DELAWARE CORPORATE LAW AND LITIGATION:

WHAT HAPPENED IN 2013 AND WHAT IT MEANS FOR YOU IN 2014

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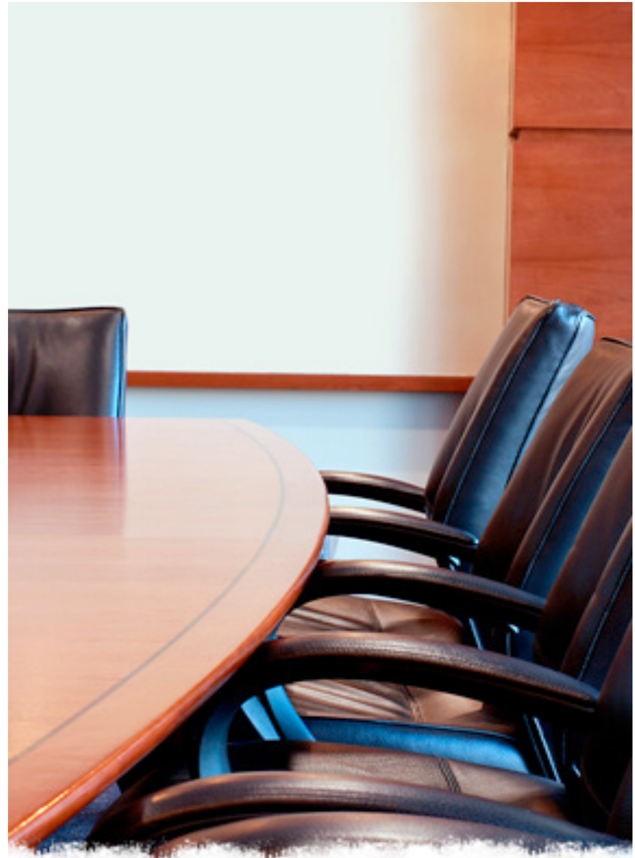
DELAWARE'S LEADING ROLE IN BUSINESS AND BUSINESS LITIGATION

Delaware has long been known as the corporate capital of the world. It is the state of incorporation for 64 percent of the Fortune 500 and more than half of all companies whose securities trade on the NYSE, Nasdaq and other exchanges. Its preeminence in business law started with its corporate code   the Delaware General Corporation Law   and has been enhanced by business law innovations that have led to the creation of many new business entities designed to meet the expanding needs of corporate and financial America.

The Delaware Court of Chancery and the Delaware Supreme Court have maintained a balance in the application of these laws between entrepreneurship by management and the rights of investors. Jurisdiction over a company and its management can be obtained based on the state of incorporation, and Delaware's courts are not just popular venues for resolving business disputes but are now the preeminent courts in the United States for resolving challenges to actions by boards of directors, such as breach of fiduciary duty claims, merger and acquisition litigation and virtually any issue implicating corporate governance and compliance with Delaware's business laws. In fact, for more than ten years an annual assessment conducted by the United States Chamber of Commerce has ranked Delaware first among the court systems in all 50 states, noting the Delaware courts' fairness and reasonableness, competence, impartiality and timeliness in resolving disputes.

Each year, the Delaware courts issue a number of significant opinions demonstrating that the Delaware courts are neither stockholder nor management biased. Some of the more recent and important cases are discussed herein, but the list is by no means exhaustive.



Delaware's guiding principles remain strict adherence to fiduciary duties; prompt enforcement of articles of incorporation, bylaws and merger agreements; and the maximization of stockholder value. The business judgment rule remains alive and well in Delaware for directors who reasonably inform themselves of important information and are free of economic or other disabling conflicts of interest, and whose only agenda is that of advancing the best interests of the corporation. While the facts and legal analyses confronting directors are usually complex, the cases often boil down to the smell test. So long as independent directors can articulate why, in their best judgment, they acted as they did and why they believed those actions were in the best interests of the corporation, the Delaware courts will respect their decisions.

WHAT'S OLD REMAINS NEW: BANKER'S CONFLICTS AND THE SHAREHOLDER LITIGATION EXPLOSION

As highlighted in last year's Update, plaintiffs' attorneys are now focusing on the roles of bankers in an effort to enjoin otherwise independent third-party transactions. This new tactic gained traction in 2011 in *In re Del Monte Foods Company Shareholders Litigation*, 25 A.3d 813 (Del. Ch. 2011), and was a significant issue in the Delaware Court of Chancery's 2012 decision in *In re El Paso Corporation Shareholder Litigation*, 41 A.3d 432 (Del. Ch. 2012). The trend continued in 2013, but this time the Court of Chancery's opinion in *In re Morton's Restaurant Group Shareholders Litigation*, 74 A.3d 656 (Del. Ch. 2013) (Chancellor Leo E. Strine, Jr.), demonstrates that a second financial adviser, when properly engaged and actively involved, can help to overcome a merger challenge based upon a primary financial adviser's alleged lack of independence.

In the *Morton's* case, the Court of Chancery granted a motion to dismiss a complaint challenging the sale of Morton's Restaurant Group, Inc. The complaint alleged that the board breached its fiduciary duty by acting in favor of a private equity firm, Harlan Castle, which owned 28 percent of Morton's and allegedly instigated the sale in order to satisfy its own "immediate" need for liquidity. The court dismissed this claim: a 28 percent stockholder is not a controlling stockholder, and no other facts showed control, so the actions of the board were subject only to business judgment review. On that level of review, a nine-month process that involved shopping the company to about one hundred potential buyers was not a breach of any fiduciary duty.

The court also dismissed a claim against Morton's board of directors premised on the directors' willingness to allow the investment bank that ran the sales process (Jefferies) to provide financing for the buyer after learning that the high bidder could not otherwise secure financing. The complaint alleged that the board breached its duties by acting in bad faith with regard to decisions it made about its investment bank. The court found this process did not create an inference of bad faith: "The decision to let Jefferies finance [the high bidder's] deal while hiring KeyBanc to provide unconflicting advice, rather than risk losing a bid at a high premium to market, does not create an inference of bad faith."

There are other banker-conflict cases pending before the Court of Chancery, with decisions expected in early 2014. Until this area of the law becomes further developed, attention should continue to be paid to the following:

- As to existing relationships between the target's financial advisor and potential bidders: past or current advisory work; past fees received; the proximity in time of work performed for bidder; the nature of any ongoing relationship; existing lender relationships whether there is an investment by the bank as principal; board representation; investments by individual bankers working on a transaction; other relevant relationships

- Generally, contingent fees do not amount to a conflict: there is alignment on the “value” issue and the conflict on the “sell” or “don’t sell” issues should be clear
- Engagement letters should identify known conflicts; require updates as potential conflicts emerge; where a potential conflict is identified, require information barriers or other steps

Further, the advice and observation from one member of the Court of Chancery, as noted in last year’s Update, remains apt:

- “Acknowledge the problem, don’t deny it or downplay it.” Vice Chancellor J. Travis Laster, 2012 Annual Tulane Corporate Law Institute
- “When all the discretionary decisions flow in the direction of the self-interest, it’s going to raise issues.” Vice Chancellor J. Travis Laster, 2012 Annual Tulane Corporate Law Institute

The importance of this and all the other issues discussed below becomes shockingly clear when one considers the statistics on M&A litigation. A recent study prepared by Matthew D. Cain (University of Notre Dame, Department of Finance) and Steve M. Davidoff (Ohio State University, Michael E. Moritz College of Law) on M&A deals in 2013 showed:

- 97.5 percent of all transactions resulted in litigation
- Each transaction resulted in an average of 7 lawsuits (an all time high)
- 41.6 percent of all transactions experienced multi-jurisdictional litigation (down from 51.8 percent in 2012)
- Median attorneys’ fee awards per settlement remained steady at US$485,000

BALANCING THE RIGHTS OF PREFERRED VERSUS COMMON STOCKHOLDERS: 4 KEY TAKEAWAYS FROM *TRADOS*

While management and the preferred stockholders of Trados, Inc. received all of the merger consideration in an end-stage transaction and the common stockholders received nothing, the Delaware Court of Chancery found that the transaction was still “entirely fair” to the common stockholders because the common stock had no monetary value before the merger. The court’s 114-page opinion in *In re Trados Inc. S’holders Litig.*, 2013 WL 4511262 (Del. Ch. Aug. 16, 2013) (Vice Chancellor J. Travis Laster) deals extensively with a variety of issues that directors and investors should consider.

Background: in US$60M sale of Trados, common stockholders received nothing

In July 2005, SDL plc acquired Trados for US$60 million. The Trados board of directors, composed primarily of management and appointees of venture capital investors in Trados, approved the merger and a management incentive plan that awarded incentives to management for a sale, even if the sale netted nothing for the common stock. The US$60 million sale price left the venture capital firms’ liquidation preferences almost fully satisfied and paid some money into the management incentive plan, but resulted in the common stockholders receiving nothing.

The plaintiff sought both an appraisal and a fiduciary duty remedy, arguing that the board had a fiduciary duty to continue to operate Trados so that it could recover money for the common stock, rather than selling at a price that would get nothing for common stockholders.

The court first resolved the fiduciary duty claim before addressing appraisal, because a finding on that claim could moot the appraisal proceeding. Because six of the seven directors were materially interested based on their obligations to the venture capital firms and the incentives created by the management incentive plan, the court applied the entire fairness standard, which places the burden of proof on the directors to demonstrate that the transaction resulted from a fair process and produced a fair price.

In this case, notably, the board made decisions that benefited preferred stockholders, notwithstanding the board's duty to common stockholders. The court therefore began by asking to whom, precisely, directors owe fiduciary duties, among potentially competing classes of stockholders:

- To reiterate, the standard of conduct for directors requires that they strive in good faith and on an informed basis to maximize the value of the corporation for the benefit of its residual claimants, the ultimate beneficiaries of the firm's value, not for the benefit of its contractual claimants. In light of this obligation, it is the duty of directors to pursue the best interests of the corporation and its common stockholders, if that can be done faithfully with the contractual promises owed to the preferred.

The Trados directors failed to demonstrate they followed a fair process

Turning to the facts, the court first found that the Trados directors failed to demonstrate that they had followed a fair process. Although Trados's new CEO suggested that he might be able to develop a new line of business rather than sell the company, the board never considered any alternative to the sale. The court went so far as to say: "[T]here was no contemporaneous evidence suggesting that the directors set out to deal with the common stockholders in a procedurally fair manner." The court held: "In this case, the VC directors pursued the Merger because Trados did not offer sufficient risk-adjusted upside to warrant either the continuing investment of their time and energy or their funds' ongoing exposure to the possibility of capital loss."

The court pointed to a number of particular procedural failings. The court intimated that the board should have at least considered the sale from the standpoint of the common stockholders. Instead, "[t]he VC directors did not make this decision [to sell Trados] after evaluating Trados from the perspective of the common stockholders, but rather as holders of preferred stock with contractual cash flow rights that diverged materially from those of the common stock and who sought to generate returns consistent with their VC funds' business model."

Further evidence of unfair dealing was found in the management incentive plan. To address a conflict of interest, the court held that directors must at the very least understand the nature of the conflict. "Directors who cannot perceive a conflict or who deny its existence cannot meaningfully address it." This principle applied with great force in this case because one director admitted, during his deposition, that the board never even discussed the conflict of interest between the common and preferred stock until the litigation began.

The court also held that the defendants missed chances to improve the record on the process by failing to either secure a fairness opinion or condition the transaction on the approval of a majority of the common stockholders.

Despite the flawed process, the court found the defendants established a fair price

With respect to the fair price analysis, the court found that the defendants had satisfied their burden of establishing that the price was entirely fair to the common stockholders.

The plaintiff proffered an expert report suggesting that the common stockholders should have received more, but that report included comparable companies that yielded an extremely wide range of values. The court ultimately concluded that no companies were comparable to Trados. Instead, the court relied on a discounted cash flow valuation prepared by the defendants' expert, which incorporated a variety of plaintiff-friendly assumptions but nevertheless demonstrated that there was no realistic scenario in which the common stock would have any economic value, even if Trados had successfully developed a new line of business rather than entering into the sale.

In making this determination, the court emphasized that the preferred shares held an 8 percent accumulating dividend, meaning that the preferred shares' liquidation preferences grew by 8 percent per year. The court found that Trados "did not have a realistic chance of generating a sufficient return to escape the gravitational pull of the large liquidation preference and cumulative dividend."

Because the common stock had no value, the court found that the directors did not breach their fiduciary duty: "In light of this reality, the directors breached no duty to the common stock by agreeing to a Merger in which the common stock received nothing." On the strength of that same factual finding, the court held that the "fair value" of Trados' common stock for appraisal purposes was zero.

The plaintiff also made a request for fee-shifting. Despite the defendants' successful defense of the claims,

the court signaled its willingness to entertain a separate fee application because of the defendants' bad faith conduct. The court emphasized that the defendant directors changed their testimony between their depositions and trial, and even explicitly disavowed "four sets of minutes in which the Board ostensibly determined in good faith that the fair value of the common stock was $0.10 per share and upon which this court previously relied." The court also pointed to the defendants' decision to file three summary judgment motions, one of which the court considered potentially frivolous, and that the plaintiff was forced to file four separate motions to compel, all of which resulted in the defendants providing additional discovery material, due to conduct the court summarized as "serial failures to produce."

Four key takeaways

1. Take into account that director independence is no automatic safe harbor for non-employees

Directors are not automatically independent if they do not work for a venture capital firm directly. One of the directors had worked collaboratively with the venture capital firm on several companies, and he had invested approximately US$300,000 in one of the funds. This director was also CEO of another company in which the venture capital firm was an investor and had a director designee. The court found that these relationships "resulted in a sense of owingness that compromised [the director's] independence." Accordingly, companies should consider these types of relationships when appointing a director believed to be independent or relying on his independence in connection with corporate action.

2. Understand the nature of directors' fiduciary obligations to preferred shareholders

The court also held that directors do not owe fiduciary duties to preferred stockholders when considering an action that might violate or circumvent the preferred shares' contractual rights. The preferential rights of preferred stockholders, even if set forth in a company's certificate of incorporation, are contractual in nature. Directors must act in good faith and on an informed basis to maximize the value of the corporation for the benefit of residual claimants (that is, common stockholders and preferred stockholders not relying on a liquidation preference or some other preference). The board only owes fiduciary duties to preferred stockholders when such holders are relying on a right shared equally with common stockholders.

3. Reevaluate management bonuses in change-in-control plans

Companies may wish to revisit their change-in-control bonus plans, because this opinion criticizes a bonus plan that functions in a common way. The court held that the structure of the management incentive plan (MIP) gave further evidence that the Trados board dealt unfairly with the common stockholders.

This holding shows that directors may violate their duty of loyalty if they improperly structure a change-in-control bonus plan to favor preferred stockholders over common stockholders or to incentivize management to take action for the benefit of the preferred stockholders. The MIP paid a bonus to management tied to the proceeds to be received in a sale transaction. The bonus was paid before any proceeds were paid to stockholders. These types of bonus plans are often implemented in venture-backed companies in which the value of the companies is believed to be too low relative to the liquidation preference to provide management with sufficient incentive value in their common equity.

The structure of the MIP was similar to a structure often seen. The MIP provided an escalating percentage of proceeds based on deal consideration. The plan also offset amounts payable to management by any dollars received by management by virtue of their holdings of common stock. The court found that the MIP skewed management's approach to a sale transaction in a manner adverse to common stockholders. First, the MIP's structure resulted in the MIP's cost being allocated disproportionately between the preferred and common stockholders. As deal proceeds exceeded the liquidation preference, common stockholders increasingly bore the cost of the MIP. The court did not provide guidance as to what would be an appropriate allocation, other than to say that an allocation in which 100 percent of the cost comes from the preferred stock would raise no fairness issues and an allocation in which 100 percent of the cost comes from the common raises serious fairness issues.

Second, the offset for common proceeds caused management to focus on maximizing their return under the MIP versus their return as common stockholders and incentivized management to pursue a sale even at valuations at which the common stockholders received

nothing. It also caused management to favor a sale rather than remaining independent in the hope of obtaining a higher value at a later date.

The court noted that, while the plaintiff in Trados did not bring a claim that the directors breached their duty of loyalty by implementing the MIP as designed, the directors would have found it difficult to prove that their doing so was fair to the common stockholders to whom the directors owed fiduciary duties.

4. **Remember that courts place great weight on contemporaneous written communications**

Finally, this opinion illustrates the importance of contemporaneous written communications of management, directors and investors (including internal reports and communications solely within the venture firms). The court placed particular significance on the reports made by the board designees of the venture firms to the designees' partners inside the firms. The opinion recites and references these reports more than 15 times.

Written materials made contemporaneously with an event are often given more evidentiary weight than subsequent testimony or statements given by the same persons. Rarely are these communications written with an eye towards litigation, and they are often more informal and conclusory than would otherwise be the case. When considering a sale of a company or other corporate action that may be later challenged, involved persons should take extra care to ensure that their written communications are accurate and consistent with their fiduciary obligations.

EXCLUSIVE FORUM PROVISIONS FOR SHAREHOLDER LITIGATION

In *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013) (Chancellor Leo E. Strine, Jr.), the Delaware Court of Chancery held that boards of directors of Delaware corporations may adopt bylaws, which are binding on shareholders, requiring that lawsuits over the internal affairs of a Delaware corporation be brought in Delaware.

The court consolidated two actions for purposes of this opinion because the actions involved virtually identical bylaws and complaints. Defendants filed a motion for judgment on the pleadings, and the court granted the motion with respect to two challenges to the bylaws.

The opinion addressed the validity of the bylaws under the Delaware General Corporation Law (DGCL) as well as the question of whether bylaws enacted by a board of directors without shareholder involvement can be enforced, as a contractual matter, against shareholder plaintiffs.

The court made two primary holdings.

First, the court found that the DGCL permits an exclusive forum selection bylaw. Specifically, 8 *Del*. C. § 109(b) allows a corporation's bylaws to "contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers, or employees." The Court held that forum selection bylaws "easily meet these requirements."

Second, the court held that these forum selection provisions are enforceable against shareholder plaintiffs, even though the bylaws were board-enacted. The court criticized the plaintiff's contract argument as being premised on an incorrect understanding of the nature of the relationship between shareholders and a corporation. Properly understood, bylaws are part of a flexible contractual relationship between shareholders and a corporation. Based on the Certificate of Incorporation, stockholders understand whether a particular board of directors has the power to enact bylaws. If the Certificate of Incorporation grants a board the power to unilaterally amend the corporation's bylaws, as permitted by 8 Del. C. § 109(a), then the board may enact bylaws and thereby unilaterally alter the flexible contract.

The court left the door open for additional litigation over the validity of exclusive forum selection bylaws in particular circumstances, however, by refusing to address plaintiffs' arguments that in certain hypothetical situations the enforcement of these bylaws might be unreasonable.

Exclusive forum selection bylaws represent a response to the phenomena of multi-forum litigation, in which plaintiffs bring the same suit in multiple jurisdictions simultaneously. The court's decision is therefore an important step toward addressing this problem.

PRECLUSIVE EFFECT OF DISMISSAL OF DERIVATIVE CLAIMS

In *Pyott v. Louisiana Municipal Police Employees' Retirement System*, 74 A.3d 612 (Del. 2013), the Delaware Supreme Court (en banc) reversed a Court of Chancery ruling that refused to give preclusive effect to a California court's dismissal with prejudice of similar derivative claims. In refusing to dismiss the Delaware derivative complaint, the Court of Chancery held: (1) as a matter of Delaware law, the stockholder plaintiffs in the two jurisdictions are not in privity with each other; and (2) the California stockholders were not adequate representatives of the defendant corporation. The Delaware Supreme Court found that the Court of Chancery erred in both respects.

On the first issue, the Delaware Supreme Court held that the privity issue should not have been analyzed under Delaware law. For that reason, the court did not even begin to analyze the substantive issue, holding instead

that California or federal common law applied to the issue and that Full Faith and Credit mandates that the California judgment be respected.

With regard to the second issue, the court held that the California stockholders were adequate representatives of the defendant corporation. The Court of Chancery had found that the California stockholders were not adequate representatives because "rather than representing the best interests of the corporation, the California plaintiffs wanted to maximize the return for the law firms that filed suit on their behalf." The Court of Chancery also suggested that stockholders who do not first obtain books and records pursuant to section 220 of the DGCL are presumptively inadequate.

The Delaware Supreme Court rejected the creation of such a presumption because there was no factual record to support that finding.

EVOLVING STANDARDS OF REVIEW FOR MERGER LITIGATION

In *In re MFW S'holders Litig.*, 67 A.3d 496 (Del. Ch. 2013) (Chancellor Leo E. Strine, Jr.), the Delaware Court of Chancery held that a controlling stockholder may secure business judgment review of its purchase of the corporation through a going private merger by conditioning consummation of the merger on the approval of (i) a special committee of independent directors and (ii) a majority of the minority stockholders.

Nearly two decades ago, in Kahn v. Lynch Commc'n Sys., 638 A.2d 1110 (Del. 1994), the Delaware Supreme Court held that entire fairness review applies to controlling stockholder transactions, and that use of either one of these two conditions would mean that the plaintiff, not the defendant, would bear the burden of persuasion on entire fairness after trial. Until the *MFW* opinion, no case presented the opportunity for a Delaware court to rule on the effect of using both procedural protections together. This opinion has great significance for future controlling stockholder transactions.

MacAndrews & Forbes owned 43 percent of M&F Worldwide (MFW). MacAndrews & Forbes announced its interest in buying the rest of MFW's equity in a going private merger at $24 per share. MacAndrews & Forbes simultaneously announced it would not proceed with the

merger absent the approval of a special committee of independent directors and the approval of a majority of the minority stockholders. MFW's board of directors established a Special Committee to consider the proposed transaction, which met eight times over three months, negotiated a US$1 increase in merger consideration, and approved the deal. A substantial majority of MFW's minority stockholders – 65 percent – voted in favor of the merger. The plaintiff stockholders commenced this action, first seeking injunctive relief based on alleged disclosure issues, but later abandoning those claims in favor of a post-closing damages action alleging the board of directors breached its fiduciary duties. The defendant directors moved for summary judgment on the breach of fiduciary duty claim, which was the subject of this opinion.

The court found that no factual disputes stood in the way of the conclusion that the Special Committee was sufficiently empowered and informed, was independent, and fulfilled its duty of care. The plaintiffs made two arguments about the Special Committee. First, the plaintiffs argued that a factual dispute existed concerning the independence of three members of the Special Committee. The court disagreed, noting that the plaintiffs failed to offer evidence of the economic circumstances of any of the directors. The Delaware Supreme Court has held that directors are presumed independent. To rebut this presumption, a plaintiff must show that the transaction is material to the director in light of his existing economic circumstances. The plaintiffs here did not offer the evidence necessary to make that showing. The court also stated that each of the three directors is independent under the New York Stock Exchange's rules, which it deemed "a useful source for this Court to consider when assessing independence."

Second, the plaintiffs argued that the Special Committee should have secured a higher transaction price for a number of reasons. The court held that these were the kinds of arguments that might be advanced in appraisal or entire fairness cases, but they did not create any issue of fact concerning whether the Special Committee discharged its duty of care. The Special Committee was independent and entitled to a presumption that it acted in good faith. It met eight times and consulted with its own legal and financial advisors. The court held that there was undisputed evidence that the Special Committee "could definitely say no" to the transaction, that it studied financial information including the possibility of other transactions, and that the Special Committee could and did negotiate with MacAndrews & Forbes concerning the offer's terms.

The court also clarified an important question about the nature of its review of a special committee's decision making. Past cases indicated that an assessment of whether a special committee was effective requires a review to determine if the committee made good decisions. The court here openly eschewed that form of review, stating "such a precondition is fundamentally inconsistent with the application of the business judgment rule standard of review." The court then held: "When a committee is structurally independent, has a sufficient mandate and cannot be bypassed, and fulfills its duty of care, it should be given standard-shifting effect."

The court then held that the plaintiffs failed to even present a factual dispute concerning the majority of the minority vote. "[T]he plaintiffs themselves do not dispute that the majority-of-the-minority vote was fully informed and uncoerced, because they fail to allege any failure of disclosure or any sort of coercion." Accordingly, this case presented the Court with a transaction that was conditioned on both of the procedural protections mentioned in *Kahn v. Lynch*.

While careful to note that the Delaware Supreme Court has yet to weigh in on the precise circumstances of this case, the court granted business judgment rule protection to the controlling stockholder because it used both procedural protections; that is, both a special committee and a majority of the minority condition. The court found that the use of both procedural protections affords minority stockholders greater protections than either of the procedural protections alone, and the use of both is the optimal transactional structure for minority stockholders. To incentivize controlling stockholders to use this structure, the court found that it must offer something more than a burden shift under entire fairness review, because *Kahn v. Lynch* already provides that benefit to a controlling stockholder who uses only one of these two devices. "By giving controlling stockholders the opportunity to have a going private transaction reviewed under the business judgment rule, a strong incentive is created to give minority stockholders much broader access to the transactional structure that is most likely to protect their interests."

Applying the business judgment rule, the court required the plaintiffs to point to facts indicating that the merger constituted waste. To demonstrate waste, the plaintiffs must prove that the transaction's terms were so outrageous that no rational fiduciary could have accepted them in good faith. The plaintiffs failed to make the showing necessary to suggest waste, because the transaction price constituted a 47 percent premium to market and 65 percent of the minority stockholders decided the price was favorable.

Key takeaway

The Court of Chancery's opinion marks an important development in controlling stockholder transactions and practitioners should take note in advising clients how to structure such transactions. As the plaintiffs have appealed the decision, the Delaware Supreme Court will soon weigh in on the issue, and the importance of where Delaware comes out on this issue cannot be emphasized enough. The standard of review applicable to a transaction has enormous implications for any litigation – which inevitably follows from the announcement of a large public-company deal. Regardless of the merits of such suits, the standard of review affects the timing within which unmeritorious actions can be dismissed, and this affects litigation costs, people costs due to time devoted to discovery and other costs, while creating business uncertainty as well as uncertainty about personal liability for the directors involved.

In carrying out the business of the corporation, management is protected by the business judgment rule, which is the standard by which courts review most, but not all, board's decisions. The business judgment rule reflects the legal premise that decisions made by directors who are fully informed and free from conflicts of interest should not, and will not, be second-guessed by a court, even if the business decision under review turns out to have been "poor." To receive a favorable presumption of the business judgment rule, a director must be disinterested and independent (i.e., satisfy the fiduciary duty of loyalty), review and consider all pertinent information reasonably available(i.e., satisfy the fiduciary duty of care), and not act in a manner or with a motive prohibited by statute or otherwise improper, and at all times act in good faith when discharging his or her fiduciary duties. This is a process inquiry. If the directors are not conflicted and are fully informed, the action will be dismissed and the substance of the transaction will not be reviewed.

If the business judgment rule cannot be asserted, then the transaction is not void but voidable; however, the heightened "entire fairness" standard will be applied and, under such circumstances, the burden is on the directors to prove that the decision or transaction at issue is fair to both the company and its stockholders. Even if the transaction is approved by an independent special committee or a vote of a majority of the minority stockholders, such procedural safeguards only shift the burden back to a stockholder-plaintiff to prove that the transaction was unfair, which means the substance of the transaction will be evaluated by a court. This is very different from transactions that are eligible for business judgment rule protection where the court merely evaluates whether a board was fully informed (duty of care) and whether a majority of the board was disinterested and independent (duty of loyalty). Satisfying the entire fairness standard is extremely difficult because the board must demonstrate fair process and fair price. Failure to establish the entire fairness of the decision or transaction can render it void and lead to personal liability for directors. Endeavoring to satisfy the entire fairness standard means lots of discovery, a trial on the merits, a time-table that can now be a year instead of a few months, and a legal budget in the millions of dollars instead of a few hundred thousand.

Sophisticated parties understand these dynamics in structuring transactions involving controlling stockholders. "Entire fairness" applies to negotiated controlling-stockholder transactions because the controlling stockholder has the ability to exercise control over some or all of the directors and therefore dictate the terms, often to the detriment of the minority who can be cashed-out against their will due to the voting power of the controlling stockholder. However, if the controlling stockholder is conditioning approval on a vote of the minority, the minority gets to decide whether the merger gets approval or not – if the price is right, it will be approved, and vice versa.

REVERSE TRIANGULAR MERGER DOES NOT VIOLATE ANTI-ASSIGNMENT CLAUSE

In *Meso Scale Diagnostics, LLC v. Roche Diagnostics GMBH*, 62 A.3d 62(Del. Ch. 2013), the Delaware Court of Chancery (Vice Chancellor Donald F. Parsons, Jr.) granted in part and denied in part a motion for summary judgment. First, the court granted summary judgment that a reverse triangular merger was not an assignment by operation of law or otherwise, meaning that the acquisition of the company holding a license to valuable technology did not require the consent of the entity that granted the license. Second, the court denied summary judgment concerning a claim that Roche Holdings had used the technology beyond the scope permitted under the license.

This opinion matters because it confirms that when a corporation acquires another corporation via a reverse triangular merger – a form of merger in which the target becomes a subsidiary of the acquiror – any contracts that grant other parties rights in the event that the target corporation assigns some asset will not be triggered. Delaware cases and commentators have forecasted this result, and this case confirms it.

This case concerns a type of intellectual property of use in pharmaceutical research. Jacob Wohlstadter founded Meso Scale Technologies, LLC (MST) to commercialize his invention of electrochemiluminescent technology (ECL), which is useful in pharmaceutical research. In 1995, MST entered into a joint venture named Meso Scale Diagnostics, LLC to continue commercializing ECL. MST's partner in the joint venture was IGEN International, Inc.

In 1992, IGEN granted a company that would later be acquired by Roche Holding Ltd. a license to use its patented ECL technology in carefully defined applications. Litigation erupted when IGEN accused Roche Holding of using ECL outside the scope of its license. In 2003, after IGEN won the ensuing litigation and canceled Roche Holding's license to use the ECL intellectual property, Roche Holding entered into a transaction (the 2003 transaction) that resulted in it purchasing IGEN. The 2003 transaction involved at least 12 separate agreements. Most importantly, after it was over, IGEN had become a wholly owned subsidiary of Roche Holding through a type of transaction known as a reverse triangular merger. That same transaction also involved the signing of a Global Consent by Meso, Roche Holdings, and multiple Roche entities, and the granting of a license to Roche Holdings (the Roche License) for Roche Holdings to use ECL within a contractually-defined field.

After the 2003 transaction, a Delaware corporation named Newco, later renamed BioVeris Corp., possessed the broad license for the ECL technology that had previously been possessed by IGEN. Section 5.08 of the Global Consent prohibited assignment of that license agreement without consent of the parties to the Global Consent, which included MSD and MST. In part, Section 5.08 read: "Neither this Agreement nor any of the rights, interests or obligations under this Agreement shall be assigned, in whole or in part, by operation of law or otherwise by any of the parties without the prior written consent of the other parties." In June 2007, Roche Holding bought BioVeris by forming an acquisition subsidiary and merging BioVeris into it, with BioVeris as the surviving corporation.

Meso filed a complaint with two counts. In Count I, Meso argued that Roche Holding violated Section 5.08 of the Global Consent by effectuating the reverse triangular merger of IGEN without securing Meso's consent. In Count II, Meso argued that Roche Holding exceeded the permissible scope of its license. The defendants (Roche Holding and several of its subsidiaries, including BioVeris) sought summary judgment on both counts of the complaint.

The court granted the defendants' motion for summary judgment concerning Count I. The court found, as a matter of law, that a reverse triangular merger is not an assignment. The court began its analysis with the text of 8 *Del*. C. § 259(a), which suggests that the corporation surviving from a merger possesses all the rights and obligations of the extinguished corporations, which "shall be thereafter as effectually the property of the surviving or resulting corporation as they were of the several and respective constituent corporations."

The court then found that reasonable parties at the time of contracting would not have expected Section 5.08 to apply to a reverse triangular merger by pointing to Delaware case law and commentary from respected experts opining that a triangular merger does not result in a transfer of the target's rights and obligations. For example, the court cited a Delaware treatise –

R. Franklin Balotti & Jesse A. Finkelstein's *Delaware Law of Corporations and Business Organizations*, § 9.8 (2013) – which explains the architecture of a reverse triangular merger: "The advantage of this type of merger is that T will become a wholly-owned subsidiary of A without any change in its corporate existence. Thus, the rights and obligations of T, the acquired corporation, are not transferred, assumed or affected." Another respected commentator described a reverse pyramid merger as using a "reverse subsidiary structure." Elaine D. Ziff, The Effect of Corporate Acquisitions on the *Target Company's License Rights*, 57 Bus. Law. 767, 787 (2002).

Meso argued that because the merger resulted in Roche Holding owning BioVeris's intellectual property rights, it was effectively a transfer. The court dispensed with this argument because Delaware's doctrine of independent legal significance means that if a corporation can accomplish a result under one section of the Delaware General Corporation Law (DGCL), it need not comply with the procedures required to accomplish that result through another portion of the DGCL.

The court then contrasted Delaware's position on this issue with California's. A 1991 case from the Northern District of California, *SQL Solutions, Inc. v. Oracle Corp.*, 1991 WL 626458 (N.D. Cal. Dec. 18, 1991), held that a reverse triangular merger results in an assignment as a matter of law. SQL Solutions held that a legal change in the ownership of the business results in a transfer if "it affects the interests of the parties protected by the nonassignability of the contract." In Delaware, in contrast, multiple cases hold that corporations remain free to engage in stock purchase transactions without effecting an assignment as an operation of law. The court concluded that "both stock acquisitions and reverse triangular mergers involve changes in legal ownership, and the law should reflect parallel results."

Meso could have negotiated for a provision that would have incontrovertibly established the right it now seeks. Specifically, the court stated that Meso could have negotiated for a "change of control" provision to operate as another trigger for the consent requirement. In the absence of language defining a change of control as triggering the requirement that Meso consent, the court held that Meso's proffered interpretation of Section 5.08 – under which the contractual term 'assignment' captured a reverse triangular merger – was unreasonable as a matter of law, and therefore granted summary judgment in favor of the defendants.

FIDUCIARY DUTIES AND LIMITED LIABILITY COMPANIES

In *Auriga Capital Corp. v. Gatz Properties*, LLC, 40 A.3d 839 (Del. Ch. 2012) (Chancellor Leo E. Strine, Jr.), the Delaware Court of Chancery held that a manager of a Delaware LLC owes default fiduciary duties of care and loyalty to minority members unless such duties are specifically modified or eliminated by agreement. This was the first decision to squarely confront the following question: when an LLC agreement is silent on the issue of fiduciary duties, is it governed by default fiduciary duties or does it have no such duties at all?

On appeal in *Gatz Properties LLC v. Auriga Capital Corp.*, 59 A.3d 1206 (Del. 2012), the Delaware Supreme Court declared the default fiduciary duty part of the opinion to be "dictum without any precedential value" because the manager admitted he owed fiduciary duties, making it unnecessary to decide whether he owed them as a default matter. The Delaware Supreme Court affirmed the award of damages to investors, but rejected as dicta the court's finding that default fiduciary duties apply to any limited liability company formed under Delaware law. The court found that the LLC agreement at issue created contractually agreed fiduciary duties when it prohibited the manager from "enter[ing] into any additional agreements with affiliates on terms and conditions which are less favorable [than] similar agreements which could then be entered into with arms-length third parties." The Delaware Supreme Court also held that Delaware law did not require any "magic words" and that such language was the "contractual equivalent of the entire fairness equitable standard of conduct" and requirement that the manager obtain a "fair price." The court thus affirmed, "exclusively on contractual grounds."

More significantly, the Delaware Supreme Court rejected as "dictum without any precedential value" the Chancery Court's decision that created default fiduciary duties as a matter of construction of the Delaware LLC Act. The court held it was "improvident and unnecessary" for the Chancery Court to extend its holding where the parties had not specifically raised the issue. Instead, the court stated that "reasonable minds

could differ" on the statutory question and refused to "express any view regarding whether default fiduciary duties apply as a matter of statutory construction [to a Delaware LLC]." By doing so, the Delaware Supreme Court made clear that the issue of default fiduciary duties is a "question [that] remains open."

The *Auriga* decision prompted a legislative change. Effective August 1, 2013, the Delaware General Assembly amended Section 18-1104 of the Delaware Limited Liability Company Act to provide that, unless the limited liability company agreement says otherwise, the managers and controlling members of a limited liability company owe fiduciary duties of care and loyalty to the limited liability company and its members.

The amendment to the one sentence of Section 18-1104 was to add the following italicized words: "In any case not provided for in this chapter, the rules of law and equity, including the rules of law and equity relating to fiduciary duties and the law merchant, shall govern."

The General Assembly's synopsis of the amendment explains as follows:

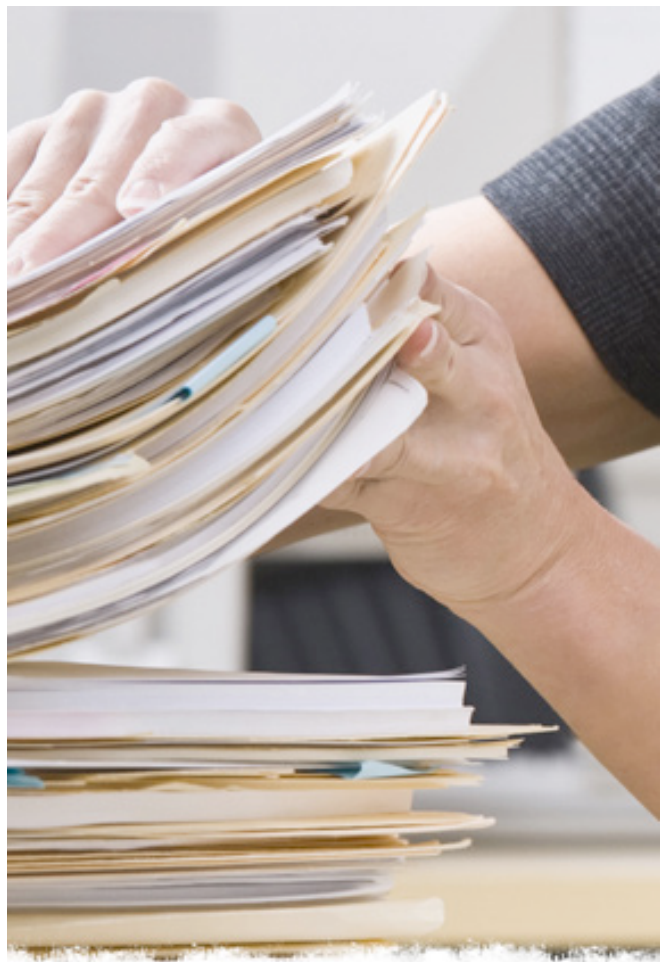
- Section 8 amends Section 18-1104 to confirm that in some circumstances fiduciary duties not explicitly provided for in the limited liability company agreement apply. For example, a manager of a manager-managed limited liability company would ordinarily have fiduciary duties even in the absence of a provision in the limited liability company agreement establishing such duties. Section 18-1101(c) continues to provide that such duties may be expanded, restricted or eliminated by the limited liability company agreement.

As noted in the General Assembly's synopsis, Section 18-1101(c) of the Act remains the same, so parties remain free in their limited liability company agreements to expand, restrict or eliminate fiduciary duties (subject to the implied covenant of good faith and fair dealing):

- (c) To the extent that, at law or in equity, a member or manager or other person has duties (including fiduciary duties) to a limited liability company or to another member or manager or to another person that is a party to or is otherwise bound by a limited liability company agreement, the member's or manager's or other person's duties may be expanded or restricted or eliminated by provisions in the limited liability company agreement; provided, that the limited liability company agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

CONTRACTUAL MODIFICATION OF FIDUCIARY DUTIES IN LIMITED PARTNERSHIP AGREEMENTS

In *Norton v. K-Sea Transp. P'ship, L.P.,* 67 A.3d 354 (Del. 2013), the Delaware Supreme Court affirmed the ruling of the Delaware Court of Chancery that dismissed a complaint filed on behalf of a limited partnership's unaffiliated former common unitholders against the general partner and board of directors of *K-Sea Transp. P'ship*, L.P.(collectively, the defendants). The unitholders alleged that the General Partner obtained excessive consideration for its incentive distribution rights when an unaffiliated third party, Kirby Corp., purchased K-Sea. The court held that the limited partnership agreement (the between the parties contractually required the general partner only to act in



good faith and the general partner exercised its good faith duty when it obtained a fairness opinion prior to the merger between Kirby Corp. and K-Sea.

This case arose out of a merger between K-Sea and Kirby. Under the limited partnership's capital structure, the General Partner was entitled to incentive distribution rights (IDRs) once payments to the unitholders exceeded certain levels. During merger negotiations, the General Partner requested that the third-party company purchase the common and preferred units, as well as the IDRs. Recognizing a potential conflict of interest because the General Partner would receive payment under the IDRs, the board of directors referred the proposed merger to the Limited Partnership's Conflict Committee. The Conflict Committee hired independent financial and legal advisors to offer a fairness opinion on the proposed merger. After reviewing the financial advisor's fairness opinion, the Conflict Committee recommended the proposed merger to the board of directors, who approved the merger and closed the transaction. Shortly after the announcement of the merger, the unitholders filed suit against the defendants.

In the Court of Chancery, the unitholders asserted the following claims against the defendants: (1) the conflict committee members breached their fiduciary duties by recommending the merger without evaluating the IDR payment's fairness; (2) the general partner breached the agreement by participating in an unfair transaction based on an inadequate review process; (3) the general partner breached the agreement by approving the merger in reliance on an improperly constituted conflict committee's special approval; and (4) the general partner breached its duty of disclosure by authorizing the dissemination of a materially misleading Form S-4. The Court of Chancery dismissed the unitholders' complaint in its entirety. The unitholders appealed the Court of Chancery's dismissal of claims 1-3.

To determine whether the general partner breached any duties owed to the unitholders, the court analyzed the agreement. The court noted that DRULPA gives "maximum effect to the principle of freedom of contract and to the enforceability of partnership agreements." Moreover, the court stated that "parties may expand, restrict, or eliminate any fiduciary duties that a partner or other person might otherwise owe, but they 'may not eliminate the implied contractual covenant of good faith and fair dealing." The court found Section 7.10(d) of the agreement eliminated any common law fiduciary duties owed by the general partner to the unitholders and replaced them with a contractual duty that the general partner "must reasonably believe that its action is in the best interests of, or not inconsistent with, the best interests of the Partnership." The court further noted that the agreement broadly exculpated all indemnities (including the defendants) so long as the indemnities acted in "good faith," which the court equated to the requirement established in Section 7.10(d) of the Agreement. Accordingly, the unitholders were required to allege facts supporting an inference that the General Partner had reason to believe that it acted inconsistently with K-Sea's best interest when approving the merger, to show that the general partner breached its duty to act in good faith. The court held the unitholders were unable to make such a showing.

The court held that the general partner acted in the best interest of the limited partnership in approving the merger for several reasons. First, the general partner acted in good faith because it approved the merger in reliance on information provided by a highly qualified financial advisor that conducted an adequate fairness opinion. The agreement contained a provision that created a conclusive presumption that the general partner acts in good faith if it relies on a competent expert opinion and the unitholders offered nothing to rebut that presumption. Second, the agreement required the general partner to only consider whether the merger as a whole was in the best interest of the limited partnership, which meant it did not have to evaluate the IDR payment's reasonableness separately from the remaining consideration. Third, the unitholders chose to invest in the limited partnership knowing that it provided fewer protections to the unitholders than those provided under corporate fiduciary duty principles. As a result, the court stated that the unitholders should be "bound to its investment decision."

DISTINCTION BETWEEN THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING AND A FIDUCIARY'S DUTY TO ACT IN GOOD FAITH

In *Gerber v. Enterprise Prods. Holdings*, LLC, 67 A.3d 400(Del. 2013), the Delaware Supreme Court partially reversed and remanded the Court of Chancery's decision dismissing all claims in the litigation. The case arose

from two transactions that former public holders of limited partnership units alleged violated contractual and fiduciary duties owed by the general partner and members of the board of directors.

The case concerned challenges to two transactions. First, in 2009, Enterprise GP Holdings, L.P. (EPE) sold Texas Eastern Products Pipeline Co., LLC to Enterprise Products Partners, L.P., at a price of US$100 million the Teppco GP sale). The Teppco GP sale occurred only two years after EPE had purchased Texas Eastern for US$1.1 billion. The general partner of the purchaser in the Teppco GP sale was a wholly-owned subsidiary of EPE. Second, in 2010 EPE merged into a wholly-owned subsidiary of Enterprise Products, allegedly to extinguish derivative claims arising from the Teppco GP sale.

The Delaware Supreme Court affirmed dismissal of fiduciary claims brought derivatively on behalf of EPE. EPE's Limited Partnership Agreement (LPA) supplanted traditional fiduciary duties with an obligation that partners act in "good faith," that is, with the belief that

the decision was in EPE's best interest. The LPA provided that if the general partner acted based on advice from experts, such as investment bankers, then the general partner would be conclusively presumed to have acted in good faith. The LPA also protected the general partner and its affiliates from any claim in connection with a conflicted transaction if the conflicted transaction received the approval of a majority of EPE GP's audit, conflicts and governance committee.

Because the defendants had followed the procedures necessary to demonstrate "good faith" under the LPA, the court affirmed dismissal of claims alleging that the defendants had violated the LPA's contractual duty of good faith.

Nevertheless, the court held that the contractual provisions establishing the "good faith" of the general partner did not bar a claim for breach of the implied covenant of good faith and fair dealing. The LPA established a contractual fiduciary duty of good faith governing the actions of the directors. In contrast, the implied covenant of good faith and fair dealing refers to implied terms that the parties to a contract would have agreed to, at the time of contracting, had they considered those terms.

The court then reversed dismissal of the implied covenant claim concerning both the Teppco GP sale and the merger. The court held that the fairness opinion used in the Teppco GP sale did not value the consideration that the unitholders actually received. Using an "unresponsive fairness opinion" constituted "the type of arbitrary, unreasonable conduct that the implied covenant prohibits." The court also found that EPE GP breached the implied covenant when obtaining special approval of the Teppco GP sale. Similarly, the court reinstated the implied covenant claim based on the merger. The court held that a "principal purpose" of the merger was to eliminate certain derivative claims, and the fairness opinion therefore should have valued those derivative claims. At the time of contracting, the parties would have agreed that any fairness opinion would have valued derivative claims of such importance to any future merger. Despite the committee's approval of the merger, the court held that unitholders had a reasonable expectation that they would receive value for eliminated claims "if the general partner chose to terminate their investment by way of a merger primarily intended to eliminate valuable assets of the limited partnership …."

As a consequence of its decision reversing dismissal of the implied covenant claims, the court also reversed and remanded dismissal of claims for aiding and abetting and tortious interference. The viability of these claims depended on whether an underlying violation of the implied covenant had occurred.

STANDING TO BRING DERIVATIVE SUITS

In *Arkansas Teacher Retirement System v. Countrywide Financial Corp.* ("Countrywide"), 73 A.3d 888(Del. 2013), the Delaware Supreme Court answered a certified question of law from the United States Court of Appeals for the Ninth Circuit, a procedural path permitted by Article IV, Section 11(8) of the Delaware Constitution and Supreme Court Rule 41, concerning the scope of the fraud exception to the rule that a plaintiff shareholder must continue to own shares to pursue a derivative claim, called the "continuous ownership rule." The Delaware Supreme Court held that a merger strips shareholders of standing to maintain a derivative claim, even if the alleged fraud that is the subject of the derivative claim necessitated the merger. In so holding, the court clarified that the so-called "fraud exception" to the requirement of continuous ownership means only that if directors of a corporation effectuate a merger for the sole purpose of extinguishing a derivative claim, that action grants the shareholders a direct suit against the directors.

This opinion arose from a derivative action brought by five institutional investors in Countrywide Financial Corporation against Countrywide's directors, in the United States District Court for the Central District of California. While the case was pending, Countrywide merged into a wholly owned subsidiary of Bank of America Corporation, divesting the plaintiff shareholders of Countrywide stock. The District Court then granted a motion to dismiss the action, holding that Delaware's continuous ownership rule meant the merger stripped Countrywide shareholders of standing to bring a derivative suit, that is, a suit on behalf of Countrywide. On appeal to the Ninth Circuit, plaintiffs argued that a recent Delaware Supreme Court opinion had broadened the fraud exception to the continuous ownership rule. The Ninth Circuit certified the question of the breadth of the fraud exception to the Delaware Supreme Court, asking whether shareholders may maintain a derivative lawsuit after a merger if the alleged fraud that is the basis of the derivative claims necessitated the merger. The Delaware Supreme Court answered the question in the negative.

The continuous ownership rule, as explained in the 1984 Delaware Supreme Court case *Lewis v. Anderson*, 477 A.2d 1040 (Del. 1984) states that a shareholder must continue owning shares for the duration of a lawsuit the shareholder brings on behalf of the corporation(that is, a derivative lawsuit). As a consequence of this role, shareholders in a corporation that is merged into another entity lose standing to either bring or maintain an existing derivative suit on behalf of the corporation in which they owned shares prior to a merger. Lewis v. Anderson also made clear that the fraud exception permits shareholders who allege that a merger occurred for the sole purpose of extinguishing derivative claims to bring a direct claim against the directors. A direct claim alleges a harm to the shareholders and any recovery goes to the shareholders; a derivative claim alleges harm to the corporation and any recovery goes to the corporation.

Plaintiffs argued to the Ninth Circuit, and then to the Delaware Supreme Court, that a 2010 Delaware Supreme Court opinion, *Arkansas Teacher Retirement Systems v. Caiafa,* 996 A.2d 321 (Del. 2010), represented a material change in the scope of the fraud exception to the continuous ownership rule. Caiafa also arose from litigation against the Countrywide directors. By way of background, after announcement of the merger between Countrywide and Bank of America, the plaintiffs in California amended their complaint to add direct claims based on the merger. The California District Court stayed those claims in favor of similar claims asserted on behalf of the same putative class that were pending before the Delaware Court of Chancery. The Delaware parties announced a settlement of the direct claims that would allow the merger to be consummated, and the California plaintiffs challenged the settlement before the Court of Chancery. The Court of Chancery approved the settlement, allowing the merger to proceed, and the Delaware Supreme Court affirmed that decision in *Caiafa*. The Delaware Supreme Court began its opinion in *Caiafa* by stating: "The Vice Chancellor denied the objection and approved the settlement, allowing [Bank of America] to close its acquisition of Countrywide, thus extinguishing [the plaintiff's] standing to pursue derivative claims."

The Delaware Supreme Court continued, in dictum in Caiafa, to discuss a claim that the plaintiffs could have brought but had failed to present. Specifically, the Court stated in Caiafa that plaintiffs could have plead "'a single, inseparable fraud' alleging that pre-merger fraudulent conduct made the merger a 'fait accompli.'" Noting that the plaintiffs had not presented this claim, the Supreme Court affirmed the Court of Chancery's decision approving the settlement, "despite facts in the complaint suggesting that the Countrywide directors' premerger agreement fraud severely depressed the company's value at the time of BOA's acquisition, and arguably necessitated a fire sale merger."

After *Caiafa*, the plaintiffs moved in California for the District Court to reconsider its dismissal of their derivative claims. The plaintiffs argued that although the derivative claims did not fit within the fraud exception described by *Lewis v. Anderson, the Caiafa* dictum represented "a new material change of law" that allowed derivative standing post-merger if the alleged fraud necessitated the merger. The District Court denied that motion and dismissed the case, holding that *Caiafa* confirmed that "shareholders – not the corporation via a derivative suit – would have had post-merger standing to recover damages from a direct fraud claim, if one had been properly pleaded." It was this decision that the plaintiffs appealed to the Ninth Circuit, and the question of whether *Caiafa* expanded the fraud exception as announced in *Lewis v. Anderson* then came to the Delaware Supreme Court as a certified question of law.

After explaining this background, the Delaware Supreme Court in Countrywide provided a relatively brief discussion of the fraud exception to the continuous ownership rule. The court rejected the plaintiffs' argument that the *Caiafa* dictum "overruled *sub silentio* more than twenty-five years of precedent that consistently held the fraud exception applies only where the sole purpose of a merger is to extinguish shareholders' derivative standing." Instead, the *Caiafa* dictum described a direct claim that shareholders could bring. *Caiafa* was not intended to expand derivative standing after a merger, and it did not do so. The Court described its opinion in *Caiafa* as "unambiguous," quoting a passage from *Caiafa* that stated if plaintiffs had pleaded a fraud claim, then the plaintiff shareholders "rather than Countrywide – could recover from the former Countrywide directors." The court therefore answered the certified question from the Ninth Circuit in the negative.

CORPORATION'S PURCHASE OF ITS OWN STOCK IS NOT A "BUSINESS COMBINATION"

In *Activision Blizzard, Inc. v.* Hayes, 2013 WL 6053804 (Del. Nov. 15, 2013), the Delaware Supreme Court relied on the rule that a transaction must be understood based on its substance rather than its form to decide that the purchase of a shell entity used to effectuate a stock purchase agreement by Activision Blizzard, Inc. did not constitute a "business combination," and therefore did not require stockholder approval under Activision's certificate of incorporation.

The shell corporation was formed as a vehicle through which Activision accomplished the purchase of both shares of its own stock and net operating loss assets (NOLs) from Vivendi, S.A. Activision and Vivendi executed a stock purchase agreement (SPA). In the SPA, Activision repurchased all of the Activision stock owned by Vivendi. Activision paid US$5.83 billion for 429 million shares of Activision stock and US$675 million in NOLs. As the Supreme Court put it: "To accomplish this part of the transaction, Vivendi created a non-operating subsidiary, New VH (referred to as 'Amber'), to hold the Activision shares and the NOLs." After the transaction, Activision would treat the shares it bought as treasury shares, thus reducing the number of shares outstanding. Vivendi would still own 11.9 percent of Activision, the public would own another 63.9 percent, and ASAC II, LP (an entity partly owned by two Activision directors that would purchase Activision shares from Vivendi in a separate transaction contemplated by the SPA), would own 24.7percent of Activision.

A stockholder filed a class action and derivative complaint, and moved for a temporary restraining order enjoining the SPA. The suit was premised, in part, on the allegation that Activision's Certificate of Incorporation required stockholder approval for a "merger, business combination or similar transaction." The Court of Chancery enjoined consummation of the transaction, but in the form of a preliminary injunction. The Court of Chancery interpreted "business combination" as an inherently ambiguous phrase, and found that the

purchase of Amber fits the dictionary definition of a business combination, and that the stock purchase was also a business combination due to its implications for control of Vivendi.

The Delaware Supreme Court reversed on this point. "Business combination," the court held, was not ambiguous in this context, and its plain meaning did not apply to this transaction. "This transaction does not involve any combination or intermingling of Vivendi's and Activision's businesses. Indeed, it is the opposite of a business combination. Two companies will be separating their business connection, leaving Vivendi as a minority stockholder without voting or board control over Activision."

In reaching this holding, the Delaware Supreme Court emphasized that the SPA represented the undoing of an earlier business combination. On December 1, 2007, Activision had purchased a Vivendi subsidiary, Vivendi Games, Inc., in exchange for 295.3 million shares of Activision common stock. In that same transaction, Vivendi purchased 62.9 million shares of Activision stock. After that transaction, Vivendi owned 61 percent of Activision's stock.

The Supreme Court acknowledged that "technically, Activision will combine with Amber." But the Court did not consider Amber to be a 'business' because it was merely a shell corporation used to effectuate the transaction: "Calling Amber a business for purposes of Section 9.1(b) disregards its inert status and glorifies form over substance."

Consequently, the Supreme Court vacated the Preliminary Injunction and remanded the case for the litigation to continue in the Court of Chancery.

WHO OWNS THE SELLER'S ATTORNEY-CLIENT PRIVILEGE AFTER CLOSING?

In *Great Hill Equity Partners IV,* LP v. SIG Growth Equity Fund I, LLLP, 80 A.3d 155 (Del. Ch. 2013), the Delaware Court of Chancery (Chancellor Leo E. Strine, Jr.) clarified the typical effect of a merger on the attorney-client privilege relating to pre-merger communications between the target and its counsel. Plaintiffs bought Plimus, Inc. which was the surviving entity after a merger, and later filed suit alleging the defendants, former representatives and stockholders of Plimus, fraudulently induced the transaction. Plaintiffs intended to use, in the litigation, communications between defendants and their attorneys leading up to the transaction. The defendants asserted attorney-client privilege over those communications, but the Court of Chancery held that the buyer now owned the attorney-client privilege.

Counsel to a party typically operates in an attorney-client relationship. Under Section 259 of the Delaware General Corporation Law, "all … privileges" of the target entity become the property of the surviving entity. The Court of Chancery held that Section 259 is not ambiguous and a merger transfers the attorney-client privilege to the surviving entity.

This holding has generated much attention in legal alerts, but the Court anticipated the uproar and explicitly provided "the answer to any parties worried about facing this predicament in the future." The Court explained that a seller wishing to preserve the privilege should follow the lead of merger agreements that contain "provisions excluding pre-merger attorney-client communications regarding the negotiation of the transaction from the assets to be transferred to the surviving corporation and explicitly acknowledging that the attorney-client privilege for these documents would belong solely to the seller after the merger." Even if a seller follows this advice, however, care should be taken to protect the information when transferring computer systems lest the seller waive the privilege by disclosing the communications.

Nevertheless, if this solution is not workable, other means to address this problem exist. First, the merger agreement could contain a covenant that the buyer will not attempt to access pre-merger attorney-client communications about the merger. The data could then be segregated from other communications before being transferred to the buyer. The buyer would then hold the privilege, but would have contractually agreed to refrain from seeing the documents. Second, the merger agreement could contain restrictions on the "uses" for which pre-merger communications could be used, such as prohibiting them from being used in a lawsuit against the seller. Third, before the sale, the target company could enter into a common interest agreement with the representative, and grant the representative the sole authority over waiving the privilege. This alternative may accomplish many of the same goals without requiring the buyer's consent in the merger agreement.

THIRD CIRCUIT STRIKES DOWN CONFIDENTIAL ARBITRATION IN THE DELAWARE COURT OF CHANCERY

In *Delaware Coalition for Open Government v. Strine*, 733 F.3d 510 (3d Cir. 2013), the Third Circuit affirmed the district court's order that struck down confidential arbitrations before members of the Court of Chancery. To make this determination, the Third Circuit used the "experience and logic" test to determine whether a proceeding qualifies for the First Amendment right of public access. The opinion therefore rejected the rationale used by the district court, which had determined that the confidential arbitration was unconstitutional because the proceeding was "sufficiently like a trial." Nevertheless, the outcome remains unchanged: members of the Delaware Court of Chancery may not engage in confidential arbitrations.

In 2009, Delaware enacted a law creating an arbitration process for certain types of business disputes. In this arbitration setting, parties in business disputes that did not involve a consumer and involved a dispute of over US$1 million could have their dispute arbitrated by a sitting member of the Court of Chancery. The parties could contractually customize the amount and manner of discovery to be conducted. Arbitration would begin approximately 90 days after the filing of a petition. Appeals from resulting decisions could succeed only upon proof that the award resulted from corruption, fraud or undue means, or that the arbitrator was guilty of misconduct. The entire record before the arbitrator, along with any proceedings before the arbitrator, would be kept confidential. The arbitration program allowed businesses the option to confidentially and rapidly secure resolution of a business dispute from a member of the Court of Chancery.

A public interest group, Delaware Coalition for Open Government, sued the members of the Court of Chancery, seeking to have the program declared unconstitutional based on the confidential nature of the arbitrations. In the district court, the plaintiff moved for judgment on the pleadings, and the district court granted that motion, holding that the right of access to civil trials extended to these arbitrations, because the arbitrations were "sufficiently like a trial" that the public nature of a trial. On that basis, the district court struck down the

portion of the Delaware statute and Chancery Court Rules that made the arbitrations confidential.

On appeal, the Third Circuit concluded that the district court erred by failing to use the "experience and logic" test to determine whether the arbitrations should be made public. The Third Circuit described that test as follows: "In order to qualify for public access, both experience and logic must counsel in favor of opening the proceeding to the public." The Third Circuit applied the experience prong of the test by looking at the history of both arbitrations and civil trials. "Exploring both histories avoids begging the question and allows us to fully consider the 'judgment of experience.'" The Third Circuit concluded that civil trials have a strong tradition of openness, and that arbitrations similarly have a strong tradition of openness, at least after excluding arbitrations before private figures. Similarly, the logic prong counseled in favor of openness, because opening arbitrations would secure all the benefits of holding public trials, and the Third Circuit found little benefit to keeping the proceedings confidential, especially in light of the Court of Chancery's rules allowing confidential treatment for sensitive business information.

The Third Circuit therefore affirmed the District Court's ruling striking down as unconstitutional that part of Delaware's arbitration law that rendered the arbitrations confidential. The Court of Chancery has since filed for a writ of certiorari with the United States Supreme Court.

STATUTORY AMENDMENTS TO THE DELAWARE GENERAL CORPORATION LAW AND ALTERNATIVE ENTITY STATUTES

2013 Amendments to the Delaware General Corporation Law

The following amendments became effective on August 1, 2013, except that the new Sections 204 and 205, along with accompanying changes, will become effective on April 1, 2014.

§ 152, Setting Consideration for Stock

The Board of Directors may use a formula to set the consideration that the corporation will receive in exchange for stock. The previous version arguably precluded the use of a formula.

§§ 204 and 205, Ratification of Defective Corporate Acts

Improperly authorized corporate acts may now be ratified through procedures outlined in Sections 204 and 205. These procedures greatly reduce the possibility that procedural failures in taking corporate actions (such as stock issuances) will lead to their later invalidation.

§ 251, Eliminating Stockholder Votes in Some Two-Step Mergers

The newly added Section 251(h) permits second-step mergers after tender offers to be finalized without the need for stockholder approval, in certain situations.

§§ 114, 312, 502, Shelf Corporations

Amendments to these two sections of the DGCL, in Section 312(b) and Section 502(a) make the formation of so-called shelf corporations less attractive. Section 312(b) now allows only directors or stockholders to authorize the renewal or revival of a corporation not in good standing. Section 502(a) prohibits an incorporator, in most circumstances, from signing any annual franchise tax reports after the first one.

§§ 361 – 368, Public Benefit Corporation

These sections, which together comprise new Subchapter XV of the DGCL, make it possible for people to enact what are called public benefit corporations. These kinds of corporations are both for-profit and the directors of such a corporation may be obligated, when overseeing the corporation, to "balance the pecuniary interest of the stockholders, the best interests of those materially affected by the corporation's conduct, and the specific public benefit of public benefits identified in the certificate of incorporation."

2013 Amendments to Delaware's Limited Liability Company Act

The following amendments to the Delaware Limited Liability Company Act, *6 Del. C. § 18-101 et seq.* (the LLC Act), became effective on August 1, 2013.

§§ 18-209, 18-212, 213, 214, 216, Survival of Interests After Merger

These amendments clarify that the interests in an LLC can survive a merger with another LLC or other Delaware business entity, and similarly clarify that equity interests in foreign companies may continue upon the domestication of that entity into a Delaware LLC, or

upon the transfer of a Delaware LLC to some other jurisdiction.

§ 18-703, Charging Orders Sole Remedy

Judgment creditors of members or membership assignee's may only recover via a charging order; this amendment explicitly rejects a number of alternative possible means of collection and explicitly states that this protection applies regardless of the number of members an LLC possesses.

§ 18-1101, Protections Given to Single-Member LLCs

A newly added Section 18-1101(j) clarifies that the provisions of the LLC Act, including the protections of limited liability afforded to LLCs, apply regardless of whether an LLC has many members or only one.

§18-1104, Default Fiduciary Duties

The new Section 18-1104 conclusively resolves an important and long-running debate by stating that fiduciary duties govern the internal affairs of limited liability companies unless the LLC's operating agreement states otherwise.

DELAWARE'S GUIDING PRINCIPLES REMAIN TRUE

These cases once again demonstrate that the Delaware courts are neither stockholder nor management biased. Delaware's guiding principles remain strict adherence to fiduciary duties, prompt enforcement of articles of incorporation, bylaws, and merger agreements, and the maximization of stockholder value. The business judgment rule remains alive and well for directors who reasonably inform themselves of important information, are free of economic or other disabling conflicts of interest, and whose only agenda is that of advancing the best interests of the corporation.

While the facts and legal analyses confronting directors are many times complex, the cases often boil down to the smell test. So long as independent directors can articulate why, in their best judgment, they acted as they did and believe those actions were in the best interest of the corporation, Delaware courts typically respect their decisions.

DLA PIPER IN DELAWARE

DLA Piper's Wilmington, Delaware office is an integral part of the firm's national and international practice and significantly enhances the firm's capacity to provide full-service solutions to our clients in all significant areas of business law. DLA Piper's Delaware lawyers are established trial and transactional lawyers recognized by Chambers USA: America's Leading Lawyers for Business, with substantial experience in handling matters in multiple venues focusing on the core areas for which Delaware is nationally and internationally renowned.

The corporate lawyers in DLA Piper's Delaware office represent corporations, boards of directors, individual officers and directors, special board committees and large investors. In addition to counseling on corporate and governance issues, this practice involves advising on deal structure and compliance with fiduciary duties as well as representation in the Delaware courts.

The litigation aspect of the corporate practice covers class actions and derivative breach of fiduciary claims, corporate control disputes, merger and acquisition litigation, actions involving the interpretation of charter provisions and bylaws, actions by directors and/or officers seeking advancement and/or indemnification, stockholder appraisal actions, stockholder requests for books and records, internal corporate investigations, litigation arising out of transactions involving subsidiaries, tender offers, asset sales, capital restructurings, stockholder meetings and votes, dissolutions, corporate reporting and compliance programs and other matters involving corporate governance and the Delaware General Corporation Law.

Also resident in DLA Piper's Wilmington office is a former two-term governor and nine-term congressman of Delaware, whose extensive state and federal experience provides a unique understanding of a wide array of issues faced by businesses that are either incorporated in Delaware or deal with Delaware entities.

ABOUT DLA PIPER

DLA Piper is a global law firm with 4,200 lawyers in more than 30 countries throughout the Americas, Asia Pacific, Europe and the Middle East, positioning us to help companies with their legal needs anywhere in the world.

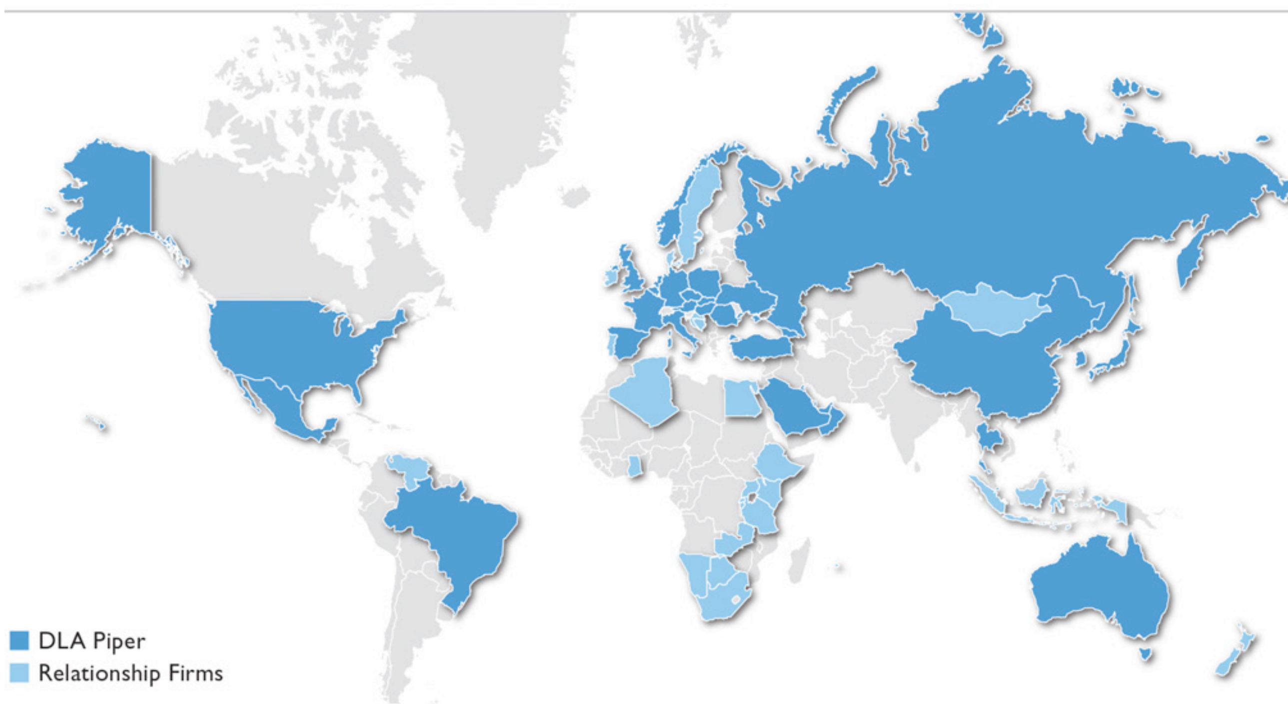
Our Corporate and Securities group, with 250 lawyers in the US and 550 worldwide, represents clients pursuing sophisticated transactions. We advise on public and private equity and debt securities offerings, mergers and acquisitions and reorganizations. In addition to offering comprehensive transactional services, we advise on corporate governance, IT, tax, compensation and technology issues. Learn more at dlapiper.com.

OUR PRIVATE EQUITY PRACTICE

DLA Piper's integrated, experienced teams represent private equity funds as well as their principals, management teams, institutional investors, financing sources and portfolio companies in all types of transactions and industries. Our clients range from emerging managers to "unfunded" sponsors, to traditional sponsors managing billions of dollars in committed capital. Along with providing legal services, we introduce clients to the opportunities, relationships and insights afforded by our global platform. We are proud to have been ranked #1 globally for total private equity and venture capital deal volume in 2011 and again in 2012 by Dow Jones Private Equity Analyst.

OUR M&A PRACTICE

Our Mergers and Acquisitions group acts each year as counsel on a large number of mergers and acquisitions transactions. In 2014, for the fourth consecutive year, DLA Piper retained its number one ranking globally for overall deal volume, according to *mergermarket's* league tables for legal advisors. In 2013 alone, that publication noted, we handled 385 transactions valued at approximately US$31 billion. We are consistently ranked among the top US firms in number of announced and completed deals.



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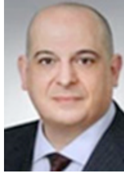

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