The M&A LAWYER

January 2024 ▪ Volume 28 ▪ Issue 1

ANATOMY OF A FALL: M&A IN 2023 AND WHAT TO EXPECT IN 2024

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The authors would like to thank their colleague Jessica Ljustina for her indispensable assistance.

While predictions of a recession did not pan out in 2023, ongoing economic uncertainty, rising interest rates, regulatory scrutiny and geopolitical tensions contributed to a second year of falling activity levels in global M&A following 2021's record-breaking year. Worldwide M&A activity in 2023 through November totaled $2.56 trillion, a decrease of 21% compared to the same period in 2022, and the slowest first 11 months for M&A in a decade. Deal volumes declined by 9% during the same period, although they remained at a historically high level.

Financing conditions remained challenging in 2023 as central banks around the world continued raising their policy rates at the steepest pace in recent decades in an effort to battle inflation, with average increases of approximately 400 basis points in advanced economies and 650 basis points in emerging market economies from late 2021 to October 2023. In the U.S., inflation remained elevated early in the year, with the Consumer Price Index for All Urban Consumers ("CPI") up 6.4% over 12 months to January 2023. To bring inflation down towards a long-run average of 2%, the U.S. Federal Reserve increased its federal funds target range by 25 basis points at each of its February, March, May, and July meetings, tapering off its aggressive pace from 2022 as the benchmark rate reached the highest level in more than two decades.

M&A activity backed by private equity funds ("PE"), which have traditionally relied on debt financing, was particularly affected by the rise in interest rates. PE-backed M&A deal value in the first 11 months of 2023 saw a year-over-year decrease of 33%, while deal volumes increased by 1%, reflecting smaller average deal sizes. Compounding the effect of higher rates set by central banks, credit supply was also constrained by tightening bank lending standards in light of ongoing economic uncertainty and in the aftermath of the high-profile issues at Credit Suisse, Silicon Valley Bank, Signature Bank and First Republic Bank and related turmoil in the industry. This

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Wish: Looking Ahead to 2024

Aggressive monetary policy measures implemented over the past two years appear to be tempering inflation from 2022 highs. In the U.S., inflation has slowed over the course of 2023 to 3.2% in October, leading bond markets to price in a cut in interest rates in the first half of 2024. While other major central banks are expected to check inflation by keeping rates higher for longer, this is consistent with greater optimism that the global economy will avoid a recession in 2024, and instead attain a "soft landing" of slower growth. A pivot from rising to stable and decreasing rates should provide a boost to deal-making in 2024. In particular, we expect improved macroeconomic conditions to support private equity exits and their deployment of cash into new investments. While dealmakers need to give due regard to evolving antitrust and foreign investment regimes in structuring and proceeding with relevant transactions, recent examples suggest that deals can be completed by parties that are willing to take on litigation risk and are able to engage with regulators on resolving their concerns. We also anticipate continued consolidation in the energy and mining sectors, with transactions motivated by perspectives on the future of the sectors and geopolitics. Technology will be another sector to watch, particularly intersected with healthcare (biotech) and the advancement of artificial intelligence, which could be a driver of M&A activity in sectors such as media and consumer/retail. Acquirors may also identify attractive investment opportunities across borders when considering fundamentals, growth potential, economic backdrop and political environment relative to prices.

Overall, M&A appears poised for a recovery in 2024.

COURT OF CHANCERY CONFIRMS HIGH BAR TO PLEADING *CAREMARK* OVERSIGHT CLAIMS AGAINST OFFICERS: *SEGWAY V. CAI*

By Gail Weinstein, Steven Epstein, Philip Richter, Steven Steinman, Erica Jaffe and Liza Andrews

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Early in 2023, in its *McDonald's* decision, the Court of Chancery established for the first time that not only corporate directors but also *officers* have oversight duties under *Caremark*. In *Segway v. Cai* (Dec. 14, 2003), the court, for the first time since *McDonald's*, has addressed officers' *Caremark* duties.

Key Points

- **The court confirmed that the same high bar to pleading a *Caremark* claim against a director also applies to pleading such a claim against an officer.** The court stated that, although it was established in *McDonald's* that an officer's oversight duties under *Caremark* are "context-specific" and generally limited to matters within the scope of the officer's corporate responsibilities, that framework does *not* "craft a lower standard for oversight claims brought

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against officers" than is applicable to such claims brought against directors. Notwithstanding what we would note is recent greater judicial receptivity to survival of *Caremark* claims in some circumstances, the court emphasized in *Segway* that "a *Caremark* claim [still] is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." The bar to successful pleading of a *Caremark* claim against an officer is high due to the requirement that the officer acted in bad faith (the focus in *Segway*), and, we would note, as discussed below, also due to the availability of the demand futility defense for derivative claims (not at issue in *Segway*).

- **The court emphasized that bad faith by the defendant, whether a director or an officer, is a predicate to *Caremark* liability.** Bad faith in this context means knowing and intentional disregard of the oversight obligation. Although the President of Segway allegedly had "consciously disregarded" financial discrepancies in her reports to the parent company about Segway's declining customer base and rising accounts receivable, the court held that there were no allegations from which it could reasonably be inferred that she had acted in bad faith.

- ***Caremark* claims are likely to be dismissed where the alleged misconduct involves "classic business decisions."** The court noted that Segway's allegations were not that Cai had overlooked fraud, accounting improprieties or material legal violations, but that she had ignored matters relating to customers, sales, revenues, and accounts receivable that had come to her attention. "Such generic financial matters are far from the sort of red flags that could give rise to *Caremark* liability if deliberately ignored," the court wrote. The decision also reinforces the line of cases in which the court has dismissed *Caremark* cases on the basis that knowledge of and ignoring general risks does not equate to conscious disregard of the risk of a specific corporate trauma.

Background

Segway Inc., which made personal transportation devices, was acquired in 2015 by a subsidiary of Ninebot (Beijing) Tech Co., Ltd., which produced similar vehicles. Segway sold its products alongside Ninebot's, but otherwise continued to operate separately post-acquisition, with its own board of directors, officers, employees, and financial and accounting systems.

Judy Cai was hired as Segway's Vice President of Finance and soon was promoted to be President. Segway experienced a significant decline in sales, shrinking of its customer base, and rise in its accounts receivable. The company responded by turning away from selling its branded products; focusing instead on selling Ninebot's products; and significantly downsizing its operations. Following the closing of the company's main facility, Cai's employment was terminated. It then became evident that the information Cai had been providing to Ninebot about shrinkage of customers and sales did not match the actual numbers in Segway's financial records and that a significant portion of the accounts receivable had been improperly recorded or not booked. When Ninebot could not reconcile the discrepancies, and Cai declined Ninebot's request to help in that effort, Segway commenced this action against Cai, alleging breach of her fiduciary duties of oversight under *Caremark*. After briefing and oral argument, Vice Chancellor Lori Will granted Cai's motion to dismiss the case.

Discussion

***Caremark* claims.** As the court explained, oversight duties arise from the duty of good faith, which is a subsidiary element of the duty of loyalty. Accordingly, to plead a viable claim for breach of the duty of oversight, a plaintiff must allege sufficient facts to

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support a reasonable inference that the fiduciary acted in bad faith. Under *Caremark*, bad faith can be established when fiduciaries: "(1) utterly fail to implement any reporting or information system or controls [(a so-called "Information Claim")], or (2) having implemented such a system or controls, consciously fail to monitor or oversee its operations, which disables them from being informed of risks or problems requiring their attention [(a so-called "Red Flags Claim")]."

The court suggested that the claim against Cai was more properly a duty of care claim than a *Caremark* claim. Segway asserted that Cai "knew or should have known that there were potential issues with some of Segway's customers, which caused Segway's accounts receivable to continuously rise"; and that Cai ignored these issues and their impact on Segway's profitability. The court stated that, on that basis, the court had assumed that Segway was asserting a *duty of care* violation by Cai. Segway "was adamant," however, that it was asserting a duty of loyalty violation—specifically, a Red Flags Claim under *Caremark*. Segway emphasized that Cai had "continuously ignored" red flags relating to the company's declining sales and shrinking customer base "and did not advise the people she needed to advise." The court therefore proceeded to analyze the claim only as a *Caremark* claim. (The court stated in a footnote that, even if Segway were raising a duty of care claim, it had not adequately pleaded gross negligence by Cai.)

Bad faith is a predicate to valid pleading of a *Caremark* claim. The court emphasized that the bad faith requirement applies whether a *Caremark* claim is against a director or an officer. To establish bad faith in connection with its Red Flags Claim, Segway had to "adequately plead that Cai consciously failed to act after learning about evidence of illegality—the proverbial 'red flag.' " The court wrote: "At a minimum, a plaintiff pursuing an oversight claim against an officer would need to demonstrate that the officer failed to make a good faith effort to monitor central compliance risks within her remit that pose potential harm to the company or others."

The plaintiff's allegations did not support an inference of bad faith by Cai. The plaintiff alleged that Cai, as President, oversaw Segway's "financial performance, including its accounts receivable": "managed the daily operations of the finance department"; and "was involved in compiling and/or reviewing summaries of Segway's finances" for Ninebot. The plaintiff alleged that Cai "was aware of serious issues with customers that led to significant increases in accounts receivable and willfully ignored [and did not report internally] problems within her areas of responsibility." The court found these allegations "an ill fit for a *Caremark* claim," however. The court stated that "[n]o potential wrongdoing (much less within Cai's purview) [was] alleged." The court noted that Segway did not, for example, allege that Cai "overlooked accounting improprieties, fraudulent business practices, or other material legal violations." Rather, Segway merely asserted that Cai at some point learned of "issues" with unspecified customers, decreases in revenues in a product line, and increases in receivables. According to the court, Segway appeared to be trying, "with 20/20 hindsight," to hold Cai accountable for a decrease in sales and increase in receivables. However, the court stressed, these generic financial issues were more in the nature of classic business decisions than red flags of legal noncompliance. The court wrote that oversight duties under Delaware law are not designed to subject fiduciaries to personal liability "for failure to predict the future and to properly evaluate business risk"—whether the fiduciaries at issue are officers or directors.

The decision furthers the line of cases dismissing *Caremark* claims where the court concluded either that: (i) the alleged knowledge of "general risks" regarding non-compliance with law or regulations did not constitute a red flag of a "specific corporate trauma" or (ii) the alleged misconduct involved a

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"classic business decision" and no "red flags of illegality" were pled. The court distinguished *McDonald's*, where it had found it reasonably conceivable that the defendant officer of McDonald's—its head of human resources—faced potential *Caremark* liability for a failure of oversight of the alleged widespread sexual harassment of the company's employees by management. The McDonald's officer, the court stated in *Segway*, allegedly had "ignored massive red flags within his remit including multiple rounds of coordinated EEOC complaints, widespread strikes, and a thirty-city walkout" in protest of the alleged sexual harassment, which was squarely within the officer's area of corporate responsibility.

Practice Points

- **Officers' increased vulnerability to *Caremark* claims.** Post-*McDonald's*, *Caremark* claims can be brought (by a board or derivatively by the stockholders) against the company's officers. *Caremark* claims by stockholders are now likely to be brought against both directors *and* officers.

- **Officers' duty of oversight.** Officers should work to establish and monitor information and reporting systems, and should report up the chain of authority any "red flags," relating to the company's key risks within the officer's sphere of corporate responsibility (or, if sufficiently material and depending on the circumstances, also outside the officer's areas of responsibility). Officers (together with the company's audit committee and outside auditors) should keep the board focused on and apprised of key developments with respect to issues and risks that are central to the business. There should be regular processes and protocols in place requiring management to keep the board apprised of key compliance and other practices, risks, or reports. When management learns of red flags (or "yellow flags"), the board should be told, and it should address the issues.

- **Consider reviewing current officer titles and areas of responsibility.** As an officer's duty of oversight will vary with the officer's level of authority and areas of responsibility, companies may wish to review their policies and practices with respect to awarding officer titles and describing officers' responsibilities. Such a review may be particularly important for companies with many officers, and for companies that award officer titles that may not comport with the responsibilities implied thereby. As an officer's essential duty of oversight is to report information up the chain of authority, a company should also consider whether to clarify the reporting obligations of officers at various levels.

- **Consider a charter amendment for exculpation of officers.** With recent focus on the increased potential for liability of officers, including under *Caremark*, companies may wish to consider amending the charter to provide for exculpation of liability for officers (as has been permitted, effective as of August 1, 2022, under an amendment to DGCL Section 102(b)(7)). Notably, such exculpation would *not* apply to *Caremark* claims brought against officers, however—as such claims are derivative and, under the DGCL amendment, the charter cannot be amended to exculpate officers for derivative claims.

- **Demand futility defense to *Caremark* claims brought by stockholders against officers.** Although not an issue in *Segway*, we note that—as highlighted in the court's third decision in the *McDonald's* case (Mar. 31, 2023)—for *Caremark* claims brought by stockholders against *officers*, the high bar to success, even at the pleading stage, is based not only on the requirement of bad faith but also on the fact that *Caremark* claims, being derivative, are subject to all of the usual defenses to derivative claims, including

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the demand futility defense. Thus, *Caremark* claims brought by stockholders against *officers* probably will be dismissed at the pleading stage on demand futility grounds, *even if* it appears that the officers breached their *Caremark* duties—*unless* the *directors* also appear to have breached their *Caremark* duties (or the directors are otherwise not independent and disinterested with respect to the misconduct at issue). After such a dismissal, an officer would face potential liability only if (i) the board (on its own, or after receiving a stockholder litigation demand) decides to bring a claim against the officer; (ii) other stockholders bring suit, asserting a different basis for demand futility than the original plaintiffs asserted; or (iii) the original stockholder-plaintiffs are successful in having the court reopen the case (under Court of Chancery Rule 30(b)) based on newly discovered evidence supporting the basis for demand futility that they had asserted and the court had rejected.

PROPOSED UK REFORMS TO MERGER PROCESS OFFER WIDER SMALL MARKET EXCEPTION AND BETTER ENGAGEMENT WITH SENIOR OFFICIALS ON MERITS AND REMEDIES

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On November 20, 2023, the UK's Competition and Markets Authority ("CMA") announced proposed reforms to its in-depth merger control review process[1] (the phase 2 review) that seek to provide more opportunities for engagement with decision makers and incentivize parties to bring forward remedies at an early stage.

The CMA's proposed revisions to its Guidance ("Draft Guidance") are a welcome change to what was often seen as an inflexible process that offered merging parties only limited access to the decision-makers and did not provide opportunities for constructive remedy discussions at a sufficiently early stage. Moreover, the proposal to publish a new interim report, providing an early insight on the Inquiry Group's substantive concerns, would enable merging parties to advocate their position and discuss the merits of the case in person with the Inquiry Group at the main party hearings (provided the initial report is sufficiently developed).

Key Points

The UK merger control process involves a two-stage review. The phase 1 decision is a finding to a "reasonable prospects" standard that the merger calls for in-depth inquiry at phase 2. The phase 2 review is overseen by a panel of part-time senior officials with experience in business, economics/accounting, law and the public sector, who form the Inquiry Group. The appointment of an independent group is intended to provide a "fresh pair of eyes" in relation to the CMA's phase 1 investigation, in which a member of CMA staff decides whether the test for reference is met. The revised procedures seek to address concerns that these decision-makers might have little engagement with the merging parties on the merits beyond set-piece hearings occurring late in the evidence gathering stage. The key changes include:

- **Early presentations to the panel on the merits:** Codifying the CMA's working practices, the parties would be invited to make early presentations on the business and products ("teach-ins") and merits of the phase 1 decision.
- **Interim report and merits hearing:** An interim

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