SIGNIFICANT 2018 DECISIONS AFFECTING PRIVATE COMPANY M&A

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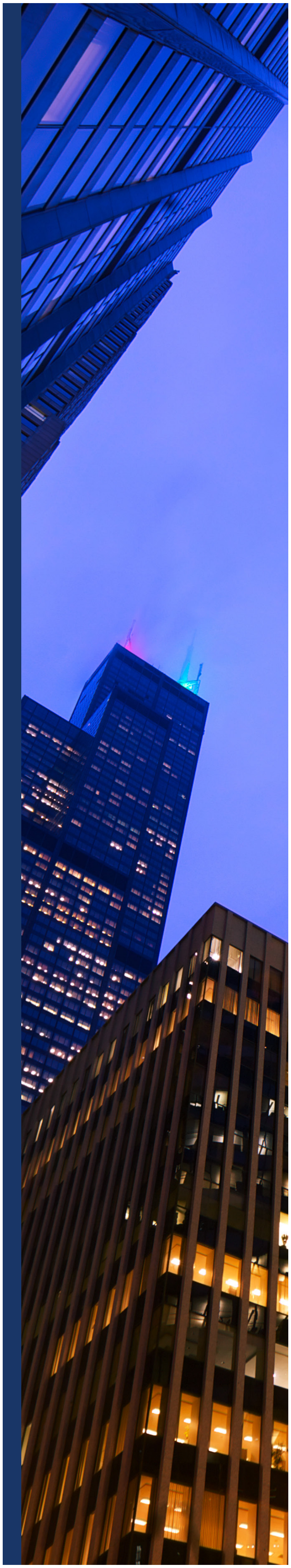

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The following compilation is our fifth annual review of significant state court decisions relevant for private company M&A transactions and related governance matters and disputes. The summary includes the landmark *Akorn v. Fresenius decision*, which is the first Delaware M&A decision to uphold a buyer's termination right on the basis of an MAE. A few of the decisions concern drafting points, a few concern overall deal process and planning points, and two of the decisions concerned fiduciary duty breaches in contested situations (one was a public company decision that has relevance to the private M&A context).

Akorn, Inc. v. Fresenius Kabi AG, 2018 WL 4719347 (Del. Ch. Oct. 01, 2018), aff'd, 198 A.3d 724 (Del. 2018)

Delaware Court of Chancery provides important interpretive guidance on the meaning of material adverse effect (MAE) clauses and is the first Delaware decision to hold that an acquirer was justified in terminating a merger agreement as a result of the occurrence of an MAE.

Facts

Akorn v. Fresenius is a major decision regarding MAEs in the M&A context, and builds on prior guidance of Delaware courts issued in *IBP* and *Hexion*.[1] *Akorn* involved the proposed acquisition of Akorn, Inc. (Akorn), a generics pharmaceutical company, by Fresenius Kabi AG (Fresenius), for $34 a share pursuant to a reverse triangular merger. The deal was signed on April 24, 2017, and had a drop dead date of April 24, 2018 (the Outside Date). At the time of announcing the deal, Akorn reaffirmed its full year guidance for 2017. Akorn's financial results for the second quarter of 2017 declined precipitously, which Akorn attributed to unexpected competition and loss of a key customer. Akorn's financial results continued to deteriorate in the third quarter of 2017. In October and November 2017, Fresenius received two anonymous whistleblower letters containing allegations about Akorn's product development process and quality compliance programs failing to comply with FDA regulations. Invoking its information access rights under the merger agreement, Fresenius conducted an investigation that uncovered "serious and pervasive data integrity problems," which called into question whether Akorn's representations and warranties under the merger agreement were sufficiently inaccurate as to reasonably be expected to result in a MAE. In a meeting with the FDA in March 2018, Akorn understated its regulatory issues and overstated its remedial efforts. Akorn's financial performance continued to deteriorate throughout this time.

On April 22, 2018, Fresenius delivered notice that it was terminating the merger agreement on two grounds: (i) an uncurable breach of Akorn's regulatory representations and warranties, which gave rise to an MAE, and (ii) an uncurable breach of Akorn's pre-closing covenants. Fresenius also alleged that the stand-alone MAE closing condition was not satisfied. Akorn filed suit, seeking a decree of specific performance to compel Fresenius to close. Fresenius filed a

[1] *See In re IBP, Inc. S'h'holders Litig.*, 789 A.2d 14 (Del. Ch. 2001); *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008).

counterclaim, seeking a declaration that it validly terminated the merger agreement. In a post-trial decision, the Court of Chancery ruled in favor of Fresenius, holding that it validly terminated the merger on both of the two grounds that it invoked, and that Fresenius properly relied on the fact that Akorn had suffered an MAE in refusing to close (although this did not give rise to a termination right under the merger agreement). The Delaware Supreme Court affirmed the Court of Chancery's decision.

Key Merger Agreement Provisions

Section 6.02 of the merger agreement set forth Fresenius' conditions to closing. Section 6.02(a)(ii) set forth the Akorn representation and warranty bring-down, and provided that Akorn's general representations and warranties must be true and correct (disregarding materiality and MAE qualifiers) as of the merger agreement date and as of the closing date except where the failure to be true and correct would not, individually or in the aggregate, reasonably be expected to have an MAE (the Bring-Down Condition). Section 6.02(b) provided that Akorn shall have complied with or performed in all material respects its obligations required to be complied with or performed by it prior to the effective time of the merger (the Covenant Compliance Condition). Section 6.02(c) provided that there shall not have occurred or be continuing an MAE (the General MAE Condition). The failure of the Bring-Down Condition and the Covenant Compliance Condition gave Fresenius a termination right if the failure was incapable of being cured by the Outside Date, so long as Fresenius was not then in material breach of its representations, warranties, covenants or agreements under the merger agreement.

Failure of the General MAE Condition

Fresenius argued that it was not obligated to close because Akorn had suffered an MAE. In considering whether this General MAE Condition was satisfied, the Court of Chancery considered the structure and rationale of a typical MAE provision. The Court of Chancery noted that the typical MAE clause, through the basic provision and numerous exceptions, allocates industry (or systemic) risk to the buyer and company-specific risks on the seller. Relying on *Hexion*, the Court of Chancery noted that for a buyer to satisfy the heavy burden it faces when demonstrating the existence of an MAE, the important consideration is whether the adverse change in the target's business "is consequential to the company's long-term earnings power over a commercially reasonable period, which one would expect to be measured in years rather than months." A decline in company performance should be evaluated against the company's results during the same quarter of the prior year. The Court of Chancery noted that in *Hexion*, a 3% decline in 2007 EBITDA from the prior year, and projected 7% (or 11% using conservative projections) decline in EBITDA for the next year, did not give rise to an MAE. The Court of Chancery noted that one treatise found that most courts required a decrease in profit of at least 40% in order to find an MAE. In dictum in a prior decision, Chancellor Allen noted that an earnings decline of more than 50% over two quarters would probably constitute an MAE.[2] In *IBP*, a 64% drop in quarterly earnings was found not to give rise to an MAE. However, in that case, then Vice Chancellor Strine noted it was a close call, and buyer's arguments were undermined by buyer's failure to provide expert evidence.

Financial Performance Downturn Constituted an MAE

In contrast to *IBP*, the Court of Chancery found that Fresenius had submitted credible and persuasive expert testimony that Akorn's financial performance had declined materially since the signing of the Merger Agreeent and that the underlying causes of the decline were durationally significant. The court noted that year-over-year declines in quarterly revenue for each quarter from the second quarter 2017 until the first quarter 2018, and in annual revenue for fiscal year 2017, ranged from 25% to 34%. Declines in operating income for the same periods ranged from 84% to 292%, and declines in earnings per share for the same periods ranged from 96% to 300%. Full year EBITDA declined 86%, and full-year

[2] *Raskin v. Birmingham Steel Corp.,* 1990 WL 193326, at *5 (Del. Ch. 1990).

adjusted EBITDA declined 51%. The Court of Chancery noted that Akorn's dramatic fall in performance during 2017 was a reversal of the yearly growth it experienced during the five year period ended in 2016. The Court of Chancery found that the downturn in performance was durationally significant because it had persisted for a full year and showed no sign of ceasing. Management had attributed the performance decline to factors such as new market entrants and loss of a key contract, which the Court of Chancery found created a situation that was likely to persist. The Court of Chancery noted that analysts had slashed estimates of 2018, 2019 and 2020 EBITDA by more than 62.6%, 63.9% and 66.9%, respectively, between the date of signing the merger agreement and the closing date, and had only decreased forward EBITDA estimates for peer companies by 11%, 15.3% and 15%, respectively. The Court of Chancery held that this was strong evidence of an MAE. The Court of Chancery rejected Akorn's argument that the decline in performance should be measured not against its performance as a standalone entity, but should also factor in the synergies to Fresenius. In looking at the MAE definition, which referenced a material adverse effect with respect to Akorn and its subsidiaries and carved out the effect of the consummation of the merger, the Court of Chancery held that the analysis should be based on the performance of Akorn as a stand-alone company.

MAE Exceptions Did Not Apply

Having found that Akorn had suffered a general MAE, the Court of Chancery considered whether any of the exceptions to the MAE applied. Akorn argued that its performance deterioration was due to known "industry headwinds," such as a consolidation of buyer power leading to drug price reductions, the FDA's efforts to approve generic drugs, and legislative attempts to reduce drug prices. The Court of Chancery noted that while industry risks were allocated to Fresenius under the MAE definition, the risk allocation reverted to Akorn if the industry headwinds had a disproportionate effect on Akorn relative to other industry participants. Rejecting Akorn's argument that an exception applied, the Court of Chancery noted that the primary drivers of Akorn's bad performance were new market entrants and loss of a key contract, which were specific to Akorn. But even if you viewed them as industry effects, they disproportionately impacted Akorn relative to other industry participants.

Fresenius did Not Assume the Risk Through Industry Knowledge

Relying on language in *IBP* that MAEs protect against unknown risks, Akorn argued that Fresenius could not claim an MAE based on risks that it learned of in due diligence or was on notice of because of industry knowledge. Rejecting Akorn's argument, the Court of Chancery noted that the argument would introduce a tort-like concept of assumption of the risk, and run counter to Delaware courts' promotion of freedom of contract.

The Court of Chancery distinguished IBP on several grounds. First, the Court of Chancery noted that the MAE in *IBP* did not contain lengthy exclusions, and neither *IBP* nor *Hexion* should be viewed as setting forth rules that apply to all MAEs, including that in *Akorn*. Second, while the analyses in *IBP* and *Hexion* were framed in terms of known versus unknown risks, both cases involved buyers being unable to rely on consequences of widely known systemic risks. *IBP* involved cyclical effects in the meat industry, and *Hexion* involved macroeconomic challenges, such as increases in crude oil and natural gas prices and changes in foreign exchange rates. Thus, both decisions should properly be viewed as consistent with the view that buyers cannot invoke MAEs for known systemic risks, which is different from the situation in *Akorn*. Third, even if *IBP* and *Hexion* could be read as applying a blanket rule that turns on known versus unknown risks, the analysis would not apply in Akorn, because the events that gave rise to the bad performance were unanticipated.

Failure of the Bring-Down Condition

One of Fresenius' bases for terminating the merger agreement was that the Bring-Down Condition was not satisfied because of the inaccuracy of Akorn's representations in Section 3.18 of the merger agreement relating to regulatory compliance. For the Bring-Down Condition not to be satisfied, Fresenius would have to show that the difference between the actual condition of Akorn and the condition as represented was great enough that it would reasonably be expected to result in an MAE. The Court of Chancery held that the "reasonably be expected" standard was an objective one that required a qualitative and quantitative analysis.

Qualitative Analysis

The Court of Chancery held that the "overwhelming evidence of widespread regulatory violations and pervasive compliance problems at Akorn" strongly supported a finding of an MAE. The Court of Chancery noted that Akorn had "pervasive data integrity and compliance problems" that prevented it from meeting FDA data integrity requirements. The Court of Chancery invoked numerous examples of Akorn's failures. For example, one of Akorn's own consultants testified that data integrity failures were so bad he would not expect to see them "at a company that made Styrofoam cups," and that its integrity issues were among the three worst of the more than120 pharmaceutical companies he had assessed. The Court of Chancery noted that evidence showed that Akorn was aware of the issues but ignored them. After the merger agreement was signed, the head of Akorn's quality function exacerbated the problem by submitting false data to the FDA. Akorn also submitted misleading information to the FDA regarding its efforts to investigate problems. Counsel retained by Fresenius to investigate the problems also identified "serious fundamental flaws" in Akorn's management of data. An expert witness retained by Fresenius also tested that he had "rarely seen integrity issues that exist at the scope and scale we see" at Akorn.

Quantitative Analysis

The Court of Chancery held that the quantitative aspects of the MAE analysis also supported the finding that Akorn's regulatory issues would reasonably be expected to result in an MAE. Akorn estimated expenses of $44 million to remediate its data integrity problems, with no other impact on valuation. Fresenius estimated remediation expenses of $254 million, plus a valuation hit of up to $1.9 billion due to suspension of products being marketed and delays in new products. The Court of Chancery found that the valuation impact would be somewhere between the two, at approximately $900 million. The court of Chancery compared this to the standalone valuation of Akorn when the merger agreement was signed of approximately $3.9 billion, and arrived at a valuation decrease of approximately 21%.

Looking at various anecdotal sources, the Court of Chancery held that a 21% valuation decrease satisfied the test of being "material when viewed from the longer-term perspective of a reasonable acquiror." The court first noted that during diligence and negotiation of the transaction, Fresenius was willing to close despite identifying a high risk of potential exposures of approximately $200 million in value, and that the valuation impact of Akorn's regulatory failures was four to five times greater. The Court also noted that a bear market is deemed to occur when stock prices fall at least 20%, and that one unpublished study found that the average negotiated price reduction following the occurrence of an MAE is 15%. The Court of Chancery considered academic studies and market practice and observed that upper and lower bounds for collars generally fall within 10% to 20% of deal consideration at signing, which indicated that parties viewed a 10% value change as material. The Court of Chancery noted a 2011 law firm study that found that median reverse termination fees equaled 6.36% of transaction value.

Fresenius' Knowledge of Regulatory Risks Did Not Foreclose an MAE Finding

The Court of Chancery rejected Akorn's argument that Fresenius could not claim the existence of a regulatory MAE because it knew about the risk of potential issues when it signed the merger agreement. The Court of Chancery noted that Delaware cases have held that "a breach of contract claim is not dependent on a showing of justifiable reliance."[3] Allowing

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[3] Citing *Cobalt Operating, LLC v. James Crystal Enterprises, LLC*, 2007 WL 2142926 (Del. Ch. July 20, 2007), *aff'd*, 945 A.2d 594 (Del. 2008).

parties to allocate risk under the acquisition agreement serves the important purpose of not forcing acquirors to undergo extensive and costly due diligence.

Akorn argued, relying again on *IBP*, that the MAE provision changes the analysis because it should be understood as backstop protection from unknown events. Rejecting Akorn's argument, the Court of Chancery reasoned that adding an MAE qualifier does not change the nature of the representation, but merely addresses the permissible degree of deviation from the representation before the representation is deemed inaccurate. Whether the buyer had concerns about regulatory compliance matters was irrelevant—the mere existence of the representation demonstrates some level of concern by the buyer. But what is important is how the parties allocated the risk of inaccuracy of the representation under the acquisition agreement. Akorn's approach would turn an MAE-qualified representation into an expansive knowledge-based qualification of the representations based on everything the buyer knew or should have known. In dictum, the Court of Chancery noted that its reasoning did not necessarily mean that a buyer who knew about a specific risk should be permitted to close and then sue for damages, because that has different public policy implications.

The Court of Chancery noted that even if you accepted Akorn's argument, while Fresenius did identify regulatory risks in diligence, it did not know about Akorn's data integrity issues, and could not have known about the actions that Akorn took after signing the merger agreement that increased the risk further.

The Court of Chancery then considered whether the regulatory compliance representations were capable of being cured prior to the Outside Date. The Court of Chancery held that no such cure was possible, noting that Akorn's own witnesses believed that the regulatory failures would take three years to cure.

Failure of the Covenant Compliance Condition

A second basis for Fresenius' termination of the merger agreement was that Akorn breached its covenant to use commercially reasonable efforts to carry on its business in all material respects in the ordinary course of business, and that such breach could not be cured prior to the Outside Date. The Court of Chancery first considered Akorn's argument that the "all material respects" language adopted the common law standard for material breach of contract. Rejecting the argument, the Court of Chancery held instead that it required a less onerous standard, akin to that used to assess materiality for purposes of disclosure, which it described as a "substantial likelihood that the fact of breach would have been viewed by the reasonable investor as having altered the total mix of information."

The Court of Chancery next considered the "commercially reasonable efforts" language. The Court of Chancery noted that while practitioners generally consider it as the fourth in a hierarchy of five efforts standards, ranging from "good faith efforts" to "best efforts," case law has interpreted "commercially reasonable," "reasonable best," and "best" similarly. The Court of Chancery held that it required Akorn to "take all reasonable steps" to maintain operations in the ordinary course of business.

The Court of Chancery framed the test whether Akorn had taken all reasonable steps to maintain operations in the ordinary course of business as an objective one, as opposed to considering what historically constituted the ordinary course of business for Akorn. The Court of Chancery held that Akorn failed to comply with this standard in several respects, including through conducting regular audits and taking steps to remediate deficiencies, failing to maintain adequate data integrity systems, submitting fabricated regulatory filings to the FDA, and failing to conduct responsible and credible investigations when provided with the two whistleblower letters. The Court of Chancery held that Akorn's breach of the ordinary course covenant was material, because the record indicated that Fresenius would not have agreed to buy Akorn if it had known that Akorn would fail to comply with the ordinary course covenant in the way that it did. The Court of Chancery held that the Covenant Compliance Condition could not have been cured by the Outside Date, and thus Fresenius was justified in invoking it as a basis for termination.

No Fresenius Material Breach

The Court of Chancery considered whether Fresenius was in material breach of the merger agreement, which would have barred it from exercising its termination right on both of the two grounds. The court first considered whether Fresenius breached its covenant to use reasonable best efforts to close. The court noted that this did not impose an obligation to merge at all costs, but should be considered in light of Akorn's representations, and Fresenius' conditions and termination rights under the merger agreement. The court held that the analysis required a consideration of whether Fresenius "(i) had reasonable grounds to take the action it did and (ii) sought to address problems with its counterparty." In finding that Fresenius did not breach its reasonable best efforts covenant, the Court of Chancery found that Fresenius was justified in undertaking the investigation of Akorn that it did after learning of regulatory issues and receiving the whistleblower letters. The court held that Fresenius acted reasonably before it decided to terminate the merger agreement, and even offered to extend the Outside Date, which Akorn refused. The court rejected Akorn's efforts to depict Fresenius as having "buyer's remorse," similar to the buyers in *IBP* and *Hexion*, noting "the difference between this case and its forebearers is that the remorse was justified."

The Court of Chancery held that Fresenius breached its covenant regarding efforts required to obtain antitrust approval, but that the breach only lasted for about a week and was not material. Accordingly, Fresenius was able to validly terminate the merger agreement.

Takeaways

Akorn is a major decision that provides guidance on a number of topics, including the following:

MAE Definition: The decision provides guidance on the nature and magnitude of a deterioration in financial performance that is required in order to constitute an MAE. The typical MAE allocates industry/systemic risks to the buyer, so risks that are general industry risks, and that don't disproportionately impact the seller relative to other industry participants, will not trigger an MAE. The deterioration has to be durationally significant, typically over years and not months, and is measured relative to corresponding periods in prior years. In *Akorn*, the deterioration was significant by any measure, and the hurdle is therefore likely to remain very high after this decision.

Buyer's Knowledge: Many practitioners read *IBP* as indicating that MAEs would be evaluated in light of the knowledge that a buyer possessed when entering into the agreement. *Akorn* suggests that is incorrect, and that the buyer in IBP assumed the risks at issue there not because the buyer knew of them, but because they were industry/systemic risks that buyers typically assume under MAE definitions. The *Akorn* decision adopts much more of a pro-contractarian approach, where the court deferred to the parties' risk allocation under the merger agreement, as opposed to reliance on notions of what a buyer knew or should have known at the time of contracting.

Sandbagging: Practitioners typically view Delaware as a pro-sandbagging jurisdiction, which means that buyers are not foreclosed from bringing claims from breach of representations and warranties even if they knew they were inaccurate at signing. The *Akorn* court noted in dictum that while it was pro-contractarian in that it would not inquire into what a buyer knew or should have known for purposes of the closing conditions, different policy considerations apply with respect to claims for breach of representations and warranties. Thus, the court called into question whether Delaware really is a pro-sandbagging jurisdiction. It is worth noting that in an unrelated 2018 decision, Justice Valihura noted that whether Delaware courts permit sandbagging is an unresolved issue, and Chief Justice Strine cast doubt on whether Delaware courts would permit it.[4]

[4] See *Eagle Force Holdings, LLC v. Stanley*, C.A. No. 10803-VCMR (Del. 2018).

MAE Bring-Down: The *Akorn* decision provided guidance on how to evaluate whether inaccuracies of representations would reasonably be expected to result in an MAE. Given its prospective nature, this is different from the analysis of a general MAE, which is more of a financial analysis. The MAE Bring-Down analysis involves a qualitative and quantitative review of the inaccuracy. The qualitative analysis in *Akorn* involved particularly egregious facts which are unlikely to be present in many situations. The quantitative analysis suggests that a valuation decrease of 20% is likely to be sufficient to support an argument that the representation inaccuracy gave rise to an MAE. A decrease of between 10% and 20% is likely to fall in a grey area.

Interim Operating Covenant: The decision provides interpretive guidance on covenants to use commercially reasonable efforts to operate the business in the ordinary course between signing and closing. As in several other decisions, the *Akorn* court minimized the significance of the difference among the various efforts standards, such as "commercially reasonable efforts," "best efforts," and "reasonable best efforts." The applicable test was whether Akorn had taken "all reasonable steps" to maintain operations in the ordinary courts of business. Practitioners should note that this was an objective standard, which involved a comparison of what Akorn did against what a typical company in its industry would do. Thus, implicitly, Akorn would have been unable to rely on its conduct prior to the merger agreement signing date as setting a benchmark.

Reasonable Best Efforts Covenant: For deal parties concerned about a potential condition failure that may give rise to that party having a termination right, the decision provides useful guidance on how the party should conduct itself in order to avoid a breach of its obligation to use the requisite degree of efforts to close. The *Akorn* court held that the applicable test was whether the applicable party "(i) had reasonable grounds to take the action it did and (ii) sought to address problems with its counterparty." Parties are not obligated to close at all costs, but should continue to push forward in light of their contractual rights to investigate circumstances giving rise to condition failures and termination rights. As was the case in Akorn, a buyer's compliance with its efforts obligations is typically a prerequisite to the buyer being able to invoke a termination right. The consequences of failing to comply can therefore be much more significant than simply giving rise to a damages claim for breach of contract.

Delaware's Pro-contractarian Approach: Throughout the decision, the Court of Chancery advocated following the language and structure of the merger agreement and eschewed Akorn's attempts to impart bright line rules that may significantly change the contractually agreed allocation of risk. The decision therefore serves as a useful reminder that if an issue or interpretation is significant to a party, the party should draft appropriate language in the acquisition agreement. For example, if a target company wants the acquiror to assume known risks, it should expressly carve them out from the MAE definition.

Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP, 2018 De Ch Lexis 550 (Del. Ch. Dec. 03, 2018)

Delaware Chancery Court held that fraud carve-out from indemnity caps only applied to indemnity claims against CEO who committed fraud, and not to indemnity claims against other stockholders.

Great Hill involved a post-trial decision in a fraud action brought by affiliates of a private equity fund, Great Hill, in connection with their acquisition of a FinTech company, Plimus, Inc., which was controlled by affiliates of another private equity fund (SIG).[5] Following Plimus' disappointing performance after closing, plaintiffs brought claims against a number of parties, including SIG and the Plimus CEO, alleging breaches of representations and warranties, and fraud and fraudulent inducement. In considering plaintiffs' arguments that the fraud exception from the indemnification cap should apply with respect to all of the defendants, the court held that the fraud exception only applied with respect to claims against the CEO, because he was the only defendant who committed fraud.

Fraud Claims

In connection with plaintiffs' fraud and fraudulent inducement claims, the Court considered four alleged instances of fraud. The court found that only plaintiffs' allegations relating to Plimus' contractual relationship with a payment processor, PayPal, gave rise to fraud. The PayPal relationship was an important one for Plimus. The relationship was in jeopardy when the merger agreement relating to the Plimus acquisition was signed, and PayPal terminated the relationship shortly after the merger closed. Plaintiffs alleged that the failure to disclose and/or the active concealment of PayPal's notices of violations and threats to terminate its agreement with Plimus, among other things, gave rise to fraudulent misrepresentations under the merger agreement. The court agreed, but held that the CEO was the only defendant who was liable for fraud because he was the only person who had actual knowledge of the falsity of the representations.

Indemnification Cap

The plaintiffs also brought indemnification claims against certain of the defendants (the Indemnification Defendants), based on alleged breaches of representations and warranties under the merger agreement. The court held that various PayPal fines and termination threats gave rise to breaches of representation relating to compliance with the bylaws and operating rules of card systems, and to relationships with suppliers.

The Merger Agreement contained an indemnification cap, which limited defendants' liability for breach of representations and warranties to their pro rata share of the escrow funds. But it made the indemnification cap inapplicable "in the case of fraud or intentional misrepresentation (for which no limitations set forth herein shall be applicable)." Plaintiffs claimed that the fraud exception applied with respect to all Indemnification Defendants, and not just those who committed fraud. The court disagreed, holding that the indemnification provisions provided "a thoughtful, bargained-for liability scheme" for stockholders subject to indemnification obligations. The court noted that these stockholders benefited from having liability limited to the escrow, and in exchange the buyer benefited from a pro-sandbagging provision elsewhere in the Merger Agreement, which provided that the buyer would be indemnified regardless of pre-contractual notice of the falsity of the representations and warranties.

The court reasoned that plaintiffs' interpretation, in the case of fraud, would lead to uncapped liability against selling stockholders, without regard to fault. Given the pro-sandbagging language, this could even be the case where the buyer knew of the misrepresentation before signing the merger agreement. The court found this interpretation to be unreasonable, and inconsistent with the language of the merger agreement and the liability scheme the parties created.

Takeaways

The court's decision has some equitable appeal from the perspective of a selling stockholder that "would have limited or no opportunity to verify the representations and warranties personally" and, therefore, should not have uncapped liability for another stockholder's fraud. Nevertheless, the decision is arguably in tension with *EMSI Acquisition, Inc. v. Contrarian*

[5] A 2013 court decision stemming from the same dispute attracted a lot of attention, and led to deal practitioners including provisions in deal agreements allocating ownership of legal privileges between deal parties. *See Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP*, C.A. No. 7906 (Del. Ch. Nov. 15, 2013).

Funds, LLC, 2017 WL 1732369 (Del. Ch. May 3, 2017), where, in refusing to grant a motion to dismiss, the *EMSI* court found plausible buyer's argument that a fraud exception applied, regardless of whether the fraud was that of the selling stockholders or of management. The *Great Hill* court, in reaching a different result, relied in part on the presence of a pro-sandbagging provision, which the Court noted could have the harsh result of Indemnification Defendants having uncapped exposure for fraud committed by management of which they were unaware but the buyer was aware prior to signing the merger agreement.

The takeaway for buyers is that they should include express language in the indemnity section that makes clear that the fraud exception to indemnity caps applies not only to claims against a tortfeasor, but also to all claims against indemnifying parties that are based on fraud committed by others. For example, the language "except in the case of fraud or intentional misrepresentation" could be modified to read: "except in the case of fraud or intentional misrepresentation (whether by management or any indemnifying party)." Sellers, on the other hand, should try to include language that makes clear that the fraud exception applies only with respect to claims against the tortfeasor. For example, the fraud carve-out could provide: "except in the case of fraud or intentional misrepresentation by the indemnifying party (which exception shall not apply with respect to indemnity claims against a person who has not committed fraud or an intentional misrepresentation)."

QC Holdings, Inc. v. Allconnect, Inc., C.A. No. 2017-0715-JTL (Del. Ch. 2018)

Company obligation to make payment for put shares survived acquisition of company in reverse triangular merger.

Background

The decision involved a motion for summary judgment by QC Holdings Inc. (QC Holdings), a former stockholder of Allconnect Inc. (Allconnect), in an action against Allconnect seeking payment of the $5 million put price arising from QC Holdings' exercise of a put option requiring Allconnect to redeem 18,604,071 shares of common stock held by QC Holdings.

The put option was originally entered into in connection with Allconnect's acquisition of substantially all of QC Holdings' assets in October 2013. The put agreement specified that (1) Allconnect's obligation to repurchase the put shares was contingent on Allconnect having sufficient funds legally available in accordance with Delaware law, and (2) Allconnect had no obligation to pay the put price as long as Allconnect had any senior indebtedness outstanding. In addition, though QC Holdings was permitted to exercise its put right during the 60-day period beginning November 15, 2015, Allconnect was not obligated to pay the put price until November 15, 2016.

Even though Allconnect had negative cashflow and outstanding senior indebtedness, QC Holdings exercised its put right on November 16, 2015. In doing so, QC Holdings complied with the agreement's requirements that it deliver a written exercise notice, an assignment separate from certificate, and the original stock certificate for the put shares. Allconnect confirmed receipt of the above. By letter dated November 2, 2016, Allconnect informed QC Holdings that it would not pay the put price on November 15, 2016 due to its outstanding senior indebtedness.

In September of 2017, Allconnect was acquired by New Imagitas Inc. (Imagitas) in a reverse triangular merger. As consideration, Imagitas paid $83 million, of which $10.8 million paid off Allconnect's debt, $67 million was paid to Allconnect's stockholders (going largely to preferred stockholders, with common stockholders receiving only 2 cents per share), and $5.1 million was used to establish an escrow fund to address the QC Holdings put claim. On October 9, 2017, QC Holdings filed suit to recover the put price and its legal fees.

The Court's Analysis

The court first considered Allconnect's argument that Allconnect's obligation to pay the put price existed only on November 15, 2016, and terminated if Allconnect was not able to pay on that date. While the court found that some language in the put agreement supported Allconnect's argument, the court rejected Allconnect's interpretation, holding that it would work a forfeiture and thus could not prevail unless supported by unambiguous language. The court noted that the put agreement did not expressly state that the obligation to pay the put price terminated, or that Allconnect had no further obligation to pay if it was unable to do so on November 15, 2016. Instead, the court noted use of words in the put agreement such as "to the extent that" and "for so long as," which implied a continuing obligation to pay. The court viewed it as "commercially irrational" for QC Holdings to agree to the type of one-day payment obligation described by Allconnect, particularly given that Allconnect could manipulate it by taking on senior indebtedness. The court noted that wording in Allconnect's letter of November 2, 2016, and the fact that Allconnect carried the $5 million redemption obligation on its books in 2016 and 2017, also supported the view that the obligation to pay the put price was ongoing.

The court then considered QC Holdings' argument that Allconnect was obligated to pay the put price as soon as the senior indebtedness was repaid, which occurred immediately prior to the effective time of the merger. QC Holdings argued that the merger consideration created sufficient funds legally available for such payment. The court rejected this argument, noting that it was inconsistent with a line of Delaware cases that held that a merger effected a transmutation at the stockholder level, and thus the merger consideration did not represent funds available for the target company to use.

For the court, the crucial question was whether the put shares remained outstanding at the time of the merger or had been transferred to Allconnect upon exercise of the put option. If the former, the shares would be cancelled in the merger and QC Holdings would be entitled to receive the merger consideration for them. If the latter, QC Holdings would have a contractual redemption right that survived the merger as an ongoing obligation of the surviving corporation pursuant to Section 259 of the Delaware General Corporation Law (DGCL). Considering applicable provisions of the DGCL and the Uniform Commercial Code, and the actions taken by QC Holdings upon exercise of the put option, the court held that Allconnect acquired title to the shares on exercise of the put option, subject to the obligation to pay the put price. Accordingly, QC Holdings had a contractual claim against Allconnect, which survived the merger.

The court then noted that under the merger agreement, Allconnect designated the escrow funds as legally available to pay the put price. In granting QC Holdings' motion for summary judgment, the court held that QC Holdings was entitled to a decree of specific performance compelling Allconnect to use the escrow funds to fulfill its obligations under the put agreement.

Takeaways

This case illustrates the potentially significant economic disparity, and associated drafting importance, between stockholders retaining their status as stockholders, or becoming creditors, on exercise of a put option. QC Holdings ended up receiving the equivalent of approximately $0.27 per share, instead of the approximately $0.02 per share it would have received if its shares had been cashed out in the merger.

In its decision, the court noted that it was not holding that whenever a stockholder exercises a put right, it loses its status as a stockholder and becomes a creditor. The court noted that it would be possible to draft in a way that made explicit whether the stockholder retained its rights and status as a stockholder, or became a creditor. What was dispositive in this case was that the put agreement required QC Holdings to deliver an endorsed stock certificate, plus an assignment, plus representations regarding the transfer of title. This resulted in QC Holdings becoming a creditor, although its rights to enforce payment were subject to statutory and common law restrictions on redemptions. Parties entering into put agreements may wish to make such treatment express in their put agreements.

Had there not been escrow funds available for payment of the put price, QC Holdings' claim would have been more complicated. Stockholders entering into put agreements should consider expressly providing that the payment obligations become due at the time of a company's sale.

Alarm.com Holdings, Inc. v. ABS Capital Partners Inc., 2018 WL 3006118 (Del. Ch. June 15, 2018), aff'd 2019 De Lexis 53 (Del. Feb. 07, 2019)

Investments made by a private equity sponsor in a business competing with an existing portfolio company's business do not, on their own, constitute a misappropriation of trade secrets, particularly when such investments are permitted by the portfolio company's governing documents.

Background

In *Alarm.com*, plaintiff Alarm.com Holdings Inc. (Alarm) brought suit against defendants ABS Capital Partners Inc., ABS Partners V LLC and ABS Partners VII LLC (collectively, ABS) asserting that (1) ABS had misappropriated trade secrets under the Delaware Uniform Trade Secrets Act (DUTSA) and (2) ABS had engaged in common law misappropriation of confidential information. Each of these claims related to ABS's equity investment in Alarm and one of Alarm's competitors and ABS' related board representation on each company's board of directors. The Delaware Court of Chancery dismissed each claim for failure to state a claim pursuant to Court of Chancery Rule 12(b)(6), finding that (1) based on the facts presented by Alarm, and in light of the documents executed by Alarm and ABS, it was not reasonably conceivable that ABS engaged in misappropriation under DUTSA, and (2) DUTSA preempted Alarm's common law claim.

In 2008, ABS Capital Partners, Inc., a private equity firm, began exploring a potential investment in Alarm. In connection with its analysis of Alarm, ABS executed a nondisclosure agreement (2008 NDA) that, while providing for the protection of Alarm's confidential information, expressly provided that, assuming ABS complied with the terms of the 2008 NDA, ABS could invest in competing businesses. After conducting its due diligence, ABS invested in Alarm, acquiring preferred stock carrying 80%of Alarm's then-outstanding voting power. In connection with such investment, ABS and the other stockholders of Alarm executed a stockholders agreement (2009 Stockholders Agreement) providing that ABS could designate three of Alarm's five directors. The 2009 Stockholders Agreement also contemplated that investors (including ABS) could own equity in competing businesses, and excluded ABS from a provision therein that revoked board observation rights from investors owning equity in competing businesses. ABS designated three members of Alarm's board, each of whom participated in board meetings, learned confidential information regarding Alarm and was involved in many of Alarm's major business decisions.

In 2012, Alarm raised additional capital by issuing a new series of preferred stock to new investors, and in connection therewith Alarm adopted a new Amended & Restated Certificate of Incorporation (2012 Charter) and its stockholders executed a new stockholders agreement (2012 Stockholders Agreement), which superseded the 2009 Stockholders Agreement. The 2012 Stockholders Agreement, among other things, increased the size of the Alarm board to seven members and reduced ABS's representation on the board to two members; it also provided for the protection of Alarm's confidential information while including a provision allowing ABS and certain other investors to invest in competing companies so long as such investors do not disclose or use any of Alarm's confidential information in doing so. Further, and specifically highlighted by the Delaware Court of Chancery, the 2012 Charter included a provision authorized by Section 122(17) of the Delaware General Corporation Law (the DGCL), which exempts stockholders such as ABS from any duty not to pursue corporate opportunities that otherwise might arguably belong to Alarm.

In June 2015, Alarm completed an initial public offering, and in connection therewith, the 2012 Stockholders Agreement expired and ABS's preferred shares converted to common stock. One of the directors originally appointed by ABS to the Alarm board continued to serve until resigning in August 2016, and no representative of ABS subsequently held a position with Alarm.

In September 2017, ABS acquired an equity interest in Resolution Products, Inc. (Resolution), a company that directly competes with Alarm, and, in connection therewith, ABS appointed a single member to Resolution's board of directors. The director appointed by ABS to Resolutions' board had not previously served on Alarm's board or held any position with Alarm, and had not observed any board meeting of Alarm.

Complaint and Legal Analysis

Alarm cited ABS's investment in Resolution and its representation on Resolution's board of directors to claim that ABS had either already misappropriated or inevitably will misappropriate trade secrets in violation of DUTSA or, in the absence of any trade secrets, has engaged or inevitably will engage in common law misappropriation of Alarm's confidential information. ABS moved to dismiss Alarm's complaint for failing to state a claim on which relief could be granted.

Upon review, the Delaware Court of Chancery noted that in order to survive ABS's motion to dismiss, Alarm's complaint would have had to plead that (1) a trade secret of Alarm existed, (2) Alarm communicated that trade secret to ABS, (3) the communication was made pursuant to an express or implied understanding that ABS would maintain the secrecy of the information, and (4) the trade secret was then misappropriated, as such term is defined in DUTSA. The court assumed, for the sake of its analysis, that the first three requirements were met and, therefore, Alarm only needed to demonstrate that trade secrets were misappropriated by ABS within the meaning of the term under DUTSA. Under DUTSA, "misappropriation" was defined in relevant part to include an "acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means," which could be demonstrated through circumstantial evidence.

The court found that even under the associated relaxed-pleading standard, Alarm's complaint did not support a reasonably conceivable inference of misappropriation. It also found that Alarm's reliance on ABS's investment in Resolution, made approximately one year after ABS's last representative resigned from the Alarm board, did not support an inference of misappropriation. The court noted that Alarm and ABS had a longstanding understanding that ABS was permitted to invest in competitors. While under the terms of the 2012 Stockholder Agreement ABS was not permitted to "make use of any proprietary or confidential information of the company in connection with such activities," the agreement recognized that an investment by ABS in a competitor of Alarm would not, on its own, violate such confidentiality terms. This understanding was also reflected in other executed agreements by Alarm and ABS over the course of their relationship, beginning with the 2008 NDA and including the 2009 Stockholders Agreement, the 2012 Charter and 2012 Stockholders Agreement.

The court found that fiduciary duty waiver language in Alarm's 2012 Charter further supported its conclusions. The 2012 Charter included an express waiver of any "duty (contractual or otherwise) not to, directly or indirectly, engage in the same or similar business activities or lines of business" as Alarm. The effect of this language was to waive any claim for breach of the duty of loyalty against ABS or its board designees based on either usurpation of corporate opportunity or anticompetitive activity. The court found that the clear intent of this language was "to permit ABS to invest in competing companies like Resolution," and the language would serve as a defense to a breach of fiduciary duty of loyalty claim, should Alarm attempt to bring one in connection with ABS's investment in Resolution. The court reasoned that it would be counterintuitive to permit Alarm to bring its statutory claims under DUTSA, which operates against nonfiduciaries, when comparable fiduciary duty claims would be waived under the 2012 Charter.

The court also dismissed Alarm's common law misappropriation claim on the basis of being preempted under DUTSA.

Takeaways

- Corporations
  - Corporations executing nondisclosure agreements, stockholder agreements or other agreements with investors that include provisions pertaining to the confidentiality of sensitive information, corporate opportunities or the investors' ability to invest in competing businesses should review the terms of such agreements carefully to make sure that they fully understand the ability of their investors under such agreements, and that such terms either adequately safeguard the corporation's sensitive information, or permit the corporation latitude to control disclosure.
  - Corporations should also consider other options for protecting their sensitive information other than labeling such information as trade secrets or as confidential under the terms of an NDA.
- Private Equity Investors
  - Private equity investors should carefully review the terms of any NDA, stockholders agreements or other documents executed with a prospective portfolio company, including the governing documents of such company, in order to make sure that they retain sufficient optionality to deploy capital in other investments as needed. Fiduciary duty/corporate opportunity waivers in charters and stockholder agreements are fairly standard provisions, and serve an important purpose.
  - Private equity investors should also make sure to abide by the terms of any NDA, stockholders agreements or other documents once such documents are executed in order to attempt to avoid any allegations of wrongdoing.
- Co-Investors
  - Co-investors with board representation or observer rights should consider seeking a most-favored-nation clause or otherwise ensuring that they obtain the same ability as other investors in the company to act upon corporate opportunities or otherwise deploy capital in other investments.

Penton Business Media Holdings, LLC v. Informa PLC and Informa USA, Inc., C.A. No. 2017-0847-JTL (Del. Ch. July 9, 2018)

When drafting dispute resolution provisions, parties must be explicit in whether they want a third party to act as an arbitrator or an expert, and the scope of information that third party may consider. When dispute mechanism procedures for another provision of an agreement are incorporated by reference to a section of the agreement, parties should explicitly outline any differences they intend to apply for disputes arising under that section.

Penton involved a motion for judgment on the pleadings in an action in the Delaware Court of Chancery stemming from the acquisition of Penton Business Media Holdings Inc. (Company) from Penton Business Media Holdings LLC (Seller) by Informa PLC and Informa USA Inc. (jointly, the Buyer) in a reverse triangular merger. The merger agreement outlined how pre-closing and post-closing tax benefits should be allocated among the parties. The pre-closing tax benefits provision directed the Buyer to pay the Seller the amount of any refund the Buyer received as a result of tax benefits applied to that period. The post-closing provision directed the Buyer to pay the Seller 40% of any tax benefits the company realized in a post-closing period. In both cases, the provisions incorporated dispute mechanism procedures set forth in the merger agreement for a dispute regarding the purchase price allocation. At issue was whether the parties intended the independent accounting firm charged with resolving a dispute pursuant to the merger agreement to act as an arbitrator or an expert. If an arbitrator, then the accounting firm had the authority to determine the scope of materials available to it for its review of a tax dispute when applying the procedures outlined for an accounting dispute in the merger agreement. This could open the door to information and materials that the parties did not contemplate within the scope of review in order to resolve a dispute. Conversely, if the accounting firm was to act as an expert only, the accounting firm's scope of review was much narrower and the information available to it would be limited to that determined by the court to be permitted by the merger agreement.

After the closing of the transaction, the Buyer delivered to the Seller a proposed tax form offsetting pre-closing liability with $40 million in deductions, which would result in an estimated refund of $600,000. If the deductions had been applied to a post-closing period, in contrast, the Seller would have been entitled to payment of approximately $16 million. The Seller disputed the allocation of the tax benefits to a pre-closing period, citing early iterations of the term sheet for the transaction and the offering circular prepared by the buyer in connection with the rights offering for the transaction as support for its position.

Following the dispute resolution mechanism in the merger agreement, the parties submitted the question of what amount of the tax deductions should be applied to a post-closing period to Ernst & Young (Accounting Firm) for resolution. However, the parties were not able to agree on what information the Accounting Firm could consider when resolving this issue. The Buyer's position was that the Accounting Firm could not consider any information other than what was permitted by the merger agreement, which it argued did not include the drafts of the term sheet and the offering circular. The Seller argued, on the other hand, that the purchase price dispute resolution provision was drafted in order to resolve accounting disputes, but a tax dispute was sufficiently different to require the use of additional outside materials. The Seller argued that the language of the merger agreement applying the dispute resolutions procedures to the pre- and post-closing tax benefit sections allowed for these additional materials to be considered.

Unable to determine the scope of information the Accounting Firm could consider, the parties also disagreed as to the scope of the Accounting Firm's authority. In its suit seeking declaratory judgment, the Seller argued that the Accounting Firm had the ability to determine the information available to it. The Buyer argued that only the court had this authority.

Applicable Language of the Merger Agreement

The pre- and post-closing tax benefit provisions piggybacked on the dispute resolution mechanism in Section 2.8 of the merger agreement that applied to purchase price adjustments. The pre-closing tax benefit provisions specified that the procedures for resolution of a dispute regarding pre-closing tax benefits should be one corresponding to the purchase price dispute resolution mechanism outlined in Section 2.8(b) of the merger agreement. The post-closing tax benefit provisions specified that the general procedures set forth in Section 2.8(b)(ii) shall apply "mutatis mutandis" in order to resolve disputed items between the Buyer and the Seller. Section 2.8(b)(ii) provided for the Accounting Firm to make a determination based solely on the following information:

(i) the definitions and other applicable provisions of this Agreement;

(ii) a single presentation (which presentations shall be limited to the remaining items in dispute set forth in the Proposed Closing Date Calculations and Purchase Price Dispute Notice) submitted by each of [the Buyer] and the [Seller] to the Accounting Firm within fifteen (15) days after the engagement thereof; and

(iii) one written response submitted to the Accounting Firm within ten (10) Business Days after receipt of each such other party's presentation, and not on an independent review.

This section further specified other sources of information the Accounting Firm could not consider:

> The parties agree that no *ex parte* conferences, oral examinations, testimony, depositions, discovery or other form of evidence gathering or hearings shall be conducted or allowed by the Accounting Firm; provided, however, that at the Accounting Firm's request, or as mutually agreed by [the Buyer] and the [Seller], [the Buyer] and the [Seller] may meet with the Accounting Firm so long as Agents of both parties are present.

The merger agreement also specified that in resolving the items in dispute, "the Accounting Firm shall be acting as an accounting expert only and not as an arbitrator and shall not import or take into account usage, custom or other extrinsic factors."

Who Determines the Scope of What an Independent Accounting Firm Can Decide

In analyzing whether the court or the Accounting Firm could decide the scope of information available to the Accounting Firm for its review, the court first asked whether the dispute resolution called for an arbitration or an expert determination.

The court held that while states and federal circuits are split on whether there is a distinction between arbitration and expert determination, Delaware does recognize a distinction between the two, and Delaware courts do not apply arbitral principles to all contractual dispute resolution mechanisms. If the dispute resolution called for an arbitration determination, the doctrines of substantive and procedural arbitrability would govern. Substantive arbitrability relates to the scope of arbitration and applicability to the dispute. Procedural arbitrability encompasses, among other things, resolving what evidence the arbitrator may consider in the scope of its review. Thus, if the dispute resolution called for an arbitration determination, the Accounting Firm could decide the question of what information was available to it. Alternatively, if the dispute mechanism outlined in Section 2.8 of the merger agreement called for an expert determination, it would fall to the court to decide what information could be considered based on the contract language.

In this case, the merger agreement explicitly called for the Accounting Firm to "act as an expert and not as an arbitrator," indicating the parties contemplated a narrow dispute mechanism utilizing the Accounting Firm's technical expertise as an accountant and not an arbitrator. In support of this conclusion, the court referenced a report prepared by the Committee on International Commercial Disputes of the New York Bar Association that recommended parties use this precise language in contracts in order to indicate an expert determination rather than an arbitration. This language alone, though, may not be sufficient. The court indicated it was possible to envision a situation where parties used the "expert not arbitrator" language, but then went on to outline dispute resolution procedures that mimicked arbitration, which could result in a court disregarding the choice of an expert determination. In such a situation, courts should consider the "type and scope of authority" given to the party assigned to resolve the dispute. However, the court held that the language in the merger agreement was not such a difficult case, and clearly provided for an expert determination.

Having determined the agreement called for an expert determination, the court concluded that the merger agreement then determines the scope of the expert's review. Whether the Accounting Firm has jurisdiction to determine the scope of the dispute resolution provisions and consider extrinsic evidence is a matter of contract interpretation. Absent explicit direction from the terms of the contract itself, the expert charged with making the decision does not have authority to interpret the governing agreement. Finding no express provision in the merger agreement bestowing jurisdiction on the Accounting Firm to interpret the merger agreement, the court held that the Accounting Firm was not permitted to do so or to determine whether it had jurisdiction to consider extrinsic evidence.

The court then turned to the plain language of the dispute resolution mechanism in the merger agreement to answer the question whether the Accounting Firm could consider extrinsic evidence in answering the question posed by the parties regarding the allocation of tax benefits. Regardless of whether the allocation dispute is viewed as arising under the pre- or post-closing tax benefit provisions, the dispute mechanism of Section 2.8(b) applied. The pre-closing tax benefit provisions specified that dispute resolution provisions "corresponding to those in Section 2.8(b)" applied. The post-closing tax benefit provisions specified that the determination of disputed items should be made by the Accounting Firm "following the general procedures set forth in Section 2.8(b)(ii), *mutatis mutandis*." Interpreting this Latin phrase as "the necessary changes have been made," the Seller argued that in applying the procedures of Section 2.8 to a tax dispute, a necessary change must be made in order to allow the Accounting Firm to use extrinsic evidence to resolve a tax question, such as sources of positive law and guidance from tax authorities. Once this extrinsic evidence is permitted, the Seller argued that the term sheets and the offering circular should be allowed as well. The court disagreed, finding that "*mutatis mutandis*" simply meant the Accounting Firm was considering a tax question instead of an accounting question. Just as accounting guidance would have been available to it in the latter case, tax guidance was available to it in this case. The court held that the plain language of the merger agreement clearly provided that no additional information was to be considered other than the materials expressly permitted by Section 2.8.

Takeaways

Without the explicit language that the Accounting Firm was to act as an expert and not an arbitrator, coupled with the narrow process for its review as outlined in the merger agreement, the dispute resolution provisions may have allowed the introduction of materials beyond what the parties initially intended. When drafting a dispute mechanism, parties should be explicit in the scope of authority granted to the third-party decision maker, as well as the materials available to them for their review.

The decision also provides a cautionary note on incorporating dispute resolution mechanisms by reference to other provisions in the agreement. The dispute resolution provisions in *Penton* were doubtless prepared with a purchase price adjustment in mind. There, it is reasonably common to provide that the person charged with resolving disputes should function as an expert and not an arbitrator. It is not uncommon for drafters, out of a concern for efficiency, to piggyback other disputes into the purchase price adjustment dispute resolution provisions. Where that is done, attention should be given as to whether an expert determination is appropriate for these other types of disputes. If not, modifying language should be incorporated into the purchase agreement.

Another takeaway for sellers is that the tax benefit provisions should be carefully thought through. In *Penton*, there was a significant economic difference on whether tax benefits were applied to the pre-closing period or the post-closing period. In the absence of express language to the contrary, the buyer will typically be the party to decide how to use the benefits, as was the case in *Penton*. If there may be a big economic difference depending on the period they are applied to, sellers should consider pushing for express language in the purchase agreement that specifies how benefits are to be applied.

Manti Holdings, LLC v. Authentix Acquisition Co., No. 2017-0887-SG, 2018 BL 353784 (Del. Ch. Sept. 28, 2018)

Delaware Chancery Court held for the first time that a contractual appraisal waiver in a drag-along was enforceable against holders of common stock.

Delaware courts have previously recognized that holders of preferred stock may contractually waive their appraisal rights *ex ante*, given that their rights are largely contractual in nature.[6] Until *Manti*, the issue of whether holders of common stock may also contractually waive appraisal rights *ex ante* was unresolved by Delaware courts. In a summary judgment proceeding, the *Manti* Court held that they can.

Manti involved an appraisal action brought by holders of common stock in connection with a cash merger in which they would receive little, if anything, for their shares. The merger was initiated by the controlling stockholder, the Carlyle Group, pursuant to the exercise of drag-along rights under a stockholders' agreement (the SA), to which the appraisal petitioners were parties. The court considered whether the petitioners were barred from exercising appraisal rights as a result of waiver language in the SA.

Section 3(e)(iv) of the SA obligated parties in connection with a "Company Sale," such as the merger, to "refrain from the exercise of appraisal rights with respect to the transaction. The court examined the language of the SA to determine whether it indicated the requisite clear intent to waive. It first considered whether the obligation to refrain from exercising appraisal rights terminated under SA Section 12, which provided that the SA, and the rights and obligations of the parties thereunder, terminate upon a Company Sale. The parties agreed that vested rights would not terminate under Section 12, but petitioners argued that the obligation to refrain from exercising appraisal rights did not vest. Rejecting petitioners' argument, the court noted that the rights and duties under Section 3(e)(iv) arose at the time "a Company Sale is approved by the Board." The court held that this language was unambiguous, and no contracting party would consider itself free to exercise appraisal rights where the Board had approved a Company Sale. The court noted that petitioners' argument would render Section 3(e)(iv) inutile because appraisal rights are meaningless unless a transaction is completed.

Petitioners also argued that the duty to refrain from appraisal and otherwise comply with the drag-along provisions of the SA was conditioned on petitioners' securities being acquired on the same Terms and Conditions as those of the Carlyle Group. Under the SA, "Terms and Conditions" was defined to mean price. Petitioners argued that that condition was not satisfied because holders of preferred stock and common stock received different consideration under the waterfall provisions of the target company's charter. The court rejected petitioners' argument on the basis that the same "Terms and Conditions" condition only applied to Company Sales involving the sale of stock and not, as was the case here, mergers.

The court also rejected petitioners' argument that even if the appraisal waiver was enforceable, it was not enforceable by the target company. The petitioners argued that permitting the company to enforce the appraisal waiver would amount to a violation of Section 151(a) of the Delaware General Corporation Law, which requires limitations on classes of stock to be included in the corporate charter. Rejecting this argument, the Court held that the SA did not restrict the appraisal rights of a class of stock, but instead represented a contractual agreement by petitioners to forbear exercising such rights.

Takeaways

This decision settles a question that existed for funds and other controlling investors in connection with structuring their investments. The decision makes clear that properly drafted and enforced appraisal waivers in drag-along provisions can

[6] *See, e.g. Halpin v. Riverstone Nat'l, Inc.*, C.A. No. 9796-VCG (Del. Ch. 2015).

be enforced against holders of common stock. It therefore reduces potential leverage that founders and other holders of common stock may have in connection with the exercise of drag-along provisions. While this resolves one area of uncertainty concerning drag-along rights, there remain others, as alluded to by the court in the following dicta: "notably, the Petitioners have not brought an action against the directors for breach of fiduciary duty or breach of contract." Drag-along provisions remain vulnerable to *Trados*-type fiduciary duty challenges,[7] and may also not be upheld where, as in *Halpin*, their terms are not strictly complied with.

Deutsche Bank National Trust Co. v. Flagstar Capital Markets et al., 2018 NY Slip Op. 06851 (N.Y. Oct. 16, 2018)

In contrast to Delaware, New York does not permit extension of the statute of limitations for breach of contract, and attempts at inception of a contract to delay commencement of the statute of limitations may violate public policy against pre-accrual extensions and be unenforceable.

Background

This decision concerns whether claims brought against the originator of mortgage loans, Quicken Loans Inc. (Quicken), that were used to create residential mortgage-backed securities (RMBS), were time barred under New York's statute of limitations applicable to breaches of contact, consistent with a prior RMBS decision of the New York Court of Appeals in *ACE Sec. Corp. Home Equity Loan Trust, Series 2006-SL2 v. DB Structured Prods., Inc.*, 25 NY3d 581 (2015), notwithstanding the existence of an "accrual clause" that purported to delay the date on which a cause of action arose.

In *Flagstar Capital*, Quicken sold the loans it originated pursuant to a Second Amended and Restated Mortgage Loan Purchase and Warranties Agreement (MLPWA). Under the MLPWA, the loans were sold in groups, with Quicken making representations and warranties about the loans as of each applicable closing date. The last closing occurred on May 31, 2007. The loans were ultimately re-sold to the HarborView Mortgage Loan Trust 2007-7 (Trust) for the purpose of issuing mortgage-backed securities. Plaintiff Deutsche Bank National Trust Co. (Deutsche Bank), the trustee of the Trust, succeeded to the rights of the purchaser under the MLPWA.

After an underwriter engaged to review a sample of the loans concluded that Quicken had breached its representations and warranties with respect to certain loans, including with respect to borrower income, debt-to-income ratios and occupancy status, Deutsche Bank commenced its action in August 2013 and filed its complaint in February 2014. Quicken then moved to dismiss the complaint on grounds that it was filed more than six years after the last closing date in violation of the statute of limitations applicable to contracts in New York.

In opposition to Quicken's motion, Deutsche Bank did not contest that the representations and warranties in the MLPWA were effective as of the applicable closing date; rather, it contended that the statute of limitations had not lapsed because of the application of the following provision, which it called the "accrual clause":

> "Any cause of action against the Seller relating to or arising out of the breach of any representations and warranties made in Subsections 9.01 and 9.02 shall accrue as to any Mortgage Loan upon (i) discovery of such breach by the Purchaser or notice thereof by the Seller to the Purchaser, (ii) failure by the Seller to cure such breach, substitute a Qualified Substitute Mortgage Loan or repurchase such Mortgage Loan as specified above and (iii) demand upon the Seller by the Purchaser for compliance with this Agreement."

[7] *See In re Trados Inc.* S'holder Litig., 73 A.3d 17 (Del. Ch. 2013).

The lower court granted Quicken's motion to dismiss, holding that the action was time-barred because (1) any breach of Quicken's representations and warranties occurred, and Deutsche Bank's claims therefore accrued, on the relevant closing date (the last of which occurred more than six years before the action was filed), and (2) the accrual clause could not serve to extend the statute of limitations. The Appellate Division affirmed, and granted Deutsche Bank leave to appeal to the New York Court of Appeals.

Analysis of New York Court of Appeals

The New York Court of Appeals affirmed. The court first noted that the default rule in New York for breach of contract causes of action is that the cause of action accrues when the contract is breached. The court explained: "[t]his Court has 'repeatedly rejected accrual dates which cannot be ascertained with any degree of certainty, in favor of a bright line approach,' and for that reason, we do not 'apply the discovery rule to the statute of limitations in contract actions.' 'To extend the highly exceptional discovery notion to general breach of contract actions would effectively eviscerate the Statute of Limitations in this commercial dispute arena.'"

The court noted that the default rule had been applied in its earlier decision in *ACE*, and if that decision was controlling here, Deutsche Bank's claims would be time barred. *ACE* also involved breach of representations and warranties in an RMBS contract, where the loan seller similarly had a "cure or repurchase" obligation. The court noted that in *ACE*, it held that the "cure or repurchase" obligation did not create a "separate promise of future performance" that could form the basis of a separate breach (with the statute of limitations starting to run from that time of that breach as opposed to the breach of the underlying representation and warranty). Instead, the "cure or repurchase" obligation merely set forth a remedy for a breach of the representations and warranties, and not a promise of the loans' future performance. The court also noted that in *ACE*, it rejected the plaintiff's argument that the cure or repurchase obligation was a substantive condition precedent to the filing of an action which delayed the accrual of the plaintiff's cause of action, holding that "'the plaintiff breached the representations and warranties in the parties' agreement, if at all, the moment the [relevant contract] was executed' and therefore '[t]he Trust suffered a legal wrong at [that] moment.'"

The court then considered Deutsche Bank's arguments that *ACE* did not control because the contract at issue in *ACE* did not contain an accrual clause, and thus *ACE* was distinguishable in two respects: (1) the accrual cause created a substantive condition precedent to suit and (2) the accrual clause evidenced the parties' intent to delay accrual of a cause of action until specified events had occurred. The Court rejected both arguments.

In support of its first point —that the accrual clause created a substantive condition precedent to suit—Deutsche Bank argued that the phrase "shall accrue" in the accrual clause evidenced the parties' intent to define a breach of the MLPWA not as the falsity of the representations and warranties alone, but as Quicken's failure to cure or repurchase nonconforming loans following notice or discovery of the falsity and after Deutsche Bank's demand for compliance with the MLPWA's terms. The court disagreed, noting that "[t]he accrual clause itself refers to a 'breach' of the representations and warranties, and the contract nowhere suggests that [Quicken's] transfer of loans that do not comply with the representations and warranties is not a 'breach of the MLPWA. Rather, the MLPWA states that [Quicken's] obligations to cure or repurchase a defective mortgage loan constitute [Deutsche Bank's] 'sole remed[y] for a 'breach of the foregoing representations and warranties.'" As in *ACE*, the "cure or repurchase" obligation set forth a remedy for a breach of representations and warranties and not a demand that is a condition to a party's performance. The performance obligation here was for Quicken to deliver loans that complied with the representations and warranties. Nothing in the accrual clause created a condition to Quicken's obligation to do that.

In support of its second point, Deutsche Bank argued that the "accrual clause manifests the clear intent of the parties that a cause of action for breach of the representations and warranties 'comes into existence (accrues)—only after the conditions of the [a]ccrual [c]lause are complete,' meaning that the statute of limitations is not triggered until that time." The court again rejected Deutsche Bank's argument, explaining that if Deutsche Bank's characterization of the parties' intent were true, it conflicts with New York law and public policy. Citing to precedent, the court explained that parties cannot extend the applicable statute of limitations before the relevant cause of action accrues. Further, even if parties do agree to extend the applicable limitations period following accrual, the court noted, they cannot extend it beyond the applicable limitations period: "[New York General Obligations Law Section 17-103] requires an agreement to extend the statute of limitation to be made 'after accrual of the cause of action,' and it allows extension of the limitations period only for, at most, the time period that would apply if the cause of action had accrued on the date of the agreement, i.e., six years from the date the agreement was made if the limitations period is six years." Accordingly, the court held that the accrual clause violated General Obligations Law Section 17-103 because (1) it was effectively an agreement to extend the statute of limitations before the accrual of the relevant cause of action and (2) it was an agreement to extend the limitations period for up to the life of the loans (i.e., in excess of the permissible six years), until discovery or notice of breach.

The court noted that the public policy favoring freedom of contract was in conflict with the public policy prohibiting extensions of the limitations periods before accrual of the cause of action, and the latter must prevail. Remedy for that lies with the legislature, which could enact a provision similar to that enacted under Delaware law, Del. Code Ann. Tit 10, § 8106(c).

Takeaways

While the decision involved an RMBS securitization, it nonetheless has relevance for M&A practitioners. As an initial point, given that statutes of limitations involve procedural, and not substantive, law, acquirors may prefer specifying Delaware over New York as a forum for dispute resolution, given the ability to extend statutes of limitations under Delaware law. Parties that are dealing with the New York statute of limitations should not rely on contractual language attempting to delay accrual of breach of representation and warranty causes of action, because the delay language is likely to be unenforceable. The dissent in *Flagstar Capital* noted that the outcome could have been different if the agreement had instead been structured as a guaranty by Quicken of the performance of any defectively issued loans. Accordingly, where survival of longer than six years is desired for claims under acquisition agreements that are subject to New York's statute of limitations, consideration should be given to whether the claims can be fashioned as guarantees instead of relying on remedies for breach of representations and warranties.

Basho Techs. Holdco B, LLC v. Georgetown Basho Investors, LLC, 2018 WL 3326693 (Del. Ch. July 06, 2018)

Stockholder use of blocking rights as part of aggressive strategy to gain majority voting control and force sale of company risks liability under entire fairness standard of review.

Background

Basho Technologies, Inc. (Basho or the Company) was a technology company co-founded by Earl Galleher in 2008. In February 2011, Basho completed a Series D round financing that was led by defendant Georgetown Basho Investors, LLC (Georgetown). Defendant Chester Davenport, who controlled Georgetown, joined the Basho board in connection with the financing. In subsequent financing rounds, Georgetown obtained an additional board seat (to give it two out of seven seats) and a blocking right over events such as M&A transactions and the issuance of shares having rights that were superior to or *pari passu* with its preferred stock rights. Evidence produced at trial indicated that Davenport wanted to force a sale of

Basho in 2013, that he anticipated that Georgetown would receive the largest share of the proceeds in any such sale, and that Davenport viewed the blocking rights as having turned Georgetown into the company's sole life line for funding.

Over the next several months, Davenport went to great lengths to prevent the company from obtaining financing from a third party that would dilute Georgetown's position. That forced the board to negotiate a bridge loan with Georgetown under less favorable terms. And as a condition to the bridge loan, Georgetown required that the company retain Cowen & Company as a financial advisor for both fundraising and a potential sale.

After an unsuccessful effort to sell the company in the first quarter of 2013, Davenport instructed Cowen to implement a Series G financing round through which Davenport used aggressive tactics like delays, threats, and imposition of unreasonable deadlines to scuttle a potential transaction with another investor and to force the company to accept Georgetown's less favorable financing proposal. The financing gave Georgetown control over a majority of Basho's outstanding voting power and the right to appoint a majority of the members of the board.

Promptly after closing, Davenport consolidated his power by removing Galleher as Chairman of the Board and giving the role to himself, creating an Executive Committee with the full power of the board in the management of the company, composed of Davenport, Reisley (a Georgetown colleague), and the future CEO, and giving Davenport and Reisley control over the remaining board committees.

Davenport then caused the company to enter into a number of insider transactions, such as by entering into a more lucrative consulting agreement with a company controlled by Reisley, and entering into new loan arrangements with Georgetown and another entity controlled by Davenport. After some signs of good financial performance, Basho's performance declined and Basho ceased operations as a going concern in May 2017.

Fiduciary Duty Claims

Galleher and other former holders of the company's common stock and preferred stock filed suit in 2015 alleging, among other things, breach of fiduciary duties by Georgetown and Davenport by forcing the company to accept the onerous Series G financing.

The court considered whether Georgetown owed fiduciary duties in connection with the Series G financing. Because Georgetown did not exercise a majority of the company's voting power before the Series G financing, the plaintiff attempted to prove that Georgetown exercised control over the transaction being challenged. The court held that this required a showing of actual control, not merely the potential ability to exercise control.

The ourt noted that a finding of control generally involves the analysis of multiple factors and held that the plaintiffs proved at trial that Georgetown exercised effective control due to:

- Georgetown's use of its contractual rights, including its blocking rights and its delaying of draws under the loan agreement, to give the company no alternative other than to accept Georgetown's terms.
- Davenport's efforts to spread misinformation about Georgetown's intentions and the status of negotiations.
- Davenport's interference with members of management.
- Davenport's influence over Cowen, and his resulting manipulation of the fundraising process.
- Georgetown having forced the Series G financing on the company, including through Davenport's threats and combative behavior.
- Georgetown's status as a significant stockholder and its ability to designate two board seats.

Having established that both Georgetown and Davenport were fiduciaries in connection with the Series G financing, the court considered whether they had breached their fiduciary duties. The court applied the entire fairness standard of review to this transaction, which requires a finding of fair price and fair dealing.

The court had little difficulty in finding that the process was unfair. It noted that Georgetown interfered with competing investments to prevent them from moving forward. Georgetown dictated, and refused to negotiate, the terms of its own proposal. The court found that the Board and stockholders only approved the deal because the directors felt they had no alternative.

The court noted that the defendants did not present any meaningful evidence of financial or economic fairness. The defendants instead argued that the Series G financing must have been fair because no other party submitted an actionable proposal. The court interpreted the absence of other actionable proposals as more indicative of the unfair process than fairness of the price. The Court noted that there was a lot of evidence that the price was unfair.

The court found that Davenport and Georgetown failed to prove that the Series G financing was entirely fair. The court also found that plaintiffs proved that the financing injured the company and the plaintiffs. The court rejected defendant's argument that Galleher and companies he controlled were not entitled to relief because they acquiesced to the terms of the transaction. The court held that the doctrine of acquiescence does not apply in situations like this, where the fiduciaries "use their power to coerce the minority into economic submission." Having found a breach of fiduciary duty, the court held Georgetown and Davenport jointly and severally liable for losses in the amount of $17,490,650, plus pre- and post-judgment interest. The court then considered liability of Georgetown, Davenport and Fotos for breach of fiduciary duty for self-dealing transactions after the Series G financing, and found them jointly and severally liable for damages of $2,778,228, plus pre- and post-judgment interest.

Takeaways

This case is a warning to investors seeking to use negative control rights as part of a hostile strategy to force a company down a path that benefits the investor but is not in the best interest of the corporation or other investors. It is particularly relevant to venture-backed companies, where charters routinely include protective provisions that give the most senior securityholders blocking rights over financings and other strategic transactions. The court went out of its way to make clear that use of such provisions does not, in and of itself, create control that triggers an entire fairness standard of review. The court wrote in a footnote:

> Lest sensitive readers fear that this decision signals heightened risk for venture capital firms who exercise their consent rights over equity financings, I reiterate that a finding of control requires a fact-specific analysis of multiple factors. If Georgetown only had exercised its consent right, that fact alone would not have supported a finding of control. The plaintiffs proved that Georgetown and Davenport did far more.

The court's decision was driven by the use of consent rights in the context of a strategy built around deception, manipulation, and threats to obtain absolute control and force a sale, coupled with significant stock ownership and right to two out of seven board seats. But control is not a bright line test. Investors with veto rights should take note of the decision when formulating exit strategies for their portfolio companies.

In re PLX Tech. Inc. S'holders. Litig, 2018 WL 5018535 (Del. Ch. Oct. 16, 2018)

Decision provides useful insights for companies and boards in dealing with activists who obtain board representation and drive agenda to sell company, and helpful reminder of general principles for running a good sale process.

In *In re PLX Technology Inc. Stockholders Litigation*, the Delaware Court of Chancery ruled that an activist hedge fund, Potomac Capital Partners II, L.P. (Potomac), acting through its co-managing member, Eric Singer (Singer), who had gained a seat on the Board of Directors (the board) of PLX Technology Inc. (PLX or the Company), aided and abetted a breach of fiduciary duties by the board in connection with the sale of PLX to Avago Technologies Wireless (U.S.A.) Manufacturing Inc. (Avago) pursuant to a two-step merger (the Merger). The court found that the board members breached their fiduciary duties as a result of various process and disclosure deficiencies to stockholders, many of which were due to Singer having manipulated the sale process and Singer and the company's financial advisor having withheld information from the other board members. Although Potomac, as a result of aiding and abetting the breach, would be liable for the difference between the transaction price and the fair value of PLX, the Court of Chancery held that plaintiffs failed to prove that the standalone value of PLX was greater than the deal price, and accordingly entered judgment in favor of Potomac.

Background

One of the ironies of the case is that Singer launched his activist campaign to force a sale of PLX as a result of information set forth in PLX's proxy statement relating to a prior sale transaction, which was terminated after being challenged by the Federal Trade Commission. Singer learned from the proxy statement that another company (Avago) had expressed interest in buying PLX during the "go shop" period for the terminated deal. When PLX's stock price tanked after the prior deal was terminated, Singer saw an opportunity to cause Potomac to accumulate a position in PLX, and generate a quick profit by forcing a sale of PLX to that other company. Singer went public with its campaign, and Potomac built up a stake in the Company of almost 10%. After Singer went public, the board engaged in another process to explore a sale, including holding further discussions with Avago, although that process was unsuccessful and discussions with Avago broke down over price. The board was concerned with Singer's singular focus on an immediate sale, and believed the timing was not right. Mike Salameh, the company's founder and a board member, communicated to Singer the board's need to fulfill its fiduciary obligations and "consider the interest of the holders of PLX stock that you do not represent, particularly the holders that may have a longer time horizon than Potomac Capital."

Potomac commenced a proxy contest to gain board representation in connection with the company's 2013 annual meeting. Potomac won three out of eight seats in the proxy contest, and its nominees joined the board in December 2013. Upon the election of the Potomac directors, the board appointed Singer as the chairman of a special committee of the board (the Special Committee), which was tasked with exploring strategic alternatives for the company. From that point on, Singer assumed the lead role in driving strategy and negotiating on behalf of the company in connection with a potential sale or other strategic alternatives.

After Singer was appointed as the chairman of the Special Committee, an executive for Avago contacted a banker at the company's financial advisor and informed him that Avago was interested in acquiring PLX in "a $300M deal," which implied a PLX per share value of $6.53, but that Avago would not be able to execute the transaction until it completed another pending transaction. The financial advisor provided this information directly to Singer, but not to any other members of the board. The record at trial showed that Singer did not provide this information to other board members and this communication was not disclosed in the recommendation statement on Schedule 14D-9 (the Recommendation Statement) provided to PLX stockholders in connection with Avago's subsequent tender offer, which was the first step of the Merger.

Once Avago had completed its other transaction, discussions between PLX and Avago advanced rapidly. Avago initially proposed to acquire PLX for $6.25 per share. Nine days later, Avago and PLX had agreed in principle to a deal at $6.50 per share, which was very close to what Avago had previously communicated to the company's financial advisor that it was willing to pay. Singer, as chairman of the Special Committee, led the negotiations with Avago and was instrumental in convincing the other board members to approve the transaction. The transaction was publicly announced on June 23, 2014. The first step tender offer was commenced on July 8, 2014.

On July 14, 2014, plaintiffs filed suit against various parties, including all of the members of the board for breach of fiduciary duties and against Potomac for aiding and abetting the breach. The plaintiffs settled with all of the directors, including Singer, so the case only proceeded against Potomac for the aiding and abetting claim.

Breach of Fiduciary Duty

Disclosure

Vice Chancellor Laster found that the board breached its fiduciary duty to disclose fully and fairly all material information within the board's control in seeking shareholder action (i.e., the tender of shares into the first-step tender offer in the Merger). In particular, he identified three deficiencies in the disclosures made in the Recommendation Statement that would have been viewed by the reasonable investor as having significantly altered the total mix of information made available.

First, the Recommendation Statement failed to disclose, and indeed was found to have downplayed, the extent to which Singer was involved in the negotiation of the deal price. Singer had a number of important conversations with Avago and the company's financial advisor and appears to have been the primary interlocutor responsible for negotiating the $6.50 per share deal price, which was virtually identical to the valuation that Avago had initially indicated to the company's financial advisor that it was willing to pay for PLX a number of months prior to the agreement being reached. In light of Singer's deep involvement and the potential conflict of interest Singer had as the principal of an investor with a short-term and activist investment thesis, Vice Chancellor Laster found that the Recommendation Statement should have included additional information about Singer's role in the process. Most importantly, the Recommendation Statement should have disclosed that the company's financial advisor told Singer well in advance of formal negotiations that Avago expected a transaction that would be valued at around $6.50 per share.

Second, the Recommendation Statement misleadingly described the process by which projections used to support the valuation of PLX in the transaction were updated in June 2014 to arrive at a valuation that supported the $6.50 deal price. PLX had prepared projections reviewed by the board in December 2013 (the December 2013 Projections) that reflected significantly higher revenue growth and profitability than the projections that were ultimately used to support the valuation in the fairness opinion provided by the company's financial advisor. The Recommendation Statement characterized the December 2013 projections as having been an aggressive plan, and stated that that they were updated in June 2014 (the June 2014 Projections) to provide more current information and were prepared in the ordinary course of business for operating purposes. In fact, the June 2014 projections did not provide more current information and were not prepared until after the $6.50 per share deal price had been agreed with Avago. Vice Chancellor Laster found the June 2014 projections were prepared solely for purposes of providing a set of projections to the company's financial advisor that could support a valuation range that encompassed the merger price and enable the company's financial advisor to deliver a fairness opinion and, accordingly, that the disclosures regarding the purpose for which the June 2014 Projections were prepared were misleading.

Third, on May 24, 2014, the company's financial advisor made a presentation to the board that contained a valuation range of $6.90 to $9.78 per share for an acquisition of the company, with a midpoint of $8.27 per share. That valuation range was based on the December 2013 projections and was not disclosed to shareholders. It is notable that the entire range of that valuation exceeded the eventual agreed deal price with Avago. The Recommendation Statement did disclose two subsequent valuations, including one based on the December 2013 projections that showed a valuation range of $6.39 to $8.98 per share, with a mid-point of $7.69, but did not disclose the May 24, 2014 valuation range based on the December 2013 projections. Although Vice Chancellor Laster believed it was a close call whether all three valuation ranges should have been disclosed, he concluded stockholders were entitled to know the range produced in the May 24, 2014 valuation and that its omission was a misleading partial disclosure.

Sale Process

The Court of Chancery also found that the board breached its fiduciary duties in connection with the sale process. The Court of Chancery applied enhanced scrutiny as the operative standard of review, explaining that the business judgment standard under *Corwin v. KKR Financial Holdings, LLC*[8] did not apply because of the disclosure issues described above.

Vice Chancellor Laster found that Singer and Potomac had a divergent interest in achieving a short-term sale that was not aligned with the stockholders writ large. Potomac's activist approach to investing generally and the investment thesis supporting this particular investment—that the terminated prior deal created an opportunity to purchase the stock at a cheap price and force a quick sale—convinced Vice Chancellor Laster that Singer and Potomac's interests diverged from other stockholders, who might have been better served if PLX remained independent and executed on its business plan, notwithstanding the board's prior attempts to sell the company.

Vice Chancellor Laster's opinion focuses on the ways in which the board failed to provide an effective check to the divergent interests of Singer and Potomac, remarking that "this was a board that was susceptible to activist pressure." Notably, after Singer and the other Potomac nominees joined the board, the board (i) became much more willing to consider a transaction at prices the board had previously rejected, (ii) ceded significant control over the strategic alternatives process to Singer and allowed him to lead the negotiations with Avago, (iii) agreed to let Singer make a counter-offer to Avago and granted authority for a deal at $6.50 when the board did not yet have a stand-alone valuation of the Company, (iv) engaged in the "art of the possible" regarding the price at which the company could be sold (i.e., sought the best available price for the company) rather than considering the sale price as an alternative to remaining a standalone company, and (v) through the Special Committee, instructed management to prepare the May 2014 projections to support the deal price even though there had not been any new developments in the business since the preparation of the December 2013 projections and decided the company's financial advisor did not need to engage in any additional pre-signing market checks. Taken together, these factors led Vice Chancellor Laster to conclude Potomac and Singer undermined the board's process and resulted in a deal the board would not have otherwise approved.

The opinion does note that, absent the divergent interest of Singer, the process the board pursued, including the narrow, pre-signing canvass, a post-signing market check and a no-shop clause in the merger agreement with a fiduciary out, a customary termination fee and a matching right, would fall within the range of reasonableness. Noting the laundry list of deficiencies in the process discussed in the prior paragraph, Vice Chancellor Laster wrote that he still would have found that the board's decisions fell within the range of reasonableness but for the critical fact that Singer withheld from the board that Avago had told the company's financial advisor in December 2013 about its plans to acquire PLX. In

[8] 125 A.3d 304 (Del. 2015).

withholding this information from the board, Singer breached his fiduciary duty and induced the other directors to breach theirs. Because Singer was a co-managing member of Potomac and its agent, led Potomac's activist campaign and acted on its behalf once elected to the board, Singer's actions were attributable to Potomac and supported a finding that Potomac knowingly participated in the steps Singer took to breach his fiduciary duties and induce the other directors to breach their fiduciary duties.

Damages

The robustness and length of the sale process ultimately redounded to Potomac's benefit when it came to the damages determination. Vice Chancellor Laster held that in a quasi-appraisal remedy such as this, the plaintiff has the burden of proving damages based on the difference between the $6.50 price per share paid by Avago and the "fair" or "intrinsic" value of the shares. Vice Chancellor Laster found a number of problems with plaintiffs' valuation expert, and, giving significant weight to the Delaware Supreme Court's decision in *Dell, Inc. v. Magnetar Glob. Event Driven Master Fund Ltd.*, 177 A.3d 1 (Del. 2017), ultimately held that the $6.50 deal price was the best measure of fair value. Accordingly, Vice Chancellor held that the plaintiffs had not suffered any damages, and entered judgement for Potomac.

Takeaways

The opinion provides several important lessons for boards in the context of shareholder activism. Prior to the annual meeting, the directors correctly focused on their duty to do what was in the best interests of the stockholder body as a whole, and not simply cave to the demands of an activist with a short time horizon. After the activist's three nominees were elected to the board, the board's principal mistake seems to have been to treat a sale as inevitable, and cede too much control over the strategic alternatives process to Singer. Singer and Potomac were not only conflicted, but they actively manipulated the sale process by withholding important information from other board members. Vice Chancellor Laster noted that the directors (other than Singer) were not at fault for Singer's withholding of information in a "morally culpable" sense, but it nonetheless resulted in a breach of their fiduciary duties. The lesson for future boards is that even in the case of a lost proxy contest, boards of directors must continue to independently exercise their fiduciary duties to take the course of action that best serves the interests of company stockholders, and consider the implications of governance arrangements that may yield effective control to an activist.

As a related point, the decision provides legal ammunition to boards defending their actions in pursuit of the long term interests of stockholders over the short term interests of activists. Vice Chancellor Laster invoked *In re Answers Corp. S'holder Litig.*[9] for the proposition that a desire for liquidity can lead directors to breach their fiduciary duties. That case is a favorite for plaintiffs' firms challenging sale transactions that are driven by a private equity or venture fund with board representation, where the fund allegedly wants an exit transaction for reasons that are particular to that fund, such as to assist in future fundraising efforts. As Vice Chancellor Laster has made clear, the decision also applies in the context of activist shareholders whose strategy is to make a quick return by forcing an immediate sale of the company.

The decision is also a reminder that activist nominees who are elected to boards, whether they are nominally independent or are affiliated with the activist fund, are subject to the same duties of loyalty and care as other directors. They cannot simply use their board seats to pursue the activist's sale or other agenda if to do so would not be in the best interests of the stockholders of the company as a whole.

The decision also provides several important reminders that are relevant to M&A processes in general. The opinion reinforces the need to ensure disclosure to stockholders is full and fair and that stockholder action is fully informed. If proper disclosures had been made, particularly regarding Singer's conversation with the company's financial advisor at

[9] 2012 WL 1253072 (Del. Ch. Arp. 11, 2012).

which Avago's pricing expectations were conveyed, the applicable standard of review under *Corwin* would have been the business judgment rule, and the case would have been dismissed. Directors nominated by third parties also must be vigilant to share information related to the company they obtain with the other members of the board of directors and stockholders, as and when appropriate, particularly where a potential divergence of interests may exist between the director or the entity to which the director's actions may be attributed and the other stockholders. Singer and Potomac's potential liability in this case stemmed from Singer's failure to disclose to the other directors that he had received information from the company's financial advisor regarding interest by Avago and a likely price at which Avago would be willing to transact, and the company's subsequent failure to disclose those communications to stockholders. A director nominated by an activist investor must still provide full disclosure to the Board of Directors and/or special committee when acting on behalf of the Board of Directors and should ensure that full and fair disclosure is made to stockholders at appropriate times.

Companies preparing projections should also continue to be conscientious of the multiple uses for which the projections may become relevant. While the December 2013 Projections appear to have been generated for ordinary business purposes, including compensation targets and insurance, and included some aspirational or aggressive elements, they became problematic when considered in tandem with the ongoing sale process and the fact that they resulted in a valuation range significantly in excess of that at which counterparties appeared willing to transact with PLX based on the various market checks. Being clear about the purposes for which projections are produced and considering their applicability in multiple contexts, including any potential transactional context, may help a company to make more complete disclosures regarding such projections when required.

The decision also has shades of *Del Monte*[10] and *Rural Metro*.[11] Those cases involved situations where the company's financial advisor ran amuck and pushed a sales process that favored its own interests over those of the corporation and its stockholders. *In re PLX* is a reminder of the need to police conflicts of investment banks and make sure that the board, and not the banker, is in control of the process.

In re PLX also provides a reminder of the importance of process. Although the directors were found to have breached their fiduciary duties, the robustness of PLX's sale process ultimately supported a finding that the plaintiffs had not suffered damages. Running good sale processes with strong market checks and appropriate deal protections remains essential to protecting companies and their directors.

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[10] *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813 (Del. Ch. 2011)

[11] *In re Rural Metro Corp.*, 88 A.3d 54 (Del. Ch. 2014), aff'd sub nom. *RBC Capital Markets, LLC v. Jervis*, 129 A.3d 816 (Del. 2015)

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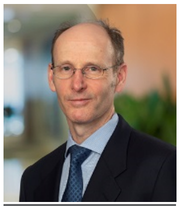

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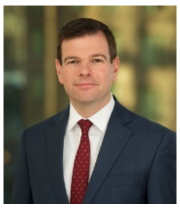

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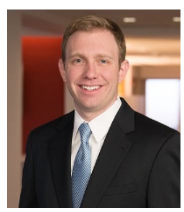

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