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Doing Deals with Competitors: Beware of Taking Minority Equity Stakes or Board Seats

Philip Giordano Counsel

On July 14, 2016, the Department of Justice reached a settlement with parties to an asset acquisition that the DOJ said would create an unlawful interlocking directorate. The parties, Tullett Prebon Group Ltd. and ICAP plc, agreed to restructure their $1.5 billion transaction so that ICAP would no longer have a right to nominate a member of the Tullett Prebon board of directors, or hold a minority stake in Tullett Prebon. The government's intervention highlights the need to review changes in board representation arising from proposed mergers and acquisitions to insure that they comply with the antitrust laws.

A Transaction Between Competitors

Both Tullett Prebon and ICAP are prominent global inter-dealer money brokers. Both are publicly traded British companies with operations in the United States. As inter-dealer brokers, they serve financial institutions to facilitate wholesale trading in bonds and other fixed income

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instruments for which there is no centralized exchange or market maker. Their voice, electronic, and hybrid trading platforms provide price discovery, transaction execution and trade processing services, along with the liquidity and anonymity necessary for efficient trading, in markets that typically involve more than a trillion dollars of trading volume each day.

Announced in November 2015, the transaction as originally structured involved the acquisition by Tullett Prebon of ICAP's voice brokerage business and the ICAP name. ICAP's shareholders were to receive a 36.1 percent stake in Tullett Prebon; Tullett Prebon's shareholders were to retain a 44 percent stake; and ICAP itself (renamed NEX Group Ltd.) was to receive a 19.9 percent stake in Tullett Prebon and the right to nominate one member of the Tullett Prebon board of directors. At the government's behest, under the revised agreement ICAP will not have a right to nominate a member of Tullett Prebon's board of directors, nor will ICAP own any part of Tullett Prebon after the transaction. Instead, ICAP shareholders will receive a 56 percent stake in Tullett Prebon.

Although ICAP will exit the voice brokerage business via the transaction, it will continue to offer electronic trading brokerage services. Thus, given that the parties would continue to compete as inter-dealer brokers in the US and worldwide after the transaction, the DOJ "had serious concerns" that ICAP's right to nominate a Tullett Prebon board member would create an interlocking directorate in violation of Section 8 of the Clayton Act.[1]

Interlocking Directorates

Section 8 forbids a person from serving "as a director or officer in any two corporations . . . that are . . . competitors, so that the elimination of competition by agreement between them would constitute a violation of any of the antitrust laws. . . ."[2] While by its terms Section 8 prohibits a "person" from simultaneously serving on the boards of competing corporations, it has been interpreted to also prohibit two different agents of the same legal entity from serving on the boards of competing corporations.[3] As a corollary, the federal antitrust agencies deem Section 8 to forbid a corporation from possessing the right to nominate a competitor's officers or directors.[4]

While US antitrust laws generally do not impose any restrictions on the composition of a corporation's board of directors, Section 8's

[1] Press Release, Department of Justice Antitrust Division, Tullett Prebon and ICAP Restructure Transaction after Justice Department Expresses Concerns about Interlocking Directorates (July 14, 2016).

[2] 15 U.S.C. § 19(a)(1).

[3] *See United States v. Cleveland Trust Co.*, 392 F. Supp. 699 (N.D. Ohio 1974), aff'd mem., 513 F.2d 633 (6th Cir. 1975), consent decree entered, 1975 Trade Cas. ¶60,611 (N.D. Ohio) (denying summary judgment to defendant financial institution that held, though its different officers, seats on the boards of competing machine tool equipment manufacturers in which it had invested).

[4] *See, e.g.,* Complaint, *United States v. Commscope, Inc. et al.*, No. 1:07-cv-02200 (D.D.C. Dec. 6, 2007) (alleging that transaction violates Section 8 of the Clayton Act where it would result in defendant owning 30 percent of the voting securities of a significant competitor, obtaining the right to appoint directly two members of the competitor's seven-member board of directors, and obtaining the right to appoint two more board members jointly with another board member).

proscription against interlocking directorates must be heeded when two corporations are competitors. A person that sits on the boards of two competitors will likely have fiduciary duties to the two companies that conflict. Competition between the two companies may be threatened where the director is called upon to contribute to the management decisions of one company that may have adverse consequences for the other. An interlocking directorate also risks exchanges of competitively sensitive, nonpublic information between competitors, unlawful coordinated conduct, foreclosure of rivals, or a number of other activities that might, in the government's view, affect competition adversely. Notably, it is not necessary for the federal antitrust agencies to establish any actual or potential adverse effect on competition in order to prove a Section 8 violation. Rather, defendants face per se liability.[5]

Interlocking directorates between small companies, including the right to nominate board members as part of a transaction, do not implicate Section 8 because the Clayton Act provides for certain *de minimus* safe harbors. Firms that each have capital, surplus and undistributed profits aggregating less than $31,841,000 are exempt from Section 8's prohibitions.[6] Larger firms can also be exempt if their "competitive sales" in the product market at issue are small or constitute a very small share of their sales. The exemption applies if either firm's "competitive sales" are less than $3,184,100 or less than two percent of sales; it also applies if both firms' "competitive sales" are less than four percent of their revenues.[7] None of these safe harbors were applicable to the Tullett Prebon/ICAP deal.

Partial Acquisition

In addition to objecting to ICAP's right to nominate a Tullett Prebon board member, the DOJ took issue with the parties' original proposal that ICAP would take a 19.9 percent stake in Tullett Prebon. The Department was concerned that the holding would compromise the parties' mutual independence, "creating a cozy relationship among competitors."[8] This provides an important reminder that a company need not acquire control of a competitor in order to run afoul of the federal antitrust laws.[9] Section 7 of the Clayton Act

[5] *United States v. Sears, Roebuck & Co.*, 111 F. Supp. 614 (S.D.N.Y. 1953) (proof of Section 8 violation does not require a showing that the Clayton Act would prohibit a hypothetical merger between two competitors in order to establish a Section 8 violation for an interlocking directorate between the two companies).

[6] 15 U.S.C. § 19(a)(1). Originally $10,000,000, the threshold is adjusted for inflation on October 1 each year by the Federal Trade Commission. 15 U.S.C. § 19(a)(5).

[7] 15 U.S.C. § 19(a)(2). The original threshold was $1,000,000 and also is adjusted for inflation on October 1 each year by the Federal Trade Commission. 15 U.S.C. § 19(a)(5). The Clayton Act defines "competitive sales" as "the gross revenues for all products and services sold by one corporation in competition with the other, determined on the basis of annual gross revenues for such products and services in that corporation's last completed fiscal year." 15 U.S.C. § 19(a)(2)(c).

[8] Department of Justice Antitrust Division Press Release, *supra* note 1.

[9] *See Denver and Rio Grande W. R.R. Co. v. United States*, 387 U.S. 485, 501 (1967) ("A company need not acquire control of another company in order to violate the Clayton Act."); *United States v. Dairy Farmers of America, Inc.*, 426 F.3d 850 (6th Cir. 2005) (reversing

proscribes the acquisition of "any part" of a company's stock where the effect "may be substantially to lessen competition, or tend to create a monopoly."[10] Depending on the circumstances, the antitrust enforcement agencies may conclude that an acquisition of a substantial minority share of a competitor's stock may, for example, reduce competitive zeal if it undermines the value of the acquirer's investment or if it threatens the "special relationship" the acquired company might have developed with its investor.[11] The government may also question whether the investment would make it more attractive to the parties to reach tacit understandings or engage in other willing cooperation that is adverse to competition.

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Practice Advisory

The Tullett Prebon/ICAP acquisition illustrates the scrutiny that the enforcement agencies continue to apply to two specific issues that can arise in mergers and acquisitions involving competitors: ownership of a minority stake and rights to nominate board members. More generally, any transfer of rights to nominate officers or directors should alert counsel to the possibility of a Section 8 issue, such as when a buyer acquires from a seller an interest in a third entity or a portfolio company that holds such rights.

In addition to its implications for mergers and acquisitions, Section 8 also raises compliance issues. Corporate compliance officers must review nominations to the board of directors to determine whether the nominee already sits on a competitor's board. And director interlocks that fall within the Clayton Act's safe harbors must be reviewed periodically to insure that changing revenues do not make the safe harbor unavailable. Finally, the introduction of new products, entry into new geographic markets and upstream or downstream integration can create a new competitive relationship between companies where none existed before—raising Section 8 issues for individuals whose simultaneous service on both of their boards predated the newly competitive relationship.

The restructuring of the Tullett Prebon/ICAP acquisition should remind both deal counsel and compliance officers to remain alert to the potential Section 8 issues that can arise whenever board compositions change so that compliance with Section 8 can be maintained.

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summary judgment for defendants where plaintiff alleged significant anticompetitive effects arising from partial acquisition of competitor).

[10] 15 U.S.C. § 18.

[11] *United States v. Dairy Farmers of America, Inc.*, 426 F.3d, at 859-60, citing *United States v. E.I. du Pont de Nemours & Co.*, 366 U.S. 316, 321 (1961).

China's Buying Spree: Is It Real and Sustainable?

Yingxi Fu-Tomlinson Partner[1] and **Aileen Chou** Associate

Chinese companies started off 2016 with a record-breaking number of overseas acquisitions, with more than $121 billion worth of cross-border deals announced in the first half of the year, according to Thomson Reuters data. Yet, this impressive figure does not paint a complete picture. As the number of proposed mega deals surges, the number of high-profile failed and withdrawn Chinese offers has also grown—leading potential targets to question whether an acquisition or investment by a Chinese company can actually be completed, and leaving their boards to evaluate deal certainty and potential deal value based on inadequate information.

Despite an unclear political climate in China and macroeconomic uncertainties, the drivers fueling Chinese companies to target overseas assets continue to propel their acquisitive ambitions. In this article, we first describe briefly these trend drivers. We then discuss the elements that create potential uncertainty around these deals. Finally, we highlight strategies that may help to minimize the uncertainty around deal completion.

What Are Some of the Key Drivers of China's Outbound Growth?

The rapid increase in Chinese investments stems from the structural shift of the Chinese economy from an export-driven model into a consumption and service-oriented economy, which is bolstered by a series of supportive political and economic policies. In recent years, China's outbound investments have been largely led by privately owned enterprises (POEs) as opposed to the state-owned enterprises (SOEs) that bought up energy and natural resources around the world in the first wave of Chinese outbound M&A starting in the 1990s. POEs are driven by different motives than SOEs; they are looking for new markets to offset the growing deceleration of China's economy, as well as R&D and technology to bolster their position at home and fuel expansion abroad.

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Move Up the Value Chain and Innovate: The 13th Five-Year Plan, adopted on October 29, 2015, highlighted the Chinese government's focus on upgrading the low-end manufacturing economy into a high value-added economy and raising the international competitiveness of Chinese products. The Chinese government announced its Made in China 2025 (MiC2025) initiative, which aims to advance Chinese industry and foster innovation. In particular, it highlights 10 sectors, as key priorities in the next era of the country's economy, including high-end computerized machinery and robotics, clean technology, aerospace equipment, renewable-energy cars, agricultural equipment and biopharma and advanced medical products. This plan will be followed by two other plans

[1] Special thanks to Weiran Song and Yuanyuan Li for their research assistance on this article.

with the aim to build the country into a leading manufacturing power by 2049.

The POEs are looking for new markets to offset the growing deceleration of the China economy, as well as R&D and technology to bolster their position at home and fuel expansion abroad.

Drive for Growth and Portfolio Diversification: Chinese companies are looking abroad to identify new growth drivers in foreign markets and diversify revenue streams beyond their previously domestic-centric focus. In a number of recent Chinese outbound M&A deals, such as the investment by wholesale apparel manufacturer Dayang Group in its customer, Vancouver-based custom suit-maker Indochino, we are seeing a reversal of the previous global trend to separate brands from manufacturers. Chinese companies are acquiring their customers in overseas markets and vertically integrating themselves to gain access to new markets and to acquire brands that can be brought back to China to strengthen their domestic position and raise their international profile.

Simplification of Foreign-Exchange Approval Processes: China Securities Regulatory Commission, Ministry of Finance, State-owned Assets Supervision and Administration of the State Council and the China Banking Regulatory Commission jointly released a notice in August 2015 encouraging listed companies to engage in mergers, cash dividends and share repurchases. Other state agencies, including the National Development and Reform Commission and State Administration of Foreign Exchange, have also recently adopted regulations that are intended to simplify foreign-exchange management and relax regulatory preapproval requirements to conduct cross-border acquisitions and remit currency.

Devaluation of acquisition currency. The PBOC surprised the world with their devaluation of the yuan in August last year. The widespread expectation of further devaluation encourages acquisitive companies to complete their purchases before further devaluations atrophy their cash reserves.

What Are Some of the Factors That Create Uncertainty Around Acquisitions by Chinese Companies?

While the factors described above will continue to drive Chinese companies to hunt for desirable acquisition targets, the regulatory and internal factors that have hampered some of these deals in the past will continue to haunt acquirers and targets in the near future.

Complicated PRC Regulatory Approval and Remittance Process: Proposed acquisitions must be cleared by the National Development and Reform Commission (NDRC), Ministry of Commerce (MOFCOM) and State Administration of Foreign Exchange (SAFE). In addition, Chinese public companies are also subject to the rules of their stock exchange. The acquirer will need to complete a filing to NDRC and MOFCOM or their local counterparts, as determined by the target's industry sector and country and whether the aggregate purchase price meets certain dollar thresholds. The remittance of currency outside China requires SAFE registration and approval. SAFE has recently stepped up ad hoc capital controls to control capital outflows. Regulators may require preinterview and preclearance prior to remittance and impose timing and amount restrictions on the transfer of funds outside China.

CFIUS Roadblock: The Committee on Foreign Investment in the United States, better known as CFIUS, may step in to investigate a proposed foreign takeover when it identifies potential national security concerns or involve critical infrastructure, may require mitigation actions or may block the deal. While there is no mandatory filing requirement, CFIUS may request parties to file and also has the authority to unwind a transaction. A CFIUS review begins with a 30-day period to authorize a transaction or begin a statutory investigation. If the latter is chosen, the committee has another 45 days to decide whether to permit the acquisition or order a blocking or divestment order.

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The 2016 CFIUS annual report to Congress showed that Chinese companies were the leading source of CFIUS filings, with 24, in 2014. The 2016 annual report highlighted the areas on which CFIUS is continuing to focus, including targets that provide products and services to government authorities with national security functions, have access to classified or other sensitive US government or US government contract information, are part of the defense, security or law enforcement sectors, produce advanced technologies useful to national security (including semiconductors, network and data security products), are in geographic proximity to certain kinds of US government facilities, may be acquired by foreign persons controlled by a foreign government and may be acquired by foreign persons that have a history of taking or intending to take actions that could impair national security.

Internal Challenges of Chinese Acquirers: Historically, the lackluster post-acquisition performance of Chinese acquisitions has been partially due to inadequate due diligence and strategic planning by the Chinese acquirers. A survey conducted by The Boston Consulting Group showed that many acquirers lacked a clear M&A roadmap and knew little about the value of possible synergies or how to capture them.[2] In addition, financial advisors have observed that novice Chinese acquirers have limited experience quantifying risks and understanding the profitability models in overseas markets and are more familiar conducting valuations based on historical financial information as opposed to forward-looking valuation techniques, such as discounted cash flow, which are more commonly used as a basis for valuations of US companies.

External Scrutiny of Unfamiliar Acquirers: Sometimes Chinese acquirers may find themselves being confronted with suspicions about their ultimate motives. Chinese acquirers are criticized as being too "opaque" and any official or unofficial ties to the Chinese government draw suspicion that the acquirer will engage in data theft and industrial espionage. In February 2016, 46 members of Congress sent a letter to CFIUS in connection with the proposed acquisition of Chicago Stock Exchange by the private property and investment firm Chongqing

[2] The Boston Consulting Group, "Gearing Up for the New Era of China Outbound M&A," September 2015.

Casin Enterprise Group to demand rigorous scrutiny of the company's ties to the Chinese government and security concerns around granting a Chinese company access to US financial markets and proprietary information of listed companies.

What Are the Strategies That May Reduce Deal Uncertainty?

To address some of the factors creating uncertainty, we recommend focusing on the following areas when evaluating an offer and negotiating deal terms:

Understand the Acquirer's Financing Sources: As Chinese companies are not allowed to use equity to make overseas acquisitions, acquirers rely on a combination of cash on hand, onshore and offshore debt financing and partner with financial investors to come up with the cash consideration for an acquisition. It is important to understand the location of the funds the acquirer will use to fund the purchase price and clarify the timing, monetary caps, preapproval and filing requirements that are required to remit currency outside China to fund the incorporation of the acquisition vehicle, escrow deposits and purchase price.

Remittance of onshore currency to fund overseas acquisitions are subject to the approvals of SAFE or a SAFE-designated regional bank. In addition, Chinese law limits onshore bank financing to 60 percent of the purchase price of any acquisition. In contrast, there is no similar restriction on the ratio of offshore debt financing to purchase price and Chinese acquirers may issue corporate bonds and rely on offshore financial institutions outside China to fund the purchase price. If the acquirer's funds are already in an offshore entity, then there are fewer concerns that the PRC regulatory process will block or delay the remittance of funds.

Incorporate Reserve Break-up Fees and Escrows

As uncertainty of completing deals with a Chinese acquirer increase, targets have increasingly demanded a reverse break-up fee. Recent reverse break-up fees accepted by Chinese acquirers have ranged from approximately three to nine percent of the enterprise value of the transaction. Triggers for payment can include:

- Failure to obtain CFIUS and other required regulatory approvals of the target's industry
- Failure to obtain PRC regulatory or stock exchange authority to clear the transaction
- Financing failure
- Inability to get shareholder approval

In addition, to minimize enforceability risk, targets may also demand that the fee be placed in escrow in a bank in the target's jurisdiction to ensure that no additional regulatory approvals will be required to remit the escrow deposits outside China. The escrow deposit will typically cover 100 percent of the highest possible reverse break-up fee specified in the agreement.

Manage the Chinese and US Regulatory Approval Process

US companies are often unaware of the numerous and elaborate preapproval, timing and reporting requirements of PRC regulators for Chinese companies to complete acquisitions, particularly acquisitions above a certain dollar threshold or targets in certain sensitive industry sectors and countries. During the negotiations, it is important that the parties detail all of the regulatory application and procedural requirements in connection with the acquisition and agree upon an approach and transaction timetable to address the issues that may be raised by Chinese regulators.

As China's economy continues to evolve into a consumer-oriented higher value economy, the interest of Chinese companies to buy overseas assets will likely remain strong, particularly in technology, life sciences, retail and consumer discretionary sectors.

On the US side, the parties will have to consider potential filing requirements for CFIUS and Hart-Scott-Rodino Act, as well as any specific requirements related to the target's industry. Targets in industries that have received increased scrutiny from CFIUS in recent years may engage in prefiling consultations with CFIUS or member agencies and modify the transaction and determine acceptable "mitigation" measures before filing to expedite clearance. These measures can range from divestiture of assets, forfeiture of sensitive contracts, appointment of special compliance personnel, and appointment of proxy boards consisting of US persons.

As China's economy continues to evolve into a consumer-oriented higher value economy, the interest of Chinese companies to buy overseas assets will likely remain strong, particularly in technology, life sciences, retail and consumer discretionary sectors. As Chinese acquirers gain experience completing cross-border M&A and develop track records in managing targets post-acquisition, the instinctive wariness toward Chinese acquirers may fade and deal implementation will become a smoother process.

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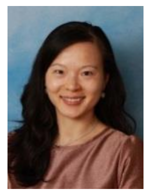

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Beware the Interplay Between Indemnification Provisions and D&O Advancement Provisions in Merger Agreements

Shareholders may have a backdoor way to force buyers to fund their litigation costs in defending against indemnification claims

Nicholas O'Keefe Partner

Hyatt v. Al Jazeera America Holdings II, LLC, C.A. No. 11465-VCG (Del. Ch. Mar. 31, 2016) involved a D&O advancement claim by Joel Hyatt and Albert Gore, Jr., both former members and directors, and Hyatt a former officer, of Current Media LLC, against its acquirer, Al Jazeera. The advancement action stemmed from a separate action brought by Hyatt and Gore against Al Jazeera seeking the release of indemnity escrow funds pursuant to the deal merger agreement (Underlying Action). In that action, Al Jazeera counterclaimed, alleging that Hyatt, as Members' Representative under the merger agreement, had wrongfully rejected various Al Jazeera claims for indemnification. Hyatt and Gore then brought a claim against Al Jazeera for advancement of their litigation costs in the Underlying Action, based on a merger agreement provision that obligated Al Jazeera to honor the D&O indemnification and advancement provisions in Current Media's operating agreement for six years. The court's decision in favor of Hyatt and Gore serves as a warning to buyers that D&O advancement provisions can be used by sellers to undermine buyers' indemnification rights under a merger agreement.

The Merger Agreement Provisions

Al Jazeera involves the interplay between two separate sections of the merger agreement. The merger agreement contained standard indemnification provisions, pursuant to which Al Jazeera was entitled to seek indemnification for specified losses, upon delivery of a claim certificate. The indemnifications section contained a fee shifting provision, pursuant to which the nonprevailing party in a court action would be obligated to pay the prevailing party's fees and expenses.

***Al Jazeera* involves the interplay between two separate sections of the merger agreement.**

The merger agreement also contained standard D&O indemnification and advancement provisions that obligated Al Jazeera to indemnify and advance fees and expenses to Current Media's former directors and officers, for a period of six years, to the same extent provided for under Current Media's Second Amended and Restated Operating Agreement (Operating Agreement).

The Parties' Arguments

Hyatt and Gore brought the Underlying Action in Hyatt's capacity as Members' Representative and Gore's capacity as a member of Current Media. They conceded that their claims in the Underlying Action did not trigger advancement rights under the merger agreement. However, in its counterclaims, Al Jazeera claimed that Al Jazeera was entitled to indemnification under the merger agreement based on breaches of representations and warranties arising from alleged breaches by Current Media of various most favored nation provisions under contracts with third parties. Hyatt and Gore argued that these counterclaims depended on Al Jazeera's contention that Hyatt and Gore, as directors and/or officers of Current Media, had caused the breach. Hyatt and Gore argued that they had a financial interest in appearing and defending their actions as directors and/or officers, and it was this situation that triggered the D&O advancement rights under the merger agreement.

Al Jazeera, on the other hand, argued that the fee shifting provisions in the indemnification section of the merger agreement evidenced an intent by the parties to solely provide indemnification, and not D&O advancement, in any dispute relating to the indemnity escrow.

The Court's Reasoning

The court noted that the dispute turned on whether, and in what circumstances, the parties intended the fee shifting provisions or the D&O advancement provisions to control the reimbursement of fees and expenses incurred to defend Al Jazeera's counterclaims.

The court rejected Al Jazeera's argument that the fee shifting provision supplanted the D&O advancement provision because, according to the court, they involved different rights that served separate purposes. The court also rejected Al Jazeera's argument that advancement was not appropriate because Hyatt was sued in his capacity as Members' Representative and not as a former officer or director. The court held that Hyatt's rights in each capacity were preserved, noting that the parties could have, but chose not to, exempt Hyatt from the right to D&O advancement under the merger agreement.

The court held that Hyatt's rights in each capacity were preserved, noting that the parties could have, but chose not to, exempt Hyatt from the right to D&O advancement under the merger agreement.

The court then considered the scope of D&O advancement. The merger agreement entitled directors and officer to advancement to the extent they would have been entitled under the Operating Agreement. The Operating Agreement provided for mandatory indemnification in pending or threatened actions, suits or proceedings "by reason of the fact" that such person was an officer or director of Current Media, and indemnification included the right to advancement of reasonable expenses of the type entitled to be indemnified. Citing *Homestore, Inc. v. Tafeen*, 888 A.2d 2014 (Del. 2005), the court equated "by reason of the fact" to there being a "nexus or causal connection" between the underlying proceedings and the defendant's "official corporate capacity". According to the court, this nexus exists if "corporate powers were used or necessary for the commission of the alleged misconduct," which does not require any allegation of breach of fiduciary duty. On the other hand, no nexus exists "when the parties are litigating a specific and personal contractual obligation that does not involve the exercise of judgment, discretion, or decision-making authority on behalf of the corporation."

In finding that the requisite nexus existed with respect to Al Jazeera's indemnification claims alleging breaches by Current Media of various most favored nation provisions under contracts with third parties, the court wrote: "although the Counterclaims appear on their face to merely implicate Hyatt's role as Members' Representative, the resolution of the validity of the [indemnification claims] in the Underlying Action, in part, necessarily requires Hyatt and Gore to defend their actions as former officers and directors, for which they are contractually entitled to advancement." On the other hand, the court found that Hyatt and Gore were not entitled to advancement with respect to a separate Al Jazeera claim that Current Media's former members agreed to indemnify Al Jazeera for fifty percent of expenses it incurred with respect to termination of a specified agreement because that claim did not require Hyatt and Gore to defend actions taken in an officer or director capacity.

The Lesson for Practitioners

This decision serves as an important warning to buyers that D&O advancement provisions can be used by shareholders to circumvent their indemnification obligations under a merger agreement. Buyers who bring a court action to enforce an indemnification claim may find themselves in the position of funding the shareholders' litigation costs, which can, at a minimum, significantly alter the incentives and negotiating leverage in the litigation. Moreover, while the Al Jazeera decision focused on advancement rights, the logic could potentially be applicable in the context of D&O indemnification rights. This could potentially permit sellers to round-trip shareholder indemnification obligations under the merger agreement by claiming that they are indemnifiable losses for offices and directors under the merger agreement's D&O indemnification and advancement provisions.

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Fortunately, the *Al Jazeera* court gave some clear guidance to buyers on how to address the risk. The court noted that the parties could have contractually exempted Hyatt from the right to D&O advancement under the merger agreement. Thus, the D&O indemnification and advancement section under the agreement could contain an exemption providing that such indemnification and advancement would not be available with respect to claims that relate to matters that are the subject of a buyer indemnification claim under the merger agreement. To be effective, the exemptive language should be included in both the merger agreement and any charter or other documents of the surviving corporation that contain D&O advancement and indemnification rights.

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Delaware Court Endorses Share Tracing in Order to Deny Appraisal Claims in Dell Merger

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After a string of Delaware decisions that have been widely interpreted as rejecting a share-tracing requirement in appraisal proceedings involving public companies, the Delaware Court of Chancery recently denied petitioners' appraisal claims on the grounds that evidence showed the petitioners' shares were voted in favor of the merger. The court's May 11 decision in *In re: Appraisal of Dell Inc.*, C.A. No. 9322-VCL is one of a number of recent developments that may help curtail the growth of the appraisal arbitrage industry.

Absence of Share Tracing Under DGCL Section 262 and Transkaryotic

Delaware's appraisal statute, Section 262 of the Delaware General Corporation Law (DGCL), obligates a stockholder seeking appraisal to show that (1) the record holder of the shares for which appraisal is sought (Record Holder Requirement) held the shares on the date it made the demand for appraisal, (2) continuously held the shares through the effective date of the merger, (3) has otherwise complied with DGCL Section 262(d) concerning the form and timeliness of the appraisal demand, and (4) has not voted in favor of the merger with respect to those shares. A problem arises regarding shares held in street name, where the record holder is Cede & Co. (Cede), the nominee for the Depository Trust Company (DTC). In a line of cases starting with *In re Appraisal of Transkaryotic Therapies, Inc.*, 2007 WL 1378345 (Del. Ch. May 2, 2007),[1] the Delaware courts have refused to require holders in street name to trace their shares and show how Cede actually voted those shares. Instead, the *Transkaryotic* court merely required a showing that the number of shares held by Cede that were voted against the merger, abstained or not voted, equaled or exceeded the number of shares that were the subject of Cede's appraisal petition. The *Transkaryotic* court viewed a share tracing requirement as involving an inquiry into actions of the beneficial holders, which were irrelevant under the appraisal statute, the focus of which was on record holders. Subsequent decisions affirmed this view. The judicial eschewal of any tracing requirement, which enables appraisal petitions to be made with respect to shares that are acquired after the record date for the merger, has been a boon to the appraisal arbitrage industry.

Evidence of How Cede & Co. Voted in In re: Appraisal of Dell

In re: Appraisal of Dell involved an appraisal claim by 14 mutual funds sponsored by T. Rowe Price with respect to Dell's going private transaction in 2013. The T. Rowe petitioners held their shares in street name through State Street Bank & Trust Company, as DTC participant, and voted them through a complicated arrangement involving State Street, State Street's outsourced voting service

[1] See an article discussing those decisions.

provider, Broadridge Financial Solutions, and T. Rowe's outsourced voting service provider, Institutional Shareholder Services (ISS). Although T. Rowe intended to vote against the merger, its shares were inadvertently voted in favor of the merger due to a failure to override default voting instructions that were built into its voting policies.

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Several pieces of evidence showed how Cede voted T. Rowe's shares. The votes were traceable as a result of a unique internal control number that Broadridge ascribes for each position held by a Broadridge client. The votes for eight of the T. Rowe petitioners were also evidenced by their Forms N-PX, which, as mutual funds, were required to be filed with the SEC. Email traffic between T. Rowe and ISS, and T. Rowe and State Street, in connection with T. Rowe's internal investigation when it became aware of the possible error after the merger, provided further evidence that T. Rowe's shares were voted in favor of the merger.

Reconciliation of Transkaryotic and In re Appraisal of Dell

In *In re: Appraisal of Dell*, Vice Chancellor Laster noted that the inquiry in *Transkaryotic* and the decisions on which the *Transkaryotic* court relied addressed whether a defendant corporation had the right to require that the record holder petitioner in those cases prove that it was duly authorized by the beneficial owner of the stock to seek appraisal. That requirement was rejected on the basis that the Record Holder Requirement of the appraisal statute dictates that it is the record holder's actions that determine perfection of the appraisal right, not those of the beneficial owner. That holding, according to Vice Chancellor Laster, was not controversial. After the *Transkaryotic* court concluded that only actions of Cede, as record holder, were relevant, it then restricted its analysis to the documents used at the stockholder meeting that showed how Cede voted. According to Vice Chancellor Laster, neither the parties nor the court in *Transkaryotic* appeared to have considered other evidence of how Cede actually voted. Vice Chancellor Laster noted a policy concern in *Transkaryotic* and its progeny (dubbed by Vice Chancellor Laster as the "Appraisal Arbitrage Decisions") that requiring an appraisal petitioner to satisfy a share tracing burden risked cutting off appraisal rights for stockholders holding in street name.

Laster's new test preserves the test set forth in the Appraisal Arbitrage Decisions, but turns it into an element that the appraisal petitioner has to show to establish its *prima facie* case. His new test introduces a means by which defendant corporations can rebut the appraisal petitioner's *prima facie* case

Vice Chancellor Laster noted that the Appraisal Arbitrage Decisions contained language that could be interpreted as precluding any sort of share tracing for shares held in street name. However, he stated that those decisions could be differentiated on the basis that, unlike in *In re: Appraisal of Dell*, there was no proof as to how Cede actually voted the appraisal shares. He stated that where there is such proof, it does not necessarily follow that the parties cannot introduce it and the court cannot consider it. In setting forth a new test, Vice Chancellor Laster stated that under the Appraisal Arbitrage Decisions, appraisal petitioners holding in street name could establish a *prima facie* case:

> "by showing that there were sufficient shares at Cede that were not voted in favor of the merger to cover the appraisal class. This showing satisfies the petitioner's initial burden and enables the case to proceed. If there is no other evidence, then as in the Appraisal Arbitrage Decisions, the *prima facie* showing is dispositive. . . . The analysis, however, need not stop there. Once the appraisal petitioner has made out a *prima facie* case, the burden shifts to the corporation to show that Cede actually voted the shares for which the petitioner seeks appraisal in favor of the merger. The corporation can do this by pointing to documents that are publicly available, such as a Form N-PX. Or the corporation can introduce evidence from Broadridge, ISS, and other providers of voting services, such as internal control numbers and voting authentication records."

Laster's new test therefore preserves the test set forth in the Appraisal Arbitrage Decisions, but turns it into an element that the appraisal petitioner has to show to establish its *prima facie* case. His new test introduces a means by which defendant corporations can rebut the appraisal petitioner's *prima facie* case.

Implications for Practitioners

In re: Appraisal of Dell is a welcome, but in some sense unremarkable, retrenchment from the Appraisal Arbitrage Decisions. It would be an odd outcome, had the court decided that T. Rowe was entitled to appraisal notwithstanding the undisputed fact that T. Rowe had voted in favor of the Dell merger. The facts arose from a mistake in processing T. Rowe's votes as a result of T. Rowe's complicated voting procedures. How often will corporations defending appraisal actions in future public mergers be presented with such favorable facts? Appraisal arbitrage funds are likely to own far fewer shares than mutual funds, have much simpler voting procedures, and be more diligent in ensuring that shares are not erroneously voted in favor of a merger.

It would be an odd outcome, had the court decided that T. Rowe was entitled to appraisal notwithstanding the undisputed fact that T. Rowe had voted in favor of the Dell merger.

If the decision does not have a big immediate impact, it could nonetheless prove very significant in the future. Given technology developments, it is likely that ownership and voting architectures will be adopted in the future that make it much easier for appraisal defendants to trace voting of shares held in street name. For example, Governor Jack Markell recently announced a state initiative to explore the use of blockchain technology, such as for "distributed ledger shares." Blockchain technology could serve as a very precise mechanism for tracking ownership and voting of shares. If that proves to be the case, in light of *In re: Appraisal of Dell*, blockchain technology evidence could become the norm for appraisal cases relating to public company mergers.

The decision is also not the only recent set-back for appraisal arbitrage funds. As described later in this newsletter, DGCL Section 262 was recently amended to prohibit *de minimis* appraisal claims and, more importantly, to permit corporations to limit the accrual of interest on appraisal claims by making early payments to appraisal petitioners. It will be interesting to see whether these amendments, and the *In re: Appraisal of Dell* decision, end up representing a turning point for an industry that has been on the rise for more than a decade.

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2016 Amendments to Delaware General Corporate Law Include Revisions to Appraisal Statute and Section 251(h)

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Several amendments recently adopted to the Delaware General Corporate Law (DGCL) may interest M&A practitioners, including the amendments to DGCL §251(h), which address various issues left open from its adoption in 2013, and amendments to DGCL §262 to eliminate certain *de minimis* appraisal claims and to give corporations a mechanism to curtail the accrual of interest on appraisal claims.

Section 251(h)— Intermediate-Form Mergers

The adoption of DGCL §251(h) in 2013 (so-called "intermediate-form mergers") provided acquirers of public companies with a means to complete a short-form back-end merger. The ability to complete such a merger would be available after completing a tender offer that results in ownership of at least that percentage of target's shares (and each class and series thereof) that would be required to complete a long-form merger (Statutory Minimum Condition). For most public targets, Section 251(h) therefore provides a means to complete a back-end short-form merger with only a majority of the outstanding voting shares, instead of the 90 percent required under DGCL §253. The new amendments address some of the ambiguities under Section 251(h).

Multiple Classes or Series of Stock

The amendments address application of Section 251(h) to targets that have more than one class or series of stock. The amendments clarify that Section 251(h) is available for targets that have a class or series of stock that is listed on a national securities exchange or held of record by more than 2,000 holders, even if they have other classes or series of stock that are not so listed or held. The amendments also provide that the offer can contain a minimum condition that relates to all of the outstanding shares of stock of the target, or to just one or more classes or series of stock. An offeror can also consummate separate offers for separate classes or series of stock.

Calculation of Statutory Minimum Tender Condition

The amendment provides that for purposes of determining whether the Statutory Minimum Condition has been satisfied, target shares held by any person that owns, directly or indirectly, all of the outstanding stock of the offeror, or that is a direct or indirect wholly owned subsidiary of any such person or of the offeror are included in the calculation (collectively, the "Offeror Affiliates"). Rollover stock (described below) is also included in the calculation.

Rollover Stock

Rollover stock is shares of stock that are subject to a written agreement to be transferred, contributed or delivered to the offeror or any Offeror Affiliate in exchange for equity of such entity. It typically arises in the context of private equity deals, where management exchange their target shares for equity interests in the post-closing entity, instead of being cashed out with the public stockholders in the tender offer or back-end merger. The amendments clarify that rollover stock is included in the calculation of whether the Statutory Minimum Condition has been satisfied. The amendments provide that rollover stock and treasury shares are excluded from the requirement that they be converted in the merger into the right to receive the same consideration as paid in the tender offer.

Receipt of Stock

Section 251(h) requires tendered shares to have been received by the depository prior to expiration of the offer in order to factor into the calculation of whether the Statutory Minimum Condition has been satisfied. The amendments clarify when shares will be treated as having been "received." Certificated shares require physical receipt of a stock certificate accompanied by an executed letter of transmittal. Uncertificated shares held through a clearing corporation such as DTC, require transfer into the depository's account through an agent's message. For uncertificated shares held other than through a clearing corporation, physical receipt of an executed letter of transmittal is required. Shares cease to be "received" if the stock certificate is canceled prior to consummation of the offer or if uncertificated shares have been reduced or eliminated due to a sale prior to consummation of the offer.

Effective Date

The amendments to Section 251(h) are effective with respect to merger agreements entered into on or after August 1, 2016.

Section 262—Appraisal Rights

Section 262 has been amended in two fairly significant respects. The amendments prohibit *de minimis* claims in order to limit the ability of stockholders to bring nuisance suits against public companies. The amendments also provide corporations with a mechanism to curtail the accrual of interest on appraisal claims, thereby removing a perceived unfairness to corporations and potential windfall to appraisal arbitrage funds.

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Elimination of De Minimis Claims

Amendments to Section 262(g) limit appraisal actions with respect to shares of public companies unless:

1. the total number of shares entitled to appraisal exceeds one percent of the outstanding shares of the class or series eligible for appraisal;
2. the value of the consideration provided in the merger or consolidation for such total number of shares exceeds $1 million; or
3. the merger was effected as a short-form merger pursuant to Sections 253 or 267.

These amendments are intended to mitigate the risk that a stockholder will use the appraisal process solely to gain leverage in a settlement negotiation. Even if the number of shares or the value of such shares were minimal, a corporation may have been inclined to settle a claim to avoid the litigation costs associated with an appraisal proceeding.

Appraisal rights are not lost in short form mergers, however, because there is no obligation for the target's board of directors to approve and recommend the merger; thus appraisal rights may be the stockholders' only remedy for an unfair transaction.

Termination of Accrual of Interest

Amendments to Section 262(h) provide that a corporation may pay a sum of money to dissenting stockholders in an appraisal proceeding prior to the entry of judgment in such proceeding, in order to avoid interest accruing on that sum. These amendments reflect an attempt to eliminate the incentive to initiate such proceedings by certain stockholders in order to benefit from the statutorily guaranteed interest rate of five percent above the Federal Reserve discount rate. This benefit is one of the factors attributed to the development of the appraisal arbitrage industry.

Previously, the initiating stockholder was awarded interest on the entire fair value amount of the shares at stake in the proceeding from the date of the merger through the date of payment of the appraisal award. This was the case even if the fair value was ultimately determined to be the same as the consideration paid in the merger. Now, a corporation may terminate the accrual of interest by opting to make a cash payment to such stockholders. After such payment, interest will accrue only on the sum of (1) the difference, if any, between the amount paid and the fair value of the shares as determined by the Court and (2) unpaid interest already accrued at the time of such payment.

Effective Date

The amendments to Section 262 are effective with respect to transactions consummated pursuant to agreements entered into on or after August 1, 2016 (or, in the case of mergers pursuant to Section 253, resolutions of the board of directors adopted on or after August 1, 2016 or, in the case of mergers pursuant to Section 267, authorizations provided on or after August 1, 2016), and appraisal proceedings arising out of such transactions.

Other Amendments

The amendments to the DGCL also include changes to numerous other sections, including to the jurisdiction of the Court of Chancery (DGCL §111), the introduction of default quorum and voting requirements for committees and subcommittees (DGCL §141), the requirements as to signatories on stock certificates (DGCL §158), and sections governing the restoration and revival of certificates of incorporation (DGCL §§311 & 312).

Effective Date

These amendments became effective on August 1, 2016.

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