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Delaware Chancery Court Clarifies Standard of Review Applicable to Mergers Involving Controlling Stockholders

The Delaware Court of Chancery has issued a trio of recent decisions that, if upheld, provide clarity on the process by which a Delaware corporation with a controlling stockholder can undertake a sale-of-the-business transaction and avoid review under the entire fairness standard. The entire fairness standard, when applicable, necessitates a long, time-consuming and expensive trial on fair price and fair process. In contrast, two of these recent cases were resolved on motions for summary judgment, and a third was dismissed for failure to state a claim. These cases together provide a roadmap for the avoidance of lengthy and costly deal litigation in merger transactions involving controlling stockholders.

Three New Delaware Chancery Court Cases Addressing the Review Standards for Deals Involving Controlling Stockholders

As we discussed in a recent client alert,[1] on May 29, 2013, Chancellor Leo F. Strine issued a decision in *In re MFW Shareholders Litigation (MFW)*[2] that found that a going-private merger transaction with a controlling stockholder/acquiror was entitled to be reviewed under the business judgment rule when the controlling stockholder/acquiror conditioned its offer up front by approvals of both an independent, properly empowered special committee and an informed, uncoerced majority-of-the-minority stockholder vote.

Subsequently, on July 23, 2013, Chancellor Strine issued an opinion in *In re Morton's Restaurant Group, Inc. Shareholders Litigation (Morton's)*,[3] dismissing a claim arising out of an acquisition pursuant to a tender offer and a second-step merger involving a 27.7 percent stockholder, finding that even if the stockholder were deemed a controlling stockholder, the complaint failed to state a claim when the transaction was at a premium over the pre-announcement price, the control premium was shared ratably among all stockholders, an independent and disinterested board recommended the sale, the company conducted an extensive market check, and more than 90 percent of the stockholders tendered their shares. Strine rejected the argument that "the mere presence of a controlling stockholder in a transaction - regardless of whether the controller receives anything different from the other stockholders - triggers entire fairness review."

[1] http://www.kayescholer.com/news/client_alerts/M-and-A-and-Corporate-Governance-Alert-03June2013

[2] 67 A.3d 496 (Del. Ch. 2013).

[3] C.A. No. 7122-CS (Del. Ch. July 23, 2013).

Most recently, on August 5, 2013, Vice Chancellor John W. Noble, in *South Eastern Pennsylvania Transport Authority v. Volgenau (Volgenau),*[4] *et al*, also found that a merger transaction involving a seller controlling stockholder was entitled to review under the business judgment rule when the transaction was approved by both a disinterested and independent special committee and a majority of the minority stockholders, in a non-waivable vote.

Reprise on In re MFW Shareholders Litigation

In re MFW Shareholders Litigation addressed a going-private transaction involving a controlling stockholder on both sides of the transaction. Prior to the *MFW* decision, the Delaware courts had consistently applied an entire fairness standard to mergers involving a controlling person on both sides of the transaction, and focused instead on conditions under which the burden of proving fairness shifted from the defendants to the plaintiffs. Chancellor Strine distinguished the facts in *MFW* from those giving rise to this general rule established by earlier Delaware Supreme Court precedent,[5] because the controlling stockholder in *MFW* conditioned his offer *up front* on the approval of *both* an independent special committee and the majority of the minority stockholders, and thus the protections available to the stockholder were fundamentally different than when only one of the two protections were available, as in *Kahn*.

Chancellor Strine held in *MFW* that when both of these protections are employed, minority stockholders have an independent agent empowered to negotiate for the best price and say "no" to a transaction, and the ability to determine for themselves, uncoerced, whether to approve the transaction negotiated by such an agent. Strine concluded that the process effectively replicates the protections available to stockholders in an arm's-length, negotiated merger transaction with a non-controlling buyer approved by a majority of the stockholders – transactions long-recognized as transactions subject to review under the business judgment rule.

> *... the controlling stockholder in MFW conditioned his offer up front on the approval of both an independent special committee and the majority of the minority stockholders, and thus the protections available to the stockholder were fundamentally different than when only one of the two protections were available ...*

In contrast to the situation Chancellor Strine considered in *MFW*, where the controlling stockholder was on both sides of the transaction, the two most recent cases involved a more typical situation: a target company had a significant stockholder who controlled minority board positions, but the buyers were unrelated third parties. Here again, the Delaware Chancery Court concluded that enhanced scrutiny under entire fairness was unwarranted.

Morton's - Sharing the Control Premium Ratably With All Stockholders

In *Morton's*, a private equity fund, Castle Harlan, Inc. held 27.7 percent of the outstanding equity of Morton's Restaurant Group, a NYSE-listed Delaware corporation. Morton's board decided to consider a sale of itself, allegedly at Castle Harlan's suggestion, and initiated a nine-month sale process, which culminated in the company entering into a merger agreement approved by an independent and disinterested board. The sales process involved a full market check, two bankers, and a substantial premium over the trading price prior to the announcement of the transaction. The premium was shared ratably among all stockholders. The acquiror had no ties to any board member, and had submitted the highest bid.[6] Nonetheless, the plaintiff

[4] C.A. No. 6354-VCN (Del. Ch. August 5, 2013).

[5] See, e.g., *Kahn v. Lynch Common Sys. (Lynch I), 638 A.2d 1110 (Del. 1994)*, in which the Delaware Supreme Court held that approval of a merger with a buying controlling stockholder by *either* the majority of the non-controlling stockholders *or* a special committee would shift the burden of proof under the entire fairness standard to the plaintiff).

[6] Prior to entering into formal discussions with the eventual buyer, Morton's had entered into an exclusivity agreement with another buyer, who lost its exclusivity by lowering the offering price below, and refusing to match, the eventual acquiror's bid.

stockholders challenged the merger and argued it should be reviewed under the entire fairness standard. Plaintiffs argued that Castle Harlan, by virtue of its 27.7 percent interest and its right to appoint two out of 10 directors, controlled the board and caused it to breach its duty of loyalty to all of the stockholders by selling in response to Castle Harlan's alleged special need for liquidity.

What Is a Controlling Stockholder?

Chancellor Strine first considered whether the 28 percent stockholder should be considered a controlling stockholder, noting that the "bare conclusory allegation that a minority stockholder possessed control is insufficient." Applying the standard set forth in *Citron v. Fairchild Camera & Instrument Corp.*,[7] he held that when a stockholder holds less than 50 percent of a corporation's outstanding stock, to be deemed a "controlling stockholder," the stockholder's power must be "so potent that independent directors...cannot freely exercise their judgment, fearing retribution[.]"[8]

In support of their claim that Castle Harlan had this level of control, the plaintiffs pointed to the fact that Castle Harlan could appoint two of the 10 board members. Furthermore, Castle Harlan had suggested engaging the financial advisor who was in fact eventually engaged. In rejecting this argument, Chancellor Strine found no facts suggesting that Castle Harlan had any influence over the rest of the board. In dismissing the claim that Castle Harlan had demonstrated control merely by recommending a banker who was subsequently retained by the board, Strine noted that "it is not unusual for certain directors or members of management to take an active role in spearheading a sales process." Plaintiffs must show "such facts as would demonstrate that through personal or other relationships the directors are beholden to the controlling person." He contrasted these facts to those in an earlier case, which he termed "perhaps ... [the Chancery Court's] most aggressive finding that a minority blockholder was a controlling stockholder." In the earlier case,[9] the blockholder was found to be a controlling person with 35 percent of the company's stock, but also was the company's visionary founder, CEO and chairman, and had "placed two of his close family members in executive positions," giving him "influence over even the ordinary managerial operations at the company." Here, in contrast, the plaintiff failed to allege facts showing such influence.

> *In dismissing the claim that Castle Harlan had demonstrated control merely by recommending a banker who was subsequently retained by the board, Strine noted that "it is not unusual for certain directors or members of management to take an active role in spearheading a sales process."*

When Large Blockholder Takes Same Price as Everyone Else, Heightened Scrutiny Is Unwarranted Absent Facts Demonstrating a Disabling Conflict

Chancellor Strine independently held that even if Castle Harlan were found to be a controlling stockholder, that fact would not, in and of itself, be sufficient to mandate an entire fairness review. He observed that here, all stockholders were treated equally. Citing *In re Synthes, Inc. Shareholder Litigation*,[10] Strine held that only unusual facts would show a disabling conflict – that is, an interest different than the unaffiliated stockholders. The Chancellor further stated that "[i]n most situations the controlling stockholder has interests identical to other stockholders: to maximize the value of its shares." Thus, when the control premium is shared ratably among all stockholders, plaintiff would have to show that the controlling stockholder engineered a "fire sale," essentially that "the pressure to sell quickly is so high that the controller imposes pressure on the corporation to artificially truncate the market check and forego additional value" from a full sales process.[11]

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[7] 569 A.2d 53 (Del 1989)

[8] I*n re PNB Hldg. Co. S'holders Litig.*, 2006 WL 24039999, at *9 (Del Ch. Aug. 18, 2006).

[9] *In re Cysive, Inc. S'holders Litig*., 836 A. 2d 531, 551-52 (Del.Ch. 2003).

[10] 50 A.3d 1022, 1036 (Del. Ch. 2012). We wrote about this case in a prior newsletter, which can be found at http://www.kayescholer.com/news/newsletters/MA-and-Corporate-Governance-Newsletter-Fall2012.

[11] See *In re Answers Corporation Shareholders Litigation*, Consol. C.A. No. 6170-VCN (Del. Ch. Apr. 11, 2012), in which the court found a 30% stockholder had effectively coerced the board to truncate the sales process and forego

The facts in *Morton's*, according to Chancellor Strine, could not support a rational inference that these conditions existed. Indeed, Morton's had undertaken a nine-month market test, utilized two bankers, contacted 137 potential buyers, engaged in due diligence and entertained several non-binding offers before engaging in a bidding process. Strine held that under such facts, the rational conclusion was that Castle Harlan instead supported an unhurried and thorough market check in an effort to maximize the sales price.

Chancellor Strine went on to discuss the facts plaintiffs relied on in alleging Castle Harlan pressured the board to sell at a suboptimal price. Plaintiffs had claimed Castle Harlan engineered the "fire sale" out of a need for liquidity, in order to establish a new fund. Chancellor Strine noted that investment funds face the need to form new funds regularly, and concluded that the motivations of Castle Harlan would be the opposite: to maximize returns for its investors in order to motivate them to re-invest in the new fund. Thus, Strine found that even if Castle Harlan were deemed to be a controlling stockholder, plaintiffs had not alleged facts showing any conflict between the interests of Castle Harlan and the other stockholders. Strine focused on the key fact that the large blockholder shared the premium ratably with all stockholders, and emphasized that Delaware law "encourages, by various means, larger stockholders to regard pro rata treatment as a safe harbor."

Strine ... emphasized that Delaware law "encourages, by various means, larger stockholders to regard pro rata treatment as a safe harbor."

Attacks on the Process Relating to Actions by the Target's Financial Advisors

Chancellor Strine also rejected attacks on the process relating to the financial advisors. Plaintiffs attacked the decision by Morton's board to permit its first financial advisor to provide financing for the buyer, after the buyer ran into difficulty finding a source of funding for the acquisition. Strine dismissed this claim in light of the fact that the board had a second, unconflicted bank, also giving a fairness opinion. Boards should take particular note that Strine commented with approval on the fact that the M&A Committee weighed the positives and negatives of the decision to permit its financial advisor to provide the financing and that the board negotiated key concessions, including the financing bank's recusal from further negotiations, a reduction in its fee by the amount of the fee charged by the now-needed second and independent banker, and a requirement that the financing bank still provide an opinion on the fairness of the deal. These are key points for a target board to consider if it faces a request from its banker to provide a buyer with financing. Strine additionally considered and rejected plaintiff's attacks on the disclosures regarding the fairness analysis, stating that "stockholders were told what the bankers did and what the key metrics of their analysis involved. Under our law, that is all that was required."

The board negotiated key concessions, including the financing bank's recusal from further negotiations, a reduction in its fee by the amount of the fee charged by the now-needed second and independent banker, and a requirement that the financing bank still provide an opinion on the fairness of the deal.

Ultimately, Chancellor Strine found that this transaction did not raise "the key problem in *Revlon* - board resistance to the highest bidder based on a bias against that bidder." The clear message in *Morton's* was that a complaint attacking a deal where there is a controlling stockholder in the target will not be sustained where the record shows no conflict of interest, and where a review of the record shows an independent and disinterested board, a thorough market check employing reasonable measures to maximize price and the control premium being shared ratably among all stockholders.

Volgenau – Use of Independent and Disinterested Special Committee and Non-Waivable Uncoerced and Fully Informed Majority of Minority Vote

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a lengthy market check in order to expedite the stockholder desire for immediate liquidity. We commented previously on this case (also found at http://www.kayescholer.com/news/newsletters/MA-and-Corporate-Governance-Newsletter-Fall2012).

Triggers Business Judgment Review Regardless of Controlling Stockholder

Volgenau, the third of the recent Chancery Court decisions addressing the standard of review for deals involving controlling stockholders, considers the appropriate standard of review in an acquisition transaction where a controlling stockholder who does not stand on both sides of the deal receives different consideration than the minority stockholders, but the transaction is recommended by a disinterested and independent special committee and is approved by stockholders in a non-waivable vote of the majority of all the minority stockholders. Vice Chancellor Noble determines that this transaction is entitled to review under the business judgment rule.

Volgenau arose out of a going-private merger transaction in which a controlling stockholder, Volgenau, held nearly 22 percent of the outstanding equity, but 71.8 percent of the voting power, of a publicly traded Delaware corporation, SRA International, Inc. (SRA). There was no dispute that Volgenau had exercised considerable influence over the operations of SRA after he had stepped down as CEO, through his position as chairman of the board and a controlling stockholder. Volgenau participated in the selection of both his replacement as CEO, DiPentima, and that person's successor, Sloane. Sloane conferred with Volgenau on all major decisions. Volgenau was actively involved in the decision to pursue a sale of the company, and in ensuring the preservation of SRA's values and culture.

There is no doubt that Volgenau, the controlling stockholder, influenced the sales process. The record shows that he had preliminary discussions with Providence, the private equity firm that eventually was the winning bidder, and which had retained DiPentima as a paid consultant and DiPentima had initially proposed the acquisition of SRA by Providence to Volgenau. Volgenau also chose most of the members of the special committee. Indeed, Vice Chancellor Noble comments that "Volgenau's selection of the majority of the committee members was not 'the best practice.'" Volgenau also met alone at his insistence with every bidder "to discuss his desire that 'SRA's name, values and culture be preserved.'"

Volgenau did not, however, restrict or impact the special committee's process. The special committee engaged an independent financial advisor and independent counsel, and negotiated with a strategic acquiror while telling Providence, Volgenau's preferred bidder, that its initial bid did not warrant negotiation, and solicited interest from five additional financial buyers. When word leaked about the process, the initial strategic buyer withdrew from discussions, but the special committee opened up the bidding process to other strategic acquirors; ultimately four other strategic buyers and seven financial buyers besides Providence considered the transaction, and two financial buyers, including Providence, competed in the ultimate multi-round bidding contest.

Providence, the winning bidder, bid a final offer equal to the other bidder's highest price, $31.25 per share in cash, and like the other bidder, required Volgenau to roll over $150 million of his equity into shares in the acquired company; Providence also required Volgenau to provide a $30 million loan, to be repaid only if the acquired company realized sufficient proceeds from a divestiture of certain assets. The special committee concluded that Volgenau would not be receiving any additional economic benefit from the loan if the proceeds of the sale of assets exceeded the principal amount of the loan. The other bidder withdrew its bid, and Providence was the only remaining bidder. The merger agreement with Providence included a 30-day go-shop, a two-tiered break-fee (1.5 percent during the go shop and 2.5 percent thereafter), a reverse break fee, and a non-waivable requirement the transaction be approved by a majority of the minority stockholders.[12] The minority stockholders received $31.25 per share in cash, which represented a 52.8 percent premium to the market price on the day of announcement.

Did Volgenau Stand on Both Sides of the Merger?

Vice-Chancellor Noble considered whether to apply the entire fairness standard or the business judgment standard in reviewing the transaction. Initially, plaintiffs argued that entire fairness was the correct standard because Volgenau allegedly stood on both sides of the transaction. In support of this claim, plaintiffs pointed to Volgenau's interest in preserving

[12] *Id.*, at 21. During the go-shop, 50 bidders were contacted and no offers were received, and the transaction was eventually approved by 81.3 percent of the total outstanding minority shares and 99.7 percent of the total minority voting shares.

SRA's culture and values, his rollover of equity and Volgenau's influence on the sales process.

Vice Chancellor Noble rejected the plaintiffs' arguments, noting that there was no prior relationship between Volgenau and Providence. Noble further emphasizes that Volgenau did not become an affiliate simply by having conversations with the prospective buyer about his interests in preserving SRA's culture and values. Quoting *Frank v. Elgamal*,[13] Noble points out that under Delaware law, "when a corporation with a controlling stockholder merges with an unaffiliated company, the minority stockholders are cashed out, and the controlling stockholder receives a minority interest in the surviving company, the controlling stockholder does not 'stand on both sides' of the merger." He found that plaintiffs had failed to dispute materially that the special committee had "executed a robust process in which all interested bidders were afforded an equal opportunity to buy SRA."

"... when a corporation with a controlling stockholder merges with an unaffiliated company, the minority stockholders are cashed out, and the controlling stockholder receives a minority interest in the surviving company, the controlling stockholder does not 'stand on both sides' of the merger."

Was the Special Committee Disinterested and Independent?

The key issue for Vice Chancellor Noble with respect to the special committee was the independence and disinterestedness of the special committee's chair, Klein. Indeed, the facts in *Volgenau* are instructive for future special committees. The Vice Chancellor reviewed Klein's compensation, and his prior and ongoing relationships with both the independent counsel and the independent financial advisor. After the transaction was concluded, Klein sought, beyond the $75,000 paid to each member of the special committee, a $1.3 million bonus for his efforts, although he requested that this bonus, never before discussed with the board, be paid to two charities with which he was affiliated.

The plaintiffs further pointed to the fact the lead banker and lead lawyer were each on the board of one of the chair's charities and the chair had used both in prior engagements, and that Klein had negotiated a discount in the fees of the counsel, but with the right on counsel's part to a significant bonus if a "terrific economic outcome" were received, and after the merger was completed, negotiated a $2 million bonus for that counsel, later reduced to $1 million due to the buyer's objections. The record showed that the chair encouraged Volgenau to pursue a change of control while he still controlled the vote, and that the chair told one bidder of another bidder's superior bid, but Vice Chancellor Noble found that neither of these actions distorted the process, or demonstrated domination by Volgenau.

The Vice Chancellor finds the chair's request for more compensation most troubling, in part because the chair seemed to have an ongoing expectation for such a bonus during the sales process. Vice Chancellor Noble also noted, however, that the troublesome requests were made only following the completion of the transaction, in part in reaction to the significant advisor fees, and were ultimately rebuffed; instead the chair only received the compensation approved at the beginning of the process. Despite the fact that the compensation was not in fact paid, the question was fairly raised by these facts as to whether the chair's expectation of the bonus called into question his motivation for completing a transaction.

Vice Chancellor Noble notes the key importance of the chair of the special committee, as he had "a predominant role in the negotiations." He explains that the chair's "independence and disinterestedness is of central importance to the functioning and cleansing effect of the Special Committee." Plaintiffs argued that "the compensation of a special committee member that is 'contingent, ambiguous, or otherwise uncertain,' raises a triable issue of material fact as to what each member anticipated in the event the Special Committee approved the transaction." The Vice Chancellor notes that although the chair may have had "an unremitting focus to obtain the highest reasonably attainable value," a desire for a significant bonus could have influenced his negotiations, since the bonus would depend on a completed deal, and he

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[13] 2012 WL 1096090, at *8 (Del. Ch. Mar. 30, 2012); see also *In re John Q. Hammons Hotels Inc., S'holder Litig.*, 2009 WL 3165613, at *12 (Del Ch. Oct. 2, 2009).

may have been less aggressive in negotiating with the bidders.[14]

The Vice Chancellor therefore had to consider whether there was a triable issue of fact as to whether the expectation of the bonus was material to the chair. Vice Chancellor Noble explained that the subjective standard is used to determine if a director's financial self-interest is material. The chair in this case requested that the bonus be distributed to two charities, and Noble found that there were no facts alleged that he would obtain any personal benefit from donations made to the charities because of him. Noble therefore concluded that there was no triable issue of material fact as to the self-interest of the chair. It is an important lesson for future special committees that the committee members should all avoid any questions that might arise relating to their compensation as committee members, and particularly avoid compensation that is "contingent, ambiguous, or otherwise uncertain," to allow a court to focus on the process relating to the transaction. The Vice Chancellor also explains that the chair's effort to negotiate the independent counsel for a job well done was not inconsistent with the chair's fiduciary duties, especially since the discretionary bonus was expressly contemplated by the law firm's engagement, thus resolving the chair's alleged conflicts.

It is an important lesson for future special committees that the committee members should all avoid any questions that might arise relating to their compensation as committee members, and particularly avoid compensation that is "contingent, ambiguous, or otherwise uncertain," to allow a court to focus on the process relating to the transaction.

The Vice Chancellor also considered claims that Volgenau had dominated the special committee process. He held that the decision to permit Volgenau to meet with interested bidders was reasonable given that Volgenau as a controlling stockholder, had the right to vote his shares as he wished, and that Volgenau's limited, incidental contacts with Providence were harmless to the process.

Vice Chancellor Noble thus concluded that the special committee was comprised of independent and disinterested directors and that the stockholders were fully informed when they approved the merger in a non-waivable majority of minority vote.[15] Accordingly, Vice Chancellor Noble reviewed the merger under the business judgment standard. Under that standard he held that he must dismiss the claims unless "no rational person could have believed (1) the Merger was favorable to [SRA's] minority stockholders and (2) the Board's decisions relating to the Merger were made with a business purpose. He declined to substitute his judgment for that of the special committee, whose actions he found to "plainly be attributed to a rational business purpose." He also explained in a footnote that even if the *Revlon* standard to "secure the best value reasonably attainable for its shareholders" applied in this case, the result here would be the same because the majority holder could have thwarted any effort to auction the company.

Differential Consideration Does Not Prevent Application of the Business Judgment Standard.

Vice Chancellor Noble considered Volgenau's rollover interest and his tendering of the $30 million note as part of the transaction, as the plaintiff alleged conflicts of interest on the part of the board in approving the deal structure. The merger agreement provided that Volgenau's rollover stock was equivalent to $150 million based on the $31.25 price that all stockholders received. The board assumed that Volgenau's rollover interest was equal to or less than $150 million. Although Volgenau received certain rights from the stockholder agreement with Providence, primarily to protect his minority interest, none of these were valued by either side. Volgenau's economic benefit from the $30 million non-recourse note was capped at $30 million. Noble therefore

[14] See *In re S. Peru Copper Corp. S'holder Deriv. Litig.*, 52 A.34d 761, 780 (Del. Ch. 2011), *aff'd sub nom. Ams. Mining Corp. v. Theriault*, 51 A.3d 1213 (Del. 2012), where as Noble indicates, the Chancellor comments that the chair of the special committee "was not ideally suited to press hard," given his employment by a significant stockholder with a differing interest being pursued with the controlling stockholder.

[15] The vote required was the approval of the majority of all outstanding minority shares, not just the minority shares voting.

dismissed claims made by the plaintiff that directors had breached their duty of loyalty by knowingly approving different consideration for Volgenau that was allegedly greater than what stockholders received, and held that the board had not consciously disregarded a known duty or intentionally violated a provision in the company charter requiring stockholders to receive equal "payments or distributions."

Conclusion

The Vice Chancellor Noble explains that the proper use of certain procedural devices can avoid judicial review under the entire fairness and, perhaps in most instances, the burdens of trial. It is clear that the Delaware Chancery Court will be willing to avoid the entire fairness standard in cases where a target has a controlling stockholder. When a large blockholder takes the same price and consideration as all other stockholders, absent evidence of a disabling interest, the court will decline to apply the entire fairness standard. Moreover, when a transaction involving a controlling stockholder is approved by an independent and disinterested special committee and an uncoerced, fully informed majority of the minority stockholders, the court will review the transaction under the business judgment rule.

By signaling its willingness to apply the business judgment rule in cases where these procedural safeguards are used, the Chancery Court is providing significant incentives for controlling stockholders to use these safeguards.

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DOJ's filing against the transaction marks a significant departure from its actions in connection with airline mergers over nearly the past decade.

US Airways and American Airlines: What Does the Antitrust Challenge Mean?

On August 13, 2013, the Antitrust Division of the US Department of Justice (DOJ) surprised a number of airline market analysts and observers by filing suit to block the $11 billion merger of US Airways Group, Inc. and AMR Corporation, the parent of American Airlines. Six states and the District of Columbia joined the DOJ's suit. The case, filed in the US Federal District Court for the District of Columbia, will be heard by Judge Colleen Kollar-Kotelly, most known among antitrust petitioners for presiding over the remedy portion of the government's antitrust suit against Microsoft.

To the parties, their merger is "the foundation of American's plan to exit bankruptcy and is the cornerstone of American's and US Airways' plan to form a more competitive and cost-effective airline to take on the country's largest air carriers." The government alleges that the merger will reduce competition among the remaining airlines, leading to higher fares and fees for passengers, and that the parties "prefer tacit coordination over full-throated competition."

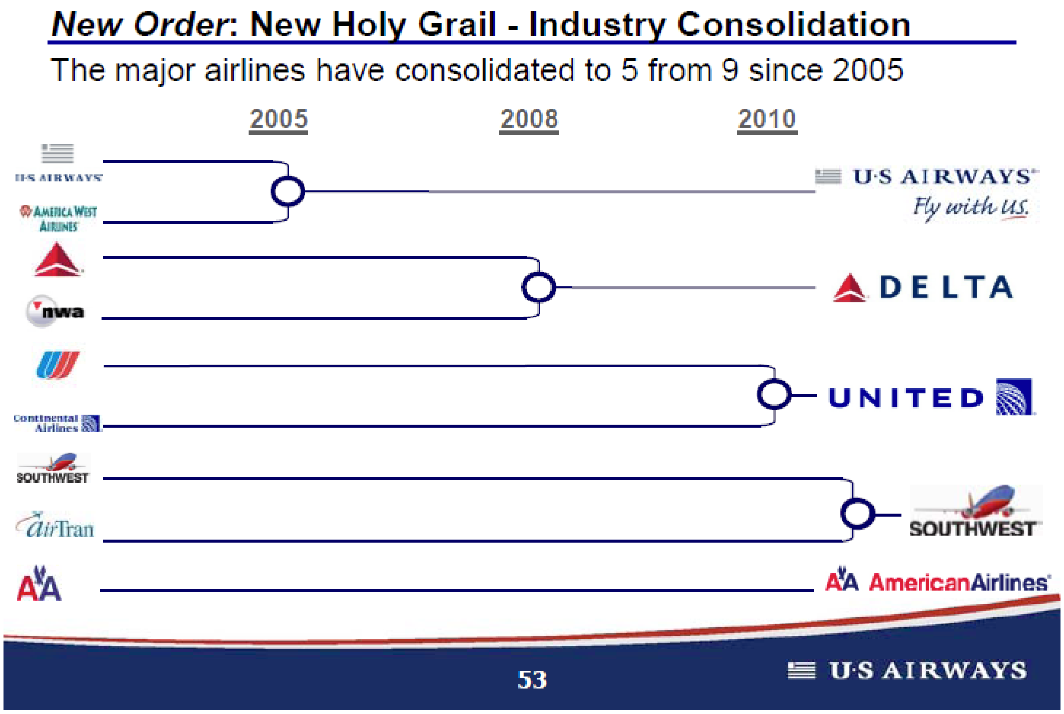
Much has appeared in the press about this antitrust challenge, and that need not be repeated here. As long-term antitrust practitioners, however, we can make a number of significant additional observations that may be of interest:

Prior Mergers in the Industry Have Made This Transaction More Difficult

DOJ's filing against the transaction marks a significant departure from its actions in connection with airline mergers over nearly the past decade. Since 2005, the agency has overseen six airline mergers, and although it has sought competitive remedies requiring the divestiture of take-off and landing slots to remedy competitive issues in particular affected geographic markets, it has not, until now, sought an injunction to block any of the mergers entirely.

Some may suggest that this is indicative of an emboldened antitrust enforcement philosophy at the DOJ, which welcomed its new Assistant Attorney General for Antitrust William Baer at the beginning of this year. More likely, however, this litigation demonstrates that prior mergers in an industry often can make it more difficult for subsequent transactions to pass antitrust muster. In many circumstances, each deal that is consummated in a particular industry marginally increases the antitrust risks for subsequent mergers unless other factors have altered the competitive circumstances for the industry in the interim.

The government graphically demonstrates its points using a US Airways chart:



DOJ Alleges a Different Economic Theory for This Merger

In considering past passenger airline mergers, the DOJ has focused on competition between the merging parties in the context of particular city pairs. While these considerations appear in this complaint as well, the larger focus of the complaint is nationwide and international. According to the DOJ, passenger airline industry consolidation has created four network airlines – United, Delta, US Airways and American – each with national and international networks that support a business model of "hub-and-spoke" passenger service that differs from non-networked airlines such as Southwest Airlines. This, according to DOJ, has altered the competitive landscape.

Allegedly now, the four major competitors operate as networked airlines, and after the merger, they will be more similarly aligned and capable of tacit coordination (or, one might say, peaceful coexistence) rather than aggressive competition.

Allegedly now, the four major competitors operate as networked airlines, and after the merger, they will be more similarly aligned and capable of tacit coordination...

Executives' Statements Can and Will Be Used Against the Company

As has become commonplace in government antitrust complaints, the DOJ launched its suit to block the US Airways and American transaction relying in part on a number of spoken or written phrases from company executives that purport to demonstrate the anticompetitive nature of their planned transaction. At this stage, because the government's complaint is only one side of the argument, we cannot know whether these statements have been taken out of context or whether they mean what the government claims. Most likely, the parties will provide greater context and argue that the government has drawn inappropriate conclusions from the phrases it has carefully chosen and inserted into its complaint. Nonetheless, these words are an important part of the opening salvo in the litigation, and the companies likely wish that at least some of the statements had been somewhat differently made.

For example, the government's opening paragraph quotes a US Airways management statement that the merger will "finish [] industry evolution" and then surrounds that quote with information about allegedly diminished competition in the airline industry that has occurred and will be more likely to occur in the future if US Airways and American are combined. The complaint goes on to provide what allegedly was the thinking of the US Airways' president in 2011 about how "fewer airlines" is a "good thing," and then explaining this thinking: "Three successful fair increases – [we are] able to pass along to customers *because of consolidation*" (emphasis added by DOJ). Similarly, by using quoted words and phrases from US Airways, the DOJ explains its theory about the effect of consolidation, stating that:

> [t]he structural change to 'fewer and larger competitors' has allowed '[t]he industry' to 'reap the benefits.' Those benefits to the industry are touted by US Airways in the same presentation as including 'capacity reductions' and new 'ancillary revenues' like bag fees.

Company statements, even when taken out of context, are often the most difficult items for a company to argue against in the courtroom. Experts and their economic models of competition from one side can be countered by experts and models from the other, but the company's executives' words – in public statements made prior to the transaction, from internal decision-making documents, and in deposition testimony – are seen as unbiased truthful descriptions of the business and its competitive standing. In addition, because the complaint is a public document, its claims provide grist for the news media and information for articles and discussions about the transaction.

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Bankruptcy Proceedings Will Add Complexity

American's ongoing bankruptcy proceedings may add complications to the antitrust proceeding. The parties have stated that American's exit from bankruptcy is hinged on its sale to US Airways, but the government's antitrust complaint includes allegations that contemplate American will emerge from bankruptcy with competitive capabilities to increase passenger capacity in the industry. As evidence of this, DOJ points out that in 2011, American placed a large order for new aircraft that DOJ argues could spur increased capacity and competition. Once again parsing US Airways' words, the government asserts that the company feared American's plans for growth because it would possibly "disrupt the new dynamic" and "Reverse Industry Capacity Trends."

American's parent corporation and the committee representing creditors in their bankruptcy case have urged US Bankruptcy Judge Sean Lane to confirm the company's plan of reorganization. Judge Lane was scheduled to confirm American's exit plan on August 15, but the DOJ complaint to block the merger was filed two days earlier. At the bankruptcy hearing held on August 15, therefore, Judge Lane dealt with many objections to the reorganization plan and asked parties to provide briefing on whether the reorganization plan should be confirmed during the pendency of the antitrust proceeding. American and its creditors argue that the plan should be confirmed even with the DOJ case pending. The DOJ filed a statement taking no position on the reorganization plan but merely explained its review of the merger.

The Parties Are Providing Information to the Court of Public Opinion

In a relatively unusual move, the parties to the transaction placed their antitrust defense counsel into the public discussion on the day after DOJ commenced the litigation. Although parties involved in antitrust litigation routinely discuss their antitrust suits in the press and provide their sides of the argument, rarely do they ask their antitrust litigators to do so. US Airways and American, however, evidently decided to do otherwise in this instance, inviting reporters to participate in a conference call with their respective attorneys on the morning after DOJ filed suit (and held its own discussion with reporters). The parties' decision to take this step may be entirely without moment, but it is not the normal practice for antitrust defense counsel – or for the particular defense counsel leading this litigation.

The Parties Are Readying for Battle

The parties are providing every indication that they intend to fight aggressively against the government's allegations in court rather than to attempt reaching a settlement. US Airways and American have hired strong antitrust litigation counsel and have already joined battle seeking a speedier trial date than the one proposed by the government. The government asked the court to set a trial date in February 2014, but the merging parties countered with a more aggressive schedule, asking for trial to begin as early as this November. The parties informed the court that they first notified the DOJ of their plans to merge in May 2012 (several months before the public announcement in February 2013).

The parties are providing every indication that they intend to fight aggressively against the government's allegations in court rather than to attempt reaching a settlement.

Whether the government's complaint will ultimately be proven and an injunction granted to block the transaction, of course awaits trial before the court. Nonetheless, the mere filing of the complaint brings uncertainty to the market and the companies' stock, costs millions of dollars in legal fees, and causes not insignificant delay in the transaction.

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In Re Trados Incorporated – Delaware Court of Chancery Finds Sale of Venture-Backed Company Meets Entire Fairness Standard Even in the Absence of Fair Process

Overview

The Delaware Court of Chancery reviewed again the fiduciary duties of the board of directors to common stockholders in the much anticipated opinion, *In re Trados Incorporated*, *Consol. C.A.* No. 1512-VCL (Del. Ch. August 16, 2013).[1] In *Trados*, the board of directors approved a sale of a venture-backed company in which preferred stockholders received nearly all of their liquidation preference, while common stockholders received nothing. Applying the "entire fairness" standard of review, Vice Chancellor Laster found that the Trados board did not breach its fiduciary duties in approving the sale. *Trados* provides important guidance to boards of directors, venture capital investors and others involved in the sale of a company in similar circumstances.

The company in this case was Trados Inc., a software company that originally obtained venture capital funding in 2000. In the original and subsequent rounds of financing, the venture capital investors received preferred stock and the right to appoint representatives to the Trados board of directors. By 2004, despite revenue growth year-over-year, the VC investors were unsatisfied with the company's results and began looking to exit. As part of that process, the board adopted a management incentive plan that would compensate management for achieving a sale of the company, even if the sale yielded nothing for the common stock. In July 2005, Trados was acquired by SDL plc for $60 million in cash and stock. The acquisition triggered the liquidation preference of the preferred stockholders under the Trados certificate of incorporation, and pursuant to the management incentive plan, the first $7.8 million was paid to certain members of management. The remaining $52.2 million was paid to preferred stockholders, with nothing remaining for the common stockholders.[2]

Directors Must Prefer the Interests of Common Stock Over Contractual Rights of Preferred

The plaintiff contended that rather than selling the company to SDL, the board had a fiduciary duty to continue operating the company in order to generate value for the common stock. Vice Chancellor Laster held after a full trial that the defendants satisfied their burden of proof showing that the decision to sell the company was entirely fair.

[1] In 2009, Chancellor Chandler denied a motion to dismiss claim that the former Trados directors breached their duty of loyalty by approving a merger transaction. *In re Trados Inc. S'holder Litig. (Trados I)*, 2009 WL 2225958 (Del. Ch. July 24, 2009).

[2] In the absence of the management incentive plan, an additional $2.1 million would have remained for the common after satisfying the preferred stockholders' total liquidation preference of $57.9 million.

In considering plaintiff's argument, Vice Chancellor Laster makes clear that under Delaware law, "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 Vice Chancellor also notes that "generally it [is] the duty of the board, where discretionary judgment is to be exercised, to prefer the interests of the common stock - as the good faith judgment of the board sees them to be - to the interests created by the special rights, preferences, etc. ... of preferred stock."[1] Vice Chancellor Laster takes note that "[t]he cash flow rights of typical VC preferred stock cause the economic incentives of its holders to diverge from those of the common stockholders" and are likely to affect the choice between selling or dissolving a company, or maintaining a company as going concern. Such divergence is likely to occur when the company is "neither a complete failure nor a stunning success," as was the case in *Trados*. Accordingly, one important lesson of *Trados* is that it is possible for a director to breach his duty of loyalty by improperly favoring the interests of the preferred stockholders over the interests of the common stock.

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.

At trial, the plaintiffs initially proved that the Trados board approved the sale without a majority of disinterested and independent directors[2] or another procedural device such as a special committee of the board to protect the interests of the common. Accordingly, the burden of proof then fell on defendants to prove that the transaction was entirely fair. Even under that highest standard of review, however, the court found that defendants carried their burden of proof, despite finding that the directors failed to follow a fair process in approving the transaction.[3]

Directors Did Not Show Fair Dealing, But Proved Fair Price

In concluding that the transaction did not satisfy fair dealing, Vice Chancellor Laster found that the management incentive plan adopted by the Trados board "favored the interests of the conflicted fiduciaries who initiated, designed, presented and approved it." Laster noted that the preferred bore the entire cost of the plan at deal values below the preferred stock's liquidation preference, and that this was neither procedurally nor substantively unfair. Once the deal value exceeded the liquidation preference, however, the plan took value away from the common, disproportionately compared to the value taken from the preferred. Vice Chancellor Laster held that, "[f]or purposes of fair dealing, the [management incentive plan] skewed the negotiation and structure of the Merger in a manner adverse to the common stockholders." The management directors, the Vice Chancellor explains, might have viewed the transaction differently if their interests had been aligned with the common, and the process would have been different, and presumably less tainted. "The [management incentive plan] converted the management team from holders of equity interests aligned with the common stock to claimants whose return profile and incentives closely resembled those of the preferred."

The management directors, the Vice Chancellor explains, might have viewed the transaction differently if their interests had been aligned with the common, and the process would have been different, and presumably less tainted.

[1] Vice Chancellor Laster states unequivocally that "[a] board does not owe fiduciary duties to preferred stockholders when considering whether or not to take corporate action that might trigger or circumvent the preferred stockholders' contractual rights."

[2] Plaintiff proved at trial that six of the seven Trados directors were not disinterested and independent. Two of the directors received payouts pursuant to the management incentive plan and three other directors were representatives of VC firms that held preferred stock. Another director was shown not to be disinterested due to other economic interests in certain holders of preferred stock. This finding alone did not mean that the directors had breached their fiduciary duties, but only that their actions in approving the merger would be reviewed under the entire fairness standard.

[3] Under Delaware law, the concept of entire fairness has two basic aspects: fair dealing and fair price. The test, however, is not bifurcated, and all aspects are examined as a whole.

In reviewing the entire fairness of the transaction, Vice Chancellor Laster found dispositive the fact that the common stock had no economic value before the sale, thus making it fair that the common stockholders receive no consideration as a result of the sale.[4] He held that "under the circumstances of this case the fact that the directors did not follow a fair process does not constitute a separate breach of duty." He concluded that the lack of fair dealing did not "infect the price"[5] in this case. He explained that here, because the board failed to employ a procedural device such as a special committee to demonstrate fair dealing, the board was required to prove at trial that the merger was entirely fair, but he held that the directors had met their burden here.

On the question of valuation, the court focused on whether Trados could generate positive value for the common stock if operated as a stand-alone entity based on its then current business plan. By applying a discounted cash flow analysis, the defendant's expert provided a valuation of the company which the court found to be balanced and persuasive.[6] This valuation produced a going concern value of $51.9 million that was less than the $60 million purchase price paid by acquirer, and also less than the preferred stockholders' total liquidation preference of $57.9 million. Thus, the court concluded that if the common stock of Trados had no economic value before the acquisition, then "the common stockholders received the substantial equivalent of what they had before ..."[7]

On the question of valuation, the court focused on whether Trados could generate positive value for the common stock if operated as a stand-alone entity based on its then current business plan.

Fair Process Is Ignored at the Directors' Peril

It is important not to read the *Trados* decision as tacit permission for boards to ignore fair process. Vice Chancellor Laster reminds directors that even though fair price carried the day in this case, fair process is still a key component of the entire fairness standard of review. It is safe to say that this result was not a foregone conclusion. It is always possible that the Chancery Court will find as an equitable matter that "an unfair process [did in fact] infect the price." A well-advised board of directors in similar circumstances should make every effort to consider reasonable steps to evidence fair dealing.

Techniques that the Delaware courts will consider as evidence of fair dealing include the establishment of an independent committee, conditioning the transaction on approval by the disinterested stockholders or obtaining an independent fairness opinion. A board should also consider the structure of a management incentive plan to provide terms that do not disproportionately take value from the common stock. A process showing that the board took steps to consider the interests of the minority stockholders will improve the record on fair dealing, and in some cases may avail a board of review under the business judgment standard, shifting the burden of proof to the plaintiff.

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[4] The Delaware Supreme Court has characterized the proper test of fairness to be whether the minority stockholder shall receive the substantial equivalent in value of what they had before. *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 114 (Del. 1952).

[5] See, e.g., *Kahn v. Tremont Corp.*, 694 A.2d 422, 432 (Del. 1997).

[6] The defendant's expert also prepared comparable company and comparable transaction analyses but concluded that the comparables were insufficiently close to Trados to generate a reliable valuation. The court found testimony presented by plaintiff's expert on valuation to be less persuasive.

[7] The company's ability to generate additional value depended on financing its business plan with internally generated cash and remaining credit facilities. To the extent that other outside funds were needed, the record showed that the company had not been able to raise new financing, none of the existing VC investors would put more money into the company, and the Vice Chancellor observed that they were not obligated to do so.

It is worth noting that evidence of the board's intent to recognize and observe its duty of loyalty and thus to introduce procedures to ensure that the interests of the common are being considered goes a long way with the Delaware judiciary. Thus, the Vice Chancellor here notes the design of the management incentive plan "as evidence that the board dealt unfairly with the common when negotiating and structuring the Merger." It would of course be possible to design a management incentive plan in a way that demonstrated the board's attention to the interests of the common. Moreover, in *Trados*, the directors did not elicit any credible evidence that the board had ever considered the separate interests of the common stockholders. Laster observes that "[c]onflict blindness and its lesser cousin, conflict denial, have long afflicted the financially sophisticated." He also notes the lack of any consideration by the board of the possible formation of a special committee, the possible obtaining of a fairness opinion, or the possibility of conditioning the merger on the vote of a majority of the disinterested stockholders.

A board facing conflicts of interest arising from the differing interests of the preferred and the common stock would be well served by a contemporaneous record demonstrating the directors' thoughtful consideration of the interests of the common, and the implementation of procedures to protect those interests.

In summary, Vice Chancellor Laster noted that the Trados board did not "set out to deal with the common stockholders in a procedurally fair manner. Nor were the defendants able to recharacterize their actions retrospectively to show that they somehow blundered unconsciously into procedural fairness." A board facing conflicts of interest arising from the differing interests of the preferred and the common stock would be well served by a contemporaneous record demonstrating the directors' thoughtful consideration of the interests of the common, and the implementation of procedures to protect those interests.

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Delaware Supreme Court Allows Expectation or Benefit-of-the-Bargain Damages for Breach of an Obligation to Bargain in Good Faith *SIGA Technologies, Inc. v. PharmAthene, Inc.*

Letters of intent and other preliminary agreements make transactional lawyers nervous. They worry that if negotiations break down and the parties fail to enter into a definitive agreement, a court will find that the inherently incomplete preliminary agreement is either enforceable as is or creates an obligation to negotiate in good faith to reach a definitive agreement on terms consistent with the preliminary agreement.[1] In an effort to avoid the resulting uncertainty, some lawyers make it a practice to include in preliminary agreements an express renunciation of any legal obligation,[2] but clients seeking to obtain at least a moral commitment from the other party sometimes resist that approach. In *SIGA Technologies, Inc. v. PharmAthene, Inc.* (Del. May 24, 2013), the Delaware Supreme Court raised the stakes by holding for the first time, at least in Delaware, that expectation or benefit-of-the-bargain damages may be recoverable for breach of an obligation to negotiate in good faith based on a preliminary agreement.

Letters of intent and other preliminary agreements make transactional lawyers nervous.

Background

In 2004, SIGA Technologies ("SIGA") acquired ST-246, a drug for the treatment of smallpox. Although ST-246 was believed to have substantial potential value, by late 2005 SIGA had experienced difficulty in developing ST-246 and was running out of the cash it needed to continue in business and turn ST-246 into a commercially viable product. As a result, SIGA began discussing a possible collaboration with PharmAthene Inc. ("PharmAthene"). PharmAthene suggested a merger of the two companies, but due to failed merger discussions between the two companies in 2003, SIGA was hesitant to pursue a merger. Instead, SIGA suggested negotiating a license agreement before discussing a merger.

[1] Courts analyze breach of contract claims based on preliminary agreements under a framework devised by Judge Leval in *Teachers Insurance & Annuity Association v. Tribune Co.*, 670 F. Supp. 491 (S.D.N.Y. 1987), which identifies two types of preliminary agreements. In the first ("Type I"), the parties have reached agreement on all of the issues that require negotiation, but have not completely formalized their agreement. A Type I agreement is enforced as a contract providing for the underlying transaction. In the second ("Type II"), the parties have agreed on some major details, but others remain to be negotiated. A Type II agreement is enforced as an obligation "to negotiate together in good faith in an effort to reach final agreement within the scope that has been settled in the preliminary agreement." *Id*. at 498.

[2] As the obligation that may arise from a preliminary agreement is contractual in nature, the parties should be able to avoid any such obligation by making their intent to do so clear. As Judge Leval noted in *Teachers*, a "primary concern for courts in such disputes is to avoid trapping parties in surprise contractual obligations that they never intended." 670 F. Supp. 491, 497. One recent example of language designed to make clear the parties' intent to avoid contractual obligations is the following: "Each party also agrees that unless and until a definitive written agreement with respect to a Possible Transaction has been executed and delivered by ● and ●, neither party, nor any affiliate thereof, will be under any legal obligation of any kind whatsoever (including any duty to negotiate in good faith) with respect to such a Possible Transaction by virtue of this Agreement or otherwise or by virtue of any written or oral expression with respect to such a Possible Transaction by either party or any of their respective affiliates or any of their and their affiliates' respective directors, officers, employees and representatives."

License discussions ensued until SIGA and PharmAthene came to an agreement on the content of a license term sheet (the "LTS"). The LTS was not signed by either party and stated "Non Binding Terms" in the footer on each page of the document.

... a "primary concern for courts in such disputes is to avoid trapping parties in surprise contractual obligations that they never intended."

The LTS contemplated the grant of an exclusive license to PharmAthene to further the development of ST-246 and the right to grant sublicenses. Additionally, the LTS described the development of a research and development committee, the tasks of that committee and the general economic terms of the transaction.

At about the same time as the LTS was completed, PharmAthene determined that it would prefer to merge with SIGA. Members of both management teams met to discuss the possible merger and during those discussions SIGA requested bridge financing from PharmAthene, so that SIGA could continue to develop ST-246 while negotiations proceeded. Representatives from PharmAthene agreed to consider bridge financing, on the condition that PharmAthene would obtain a license to ST-246 if the merger talks failed.

In connection with the merger negotiation, PharmAthene sent a draft merger term sheet to SIGA, which contemplated the simultaneous execution of a merger agreement and a license agreement in accordance with the terms set forth in the LTS. The license agreement was to become effective only upon termination of the merger agreement. SIGA's Board Chairman, Donald Drapkin, responded that he was unwilling to pay lawyers to draft a formal license agreement and that the LTS should be attached to the merger agreement and would guarantee PharmAthene its license for ST-246 if the merger discussions fell apart. On March 10, 2006, SIGA and PharmAthene signed a letter of intent for a merger and attached the LTS to that document.

On March 20, 2006, SIGA and PharmAthene entered into a bridge loan agreement under which PharmAthene loaned SIGA $3 million. The bridge loan agreement expressly obligated the parties to negotiate a license agreement in good faith in accordance with terms of the LTS if either the merger letter of intent or a definitive merger agreement was terminated.

On June 8, 2006, SIGA and PharmAthene signed a merger agreement, which contained a clause substantively identical to the clause in the bridge loan agreement, obligating the parties to negotiate a license agreement in good faith in accordance with the terms of the LTS if the merger agreement was terminated. Additionally, the merger agreement obligated the parties to use their "best efforts" to carry out and consummate the contemplated agreements. By the express terms of the merger agreement, these provisions were to survive the termination of the merger agreement. SIGA and PharmAthene each had the option to terminate the merger agreement if the merger did not occur by a "drop-dead date" of September 30, 2006.[3]

After the merger agreement was signed, SIGA's fortunes improved substantially. It received grants of $5.4 million and $16.5 million from the National Institutes of Health, approved an agreement with a clinical trial organization for the first human trial of ST-246 and received the results of a primate trial study in which ST-246 had a 100% success rate against smallpox. When the SEC failed to clear SIGA's proxy statement by the September 30, 2006 "drop-dead date" SIGA, which had come to regret the commitments it made to PharmAthene when it needed PharmAthene's support, decided to terminate the merger agreement. Shortly thereafter, SIGA raised an additional $9 million by selling 2 million shares of its stock at three times the 2005 share price.

[3] There was testimony that Drapkin requested the early drop dead date to create a compressed time line so that everybody would rush, but that he assured PharmAthene that "if we need extensions [SIGA] will grant them."

Following termination of the merger agreement, PharmAthene began to work toward the license agreement called for by the bridge loan agreement and the merger agreement and hired an attorney to prepare the license agreement on terms consistent with the LTS. SIGA responded with a document reflecting terms that were "radically different from [and more favorable to SIGA than] the terms set forth in [the LTS]." On December 20, 2006, SIGA issued an ultimatum: it would not continue discussions unless PharmAthene was willing to negotiate "without preconditions" as to the binding nature of the LTS. PharmAthene responded by commencing litigation against SIGA in the Delaware Court of Chancery.

Chancery Court

After denying SIGA's motions to dismiss and for partial summary judgment, Vice Chancellor Parsons presided over an 11-day trial and received extensive post-trial briefing. He then determined that:

- Delaware law applied to the dispute[4];
- SIGA was liable for breach of its obligations under the bridge loan agreement and the merger agreement to negotiate a definitive license agreement in good faith in accordance with the terms of the LTS;
- SIGA was also liable under the doctrine of promissory estoppel; and
- the appropriate remedy was payment by SIGA to PharmAthene of an equitable payment stream approximating the terms of the license agreement to which the Vice Chancellor found the parties would have ultimately agreed had they negotiated in good faith on terms consistent with the LTS.

The Vice Chancellor also awarded attorneys' fees and costs to PharmAthene. An appeal to the Delaware Supreme Court followed.

Delaware Supreme Court

The Delaware Supreme Court concluded that "an express contractual obligation to negotiate in good faith is binding on the contracting parties," citing its decision in *Titan Investment Fund II, LP v. Freedom Mortgage Corp*[5]., and recognizing that there had been "some ambiguity" concerning that question before its decision in *Titan* last year.

The Court had little difficulty affirming the Chancery Court's holding that SIGA had undertaken such an obligation to negotiate in good faith, based on the express contractual language in the bridge loan agreement and merger agreement. It also affirmed the Chancery Court's holding that the contractual obligation to negotiate in good faith to execute a license agreement "in accordance with the terms set forth in the [LTS]" required the parties to negotiate a license agreement with terms that were economically similar to terms in the LTS, despite the fact that the LTS was not signed and contained a footer on each page stating "Non Binding Terms."

Finally, the Court affirmed the Chancery Court's holding that SIGA had attempted to negotiate a license agreement with terms that were "drastically different and significantly more favorable to SIGA and acted in bad faith when negotiating the license agreement in breach of its obligations under the two agreements." The Court cited with apparent approval Judge Leval's statement in *Teachers* that "[w]hile 'good faith differences in the negotiation of open issues may prevent reaching a final contract,' a counterparty cannot 'insist[] on conditions that do not conform to the preliminary agreement.'"[6]

[4] Governing law was an issue because the two agreements requiring good faith negotiation of the license agreement were governed by different laws; the bridge loan agreement provided for the application of New York law, while the merger agreement provided for the application of Delaware law. As explained below, the choice of Delaware law wound up having great significance in determining the remedy to be awarded.

[5] *Titan Inv. Fund II, LP v. Freedom Mortg. Corp.*, 58 A.3d 984 (Del. Dec. 5, 2012)(ORDER).

[6] 670 F.Supp. 491, 498.

The Court provided some insight as to how it viewed SIGA's conduct when it explained that under Delaware law, a finding of bad faith "implies the conscious doing of a wrong because of dishonest purpose or moral obliquity; ... it contemplates a state of mind affirmatively operating with furtive design or ill will."

... a finding of bad faith "implies the conscious doing of a wrong because of dishonest purpose or moral obliquity; ... it contemplates a state of mind affirmatively operating with furtive design or ill will."

The Court reversed the Chancery Court's conclusion that SIGA was liable on the basis of promissory estoppel, holding that "[p]romissory estoppel does not apply, however, where a fully integrated, enforceable contract[7] governs the promise at issue."

The Court then turned to the question of the appropriate "remedy for breach of an agreement to negotiate in good faith where the court finds as fact that the parties, had they negotiated in good faith, would have reached an agreement," noting that the question had not been clearly answered by its prior decisions. Surveying the law in other jurisdictions, the Court recognized that the New York Court of Appeals had established that under New York law a plaintiff could recover only reliance damages – *i.e.*, its out-of-pocket expenses – for such a breach and could not recover expectation or benefit-of-the bargain damages – *i.e.*, the profits it would have made under the definitive agreement that was to have been negotiated.[8] The Court noted that the law in other jurisdictions was largely unsettled and that some federal courts had expressed some question as to the clarity of the holding in *Goodstein*.

The Court proceeded to resolve that question under Delaware law – "We now hold that where the parties have a Type II preliminary agreement to negotiate in good faith, and the trial judge makes a factual finding, supported by the record, that the parties would have reached an agreement but for the defendant's bad faith negotiations, the plaintiff is entitled to recover contract expectation damages."[9] The Court remanded for reconsideration of the damages award consistent with its opinion.[10]

"We now hold that where the parties have a Type II preliminary agreement to negotiate in good faith, and the trial judge makes a factual finding, supported by the record, that the parties would have reached an agreement but for the defendant's bad faith negotiations, the plaintiff is entitled to recover contract expectation damages."

Lessons Learned

The Delaware Supreme Court's decisions in *SIGA* does not break new ground on the questions of whether the parties can obligate themselves to negotiate in good faith based on a preliminary agreement. Indeed, Chief Justice Steele's opinion for the Court can be read as suggesting that Delaware law may require a more explicit statement by the parties of their intention to create such an obligation than is required under New York law. However,

[7] In this case, the bridge loan agreement and the merger agreement.

[8] *Goodstein Constr. Corp. v. City of New York,* 80 N.Y.2d 366, 590 N.Y.S.2d 425, 604 N.E.2d 1356 (1992).

[9] The Court cautioned that "[a]n expectation damages award presupposes that the plaintiff can prove damages with reasonable certainty. *Callahan v. Rafail*, 2001 WL 283012, at *1 (Del.Super. Mar. 16, 2001) (citation omitted) ("It is well-settled law that 'a recovery for lost profits will be allowed only if their loss is capable of being proved, with a reasonable degree of certainty. No recovery can be had for loss of profits which are determined to be uncertain, contingent, conjectural, or speculative.' ")."

[10] In a scheduling conference following the remand, Vice Chancellor Parsons observed that he would have to go back and review the record and determine whether he should award money damages, equitable relief or nothing. Further, he stated "as far as I'm concerned, I am completely unrestrained, and I could award money damages of whatever number I set. What did they ask for? Between $400 million and a billion dollars. Maybe it could be in there, maybe it could be something less. I don't know."

SIGA appears to be the first appellate decision in the United States to clearly hold that the remedy for breach of such an obligation is not limited to reliance or out-of-pocket damages and that expectation or benefit-of-the-bargain damages are available in an appropriate case.

It is very dangerous for a party that may be viewed as having acted in bad faith to be placed in the position of defending itself in a court of equity.

Although we do not yet know how Vice Chancellor Parsons will determine damages on remand or whether the Delaware Supreme Court will have the opportunity to review that determination on appeal, the *SIGA* decision clearly increases the stakes when the parties to a preliminary agreement disagree as to whether it was intended to create an obligation to negotiate in good faith. As a result, lawyers need to make sure that their clients understand the risks of ambiguity if the parties do not expressly disavow the existence of any legal obligation in a preliminary agreement (*e.g.*, by not including explicit language of the type included in note 2, *supra*). The decision also adds to the significance of choice of law provisions in preliminary agreements, particularly given the very different approach taken by the New York Court of Appeals in *Goodstein.* Finally, it stands as a reminder that it is very dangerous for a party that may be viewed as having acted in bad faith to be placed in the position of defending itself in a court of equity.

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Ten Steps to Limit Corruption Allegations in China

Transparency International's 2012 Annual Corruption Perceptions Index ranked China 80th among 176 countries. By comparison, the United States ranked 19th and Denmark ranked first as being least corrupt. But China recently has begun making visible efforts to clean up its image, both by strengthening its anti-corruption rules and cracking down on enforcement. High-profile investigations announced by China's Ministry of Public Security regarding bribery allegations against at least one leading pharmaceutical company and other multinationals in late July are causing many companies doing business in the PRC to take note.

Here are ten steps that multi-national companies operating in China should undertake to not run afoul of an increasingly intolerant regulatory environment:

1. Understand China's Anti-Corruption Laws

Although some perceive that the PRC laws on bribery are vague and complex, recent events demonstrate that China is increasingly aggressive in rooting out corrupt business practices. As a signatory to the recent United Nations Convention Against Corruption, the PRC's anti-corruption laws comply with the UN requirements. PRC laws also prohibit most conduct that violates the Foreign Corrupt Practices Act (FCPA) and even commercial bribery that does not involve a state-controlled entity. After passage of these laws, the PRC court issued guidance to assist in interpreting them. If company executives have a question regarding compliance, consult with a reputable PRC-qualified attorney.

2. Eschew Gifts and Entertainment

While many sales force employees at multinationals regard the bestowing of desirable gifts or entertainment on Chinese public officials in decision-making roles as standard operating procedure to help facilitate the purchase or adoption of their companies' products, companies must institute a zero-tolerance policy regarding corruption. Chinese law, the FCPA and the UK Bribery Act absolutely prohibit companies from paying bribes to foreign government officials and political figures. The presentation of a gift, however small, can violate these laws if authorities can demonstrate that it is given with the intent to obtain or retain business or can be construed as providing improper advantage. Indeed, PRC rules require any gift that might affect an official's impartial exercise of his public function be turned over to the state. As an initial matter, the company should set standards for gift giving that are implemented by an experienced local compliance director. The local compliance director should have the support and backing of senior management to deny requests that fall outside the compliance polices of the company and local law. Lastly, employees should only give gifts that are for official, rather than personal, use, and should present them openly and in front of a group of people.

3. Vet Third Parties

Third parties are the single biggest risk to companies doing business in China. In 2012, every US FCPA enforcement action involved a third party such as a contractor, subcontractor or consultant. Steps should be taken to assess the need for, and evaluate the background and qualifications of, third parties hired to facilitate business for a company. Do not ignore any red flags in a background report, and keep careful records of any due diligence undertaken and then scrutinize the results of that due diligence.

4. Monitor All Travel Arrangements

Request for travel is common from PRC officials in China. In recent years, we've seen Chinese travel agencies used as a conduit for bribes to government officials. Since 2007, nine reported FCPA resolutions involved travel agents or travel-related corrupt activity. For example, one US telecom company faced actions by US regulators after spending millions of dollars for more than 300 trips for Chinese government officials. The stated travel purpose was for the inspection of factories and to train the officials in how to use the company's equipment, when, in reality, the officials instead visited tourist destinations such as Hawaii, Las Vegas, the Grand Canyon, Niagara Falls, Disney World, Universal Studios and New York City. Companies can avoid corrupt behavior in this regard by ensuring that the compliance policy for travel is adequate to address the corruption risk in the culture. Create or update your travel policy to require a specific business basis for the trip, mandate approval be granted by senior managers only and require the submission of a detailed itinerary that lists each line item separately to ensure items such as stipends, per diems and unintended leisure travel do not creep into otherwise legitimate travel plans.

5. Institute Risk-Based Compliance

The government-issued *A Resource Guide to the U.S. Foreign Corrupt Practices Act* states, "DOJ and SEC will give meaningful credit to a company that implements in good faith a comprehensive, risk-based compliance program, even if that program does not prevent an infraction in a low risk area because greater attention and resources had been devoted to a higher risk area." Consequently, a company should implement specific anti-corruption risk controls tailored to the environment. For example, a company whose only customer is the Chinese government faces considerable risk of corruption, so it should develop compliance policies that address that risk and specifically lay out procedures and protocols for the employees interfacing with government officials on behalf of the company to follow.

6. Provide Compliance Training

If employees are trained on the law and understand the reasons behind the compliance policy, companies will likely experience a measurable decrease in their corruption risk. The higher the risk, the more important in-person training supplemented by a web-based training module, certifications and oversight becomes. Companies should evaluate position titles that present high-risk and target these employees for higher level anti-corruption training. These positions could include those in sales and marketing; employees that interact with government officials; personnel charged with maintaining agency external relationships; human resource personnel with international responsibilities; and appropriate legal, compliance and finance personnel. In addition, training should be offered in the local language where appropriate.

7. Make Internal Audit and Finance Accountable

Internal audit and finance teams should share joint responsibility for anti-corruption compliance with company lawyers and compliance professionals when operating in high-risk markets. In a recent FCPA enforcement action, the SEC described the failure of the internal auditor to detect a corrupt transaction as a failure of leadership. According to the SEC, company management "had the ability to review or cause internal audit to review" suspect transactions; the failure to do so decreased the ability of the internal audit to "provide an independent internal control function." To avoid this, many companies are investing in specific anti-corruption training for audit and finance personnel. This team of professionals should have the full support of company leadership, including local management, to implement monitoring and, as necessary, enhanced controls or remedial steps to address anti-corruption risk.

8. Conduct Business Combinations Due Diligence

Several reported FCPA cases highlight the important of anti-corruption due diligence in the context of business combinations in China. The failure to identify an FCPA issue in advance of a merger, joint venture or other business combination has been credited, in one instance, with the complete loss of the value of the investment. Conduct a risk assessment of the company to identify high-risk areas within the business where corruption is more likely to occur. Although much depends on the company's stake in the venture, even minority stakeholders would be wise to exercise caution and ensure that appropriate risk-based due diligence is conducted. Companies should engage in documented due diligence prior to closing a merger or other business combination. The documentation usually starts with due diligence questionnaires issued to key managers, co-investors and relevant consultant followed by interviews related to responses that raised red flags, and also should include documentation to verify the answers to certain types of questions.

9. Determine If Chinese Employees Are Viewed as Foreign Officials

The Chinese government operates through a complex web of state-owned enterprises (SOEs), in key industries such as aviation, oil and gas, telecommunications and healthcare. US enforcement authorities interpret the term "foreign officials" to apply not only to bureaucrats, but also to employees of SOEs given their status as an "instrumentality" of the state. Multinationals seeking to limit potential corruption liability should closely review this question and exercise care in determining whether employees of any company are indeed "foreign officials" for purposes of anti-corruption laws.

10. Monitor, Audit and Enforce Compliance Policies

Anti-corruption programs must be embedded in the way a company does business. Compliance begins at the C-level, but it is up to middle management to deliver and reinforce the importance of anti-corruption compliance to ensure that it reaches employees most vulnerable to corrupt conduct. Those with compliance responsibilities must regularly monitor the effectiveness of compliance polices and their enforcement. Those found in serious violation of anti-corruption policies should face real and transparent consequences for their behavior so that employees understand that management takes corruption seriously.

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First Circuit Holds Private Equity Fund Potentially Liable for Portfolio Company's Pension Plan Withdrawal Liabilities

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On July 24, 2013, the United States Court of Appeals for the First Circuit issued a decision, *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, holding that a private equity fund could be a "trade or business" and could, therefore, be found jointly and severally liable as a member of a portfolio company's "controlled group" for purposes of multiemployer plan withdrawal liability under the Employee Retirement Income Security Act (ERISA). This important and controversial decision reverses a district court opinion holding that the private equity funds were not "trades and businesses" and is the first appellate court decision to consider this issue.

. . . a private equity fund could be a "trade or business" and could, therefore, be found jointly and severally liable as a member of a portfolio company's "controlled group" for purposes of multiemployer plan withdrawal liability...

Background: ERISA Controlled Group Liability

Under ERISA, if a contributing employer withdraws from a multiemployer plan, the employer and members of its "controlled group" are jointly and severally liable for the employer's allocable share of the plan's unfunded pension liabilities at the time of the withdrawal. A "controlled group" consists of all entities engaged in a "trade or business" under "common control" with the contributing employer. Common control usually requires an 80 percent or greater ownership interest in one or more chains of entities. The joint and several liability applies to defined benefit pension plans, multiemployer plans and certain other benefit liabilities.

The District Court's Decision: Not a Trade or Business

In 2006, two related private equity funds sponsored by Sun Capital Advisors acquired Scott Brass Inc. The transaction was structured so that one fund owned 70 percent of the portfolio company, and the other fund owned the remaining 30 percent. At the time of the acquisition, the company was a contributing employer to the New England Teamsters & Trucking Pension Fund, a multiemployer pension plan.

In 2008, the company withdrew from the multiemployer plan and, shortly thereafter, filed bankruptcy. Following the bankruptcy filing, the plan filed a lawsuit seeking to hold the private equity funds jointly and severally liable for the bankrupt portfolio company's share of the plan's unfunded pension liabilities. In relevant part, the plan alleged that liability should be extended to the funds because they were participants in a joint venture or partnership under "common control" with the bankrupt company. The district court disagreed and ruled in favor of Sun Capital, determining based upon tax court precedent that the funds were passive investors not engaged in a "trade or business" for purposes of ERISA.

The First Circuit's Decision: Reverses and Finds Trade or Business

On appeal, the First Circuit reversed in part and remanded in part, holding that, under the circumstances, the funds could be more than a passive investor and a trade or business. In reaching its decision, the First Circuit reviewed a 2007 decision of the Pension Benefit Guaranty Corporation's Appeals Board that found a private equity fund liable as a "trade or business" based on active involvement in its investments. The First Circuit agreed with the PBGC's analysis in its holding.

The First Circuit did not set forth any brightline test and instead adopted an "investment plus" approach, focusing its analysis on whether, in addition to the funds' involvement as passive investors, there were other factors present that would allow it to conclude that the funds were "actively involved in the management and operation" of the portfolio company. The court ultimately determined that one of the funds exhibited the requisite degree of active involvement in the portfolio company's management and operation and remanded the case to the district court to determine whether the other fund had similarly exhibited active involvement.

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Factors That the Court Relied On

In reaching its conclusion, the court discussed facts relating to the involvement by the private equity funds (and their affiliates) with the portfolio company's operations and activities, finding that this involvement could distinguish the investment from a mere passive investor relationship. The court focused on:

- the fact that the portfolio company paid management fees to entities that were related to the general partners of the funds, and those fees were offset against amounts otherwise owed by one of the funds to its general partner
- statements in the fund's organizational documents that its general partner had the power to make employment decisions on hiring, terminating and compensating employees of the portfolio company
- statements in the partnership agreement and offering documents regarding the fund's active involvement in the operation and management of its portfolio companies
- the relationship that an affiliate of the general partner had with the portfolio company to provide management and consulting services

The court stated that the "sum of all of these factors satisfied the 'plus' in the 'investment plus' test."

The court stated that the "sum of all of these factors satisfied the 'plus' in the 'investment plus' test."

For the District Court to Consider on Remand

The court viewed the first factor – the fee offset – as an economic benefit not usually received by passive investors and remanded to the district court to determine the factual issue of whether one of the private equity funds received economic benefits from a fee offset.

Because neither private equity fund owned 80 percent of the portfolio company, the First Circuit also remanded to the district court to rule on the claim by the multiemployer plan that the ownership of the two funds should be combined. The court did, however, reject an argument by the multiemployer plan that the funds should be liable because they had structured their ownership so as to avoid this 80 percent ownership by either fund.

Ramifications for Private Equity

This is far from over and we can expect more to follow in the wake of this decision.

Broad Implications for Possible ERISA Liability

The implications of the decision under ERISA are broader than a private equity fund's controlled group liability for pension and multiemployer plans. In addition to the possibility of the private equity fund itself being treated as a member of the controlled group of a portfolio company with an underfunded pension plan or multiemployer plan, the First Circuit's application of this interpretation of ERISA could also cause other portfolio companies controlled by the private equity fund to be members of the controlled group to the extent common ownership met the 80 percent requirement. This would mean that the portfolio companies would be liable for other portfolio companies' ERISA liabilities.

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Possible Effect on Tax-Qualified Plans and Tax Issues

If the Internal Revenue Service were to adopt a similar framework for "trades and businesses" in viewing entities that make up the "controlled group," employers may need to treat the tax-qualified plans of all portfolio companies of a private equity fund as part of one controlled group, possibly requiring coordinated testing of portfolio companies that are run completely separate from each other. Further, there could also be tax implications for the fund's investors and its general partner, depending upon the position ultimately taken by the IRS.

Conclusion and What to Watch For

Many practitioners and funds had taken the position – reinforced by the district court decision – that private equity funds were not trades or businesses and, therefore, were shielded from the pension liabilities of their portfolio companies. Private equity funds will want to review this First Circuit decision and developing case law in this area in light of their own structure, ownership and the relationship of entities owning and managing their portfolio companies.

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Ultimately, while *Sun Capital* should be of significant concern to any fund with portfolio companies that participate in multiemployer and single employer defined benefit pension plans, sponsors may be able to structure around much of this risk. Notably, for a fund to qualify as a member of a "controlled group," it must satisfy both tests: i.e., the fund must be engaged in a "trade or business" and be under "common control" with the portfolio company. The First Circuit's decision focused on the first test. As for the second test, the court remanded that question to the district court. Historically some sponsors have sought to avoid the second "common control" test by limiting ownership of portfolio companies to less than 80 percent or allocating ownership among two or more funds. In *Sun Capital*, the plan argued that the funds' respective ownership stakes (70 percent and 30 percent) should be combined as attributable to a single partnership or joint venture. That issue will be very much alive on remand.

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