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M&A/PE Quarterly

A QUARTERLY ROUND-UP OF KEY M&A/PE DEVELOPMENTS

When Legal Counsel's Emails Are Hacked and a Stockholder's Merger Consideration is Paid to the Hackers, Who is Liable?—Sorensen

In *Sorenson Impact Foundation v. Continental Stock Transfer & Trust Company* (Apr. 1, 2022), computer hackers intercepted the email communications of a law firm (the "Law Firm") involved with the $130 million merger pursuant to which Tassel Parent, Inc. (the "Buyer," a subsidiary of private equity firm KKR) was acquiring Graduation Alliance, Inc. (the "Target"). The hackers posed online as two of the Target's actual stockholders and succeeded in having the merger consideration paid to them instead of the stockholders. The hackers were never apprehended or identified. The actual stockholders—Sorenson Impact Foundation and James Lee Sorenson Family Foundation—brought suit in the Delaware Court of Chancery against Continental Stock Transfer & Trust Company (the "Paying Agent"), the Buyer, and the Target (which was the surviving corporation and which we refer to herein, in combination with the Buyer, as the "Company"). Vice Chancellor Glasscock (i) dismissed the claims against the Paying Agent on the basis of lack of personal jurisdiction; (ii) let stand the claims against the Company; and (iii) left open the issue whether the Law Firm (which had communicated directly with the hackers) was a necessary party to the action and must be joined as a defendant.

Background. The Sorenson entities properly submitted their letters of transmittal and stock certificates to the Paying Agent, requesting payment in their name to an account at Zions Bank in Utah. Computer hackers then intercepted the Sorenson entities' email communications with the Law Firm. (Which entity was represented by the Law Firm was in dispute.) Assuming the identity of the Sorenson entities, the hackers then communicated via email with the unsuspecting Law Firm and requested that payment of the merger consideration be changed to an international account at a Hong Kong bank. A week later, they requested that the payment be made in the name of HongKong Wemakos Furniture Trading Co. The Law Firm communicated these instructions to the Paying Agent.

The Paying Agent Agreement, between the Buyer and the Paying Agent (the "PAA"), stated that the Buyer would provide the Paying Agent with a schedule listing the stockholders to be paid the merger consideration. The PAA also provided that the Paying Agent would examine submitted letters of

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Spring 2022

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transmittal to ascertain that they were properly completed; would consult with the Buyer with respect to any actions needed to correct any "irregularities" in the letters of transmittal; and could waive any such irregularities if approved in writing by designated officers of the Buyer. The form of letter of transmittal stated that a shareholder requesting payment in a name other than that on the stock certificate would have to provide a "medallion guarantee" of its signature by a qualified provider.

The Paying Agent informed the Law Firm that the purportedly updated letter of transmittal from the Sorenson entities required a medallion guarantee and none was provided. The Paying Agent allegedly discussed the issue with certain (unspecified) "defendants" and offered three options that it would find acceptable such that it would proceed with payment. The Buyer could (i) require that the medallion guarantee be submitted; (ii) waive the medallion guarantee requirement and provide the Paying Agent with a hold harmless agreement; or (iii) change the name on the payment schedule to match the HongKong Wemakos name. Allegedly, the defendants, rushing to resolve the issue before a deadline for closing, chose option (iii). The Buyer changed the Sorenson entities' names on the payment schedule and the Paying Agent then made payment to the account the hackers had designated.

Discussion

The Paying Agent is not subject to Delaware jurisdiction. The court rejected the plaintiffs' argument that the Delaware forum selection provisions in the Merger Agreement and the letter of transmittal were binding on the Paying Agent. First, the Paying Agent was a New York domiciliary. The PAA was governed by New York law and, although the form of letter of transmittal was an exhibit to the PAA and the Merger Agreement was an exhibit to the form of letter of transmittal, the PAA contained no "explicit manifestation of intent" to incorporate by reference the terms of the Merger Agreement or the letter of transmittal. Moreover, the Merger Agreement specifically provided that the Paying Agent was not a party to nor bound by the Merger Agreement; and the letter of transmittal did not constitute a contract that created enforceable duties (and, in any event, also did not contain an explicit manifestation of intent to incorporate by reference the Merger Agreement or the PAA). Second, the court held that the Paying Agent, merely by acting for the two Delaware corporations that were merging, did not have sufficient minimum contacts with Delaware for the state to assert jurisdiction under its long-arm statute. Finally, the court observed that, as the PAA was "a commonplace commercial contract," with no Delaware-specific law at issue, Delaware had no special interest in adjudicating the dispute.

The Company, although it technically complied with the Merger Agreement requirement to pay the merger consideration to the Paying Agent, may be liable for not "ensuring" ultimate payment to the Sorenson entities. Under the Merger Agreement, the Buyer was required to pay "to the Paying Agent" the amount due to all stockholders who submitted letters of transmittal meeting the conditions relating thereto. The Sorenson entities had satisfied such conditions and submitted a letter of transmittal; and the Buyer had made such payment to the Paying Agent. However, the court found that it was "reasonably conceivable" (the standard applicable at the pleading stage) that the Merger Agreement, "[r]ead holistically," could be interpreted to impose an obligation on the Buyer "to do more than make a payment to its agent, that is, to ensure payment to the 'entitled' stockholders…." Notwithstanding that the plaintiffs did not plead that the Buyer had breached the Merger Agreement (but, instead, had pleaded that the Buyer was vicariously liable for the Paying Agent's breach of the PAA), the court found that the Complaint gave sufficient notice to the Buyer that it was being sued for failure to pay the merger consideration that was due to the plaintiffs, in violation of the Merger Agreement. The court therefore rejected dismissal, at the pleading stage, of a breach of contract claim against the Company.

The court dismissed the claims against the Company for vicarious liability of the Paying Agent's alleged contractual breaches; but let stand the claims against the Company for unjust enrichment. With respect to the claim for vicarious liability, the court stated that, under Delaware law, while a principal (the Company) may be liable *for torts* committed by an agent (the Paying

Agent) when the agent's tortious conduct was undertaken pursuant to the agency relationship, a party cannot be vicariously liable for its agent's *non-tortious* conduct (such as breach of contract). The court noted that while the plaintiffs had pleaded a tort claim (negligence) against the Paying Agent, they had failed to plead a vicarious liability claim against the Company associated with the tort (and instead had pleaded only breach of contract). With respect to the claim for unjust enrichment, the court, without discussion, wrote that it was difficult to see how the Company "can have liability apart from breach of contract." However, the court, stating that it was "mindful of the alternative nature of the claims," and that it was "bow[ing] under the weight of precedent," declined to dismiss the claim "at this time" and left it for "consideration on a record."

The court left open the issue whether the Law Firm was a necessary party to the action. The Company argued that the Law Firm, which was not named as a defendant, was a necessary party to the suit. The court requested supplemental briefing on the issue before ruling on it.

Practice Points

- **M&A participants should carefully plan to avoid, and to appropriately respond to, possible hacking—and should consider specifically addressing the potential liability issues in the event that hacking (or other improper diversion of merger consideration) occurs.** M&A transactions present significant opportunities for cyber criminals. While previous hacking attempts usually have involved stealing information for purposes of engaging in insider trading, *Sorenson* highlights the risk of hackers successfully intercepting email chains, assuming the identities of actual shareholders, and re-directing payment of the merger consideration to themselves. A buyer, seller, target and paying agent, as well as legal counsel, should seek to ensure that appropriate systems are in place to prevent hacking. Even with careful planning and processes, however, hacking may be successful. Thus, M&A parties should consider specifically addressing in their agreements who would (and who would not) be liable if any of them was hacked. The court, citing the plot of *The Maltese Falcon*, framed the issue as follows:

  > Two parties contract for the sale of a chattel: say, a statuette of a falcon covered in black enamel. The payment is to be in cash. Neither wishes to make the transfer in person. Accordingly, they agree that the buyer will hire an agent who is to deliver the bird. Once delivery is made, the agent is to receive cash from the buyer, which he is then to pay over to the seller. The first part of the transaction is completed without incident. The buyer immediately resells the dingus to new buyers, who then take it on a ship and out of the jurisdiction. The agent then departs with the cash. As he is approaching the buyer's home to complete the payment, a gunsel accosts him, and robs him of the cabbage. This mugger, despite the best efforts of the police, is never apprehended or even identified. Who in this scenario must bear the loss?

- **A buyer, the target, and the paying agent (as well as legal counsel) all should pay attention to red flags with respect to letters of transmittal and seek to ensure an appropriate resolution of any irregularities.** Red flags might include, for example, last minute changes to a letter of transmittal or payment instructions; a name change in the payment instructions without the required guarantee of signature; or a failure to meet other specified requirements (especially if relating to a large payment amount and, perhaps, if payment is to be redirected from a U.S. bank to a foreign bank for a U.S. shareholder). In *Sorenson*, arguably the red flags would have warranted that the Paying Agent make a call to (rather than communicate only by email with) the purported stockholders regarding the irregularities in their letter of transmittal. Further, the Paying Agent should have followed the instructions in the PAA to obtain the written consent of the designated officers of the Buyer. Moreover, arguably, the Paying Agent should not have offered, and the Buyer should not have chosen, the option of simply changing the stockholder's name on the payment schedule. While that option resolved the issue for the Paying Agent on a technical basis, it offered no substantive substitute protection for the missing medallion guarantee.

- ***Sorenson*** **also serves as a reminder that, under Delaware law:** (i) If parties intend that an agreement incorporates by reference another agreement, they must include in the agreement an "explicit manifestation of intent" therefor. (ii) If parties intend that the terms in a letter of transmittal (or other ancillary documents) will be binding on any party, they must state as much in a binding agreement (such as the merger agreement or paying agent agreement, depending on which parties are to be bound), as a letter of transmittal generally is not a contract that creates enforceable duties. (iii) A buyer may wish to consider providing in the paying agent agreement that the paying agent will be bound by the forum selection and/or submission to jurisdiction provisions in the merger agreement. (iv) Target stockholders should keep in mind that a buyer can have vicarious liability (as a principal) for misconduct by the paying agent only if the paying agent's conduct was tortious (*e.g.*, negligence). Buyer liability for the paying agent's breach of the paying agent agreement may arise only based on an aiding and abetting claim.

Freeze-Out of Minority Partners Was Not "Entirely Fair" Although the Price Paid Was Set Based on an Outside Appraisal Firm's Valuation —Salem Cellular

In *In re Cellular Telephone Partnership Litigation* (Mar. 9, 2022), a wholly-owned subsidiary of AT&T, Inc., which was the 98.12% controlling partner of Salem Cellular Telephone Company (the "Partnership"), froze out the minority partners by acquiring the Partnership's assets and liabilities and then liquidating the Partnership. AT&T paid to the Partnership, and then caused the Partnership to distribute to the minority partners their respective pro rata shares of, the Partnership's value as had been determined by a major national valuation firm that AT&T had retained (the "Valuation Firm"). Litigation ensued with respect to AT&T's freeze-out of the minority partners of this and fifteen other AT&T cellular partnerships. In the decision issued March 9, 2022, which related only to the plaintiffs' fiduciary claims against AT&T with respect to the freeze-out of Salem Cellular's minority partners (the "Freeze-out"), the Delaware Court of Chancery held that the transaction (which, as the parties had agreed, was subject to the "entire fairness" standard of review because the controller stood on both sides of the transaction), did not satisfy the entire fairness standard and that AT&T therefore had breached its duty of loyalty to the minority partners.

Most notably, the decision suggests that outside appraisal, alone, may not be sufficient to establish entire fairness—at least where, as was the case in *Salem Cellular*, the court views the controller's timing and initiation of the transaction at issue to have been opportunistic (*i.e.*, designed to benefit the controller at the expense of the minority); the appraisal was by a firm retained by the controller; and the court views the appraisal as seriously flawed.

Background. Over several years, AT&T had been planning for a buyout of the minority partners' interests in its controlled joint ventures that held licenses to provide cellular telephone services across the U.S. *Salem Cellular* involved the buyout of the minority partners in the partnership that held the license for the Salem, Oregon area. Prior to the buyout, AT&T retained the Valuation Firm, which determined the fair value of the partnership to be $219 million (based on a DCF analysis and a comparable companies analysis, weighted 50% each). The plaintiffs, former minority partners in the Partnership, claimed that AT&T had breached its duty of loyalty to the minority partners by freezing them out at an opportunistic time and at an unfair price. The plaintiffs had received a total of $4.1 million in the liquidation. At trial, a valuation expert retained by AT&T (the "Valuation Expert") testified that based on her own analyses (a DCF analysis, comparable companies analysis, and comparable transactions analysis, weighted 50%, 25% and 25%, respectively) the fair value of the Partnership fell within a range of $171.3 million to $224.1 million. Noting that the Freeze-out price of $219 million fell toward the high end of the range, she opined that the price represented "at least the Fair Value of the Partnership equity interests."

The court found that neither AT&T's process nor price were fair, and therefore that it had breached its duty of loyalty. Conducting its own DCF analysis, the court determined that a "reasonable estimate" of the fair value of the Partnership was $714 million (more than three times the Valuation Firm's valuation). The court awarded the plaintiffs damages of $9.3 million, representing their pro rata share of that amount less what they had received in the liquidation.

Discussion

The court found that the process was unfair. The court wrote: "The only step AT&T took towards instantiating a fair process was to hire a financial advisor to value the Partnership, then use that valuation when setting the price for the Freeze-out." That step, the court found, was not sufficient to outweigh the lack of fair dealing by AT&T that was evidenced by: (i) the opportunistic timing and initiation of the Freeze-out; (ii) no negotiation process and a coercive structure of the transaction; and (iii) flawed valuation methodologies by financial advisors that had been retained by AT&T.

- ***Opportunistic timing and initiation of the transaction.*** The court found that AT&T's "primary purpose" in freezing out the minority partners was to capture for itself, and to deprive the minority partners of, the anticipated significant increase in value of the Partnership that was expected to occur based on an evolving "data revolution." AT&T had argued that its objective was to simplify its complex corporate structure and eliminate the associated high administrative costs. The court agreed that AT&T had these objectives, but concluded they were not the "primary motivation." The court pointed, first, to AT&T's own planning materials, which reflected its desire over many years to buy out its minority partners in its cellular telephone partnerships in light of its expectation, which turned out to be correct, of "an explosion in data usage" that would lead to profitable new businesses and products for the partnerships. In its planning, the court noted, AT&T "specifically focused on the Partnership" and certain other entities "because the minority investors could be eliminated unilaterally." Also, the court observed that the anticipated savings from avoiding distributions to the minority partners of the Partnership dwarfed the administrative savings from the Freeze-out, making it unlikely that administrative savings were the primary motivation. The court concluded: "AT&T acted because it anticipated a period of significant growth in data-driven wireless businesses, wanted 100% of the benefits for itself, and did not want to share the benefits with the minority partners."
- ***No negotiation and coercive structure of the transaction.*** In determining that the process was unfair, the court noted that "no special committee or other independent bargaining agent negotiated on behalf of the minority." Although the partnership had a minority representative on the Executive Committee, and the Executive Committee could have empowered the minority representative to negotiate, AT&T "did not engage with the minority representative" and kept the minority partners "in the dark." In addition, AT&T "did not condition the Freeze-out on a majority-of-the-minority vote." While not required, such a vote would have been a "positive factor" for AT&T in meeting its burden to substantiate fairness, the court stated. Further, the transaction was structured to be "coercive." AT&T offered to buy the minority partners' interests at a 5% premium to the Valuation Firm's valuation, and at the same time told the minority partners that they otherwise would be cashed out in the subsequent liquidation in which no premium on the valuation would be paid. The "two-tier offer…pressured the minority to accept the front-end price…," the court wrote. Notably, a majority of the minority partners (by both number and interest) did not accept the front-end offer, notwithstanding the coercive structure—which, the court reasoned, was "strong evidence that the offer was unfair even with a 5% premium." Finally, the court pointed to evidence that, at the special meeting at which AT&T voted its controlling interest to approve the Freeze-out, AT&T had provided false answers and had refused to provide answers to questions posed by the minority partners (relating to, for example, AT&T's relationship with the Valuation Firm and whether other valuations had been obtained).

- ***Flawed valuation methodologies by possibly non-independent financial advisors.*** AT&T argued that the process was fair because it had engaged an independent valuation firm to determine the valuation and had set the price based on that valuation, and, moreover, the fairness of that valuation had been confirmed by an independent valuation expert. The court was skeptical as to the "independence" of both financial advisors, however. With respect to the Valuation Firm, first, the court stated that AT&T's hiring an independent financial advisor in connection with its conflicted transaction was not "striking"—indeed, it would have been striking if AT&T had not done so, the court commented. Moreover, the court noted that "AT&T hired and paid [the Valuation Firm]," and stated that, as Delaware appraisal proceedings have shown, "valuation professionals reach outcomes that are influenced by the interests of the party that retains them…." The court noted further that AT&T, over several years, had repeatedly engaged the person acting as the lead partner from the Valuation Firm, including when he had been employed at two other firms (in one of which cases AT&T had to obtain a waiver of his non-compete agreement so that he could act for AT&T). This "looked less like the engagement of a truly independent outside advisor and more like the continuation of a longstanding business relationship with an individual who knew how to deliver the answer AT&T wanted," the court wrote. Moreover, the court found that "the evidence [was] mixed" as to "what [the Valuation Firm] did." On the negative side, for example, "AT&T withheld important pieces of information from [the Valuation Firm]"—such as board presentations about the buyout and certain revenue information, both of which "steered [the Valuation Firm] towards [AT&T's] preferred valuation," according to the court. The court concluded that, "[o]n the whole,…AT&T's interactions with [the Valuation Firm] provide[d] additional evidence of an unfair process." With respect to the Valuation Expert, the court seemed to express skepticism as to her independence as well, based on AT&T having used her "repeatedly" as a trial expert in various cases involving its freeze-outs in other partnerships, as well as her approaches in this case being inconsistent with approaches she had taken in other similar cases.

The court found that the price was unfair. The court found that neither the Valuation Firm nor the Valuation Expert "used persuasive valuation methodologies," and that there was evidence that the price was unfair.

- ***The court observed that AT&T's own internal analyses indicated a substantially higher value for the Partnership.*** The court cited contemporaneous documents showing that "AT&T placed a significantly higher value on the Partnership and its sister entities [(*i.e.*, its other cellular partnerships)] than it paid." AT&T's internal analyses "provide[d] persuasive valuation evidence," the court stated, as "a buyer who possesses material nonpublic information about the seller is in a strong position (and is unique incentivized) to properly value the seller."
- ***The court noted that the outside valuations did not take into account the significant value to the Partnership of its contractual entitlements under a Management Agreement with AT&T.*** The Management Agreement required AT&T to provide a 25% premium to the Partnership for shared revenues and a 10% discount to shared expenses. These rights were ignored in the valuations because AT&T had not complied with these requirements. The court stated that, while the analyses thus reflected the historical reality, ignoring the value of these rights–and the litigation asset resulting from AT&T's having "pervasively disregarded" them–rendered the analyses inaccurate, undervaluing the Partnership by at least 25%.
- ***The court criticized the judgments made by the experts in their analyses.*** The court found that the Valuation Firm and the Valuation Expert had relied on unsupportable assumptions and inputs in their respective DCF analyses, in part due to data provided by AT&T that was unreliable. Among the problematic assumptions in the court's view were: (i) concededly unreliable subscriber counts from AT&T (by the time of the Freeze-out, due to both industry developments and AT&T's faulty record-keeping, AT&T "could not provide basic information about its subscribers or the Partnership's"); (ii) the use of a blended corporate tax rate for the Partnership of 38.5% ("even though the Partnership is a pass-through entity that does not pay tax at the entity level"); and (iii) the use of an "artificially low perpetuity growth rate" of 1.5% (which was lower even than the expected inflation rate, and thus treated the Partnership as a "wasting asset").

- ***The court commented that the Valuation Expert, by reaching different judgments than the Valuation Firm, "cast doubt" on the latter's analyses.*** The court repeatedly noted where the Valuation Expert's judgments in her analyses differed from those made by the Valuation Firm–such as her relying 25% on a comparable companies analysis while the Valuation Firm relied 50% on that methodology, and her excluding two companies from the comparable companies analysis that the Valuation Firm had included. These differences arguably undermined the validity of the Valuation Firm's analysis, the court stated.

- ***The court noted that the Valuation Expert's approaches were inconsistent with those she had taken in other similar cases.*** For example, in this case, she accorded no value to a step-up in basis, while she had valued a step-up in basis in a similar freeze-out in which she had been involved; and, in this and two other cases involving similar wireless company freeze-outs, she had used "three different weighting schemes" (50%-50% to a DCF and a comparable companies model in one case; 50%-30%-20% to a DCF, a comparable companies, and a comparable transactions model in another case; and 50%-25%- 25% to a DCF, a comparable companies, and a comparable transactions model in this case).

- ***The court stated that the comparable companies and comparable transactions analyses undervalued the Partnership by not taking into account the "unique" nature of the spectrum licenses the Partnership held.*** The court described the Partnership (and AT&T's other cellular partnerships) as "unique because their primary asset was their spectrum licenses, which were the 'crown jewel' of AT&T's wireless business." In addition, the court stated, "[t]he partnershups also were unique because they were organized as pass-through entities for tax purposes and remitted the overwhelming majority of their earnings as distributions to partners." It was therefore "difficult," in the court's view, "to find public companies with comparable assets, operations and business models."

The court awarded relief based on the partnership's "operative reality" prior to the challenged transaction. The plaintiffs advanced a theory of damages rooted in the present value of the distributions they would have received as minority partners but for the Freeze-out. The court stated that it agreed with the "basic approach" of valuing the interests in the Partnership at the time of the Freeze-out, but not with using the present value of distributions to quantify the damages award. The court reiterated that the question of fairness in a controller freeze-out context is based on whether each minority investor received "the equivalent in value of what he had before." The court emphasized that this question required valuation of the Partnership not as a stand-alone entity, but taking into account its "operative reality" at the time of the transaction. AT&T's financial advisors had treated the Partnership as a "wasting asset," rather than as "an essential part of AT&T's nationwide wireless network, which AT&T operated on an integrated basis, and which was expected to be entering a prolonged period of growth as a result of the data revolution." The court, stating that "the validity of the DCF model as a conceptual approach is beyond question," conducted its own DCF analysis, using as the "basic framework" the DCF analysis prepared by the Valuation Firm, as modified by the Valuation Expert, but "fixing" the "erroneous and unreliable assumptions" therein, and "giv[ing] the benefit of the doubt" to the plaintiffs. The court revised assumptions for the projections, created forecasts for the partnership, and, in a detailed analysis over 34 pages long, arrived at a "responsible estimate" of $714 million for the value of the Partnership. The plaintiffs were entitled to 1.88% of that amount ($13.4 million), less what they had already received in the liquidation ($4.1 million)—thus, the court awarded damages of $9.3 million.

Practice Points

- **A controller should be mindful that obtaining a financial advisor's or expert's valuation or a fairness opinion, standing alone, may not render a conflicted transaction "entirely fair."** The court reiterated in *Salem*, that "entire fairness" requires more than that the transaction was legally and contractually permissible—it must have been "actually fair." The decision suggests that setting the price for such a transaction based on a financial advisor's valuation or fairness opinion may not, without additional protections for the minority holders (such as use of a special committee to negotiate on behalf of the minority), be sufficient to establish "entire fairness." The court wrote that the fair dealing inquiry "d[id] not turn on whether AT&T did the bare minimum" required under the partnership agreement or permitted under Delaware law, but on whether "there were steps designed to ensure fairness to the minority." At the same time, we note that the factual context of this case included, in the court's view, among other negative factors, flawed methodologies by possibly non-independent financial advisors, and, perhaps most importantly, apparently opportunistic timing by the controller to deprive the minority holders of anticipated significant additional value, as well as internal valuations showing that the controller itself had valued the company substantially higher. If not for these negative factors, the judicial result may well have been different. Accordingly, controllers should consider carefully the potential benefits in mitigating litigation risk that are afforded by conducting a process that provides appropriate protections for the minority holders, including selecting independent advisors, using a special committee, and/or requiring a majority-of-the-minority vote.

- **Depending on the facts and circumstances, determining the value of the company at the time of closing may require:** (i) appraising its value as part of the controller's integrated holdings, rather than its value as a stand-alone company; (ii) appraising the value of its contractual entitlements, even if the benefits were not received due to a counterparty's breach; and (iii) appraising the value of its litigation claims, such as for contractual entitlements not received due to a counterparty's breach. With respect to (i), in *Salem Cellular,* the court emphasized that much of the value of the Partnership was based on its being part of AT&T's integrated national cellular network. "The value of AT&T's network lay in the promise of ubiquity, and the Partnership market area was critical to that offering." As a result, the court noted, AT&T subsidized the Partnership by providing capital at its weighted average cost, rather than the higher cost the Partnership would have had to pay if it were a stand-alone entity operating an isolated cellular network. Further, the court noted, the Partnership "also benefited from other relationships with AT&T" and, because of its pass-through status, it could make distributions to its investors that were not reduced by entity-level taxes. With respect to (ii) and (iii), in *Salem Cellular*, the court considered the loss of the Partnership's contractual entitlements under the Management Agreement (which had never been provided by AT&T), and the Partnership's ability to bring a claim against AT&T for breaches of that agreement, as part of what the minority partners "had" that was "taken" from them in the Freeze-out.

- **An outside expert retained by a buyer (rather than a special committee) may be viewed by the court with skepticism.** Moreover, based on the court's commentary in *Salem Cellular,* depending on the facts and circumstances, such skepticism may be compounded if a specific individual is engaged who the buyer has repeatedly engaged before, or for whom the buyer went to surprising lengths to secure the engagement (such as having obtained a waiver of a non-compete agreement applicable to the person). In any event, an advisor should be provided with access to all of the necessary background and financial materials and information relevant to its valuation, and the buyer (or committee) should not "steer" the advisor's determinations. In addition, generally, material conflicts, or material prior engagements of and other material relationships with, the financial advisor should be disclosed in connection with the transaction.

- **An additional financial advisor, engaged to support a previous advisor's analysis, should, to the extent possible, explain why its revisions to (or different approaches from) the other advisor's analysis do not undermine the credibility of that advisor's work.** While, clearly, a second-engaged advisor should conduct an analysis based on its own best judgments, it should, where possible and appropriate, explain, for example, that a wide range of inputs, or a specific different methodology adopted by the first-engaged advisor, also would be justified. In addition, a buyer's (or special committee's) decision to engage a second advisor to support conclusions of the first advisor should be made only after careful consideration. Finally, a buyer (or special committee) should consider carefully a decision not to call the advisor on whom it relied for the transaction. (In *Salem*

Cellular, the court noted that it viewed as strange AT&T's decision not to rely at trial on, or even to call for testimony of, the advisor that had valued the company for the transaction.)

- **Controllers with similar structures for various entities should be aware that the valuations and actions taken in one situation may be used against them in another situation.** In addition, a financial advisor should, to the extent appropriate, be consistent in its approaches across similar transactions. If the approaches taken are different, the valid reasons therefor should be explained.
- **Controllers, when setting up entities with minority owners, should consider specifying a process and/or price for a buyout.** The partnership or shareholders agreement might, for example, provide for a call right at a specified or formula price, and/or a specified safe harbor process, for a buyout by the controller.
- **M&A participants should keep in mind the court's deep sophistication with respect to DCF analyses and financial analysis generally.** *Salem Cellular* serves as another reminder that the court, with its extensive experience with DCF analyses in the statutory appraisal rights context, is willing, able, and generally inclined to examine in great detail the underlying assumptions and judgments made in a DCF analysis presented to it, and to conduct its own DCF analysis if necessary to correct flaws it perceives. Further, we note that–after commenting that "outside counsel" had "shape[d] the record for litigation" such that "AT&T's internal documents did not openly reveal AT&T's valuations" of the Partnership–the court, "digging into" a supporting spreadsheet for an AT&T management presentation used to obtain CEO approval for the buyouts, disregarded the conclusions reflected on the spreadsheet and determined that AT&T actually "had much higher valuation expectations."

SEC Issues Far-Reaching Proposed Rules and New Guidance Relating to SPACs, Business Combinations, Beneficial Ownership, Climate Change, and Cybersecurity

Proposed Rules on SPACs

On March 30, 2022, the SEC proposed new rules that would eliminate many of the current benefits for a private company in going public through a merger with a SPAC (special acquisition company) rather than through a traditional IPO (initial public offering) process. The proposed rules are more far-reaching than was expected and would transform the SPAC process, making it lengthier, more costly, and more complex, and imposing a greater risk of liability for the entities involved. While the SEC stated in the proposing release that the proposed rules are intended to provide investors with disclosures and liability protections comparable to those that would be present in a traditional IPO, we would observe that, arguably, the proposed rules are in fact significantly more burdensome than those applicable in a traditional IPO—in light of the requirements relating to the SPAC making a fairness determination with respect to the de-SPAC transaction and the significantly expanded potential liability for financial advisors and others with respect to de-SPACs. Even before issuance of the proposal, the SPAC market has been receding due to increased regulatory, judicial and investor scrutiny and skepticism. The proposed rules, if adopted, would accelerate this trend. Please see **here** our Client Memorandum in which we summarize the proposed new rules; discuss their likely impact; and note open issues arising from the proposal.

Guidance on SPAC Redemptions

On March 30, 2022, the SEC published a new compliance and disclosure interpretation (C&DI) with guidance relating to the repurchase of SPAC shares by a sponsor or its affiliates during the pendency of a redemption offer prior to the SPAC shareholders meeting to approve a proposed de-SPAC business combination. In some cases, a sponsor may seek to effect or facilitate repurchases of SPAC shares during the pendency of the redemption offer (for example, if a high level of redemptions is anticipated and there is a concern about satisfying a minimum cash condition applicable to the de-SPAC transaction). As the SEC has previously indicated that a redemption offer may be viewed as a tender offer, and as the tender offer rules (subject to limited exceptions) prohibit an offeror or its affiliates from repurchasing outside a pending tender offer the class of securities tendered for, questions have arisen as to whether and how repurchases could be made during the redemption offer period. The C&DI states that, if the SPAC redemption offer constitutes a tender offer, the Rule 14e-5 prohibitions will apply. However, the SEC will not object to purchases made outside the redemption offer if certain conditions are met.

Most notably, the conditions include a requirement that repurchases cannot be made at a price higher than the redemption price. This limitation on the repurchase price will reduce the number of shareholders interested in selling their shares rather than having them redeemed. Also, the conditions include the filing of a Form 8-K prior to the SPAC shareholder vote on the de-SPAC transaction, with specified required disclosures relating to the amount of, purchase price for, sellers of, purpose of purchasing, and impact on the likelihood of approval of the de-SPAC from, securities purchased outside the redemption offer by the sponsor and its affiliates; and the number of SPAC securities for which the SPAC has received redemption requests pursuant to the redemption offer. These new disclosures will provide SPAC shareholders, prior to their voting on the de-SPAC, with a clearer understanding of the SPAC's likely post-de-SPAC cash position (and, thus, valuation), and the extent to which SPAC insiders are providing support to ensure consummation of the de-SPAC.

Proposed Amendments to Beneficial Ownership Reporting

On February 10, 2022, the SEC proposed extensive changes to the rules under Sections 13(d) and 13(g) of the Securities Exchange Act of 1934 (the "Exchange Act"). The proposals would bring major changes to beneficial ownership considerations surrounding cash-settled derivative securities (other than security-based swaps); would substantially expand the field of conduct that may create a "group" of two or more investors in any issuer; and would substantially shorten the deadlines applicable to the filing of Schedules 13D and 13G and amendments thereto. The proposals would also impact the determination of persons subject to Section 16 of the Exchange Act (which applies to beneficial owners of, and members of groups that beneficially own, more than 10% of the outstanding shares of a registered class of equity securities). Moreover, we note that the beneficial ownership concepts are incorporated into (and so the proposed amendments would affect) many different types of corporate plans and agreements, such as shareholder rights plans, long-term incentive plans, employment agreements, debt agreements, and others. The proposed rules also would affect the economics of shareholder activism by requiring earlier disclosure of an investor's position (thus reducing the profit that could be made from an increase in the market price upon announcement because the size of the stake that could be accumulated pre-announcement would be smaller). Please see **here** our Client Memorandum in which we summarize the proposed new rules and discuss their likely impact.

Guidance on Form 8-K Disclosure in Respect of Business Combinations

On March 22, 2022, the SEC published two C&DIs relating to Item 1.01 of Form 8-K, which requires disclosure of material definitive agreements not made in the ordinary course of business (such as a business combination agreement), including a brief description of the material terms and conditions of the agreement. The first of the new C&DIs specifies information that generally should be viewed as material and therefore should be disclosed. While most of these items already typically are disclosed, the new guidance may result in more detail being provided—particularly with respect to the guidance to disclose the anticipated timeframe for filing a registration, proxy or information statement, or tender offer materials, and the anticipated timing of the closing, and also to disclose the nature of the target's business and other information disclosed by the target in announcing the transaction.

The second of the new C&DIs clarifies the SEC's view that it is best practice for the business combination agreement reported on Item 1.01 of Form 8-K to be filed as an exhibit to the Form 8-K. The C&DI notes that the recently revised instructions to Form 8-K allow registrants to redact sensitive terms in an agreement filed as an exhibit to the 8-K, without submitting a request for confidential treatment. Therefore, the SEC no longer views the need for confidential treatment of certain terms of the agreement as a valid basis on which not to file the agreement as an exhibit. The C&DI states that a registrant who is unable to filed the agreement as an exhibit should provide an explanation as to why the agreement could not be filed.

Proposed Rules on Climate Disclosure

On March 21, 2022, the SEC proposed a comprehensive set of climate-related disclosure requirements that, if adopted as proposed, would require SEC registrants, including both U.S. domestic companies and foreign private issuers, to provide expansive qualitative and quantitative climate-related information in their registration statements and periodic reports filed with the SEC. Taken together, the information called for in the proposed rule would represent a significant expansion of SEC registrant disclosure requirements. This is the first time the SEC has proposed to mandate standardized climate-related disclosures.

The proposed rule would require SEC registrants to provide detailed quantitative and qualitative disclosures in the narrative sections of their registration statements and periodic reports, as well as further disclosure in the notes to the financial statements included in those filings. The burden of the additional requirements provided for in the proposed rule would not be felt equally across registrants and industries. Some types of registrants, such as energy or energy-intensive technology companies, would be considerably affected, and the resulting disclosures could invite heightened scrutiny by investors and others of the fundamental aspects of these businesses, the products they bring to market, and the related environmental impact. Some registrants may be incentivized to become private in light of this. The requirements, if adopted, would likely result in significant increased internal costs to ensure compliance, including in the creation or further development of related governance and risk management processes. Given the anticipated volume of comments and the threat of litigation challenging the proposed rules, the timing and substance of final rules, if any, remains uncertain. Please see **here** our Client Memorandum in which we summarize the proposed new rule and discuss its likely impact.

Proposed Rules on Cybersecurity

On March 9, 2022, the SEC released proposed rules, applicable to all registrants, on cyber incident reporting, cyber risk management and cyber-related governance. If adopted, the rules, which are prescriptive, would significantly increase corporate accountability on cyber risk. The proposed rules would require reporting of cybersecurity incidents within four business days after a company has determined that an incident is material (with the determination as to materiality being made as soon as reasonably practicable after discovery of the incident), and would require periodic updates about such previously reported incidents (with no delayed disclosure exceptions based on ongoing law enforcement investigations). The proposed rules also would require periodic disclosures regarding cybersecurity risk management, board and management oversight, and director cybersecurity expertise. Please see **here** our Client Memorandum in which we summarize the proposed rules and their likely impact.

Also, on February 9, 2022, the SEC proposed new rules and amendments under the Investment Advisers Act of 1940 and the Investment Company Act of 1940 that would require the implementation of cybersecurity risk management and disclosure obligations by registered investment advisers ("advisers"), registered investment companies, and business development companies ("BDCs"). The stated goals of the proposal are to require advisers and funds to implement policies and procedures with specific elements to address cybersecurity risks that can lead to significant business disruptions and the loss or theft of data or assets; and to ensure disclosure of information concerning the impact of cybersecurity risks and incidents on the operations of advisers and funds across the industry. The proposal would require advisers and funds to (i) adopt and implement written policies and procedures designed to address cybersecurity risks that could harm advisory clients and fund investors; (ii) promptly report to the SEC on a confidential basis "significant cybersecurity incidents" affecting the adviser or its fund or private fund clients; (iii) publicly disclose in brochures and registration statements cybersecurity risks and significant cybersecurity incidents that occurred in the last two fiscal years; and (iv) adhere to new record keeping requirements designed to improve the accessibility of cybersecurity information to help facilitate the SEC's oversight and enforcement missions. Please see **here** our Client Memorandum in which we summarize the proposed rules and offer recommendations for registrants to consider.

Other Decisions & News of Interest

Exculpation of Officers Would Be Permissible Under Proposed Amendments to the DGCL. Proposed amendments to the Delaware General Corporation Law ("DGCL"), which if adopted (as is expected) would become effective August 1, 2022, would permit corporations to include in their certificates of incorporation provisions exculpating (*i.e.*, protecting from monetary liability) certain corporate officers for fiduciary breaches of the duty of care. Currently, DGCL Section 201(b)(7) permits exculpation only of directors. As a result, in many recent cases, duty of care claims brought against directors and officers have been dismissed against the directors at the pleading stage, on the basis of the company's charter exculpation provision, but not dismissed against the officers (given the lenient standards applicable at the pleading stage and the lack of exculpation). In several cases in recent years, for example, claims brought against directors for approving an acquisition were dismissed while claims against officers for alleged gross negligence in preparing disclosure relating to the transaction were not dismissed.

Under the amendment, the "officers" that a corporation could cover would be (i) the CEO, president, COO, CFO, controller, treasurer, and chief accounting officer; (ii) an officer identified in the company's public filings as one of its most highly compensated; and (iii) a person who has agreed in writing with the company to be identified as an officer for purposes of Delaware's long-arm jurisdiction statute (DGCL Section 3114(b)). As is the case currently with respect to exculpation for directors, officers could not be exculpated from liability for: breaches of the duty of loyalty; acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law; illegal stock redemptions, stock repurchases or dividends; or any transaction in which the officer derived an improper personal benefit. Unlike with respect to exculpation of directors, officers could be exculpated only for claims brought directly against them by stockholders (and not for claims brought against them by the board in the name of the corporation, nor for derivative claims brought against them by stockholders). This difference reflects that directors, who are responsible for oversight and long-term planning, rely on officers for management of the corporation's day-to-day affairs.

Pending adoption of the amendments, companies being newly formed or going public can consider including exculpation for officers in their charter, with the effectiveness of the provision conditioned on (and effective only as of) adoption of the amendments. Existing corporations should consider whether to amend the charter to provide for exculpation of officers. Key considerations would include whether stockholders would be adverse to the change (it is not certain what view institutional investors and proxy advisory firms will have); whether retention of officers may be difficult for corporations that do not provide such exculpation; and whether inclusion of the exculpation becomes (or is expected to become) market practice.

Other Important Proposed Amendments to the DGCL. Another important amendment being proposed (and that is expected to be enacted) would provide significant flexibility in structuring transactions in which an entity domesticates to become a Delaware corporation. The proposed changes to DGCL Section 388 provide that actions approved by the non-Delaware entity prior to domestication, in a "plan of domestication," would not then require approval by the newly domesticated Delaware corporation's board or stockholders. For example, if a SPAC were to be domesticated to Delaware in connection with a proposed de-SPAC merger, before the merger it could amend its charter as part of its plan of domestication, and the changes would be effective without any need for further approval by the Delaware corporation's board and stockholders. Other proposed amendments include the following: (i) revision of the appraisal statute (Section 262) to allow beneficial owners to make appraisal demands in their own name and to provide appraisal rights in the case of a conversion of Delaware corporation to another entity; (ii) elimination of the requirement that a stocklist be available *during* meetings of stockholders; (iii) harmonization of the process by which the issuance of stock and options or rights to acquire stock may be authorized; (iv) addition of procedures relating to notice of stockholders' meeting to cover the adjournment of virtual meetings when a technical failure has occurred; and (v) confirmation that (under Section 228(c)) a person may give a written consent of stockholders to be effective at a future date, before such person is a stockholder (so long as the person is a stockholder at the time the consent is to become effective).

Court of Chancery Interprets a Stockholders Agreement Requiring "Consent" and "No Objections" to a Merger As Not Waiving the Right to Bring Fiduciary Claims—Manti v. Carlyle. In *Manti Holdings LLC v. The Carlyle Group Inc.* (Feb. 14, 2022), the Delaware Court of Chancery rejected dismissal of fiduciary claims brought in connection with the sale of Authentix Acquisition Company, Inc. The defendants argued that the plaintiffs had waived their right to bring such claims when they entered into a stockholders agreement requiring that, if the transaction was approved by holders of at least 50% of the then-outstanding shares, they would "consent and raise no objections to [the] transaction." Vice Chancellor Glasscock found that the language did not constitute a "clear and unambiguous" waiver of the right to seek redress against the company's controller and directors for breach of fiduciary duties in connection with the transaction. The Vice Chancellor reasoned that, read as a whole, the provision at issue more directly related to covenants in the agreement prohibiting the exercise of appraisal rights and requiring the execution of any necessary ancillary documents. The court stated that it was not deciding whether a clear and unambiguous waiver of a right to bring fiduciary claims would be enforceable as a matter of public policy.

Court of Chancery Grants Discovery to Appraisal Petitioners Who Filed Solely to Obtain Information to Be Used in Fiduciary Litigation Challenging a Merger—*Wei v. Zoox*. In *Wei v. Zoox, Inc.* (Jan. 31, 2022), the Delaware Court of Chancery found that the appraisal petitioners' sole purpose in filing an appraisal petition was to obtain information to be used in drafting a complaint asserting breaches of fiduciary duty in connection with the company's recent merger. The petitioners had lost their standing to seek inspection of the corporate books and records under a Section 220 demand due to the rapid closing of the merger. Although Chancellor McCormick rejected the petitioners' demand for the broad discovery that typically is available in appraisal actions, she granted discovery equivalent to what would have been available to them under a Section 220 inspection had they not lost standing under Section 220.

Court of Chancery Appraisal Award Takes Into Consideration an Increase in Value of the Target Company Between Signing and Closing—BCI*M v. HFF*. In *BCIM Strategic Value Master Fund, LP v. HFF, Inc.* (Feb. 22, 2022), the Delaware Court of Chancery awarded the appraisal petitioner significant additional consideration based on the target company's value having increased during the period between signing and closing of the merger agreement—as required by Delaware law which bases appraisal awards on the value of the target company at the time of closing (excluding value anticipated from the merger itself). The case involved the $1.8 billion cash-and-stock acquisition of HFF by Jones Lang LaSalle Inc. In the six weeks between the signing of the merger agreement and the closing, the per share deal consideration (based on a more than 13% decline in the price of JLL's stock between signing and closing) declined from $49.16 at signing to $45.87 at closing. Although Vice Chancellor Laster found flaws with the sale process (a single-bidder process involving potentially conflicted lead negotiators), he determined that the process was sufficient for the court to rely on the merger-price-less-synergies methodology to determine appraised fair value. The Vice Chancellor deducted $4.84 per share from the merger price for expected synergies that JLL had documented were embedded in the deal price—resulting in an implied valuation of the company of $44.29 per share at the time of signing. He then tackled the "difficult task" of addressing the petitioners' contention that HFF's value had increased between signing and closing, based on its "extraordinary outperformance" during the period as compared to expectations. JLL argued that the outperformance merely reflected favorable quarterly results. The Vice Chancellor found, however, that the outperformance was more "significant and durable" than in other cases (such as *PetSmart*) where the court has rejected an adjustment to the deal price on the basis of post-closing positive results. In this case, the court stated, HFF's management believed that the business would outperform both internal and external expectations and this turned out to be the case on a continued basis.

To calculate the company's fair value at the time of closing, the Vice Chancellor stated that he would use market-based indicators of value (rather than a DCF analysis). The increase in value could not be determined simply based on the company's increased stock price, however, because between signing and closing a stock price primarily reflects expectations with respect to the merger rather than performance-based value. Instead, the Vice Chancellor, based on expert testimony with respect to a regression analysis of prior instances in which the company had outperformed earnings guidance, estimated the likely percentage change in the stock price that was attributable to the company's improved performance. The analysis indicated a 5.2% increase in the stock price as a result of improved performance. Applying that percentage to the $44.29 per share value at signing, the court determined that fair value at the time of closing was $46.59 per share. The Vice Chancellor stated that, while the unusual facts of this case relating to the "extraordinary" outperformance by the target led him to rely on statistical analysis by experts to determine the target's value at closing, generally Delaware courts view buyers (who have material nonpublic information about the target) as being in a "strong position" to properly value the target. He noted that the buyer's financial advisor had opined that HFF's value at the time of closing was $46.80—which corroborated the reasonableness of the estimate of $46.59.

We note that:

- While the court's determination of per share fair value as of signing ($44.29) was significantly below the value of the deal consideration at signing ($49.16), the court's determination of fair value as of closing ($46.59) was above the value of the deal consideration at that time ($45.87).
- While merger parties should keep in mind that an increase in the target's value between signing and closing can affect the result in an appraisal proceeding (and thus the total consideration for the deal), there have been few cases in which an increase in the target's value pending closing meaningfully affected the appraisal result. In this case, unusual facts led to the target's outperformance being both significant and durable.
- The risk of significant changes in the value of targets between signing and closing may increase in the current environment of increased regulatory scrutiny of deals, which has prolonged the typical period of time to closing (and in some cases can result in very lengthy periods)—and particularly if the stock market and general economy experience increased volatility.
- An all-stock deal does not trigger appraisal rights; and, in a cash-and-stock deal (which does trigger appraisal rights), a significant decline in the value of the buyer's stock pending closing may (unless there is an adjustment to the exchange ratio) instigate the filing of appraisal petitions as a route to a possibly improved return.

Court of Chancery Holds 41% Stockholder Was a Controller—*In re MPM Holdings Inc. Appraisal & Stockholder Litig.* In *MPM* (Jan. 13, 2022), the Court of Chancery, in a transcript ruling, held, at the pleading stage of litigation, that there was "more than enough evidence" for the court to conclude that a private equity firm holding 41% of the company's outstanding shares may have been the company's *de facto* controller.

The court, based on a "holistic analysis" of various factors, concluded that there was an "overarching inference" of control. The court cited a shared services agreement between the company and a business controlled by the stockholder, which the company had acquired, which gave the stockholder a grip on the company's business through its influence over all critical areas (such as administration, senior management, technology, accounting, finance, and more). In addition, the stockholder may have held itself out as the *de facto* controller; others may have considered it to be the *de facto* controller; and board meetings were held at its offices.

Court of Chancery Holds Company's Non-Shareholder Creditor Was a Controller—*Blue v. Fireman.* In *Blue* (Feb. 28, 2022), the Court of Chancery, reiterating that stock ownership is not a prequesite to controller status, held that the target's creditor was its controller. The plaintiffs alleged that the target company's merger with a SPAC created to acquire cannabis companies was unfair to the company's common stockholders due to a side deal with the [p] rivate equity firm that was the target's largest creditor. The creditor had loaned the target $20 million, in the form of convertible notes and a short-term loan, and had received warrants and the right to appoint three additional directors to the target's board. By the time the target was completing negotiations on the proposed merger with the SPAC, the creditor had accrued 83% of the voting power through a proxy. The plaintiffs alleged that the creditor, as a condition to its approving the proposed merger, required that the target board amend the terms of notes and warrants, as a result of which $40 million of the merger consideration was diverted to the creditor. The court found that the claims were direct rather than derivative as they challenged the fairness of the merger itself; and that the $40 million alleged diversion from total merger consideration in the range of $120 million to $130 million was material. The court found that the creditor was a controller based on its ability to exercise a majority of the company's voting power. The fact that the voting power resulted from the creditor-debtor relationship was "inconsequential," Vice Chancellor Zurn wrote. She reiterated that holding shares "is not a prerequisite to exercising voting control that carries the weight of fiduciary duties." The Vice Chancellor also determined that entire fairness review was applicable, but requested supplemental briefing from the parties as to whether it would apply to the merger or only to the amendments to the notes and warrants.

Court of Chancery Finds Omission in Proxy Statement of Information about a Prior Acquisition Proposal Was Not Material—*Galindo v. Stover.* In *Galindo* (Jan. 26, 2022), the Court of Chancery held that the omission of information in a proxy statement concerning a prior acquisition proposal made to the company was not material. The court emphasized that neither the board nor management had seriously considered the proposal; and that the circumstances surrounding the earlier proposal differed significantly from those concerning the proposed merger, with respect to time, deal structure and the company's present circumstances in light of the COVID-19 pandemic. The case was dismissed under *Corwin*.

Court of Chancery Dismisses *Caremark* Claim—*In re Camping World Holdings, Inc. Stockholder Derivative Litig.* In *Camping World* (Jan. 31, 2022), the Court of Chancery dismissed the plaintiffs' *Caremark* claim alleging lack of oversight by the board. The court found "fundamentally inconsistent" the plaintiffs' contentions that the defendant directors were liable under both a *Caremark* theory (based on their lack of knowledge and failure of oversight relating to the CEO's allegedly problematic integration of newly acquired stores) and, at the same time, a *Brophy* insider trading theory (based on their knowledge of material non-public information about problems with the integration). In light of a handful of recent cases in which the court has rejected dismissal of *Caremark* claims, it is of note that the court reiterated that oversight liability under *Caremark* "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."

California Law Mandating Board Diversity is Ruled Unconstitutional. On April 1, 2022, a Los Angeles County Superior Court judge granted summary judgment to the plaintiff that challenged as unconstitutional the landmark California law adopted in September 2020 that mandated that corporations ensure diversity among their board members. The law required that, by the end of 2021, a corporate board of a public company with a main executive office in California had to have at least one director who is a member of an "underrepresented community"; and, depending on the size of the board, that there be up to three such directors by the end of 2022. (The law defined a member of a underrepresented community as "an individual who self-identifies as Black, African American, Hispanic, Latino, Asian, Pacific Islander, Native American, Native Hawaiian, or Alaska Native, or who self-identifies as gay, lesbian, bisexual, or transgender.") A report issued by the California Secretary of State in March 2022 found that, of the roughly 700 corporations subject to the law, about 300 corporations had complied as of the end of 2021. The law provided for fines of $100,000 for a first violation and $300,000 for repeated violations (although, according to the state, no fines have been imposed).

We note that:

- A related lawsuit brought by the same plaintiff (a nonprofit conservative advocacy group) is challenging the 2018 California law that requires that corporate boards include a specified number of women directors based on the size of the board. This law relating to gender diversity on boards currently remains in effect, pending resolution of the lawsuit. (A bench trial concluded in February 2022 but a decision has not yet been issued.)
- It had been widely expected when these gender and "unrepresented community" diversity-related laws were adopted that they would be challenged and might be overturned. An appeal of the decision to reinstate the law just held unconstitutional (which ultimately could reach the U.S. Supreme Court) could take significant time to resolve.
- The NASDAQ's rules mandating diversity on boards remains in effect. In addition, institutional investors, proxy advisory firms, retain investors, and others continue to focus on board diversity (as well as other ESG-related issues).

Paper by Influential Authors Urges Changes in Delaware Law. In our Fried Frank M&A/PE Quarterlies and other Briefings, we have referred consistently to a post-*Corwin* and *MFW* "swinging back of the pendulum"—that is, following a raft of dismissals of cases under those doctrines soon after *Corwin* and *MFW* were issued with a view to reducing excessive M&A litigation, an apparent tightening of the standards the courts have applied for such dismissals. In a new paper by authors of a previous article that influenced the courts to adopt *Corwin* and *MFW*, the authors criticize certain current "doctrinal approaches" by the Delaware courts that, in their view, again now "create excessive litigation" by not sufficiently "respect[ing] . . . intra-corporate decision-making processes...." In the paper, *Optimizing the World's Leading Corporate Law: A 20-Year Retrospective and Look Ahead*, the authors—Professor Lawrence Hammermesh, former Delaware Justice and Vice Chancellor Jack B. Jacobs, and former Delaware Chief Justice and Chancellor Leo E. Strine, Jr.—primarily object to the Delaware court's expansion of the reach of the entire fairness standard of review to contexts "where it does not fit." Specifically: (i) **MFW.** The authors criticize the Delaware courts' extension of *MFW* to board decisions outside the context of freeze-out mergers. Based on a theory of "inherent coercion" by a controller, the courts have held that entire fairness review applies to a broad range of transactions involving a controller unless the requirements specified in *MFW* (*i.e.*, approval by a special committee of independent directors and by a majority-of-the-minority stockholders) have been satisfied. The authors argue that the *MFW* requirements "were not designed for and do not rationally pertain" to these kinds of transactions (many of which do not even require any stockholder vote). They advocate abandoning the inherent coercion theory and limiting the reach of *MFW* to transactions in which a controlling stockholder (a) seeks to acquire the minority's shares or (b) approval by both the board and the stockholders is statutorily required. (ii) ***Controllers.*** The authors criticize the courts' expansion of the status of "controller" to (and thus entire fairness review to transactions involving) "persons having little or no share voting power" and the courts' "lump[ing] together unaffiliated stockholders into a 'control bloc.'" They propose limiting the concept of "controlling stockholder" to a stockholder with voting power giving it "at least negative power over the company's future" in the sense of representing "a practical impediment to any change of control." (iii) ***Self-dealing.*** The authors argue that the courts have not sufficiently distinguished between "transactions involving classic self-dealing and transactions in which a fiduciary (whether a director or controlling stockholder) receives an additional benefit only because of being differently situated." They advocate "restoring that distinction, at the injunctive stage, by applying *Unocal* and *Revlon* intermediate judicial review to transactions where a fiduciary merely receives (but does not force) a benefit, such as a post-merger compensation package, not received by other stockholders." In the context of a post-closing damages action, they argue, the review standard should require that the plaintiff plead a duty of loyalty violation and resulting damages. (iv) ***Demand futility.*** The authors also criticize the courts' "circumscribing" the *Aronson* test for demand futility by prescribing dismissal of a well-pleaded breach of the duty of loyalty unless a majority of directors face likely liability on a non-exculpated claim. They advocate "re-invigorating" the "safety value" of the second prong of the *Aronson* test "to allow demand excusal if the particularized facts support an inference that a breach of fiduciary duty has harmed the stockholders." They argue that, "if that is not the case, and Delaware law presumes that independent directors who approved a transaction alleged to involve unfair self-dealing can turn around and impartially sue their interested colleague on the board over that same transaction after the fact, then logically it should also presume they can perform the easier and less dramatic upfront function of effectively negotiating a fair transaction or saying no if fair terms are not reached." (v) ***"Substantive coercion" and "waste."*** The authors criticize the courts for "maintaining doctrinal complications" such as "substantive coercion" and "waste," which, in their view, "obscure proper application of standards of review and frustrate the principles that should drive case outcomes." They advocate eradicating the concept of substantive coercion "as a basis for board authority to block a non-coercive bid and relying instead simply on the board's ordinary authority"; eliminating "corporate waste" claims under the business judgment rule where the disinterested stockholders approve the challenged transaction; and overruling the courts' "effort [(through *Cede II* and *Unitrin*)] to link together all three core standards of review." (vi) ***Officer exculpation.*** The authors advocate that exculpation of officers be permitted under DGCL Section 102(b)(7)—a change that the Delaware legislature is expected to make this year (see above the note on proposed DGCL amendments). (vii) ***Section 220 demands.*** The authors criticize the court's expansion of the scope of "books and records" made available under DGCL Section 220, which, in their view, enables stockholders "to prospect for a claim challenging a merger," which, in turn "encourages defendants to interpose delaying tactics and objections that frustrate the intended summary character" of Section 220 proceedings. The authors advocate amendment of Section 220 to provide that "where a public company stockholder vote is held on a merger, 'books and records' should be limited to the equivalent of SEC Rule 13e-3 materials within the company's control."

Our Client Briefings Issued This Quarter

Court of Chancery Clarifies Delaware Law on "Sandbagging"—*Arwood v. AW Site Services*

In *Arwood* (Mar. 9, 2022), the Court of Chancery clarified that Delaware generally is a "pro-sandbagging" jurisdiction—that is, unless the parties provide otherwise in their acquisition agreement, a buyer that "sandbags" a seller (*i.e.*, knows when entering into a merger agreement that one or more of the seller's representations and warranties in the agreement is false) is still entitled to indemnification under the agreement for breach of the representations and warranties. Vice Chancellor Slights also amplified the sandbagging doctrine by holding that it is only implicated when the buyer, pre-closing, "*actually knew*" of the falsity of a representation and warranty, even if the buyer's lack of actual knowledge was due to its own "reckless disregard" for the truth. In addition, the case offers important reminders for private equity firms when acquiring a small company, especially if from an unsophisticated seller. Please see **here** our Briefing, in which we discuss "sandbagging"; analyze the court's decision; and offer related practice points.

Court of Chancery Orders Buyer to Close, As Target's Pandemic Responses (Based on Unique Facts) Did Not Breach Its Ordinary Course Covenant—*Level 4 Yoga*

Level 4 Yoga v. CorePower Yoga (Mar. 1, 2022) was a highly anticipated decision, as it is only the third Delaware case to have gone to trial that addresses whether the COVID-19 pandemic and related business shut-downs excused a buyer from closing an M&A agreement. Vice Chancellor Slights ruled in this case that the buyer was obligated to close—because the pandemic did not constitute a "Material Adverse Effect" and the target's pandemic responses did not breach the ordinary course covenant. The court's result was based on atypical features of the transaction at issue, however, relating to the parties' relationship (as franchisor and franchisee) and the unusual structure of the acquisition agreement (which contained no closing conditions and appeared to be intended as a "one-way ramp to closing"). Please see **here** our Briefing, in which we discuss the key points from the court's opinion; briefly review the earlier two cases addressing MAEs and ordinary course covenants in the context of the pandemic; and offer related practice points.

"A Proposed Postpandemic Framework for Ordinary Course and MAE Provisions in Merger Agreements: Reviewing Recent Market Practice Changes and Addressing Skewed Incentives"

See our article published in the Yale Law Journal (see **here**), which includes a study of how market practice has evolved in respect of ordinary course covenants and MAE provisions in response to the COVID-19 pandemic, in particular with respect to the issue of flexibility for target companies to take action in response to the pandemic or other extraordinary events that may occur pending closing.

Implications of *Lee* for a Board's Decision to Reject a Nomination Notice That is Not in Compliance With the Company's Advance Notice Bylaw

In *Strategic v. Lee Enterprises* (Feb. 14, 2022), the Court of Chancery emphasized that, under Delaware law, as a general matter, a corporation has a valid interest in enforcing the technical requirements of its advance notice bylaw. At the same time, Vice Chancellor Will confirmed that the court generally will not accord business judgment deference to a board's decision to reject even a plainly non-compliant nomination notice, and an enhanced scrutiny standard of review will apply. The decision indicates that directors will meet the enhanced scrutiny standard so long as they acted reasonably. Please see **here** our Briefing, in which we discuss the decision and offer related practice points for boards.

Implications of the Court of Chancery's Decision that De-SPAC Mergers Will Be Reviewed Under the Entire Fairness Standard—Am*o v. MultiPlan*

In *Amo v. MultiPlan* (Jan. 3, 2022), the Court of Chancery, for the first time, addressed fiduciary duties and related principles in the context of a SPAC. Vice Chancellor Will held (at the pleading stage) that the entire fairness standard of review would apply to the challenged de-SPAC merger and rejected dismissal of the plaintiffs' fiduciary claims against the SPAC's sponsor and directors. As the issues in the case arose from, and the court's rulings were based on, conflicts of interest that are inherent in the SPAC structure (rather than specific to the transaction being challenged), the decision likely will have broad applicability to de-SPAC transactions. Notably, practitioners have long viewed the SPAC stockholders' right to redeem their shares prior to a de-SPAC merger as a distinguishing feature that would significantly mitigate fiduciary duty risk for SPAC sponsors and directors in connection with de-SPACs (as compared to controllers and directors in the non-SPAC context). While *MultiPlan* should serve to discourage certain conduct by aggressive actors, we believe that, in light of the redemption feature in SPACs, further development of Delaware law will define workable parameters under which the court will more readily dismiss challenges to de-SPAC transactions where the disclosure to stockholders is adequate. Pending such development, in light of *MultiPlan*, there likely will be significantly more litigation challenging de-SPACs; SPAC sponsors and directors should intensify their efforts to ensure adequate disclosure; and modifications to the SPAC structure and practices should be considered. Please see **here** our Briefing, in which we analyze the decision; discuss how the law may evolve; and offer related practice points for SPAC sponsors and directors. We note also that the new rules proposed by the SEC relating to SPACs (discussed above), if adopted, may limit the impact of *MultiPlan*.

M&A/PE Round-Up

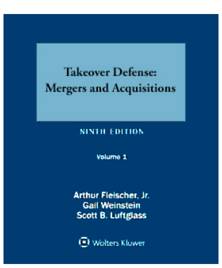
2022 FIRST QUARTER HIGHLIGHTS

Counsel to Standard General L.P., alongside an affiliate, in the affiliate's US$8.6b acquisition of TEGNA, a broadcast, digital media, and marketing services company.

Counsel to Renaissance Alliance in its acquisitions of independent insurance companies Agency Network Exchange and United Valley Insurance Services. The two acquisitions represent US$2.4b in premium, bringing the total valuation of Renaissance members to US$3.6b.

Counsel to AEA Investors in the US$1.6b purchase, by AEA and its co-investor, ADIA, of AmeriVet Partners, a veterinarian services business

TAKEOVER DEFENSE: MERGERS AND ACQUISITIONS



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

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