, business and criminal backgrounds.

Chancery Decision Interprets Earnout Trigger Event, Distinguishing Between a "New Agreement" and an "Amendment"

Shareholder Services v. HPI Holdings (Apr. 26, 2023) involved a dispute over whether HPI Holdings, the buyer of AHS ("AHS") (a medical billing business) was required to make an earnout payment of $6 million to the sellers under the parties' merger agreement. During the merger negotiations, one of AHS's customers, Brevard Physician Associates ("BPA"), notified AHS that BPA intended to terminate its Service Agreement with AHS, under a provision in the Service Agreement that permitted termination for convenience after a 90-day (or in some circumstances 180-day) notice period. Following the merger closing, the buyer placed $16.8 million into escrow for potential earnout payments.

Under the merger agreement, the sellers would receive $6 million of the escrowed amount if, after the merger closing, BPA (a) signed a new agreement with HPI, with substantially the same economic terms as the existing agreement, but without the early termination clause; (b) signed an amendment to the existing agreement, removing the early termination clause; or (c) signed a new agreement with HPI satisfactory to HPI in its sole discretion. On December 22, 2021, BPA and HPI entered into a one-page "Agreement to Amend Services Agreement" (the "December Agreement"), which incorporated the existing 36-page Service Agreement except as "affected, modified or changed" by the December Agreement. The December Agreement (i) specified that it would last no less than one year, with automatic renewals; (ii) provided for a new fee schedule; (iii) eliminated fee-related penalties and quarterly performance incentives; and (iv) suspended BPA's prior right to terminate at any time with 90 days notice until September 30, 2022 (thus pushing out for a year the early termination option).

AHS contended that the December Agreement triggered the $6 million earnout payment, as it satisfied (c) above (because it was a "new agreement" that was "satisfactory" to HPI). The court rejected the plaintiff's arguments that the December Agreement was a "new agreement" given the title (referring to an "Agreement to Amend" and that it supplanted certain provisions in the Service Agreement. The court noted that the December Agreement, in the text, consistently referred to itself as an amendment to the Service Agreement; and, while it modified a few provisions of the Service Agreement, stated that it was incorporated into and became a part of the Service Agreement, so that the Service Agreement continued to exist and the December Agreement reflected an intent by the parties to modify, rather than to replace, the Service Agreement.

AHS contended, in the alternative, that the December Agreement satisfied (b) above (because it was an amendment that removed the early termination provision). The court concluded that the December Agreement did not expressly "delete and replace" the early termination provision in the Service Agreement (although it had done so with respect to other provisions that were modified). Also, pushing out the date for early termination had "suspended" or "delayed" BPA's early termination right, but had not "removed" the early termination provision.

DGCL Amendments Expected to be Enacted as of August 1, 2023

In May and June 2023, the Delaware legislature passed proposed amendments to the Delaware General Corporation Law. If signed into law by Delaware's governor, as is expected, the amendments would become effective as of August 1, 2023. (The amendments relating to a safe harbor from stockholder approval of sales of collateral securing mortgaged or pledged assets is discussed, separately, in the article above, "Boards Should Consider Whether to Adopt Charter Amendment Opting Out of Safe Harbor from Stockholder Vote Requirement on Sale of Mortgaged or Pledged Assets.")

Streamlining the Ratification of Defective Corporate Acts. The new amendments would streamline the requirements of DGCL Section 204 to revitalize it as a more practical and efficient route for corporations to self-ratify defective corporate acts (such as stock issuances that otherwise are void or voidable due to a failure to duly authorize the acts), without the need for judicial involvement under DGCL Section 205. Generally, the amendments would: (i) eliminate the requirement under Section 204 to file a certificate of validation with the Secretary of State, unless the act to be ratified, under any section of the DGCL, required the filing of a certificate and such certificate was never filed or was filed but must be changed to give effect to the ratification (including a change in the certificate's effective time; (ii) reduce the level of detail and narrative that must be set forth in a certificate of validation when it is required that one be filed; and (iii) clarify that the stockholders, if any, who are entitled to vote on a ratification are all of the holders of shares of valid stock outstanding and entitled to vote at the time the board adopts resolutions ratifying the defective corporate act.

Authorizing Stock Splits and Changes in the Number of Authorized Shares.

Forward Stock Splits. The new amendments would facilitate public offerings (and make the DGCL consistent with the prevailing law on forward stock splits in a majority of states) through the enactment of a new DGCL Section 242(d). This new Section would render unnecessary the practice corporations generally have engaged to circumvent the impracticalities associated with seeking stockholder approval after pricing an offering. The practice has been to have the board approve a variety of ratios for the forward stock split and then, prior to pricing, seek stockholder approval for amendment to the certificate of incorporation at several alternative ratios, with the board choosing which ratio to implement once the pricing is completed. Under new Section 242(d), no stockholder vote would be required in many situations, in recognition of the fact that, because all outstanding shares of the class of stock subject to forward stock split are increased by the same ratio, there is no economic, voting or other impact of a forward stock split on the holders of such shares. Specifically, new Section 242(d) would eliminate the requirement for stockholder approval to amend the certificate of incorporation to effect a forward stock split if the corporation has only one class of stock outstanding that is not subdivided into series, unless such approval is otherwise required by the certificate of incorporation. If a forward stock split is authorized without stockholder approval, the certificate of incorporation may also be amended without stockholder approval to increase the number of authorized shares of the same class of stock, up to an amount proportionate to the stock split ratio, unless stockholder approval is required by the certificate of incorporation.

Reverse Stock Splits. New Section 242(d) would also change the stockholder vote requirement to amend the certificate of incorporation to effect a reverse stock split or change the number of authorized shares of a class in connection with a reverse stock split (or otherwise, except as described above in connection with forward stock splits). These changes would address the difficulty corporations have faced in obtaining stockholder approval by a majority of the outstanding shares entitled to vote thereon, in light of the significant number of shares held in street name and brokers' ability to exercise their discretion in voting such shares only on "routine" proposals). Under new Section 242(d), unless otherwise required by the certificate of incorporation, the stockholder voting requirement would no longer be a majority of the outstanding shares but, instead, a majority of the votes case, so long as such class of stock is listed on a national securities exchange and the corporation would continue to meet the listing requirement relating to the minimum number of holders immediately after giving effect to such amendment.

Opt-in. New Section 242(d) will permit a corporation to provide in its certificate of incorporation that the corporation "opts in" to the *current* voting standard (a majority of the outstanding shares), rather than being governed by the modified standard (a majority of the votes cast), for forward or reverse stock splits and changes in the number of authorized shares. To opt in, a corporation would expressly state in the certificate of incorporation that the stockholder vote otherwise required under Section 242(b) is required to approve the matter, or would expressly state which of the provisions of new Section 242(d) it is opting out of.

Record Date for Action by Consent of Stockholders. The amendments would simplify the determination of the record date for stockholders entitled to notice of action by consent of stockholders. Under amended DGCL Section 228(e), notice of action by consent must be provided to persons who (i) were stockholders as of the record date for such action by consent; (ii) would have been entitled to notice of the stockholders' meeting if such action had been taken at a meeting and the record date for such notice of such meeting were the same as the record date for such action by consent; and (iii) have not consented to such action. Also, corporations entitled under federal securities laws to use a notice of internet availability of proxy materials would be permitted to use such notice to satisfy the Section 228(e) notice requirement.

Anti-ESG Legislation Continues

While corporate boards and investment managers have incorporated a strong focus on ESG (environmental, social and governance) issues into their regular decision-making and priorities, ESG has become highly politicized in the U.S. In several cases, legislatures in blue-leaning states (including New York) have passed laws or state pension initiatives to

promote the consideration of ESG factors in investment decisions. At the same time, legislatures in at least 23 red-leaning states (including Texas and Florida) have passed or proposed laws or initiatives to prohibit or restrict state pension funds or agencies from doing business with investors and companies that consider ESG factors in their investment decisions. These "anti-ESG" laws and initiatives typically are written broadly, but most contain exceptions and their interpretation is still evolving. (See **here** "Continued Politicization of ESG," in the *Fried Frank M&A/PE Quarterly*, Spring 2023.)

In the most recent iteration of anti-ESG legislation, on June 14, 2023, the North Carolina Legislature, strictly on party lines, passed a bill that would block state entities from considering ESG factors when making investment and employment decisions. Under the legislation, the state treasurer could make investment decisions only based on "pecuniary factors," which is defined as factors with a material impact on an investment's financial risk and return; and state agencies could not use ESG criteria to make decisions relating to hiring, firing or evaluating employees, or relating to the awarding of state contracts. While it is uncertain whether the Democratic Governor will sign or veto the Republican-led legislation, it appears that the Republican-dominated Legislature would have sufficient votes to override a veto.

In light of the conflicting regimes among states, and between states and the federal regime, asset managers and private equity firms need to keep informed about pro- and anti-ESG legislation and policies; identify the exceptions and carveouts provided in the small-print of these laws and policies; keep abreast of regulatory and judicial interpretation of the laws and policies; monitor their compliance with these conflicting regimes; review their ESG-related policies, procedures and disclosures to determine if they need to be clarified, strengthened or amended; understand and balance the conflicting interests of their stakeholders with respect to ESG issues; and proactively prepare for political and legal challenges to their ESG-related policies and decisions.

Fried Frank M&A/PE Briefings Issued This Quarter

Fried Frank issued the following Briefings on key Delaware judicial decisions and developments during this quarter (please click on the title to read the full Briefing):

***Chancery Reaffirms Very High Bar for Successful Challenge of Even "Terrible" Business Decisions by an Independent Board*—Coral Springs v. Dorsey**

In *City of Coral Springs Police Officers' Pension Plan v. Jack Dorsey, Block, Inc., et al* (May 9, 2023), the Delaware Court of Chancery dismissed a lawsuit against the directors of Block, Inc. (a tech company, originally called Square, Inc., led by former Twitter CEO Jack Dorsey) challenging Block's $237.3 million acquisition in 2021 of an 86.23% stake in TIDAL, a music streaming company 27% owned by Shawn Carter (who is professionally known as Jay-Z). The court dismissed the case after finding that the plaintiffs did not establish that the independent directors of Block acted with bad faith (and that, therefore, they did not establish demand futility).

The decision serves as a reminder of the very high bar for a finding that an independent board acted in bad faith. Even in the context of a decision to approve what was "by all accounts, a terrible deal" following a minimal and flawed process, an independent and disinterested board will not have liability unless it acted in bad faith. The decision indicates that, generally, the court will not find bad faith unless the board essentially did almost *nothing* to evaluate the transaction before approving it. In this case, where the directors received a presentation about the transaction, had three short meetings, and asked management questions, they had not acted in bad faith, the court found—even though, apparently, the answers to the questions they asked all strongly indicated that the deal should not be done. Also of note, although the court held that the director defendants had no liability, the court's recitation of the background facts and other commentary made clear the court's view that Dorsey may have been motivated by his friendship with Carter and that the directors had not done a good job and had made what was obviously a "terrible business decision."

***Non-Majority Stockholder's Ability to Control a Transaction Did Not Render Him a Controller As He Did Not Try to Control*—Oracle**

In *In re Oracle Corporation Derivative Litigation* (May 12, 2023), certain former stockholders of Oracle Corporation brought a derivative suit claiming that Oracle had overpaid when, in 2016, it acquired NetSuite Corporation for $9.3 billion. The plaintiffs contended that Larry Ellison (the founder and a major stockholder of both Oracle and NetSuite), aided by Safra Catz (Oracle's CEO), had used his outsized influence at Oracle to cause Oracle to overpay for NetSuite, which advantaged

him because he owned a larger percentage of NetSuite than of Oracle. The transaction did not require, or involve, an Oracle stockholder vote. After a ten-day trial, the Delaware Court of Chancery found that, based on Ellison's "outsized influence" at Oracle, he likely could have controlled the transaction had he wanted to, but that the record at trial established that he had not tried to. The court therefore concluded that he was not a controller. The court also found that, although Ellison and Catz had withheld certain information from the special committee, the information was not material and did not indicate that they had exercised control of the committee. The court therefore held that business judgment review, rather than entire fairness, applied and the court held in favor of the defendants.

The decision provides important amplification of the law on controllers and entire fairness. The court held that a challenged transaction involving a conflicted non-majority stockholder who had *the ability to control* the transaction *but did not attempt to do so* will be reviewed under the business judgment rule, rather than entire fairness. The court emphasized that Ellison had absented himself from the process, and that a special committee that was independent of him had functioned effectively to consider and negotiate the transaction.

The decision also underscores the advantages of a board's use of an independent special committee to lead the process for a potentially conflicted transaction. The court emphasized that the committee's members and advisors were independent and experienced; the committee had conducted extensive due diligence on NetSuite; and the committee and Catz had negotiated hard on Oracle's behalf, including having been willing to walk away from the deal and ultimately having obtained agreement for a price below the maximum the committee had decided Oracle should pay. Finally, the decision serves as a reminder that a pleading-stage inference of control does not foreclose business judgment review at trial. In an earlier decision, at the pleading stage of the litigation, the court, applying plaintiff-friendly inferences (as it is required to do at that stage), had concluded that Ellison may have been a controller with respect to the NetSuite acquisition and therefore that the entire fairness standard of review would apply. At trial, however, as the record established that Ellison in fact was not a controller, the court applied business judgment review (under which it ruled in favor of the defendants). The decision thus underscores the importance of a board's establishing a record as to a potential controller's actions with respect to a transaction—and, also, in the event the transaction is challenged, how the record potentially could be used *at the pleading stage* to increase the likelihood of avoiding trial (which in this case continued for over six years).

We note that the court did not address whether, if the court finds that a person *was* a controller with respect to a transaction, the effective functioning of an independent special committee would "cleanse" a non-squeeze-out merger transaction that did not require a stockholder vote. The court also did not address whether there might be circumstances under which a person with the ability to control a transaction could, by virtue of his or her general influence and clout, be deemed to have controlled a transaction even if he or she had been fully absented from the process.

***Chancery Court Issues Important Decision Relating to Buyer Indemnification Rights and Seller Participation Rights in Connection with Post-Closing Governmental Investigations*—Anthem**

In *LPPAS Representative, LLC v. ATH Holding Company, LLC* ("*Anthem*") (May 2, 2023), the Delaware Court of Chancery held that a buyer of several healthcare-related companies had vitiated its indemnity rights against the sellers by failing to comply with common provisions of the sale agreement giving the sellers a right to participate in the acquired companies' defense strategy with respect to post-closing governmental investigations relating to the acquired companies' pre-closing conduct.

The decision indicates that certain actions that a buyer may take after post-closing discovery of regulatory or criminal violations at the acquired company—even when such actions were legally required or commonly considered good practice—may limit the buyer's indemnification rights with respect to those violations**.** Chancellor Kathaleen St. J. McCormick found that the buyer's decision to respond to Department of Justice ("DOJ") subpoenas and engage in discussions with the DOJ and another regulatory agency, as well as the buyer's self-reporting of additional possible violations, without first obtaining input from the sellers, violated the sellers' participation rights provided for in the indemnification provisions of the sale agreement. While the case related to possible Medicare fraud, the court's holding is important to buyers of ***any*** companies that regularly deal with regulatory authorities (among many possible examples, defense contractors, investment advisors, energy companies, and so on) and that respond to governmental subpoenas and civil investigative demands.

We note that the decision may impact buyers' substantive strategy when dealing with the government in connection with such post-closing discoveries and investigations**.** Buyers often want to "get out front" with the DOJ or other regulators to convey the message that, regardless of what may have occurred under prior ownership, the new owners are committed to compliance and to "cleaning up" whatever problem they inherited. Buyers may consider a rapid response, or a demonstrable

break and independence from prior ownership, to be strategically important, especially when seeking cooperation credit or leniency from a regulator, or the ability to conduct its own investigation and report the results to the regulator. This decision may limit the buyer's ability to distance itself from the seller in that way.

The Top Three Antitrust Issues in Real Estate Today

This report discusses the top three antitrust issues impacting the real estate industry in 2023: Information Sharing and Algorithmic Pricing; FTC Rulemaking and Restrictive Covenants; and Labor Market Restrictions.

U.S. Supreme Court Reaffirms Section 11 Plaintiffs Must Track Stock Purchases to Specific Registration Statements—Slack Technologies v. Pirani

In *Slack Technologies v. Pirani* (June 1, 2023), a unanimous U.S. Supreme Court held that in order to state a viable claim under Section 11 of the Securities Act of 1933, a shareholder must plead (and ultimately prove) that the purchased shares can be traced back to a specific registration statement of the issuer. The Court rejected the Ninth Circuit's recent attempt to create an exception to what had previously been considered a fairly settled tracing requirement for unregistered shares purchased as part of direct listings. In light of the Court's insistence that Section 11's tracing requirement is equally applicable whether an issuer conducts a traditional IPO or a listing that includes both a registered offering and a direct listing of previously issued unregistered shares, this decision will make it more difficult for shareholder plaintiffs to establish their standing to bring a Section 11 claim against an issuer that has gone public via a direct listing that encompasses both registered and unregistered shares.

Blocked and Tagged: Breaking Down the EU's Suspension of Meta's Personal Data Transfers to the US and Billion Euro Fine

Following a EU General Data Protection Regulation dispute resolution process, the Irish Data Protection Commission published its final decision following its multiyear investigation into whether the cross-border transfer of EU personal data from Meta Platforms Ireland Limited to it U.S. parent, Meta Platforms, Inc., in connection with operating Meta's Facebook Service violated the GDPR. Meta now has six months to suspend its data transfers and five months to cease its processing and storage of EU personal data in the U.S. and must pay a 1.2 billion Euro fine. Meta has announced that it intends to appeal the decision. In our memorandum, we analyze the decision, summarize the current legal landscape, and note considerations for companies transferring EU data to the U.S.

RoundUp

2023 Second Quarter Highlights

Deals:

- Counsel to AEA Investors in its $1.75 billion sale of Spectrum Plastics Group to DuPont.

Accolades:

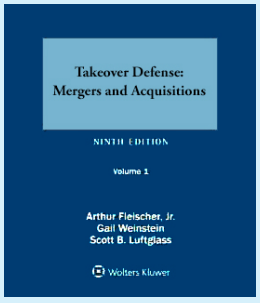
- Amber Banks and Randi Lally Named Top Women in Dealmaking by The Deal
- Advised Grindrod Shipping Holdings in its $506 million acquisition by Taylor Maritime Investments. The deal was awarded 2022 M&A Deal of the Year Award by Marine Money.

Recent Fried Frank M&A Quarterlies:

- Spring 2023
- Fall 2022
- Spring 2022

Takeover Defense: Mergers and Acquisitions

The Ninth Edition of Fried Frank's "Takeover Defense: Mergers and Acquisitions," a one-of-a-kind resource by corporate senior counsel Arthur Fleischer, Jr. and Gail Weinstein and partner Scott B. Luftglass, has recently been published. The treatise is a comprehensive, must-have resource for practitioners representing any participant in M&A activity, including bidders, sellers, senior management, sponsors, and investment banks.



Attorney advertising. Prior results are not guaranteed.