Sidley Perspectives
ON M&A AND CORPORATE GOVERNANCE

DECEMBER 2015

IN THIS ISSUE

ANALYSIS

DISCLOSURE-ONLY SETTLEMENTS: A DISAPPEARING—OR A CHANGING—TARGET?

By Jack B. Jacobs, Senior Counsel[1]

For the past three years "disclosure-only" settlements of class action lawsuits attacking corporate M&A transactions have increasingly become scrutinized and excoriated, by both academics and judges. Several of those settlements have even been rejected *sua sponte*. The reasons are understandable: 97% of the M&A transactions announced during the past three years have been the subject of class action damages lawsuits brought in Delaware and elsewhere. The paradigm case runs like this: the plaintiffs allege claims that, in approving the deal, the target company board violated fiduciary duties and employed a defective decision-making process under *Revlon*. Those claims often have no or at best a questionable basis in supporting fact. Within weeks, and having taken either minimal or no discovery into the merits of their claims, the plaintiffs' counsel negotiates a settlement that involves (1) no monetary recovery for the class—only additional proxy disclosures, often unrelated to the underlying wrong alleged in the complaint and found to be of little or no value; (2) a global (sometimes pejoratively called "intergalactic") release absolving the defendants of all claims arising out of the transaction, those actually alleged and also those that could have been alleged; and (3) the defendants' agreement not to object to a court-awarded fee somewhere in the high six figures.

It is difficult to defend these settlements on social utility grounds, since they benefit only plaintiffs' counsel and the defendants. Plaintiffs' counsel receive a large fee for a minimal investment of time and financial risk. The defendants—whose primary interest is in getting the deal closed—receive what amounts to an insurance policy against any future transaction-related claims, paid for not by themselves but by the corporation, in the form of an attorneys' fee that represents a negligible percentage of the transaction value. The only parties not benefited—and in many cases legitimately aggrieved—are the shareholders on whose behalf the lawsuits are supposedly brought. The shareholders receive no money—only additional proxy disclosures that have little or no relationship to the underlying fiduciary claims, and add little or no value. And, to the extent the complaint alleges underlying fiduciary claims that might be found meritorious had there been a diligent pre-settlement investigation, the shareholders are barred from pursuing those claims. The other constituents that receive no benefit from the disclosure-only settlement are the legal system and the courts called upon to administer it, both of which become perceived as disreputable. In Vice Chancellor J. Travis Laster's words, "the omnipresent litigation undercuts [both] the credibility of the litigation process" and "Delaware's credibility as an honest broker in the legal realm." *Acevedo v. Aeroflex Hldg. Corp.*, C.A. No. 7930-VCL (Del. Ch. Jul. 8, 2015).

1 Jack B. Jacobs is senior counsel in Sidley's Wilmington office who served on the Delaware Supreme Court from 2003 to 2014 and, prior to that, on the Delaware Court of Chancery since 1985. The views expressed in this article are those of the author and do not necessarily reflect the views of the firm.

It therefore is not difficult to understand why disclosure-only settlements have come increasingly under attack, and why their critics claim that they should be categorically disallowed. Some predict that will happen, at least in Delaware.[2] In reality, however, even if that were to occur, it would solve only part of the problem created by the "litigation tax" on M&A transactions.

The only parties not benefited from disclosure-only settlements—and in many cases legitimately aggrieved—are the shareholders on whose behalf the lawsuits are supposedly brought.

It may well be that the plaintiffs' law firms that employ the paradigm disclosure-only settlement as a business model deserve limited sympathy. But for the director-defendants who have run a pristine M&A sale process with no conflicts, yet find themselves as defendants in multiple shareholder class action lawsuits, disclosure-only settlements have been regarded as the only practical solution. To litigate a shareholder class action lawsuit to a conclusion in today's world is often exorbitantly expensive. And where, as often is the case, the directors have done nothing wrong, then the justice system should afford those parties a way to extricate themselves without incurring exorbitant litigation costs. Their argument is that, although to be sure those settlements generate no direct monetary recovery for the shareholders, they do benefit the company (and shareholders indirectly) by minimizing litigation costs that would be far higher absent a disclosure-only settlement, imperfect as it may be.

But that argument will not justify maintaining the status quo, because disclosure-only settlements sweep away M&A shareholder class actions that may have merit, i.e., that should be prosecuted and not settled before the validity of the claims is established. Recent cases demonstrate that M&A deals have occurred where the acquired company directors breached their fiduciary duties, thereby entitling the shareholders to a recovery. A regime that permits disclosure-only settlements to suppress genuinely meritorious lawsuits would disserve the interests of both the shareholders and the legal system. What is needed, therefore, is a mechanism that strikes the right balance between the legitimate interests of directors to rid themselves of non-meritorious M&A lawsuits at a reasonable cost, and the legitimate interests of shareholders in holding their fiduciaries accountable in M&A transactions so important to investors and the larger economy. For that reason, I predict that disclosure-only settlements will not disappear, but will most likely continue in an altered, more reasonable form. The question is what those settlements will look like. Recently, one member of the Delaware Court of Chancery has afforded the corporate bar some helpful guidance in navigating through this troubled area.

Despite rumors to the contrary, that Court has not announced an intent to reject any and all disclosure-only settlements. What the Court has admonished is that: (1) those settlements must be reasonable, that is, the value of the claims that the shareholders will be giving up in a release must be equivalent in value—and proportionate—to the benefit that the shareholders will receive in return, and (2) any attorneys' fee to plaintiffs' counsel will be measured against—and limited by—the value of that benefit, with little or no weight given to the amount the corporation agreed to pay. Applying those principles to settlements that take the paradigm disclosure-only form, the court will approve them only if the release is limited to disclosure claims, and the attorneys' fee is found to represent a reasonable percentage of the dollar value of the disclosure—assuming that value can be measured. If the settlement involves the release of one or more underlying substantive claims in addition to disclosure, then the consideration must either involve additional and separate value, or the settling parties must demonstrate to the court's satisfaction that they engaged in bona fide discovery establishing that the substantive claims being surrendered have no value.

It may be that one or both sides of the litigation may be unwilling to settle under this regime—the plaintiffs because of unwillingness to invest more time and risk in the case, and/

2 One may ask whether, if disclosure-only settlements were proscribed in Delaware and Delaware corporations uniformly adopt exclusive forum bylaws, the cases will simply migrate to federal courts and take the form of actual disclosure cases. In this author's view, that outcome, while possible, is not likely because there are other (including fee-related) reasons why shareholder plaintiffs would prefer to avoid federal courts.

The prediction of the demise of disclosure-only settlements may be premature. More likely they will continue in a more reasonable form that strikes the right balance between the legitimate interests of directors to rid themselves of non-meritorious M&A lawsuits without undue expense, and the legitimate interests of shareholders in holding directors accountable.

or the defendants because the release is too limited. What recourse do the parties have? The Delaware Court of Chancery has suggested three alternatives. One, the plaintiffs can dismiss the action without prejudice. Two, the defendants can take steps to moot the lawsuit on their own (e.g., by additional, voluntary proxy disclosures or changing the deal protection features of the merger agreement). They would then move to dismiss the case on mootness grounds, and agree to pay plaintiffs' counsel an attorneys' fee that must be publicly disclosed but without receiving court approval. Or three, the defendants could move to dismiss the complaint on the basis that the M&A deal was approved by a fully informed shareholder vote and should therefore be upheld under the business judgment standard of review. If those are the found facts, then the motion will be granted.

For these reasons, the prediction of the demise of the disclosure-only settlement may be premature. This development is still a moving target, and only time will tell whether the disclosure-only settlement will entirely disappear or reincarnate in a more reasonable form.

BOARD PRIORITIES IN THE FACE OF EXPANDING EXPECTATIONS

By Holly J. Gregory, Partner[3]

The most notable trend in corporate governance for the past decade, and likely for the year ahead, relates to the expanding influence of institutional shareholders on the governance of U.S. publicly-traded companies. This influence is evident in public pension fund efforts to expand shareholder rights using the tools of shareholder proposals and negotiated settlements on governance issues, and in hedge fund efforts to influence board decisions through activist strategies. While these and other forms of shareholder activism show no signs of abating, they are provoking greater engagement between companies and their shareholders.

At the same time that shareholders are seeking greater influence on corporate affairs, investors, regulators, media critics and the public continue to demand more of the board. The board is expected to defend against all kinds of risks, including failed business strategies, cybersecurity breaches, and natural disasters. In this complex environment of expanding expectations, the board must continue to focus its time and attention on the priorities it identifies based on the unique circumstances facing the company. While the details will vary from company to company, the main areas of board focus remain:

- Management delegation, performance oversight and succession planning
- Strategic direction, risk management and crisis preparation
- Internal controls, financial reporting and compliance
- Board composition, leadership and performance
- Shareholder activism and shareholder engagement

Management Delegation, Performance Oversight and Succession Planning

Directors should be careful not to function at a level similar to executive officers, or they risk losing the protection of the exculpatory provision typically included in a company's charter, which is available only to directors.

The primary tasks for the board in this area are to:

- Select the CEO, and clearly articulate the authority delegated to the CEO and expectations for CEO performance.
- Monitor CEO and executive performance and continually assess whether reliance on these executives is reasonable.
- Plan for succession of key executives in both normal and emergency circumstances.
- Replace the CEO when the circumstances warrant it.

3 Holly J. Gregory is a partner in Sidley's New York office and a co-leader of the firm's global Corporate Governance and Executive Compensation practice. The views expressed in this article are those of the author and do not necessarily reflect the views of the firm. This article is based on an article entitled *A Board Roadmap for 2016* by Ms. Gregory, which was published in the December 2015/January 2016 edition of Practical Law's *The Governance Counselor.*

- Determine appropriate incentives to attract and retain leaders.
- Align the pay of key executives with performance expectations.
- Advise and coach management as appropriate, providing management with the benefit of the board's collective expertise but without dictating actions that are clearly within management's purview.

Strategic Direction, Risk Management and Crisis Preparation

Discussion of strategic issues and associated risks should account for a significant portion of board meeting time. The board should give special attention to supporting appropriate long-term investment and prudent risk-taking in the face of short-term pressures for immediate returns, or other conflicts. The board should also:

- Approve the strategic and operating plans, and related budgets, after active iteration with management and deliberation.
- Determine with management the company's "risk appetite" with regard to its strategy and operations.
- Monitor management performance using preset benchmarks where possible to determine progress in relation to strategic and operating plans and related budgets.
- Assess management efforts (and related processes) and controls related to the identification, monitoring, management and mitigation of risks.
- Understand the significant risks to the business and how the company is prepared to respond.
- Evaluate management efforts to prepare for crisis incidents, and prepare to be actively involved in circumstances where management may be conflicted.

As part of its oversight of risk management and crisis preparation, the board should consider conducting periodic reviews of plans for natural and other disasters, such as broad failures of the power grid and cybersecurity breaches.

Internal Controls, Financial Reporting and Compliance

In light of the Department of Justice's renewed focus on criminal and civil prosecution of individuals in cases involving corporate compliance failures and corporate malfeasance, oversight of internal controls, financial reporting and the compliance and ethics programs that help set the tone for corporate culture continues to be important for the board (often with significant aspects of a board's oversight delegated to the audit committee). In this area, the board should:

- Ensure that appropriate information and reporting systems and related investigation processes are designed to support the identification of individual wrongdoers.
- Support a tone at the top that stresses that: (1) compliance is strategically important and essential for achieving business priorities; and (2) everyone has personal responsibility for compliance.
- Establish a corporate culture that encourages cooperation and avoids an unduly defensive "circle the wagons" mode when a problem does arise.
- Understand and oversee management's internal controls and procedures to ensure that financial reporting is accurate and the company complies with applicable laws and regulations.
- Attend to the corporate culture, affirm the expectations that management will abide by and further within the company the principles of ethical behavior, fair dealing and integrity.
- Oversee management's efforts to:
  - educate company personnel about the corporate code of conduct and expected standards of ethical behavior;
  - encourage internal reporting ("whistle-blowing");
  - monitor compliance; and
  - identify and respond as appropriate to red flags or a series of yellow flags.
- Review and reiterate whistle-blower anti-retaliation provisions.

- Pay special attention to related person transactions and other conflicts of interest that involve directors or members of senior management.
- Attend to issues of, and set standards and policies regarding, sustainability and social responsibility, including environmental issues, involvement in the political arena and human rights.

Board Composition, Leadership and Performance

Boards need highly competent and committed directors with a combination of expertise and experience that are relevant to the company's business and direction. Being able to bring objective judgment to bear and express and consider diverse viewpoints while driving toward consensus are necessary qualities for directors. In this area, the board must:

Shareholder activists are focused on directors' competency and relevancy, and these subjects are also the likely focus for future use of proxy access.

- Recruit highly qualified directors with relevant expertise who can make the requisite time commitment.
- Provide compensation for directors that fairly reflects the time and energy that is required, but remember that decisions about director compensation involve inherent conflict and should be demonstrably fair to the company.
- Consider board refreshment mechanisms, including age and tenure limits and individual director evaluation.
- Avoid treating the re-nomination decision as a foregone conclusion. Re-nomination decisions must be based on an assessment of the director's relevant expertise, time commitment and actual performance.
- Evaluate and attend to issues of board and committee leadership, ensuring that leadership is in place to provide a strong (though generally supportive) counterweight to management.
- On an annual basis, evaluate and discuss the effectiveness of the board, the board committees and board and committee leaders.
- Consider evaluation of individual directors either as a component of board evaluation or as a component of re-nomination decisions (or both).
- Attend to board culture, including processes designed to assure that diverse views are expressed, yet consensus is developed efficiently. The tone and quality of relations with management and among directors should be one of mutual respect and collegiality, and should support open and constructive discussion.
- Organize the board's work, including determining board and committee agenda and information needs, ensuring that the most important matters receive priority attention.
- Consider emerging ideas about best practice, shareholder proposal trends and proxy advisor policies in the annual discussion of board effectiveness and in the annual review of governance principles and committee charters, but ensure that corporate governance is tailored to the company's unique and specific needs.

Shareholder Activism and Shareholder Engagement

Shareholder activism that is focused on strategic and financial initiatives is continuing to have a significant influence on the corporate governance environment. The proponents of particular strategic, financial, governance, environmental and social reforms may have interests that are not shared by the broader array of shareholders. Further, there may be divergence between the interests of pension fund managers, mutual fund managers, hedge fund activists and retail investors. Adding to the complexity, the interests of investment managers are not always wholly aligned with the interests of their beneficiaries, while proxy advisor interests present another layer of divergent interests. These are all conflicts that directors need to understand and sort through as they interpret the concerns and demands expressed by the more vocal shareholders. In this area, the board should:

One benefit of regularly engaging with key shareholders and building a relationship that is built on transparency, understanding and trust is that these shareholders may be more willing to presume that the directors (1) know the business best and (2) are making business decisions on an informed basis and with the good faith belief that their decisions will serve the best interests of the company.

- Engage with key shareholders on a regular basis (in listening mode) to gain insights into their viewpoints and use shareholder engagement as an opportunity to develop enduring relationships.
- Understand how various shareholder perspectives differ based on their diverse interests.
- Consider and address as appropriate shareholder requests and proposals.
- Stay informed of the perspectives of proxy advisors, but do not fall into the trap of assuming that shareholders' views are always in agreement with proxy advisor perspectives.
- Collaborate with the senior executive team to inform, and engage with, shareholders about corporate strategy, key board decisions, and the rationales for those decisions so that shareholders do not blindly follow proxy advisor recommendations.
- Understand, but do not succumb to, external pressures while continuing to apply informed decisions that directors believe are in the best interests of the company as they help management focus on corporate resiliency and sustainable, long-term performance.

In light of the unrelenting pressures put upon boards, they should focus their time and attention on the priorities described herein, modified as appropriate based on the company's unique circumstances.

CFIUS AND TSINGHUA'S BID FOR MICRON

By James Mendenhall, Partner[4]

Chinese investment in the U.S. has always been controversial, but the world has changed significantly over the last ten years. The Committee on Foreign Investment in the United States (CFIUS)—the U.S. government body charged with reviewing the national security implications of transactions that might result in control of a U.S. business by a foreign person or entity—has approved many high profile Chinese investments, including Lenovo's 2014 acquisitions of Google's Motorola Mobility unit and IBM's server business.

According to the Rhodium Group, Chinese investment in the U.S. grew from $2 billion in 2005 to $11.9 billion in 2014.

But controversy has not been put to rest completely. In 2013, CFIUS reviewed the acquisition of Smithfield Foods by Shanghui International Holdings. CFIUS approved the transaction, but not after several members of Congress raised concerns. The Senate even held a hearing to discuss the transaction. More recently, tensions flared again when, in July 2015, Chinese state-owned company Tsinghua Unigroup made a $23 billion bid for Micron Technology, the last major U.S. producer of DRAM memory chips.

Senator Charles Schumer (D., N.Y.) responded to the bid by Tsinghua with a letter to U.S. Treasury Secretary Jack Lew expressing "deep concern" over the "national security implications of allowing China to gain market control over the production of components tied to modern U.S. defense systems, potentially including Micron's memory chips." He "urged [CFIUS] to thoroughly investigate and take appropriate action to withhold approval" of the deal "until China has undertaken reforms to their existing policies that constrain U.S. technology firms' access to China's market and violate U.S. intellectual property rights." Thus began a new investment controversy just as President Obama prepared to host Chinese President Xi Jinping for a state visit.

CFIUS's handling of this matter will be watched closely not only by members of the U.S. Congress but also prospective Chinese investors and U.S. businesses. Whichever way CFIUS decides, it is unlikely to signal a closing of the U.S. market to Chinese investment more generally. It will be a decision based on the unique characteristics of this particular transaction.

4 James Mendenhall is a partner in the International Trade and Dispute Resolution group in Sidley's Washington, D.C. office. The views expressed in this article are those of the author and do not necessarily reflect the views of the firm.

What is CFIUS?

Despite what some commentators have implied, CFIUS is not charged with taking action in response to foreign market access barriers or unfair trade practices. CFIUS reviews foreign direct investment for potential national security risks. That is its sole mandate, although the scope of that authority is very broad.

CFIUS may review any transaction, in any sector, and of any size that will result in control of a U.S. business by a foreign person or entity. A U.S. business would include the assets of a company that can function as a business. "Control" means "the power, direct or indirect, whether or not exercised, through the ownership of a majority or a dominant minority of the total outstanding voting interest in an entity…or other means, to determine, direct, or decide important matters affecting an entity."

CFIUS is authorized to mitigate a national security threat that arises from a reviewed transaction by negotiating and enforcing a "mitigation agreement," under which the transaction parties agree to, for example, modify a transaction or adopt special governance arrangements to address the national security concerns in exchange for CFIUS clearance. The President is authorized to suspend or prohibit a transaction under CFIUS jurisdiction, when, in the President's judgment, there is credible evidence that the foreign person might take action that threatens to impair U.S. national security, and when no other provision of law (other than the International Emergency Economic Powers Act) provides suitable authority for the President to protect national security.

CFIUS may review any transaction, in any sector, and of any size that will result in control of a U.S. business by a foreign person or entity. When working on cross-border transactions, consider whether a notice filing with CFIUS is advisable and adjust the transaction timeline accordingly.

The CFIUS review process typically begins when parties to a transaction jointly file a notice with CFIUS. Although CFIUS notices are voluntary, parties may decide to file because (1) the transaction is in a space that they know CFIUS is concerned about; (2) they want to mitigate political fallout; and/or (3) they seek legal certainty—once CFIUS approves a deal it cannot come back later to revisit the issue. If the parties do not voluntarily file a notice, CFIUS may (although it rarely does so) request that the transaction parties file a notice or initiate a review itself. CFIUS may do so even after a transaction has closed, and CFIUS has the authority to order divestment or take other action.

The Proposed Micron Transaction

Tsinghua faces an uphill battle in seeking to obtain CFIUS approval. This is not an example of a case where CFIUS review is prudent simply to mitigate political backlash. Nor is it a case in which political controversy and concerns over economic security are likely to drive the decision. Still, there are plenty of real national security questions in play that CFIUS will want to review closely. Investments in technology companies are often sensitive. The fact that Micron is the sole U.S. supplier of DRAM memory chips and is likely to have significant or sensitive contracts to supply the U.S. government or conduct R&D will make approval even more difficult.

Even if CFIUS blocks the transaction, however, one should not read too much into it. It would not be correct to conclude that the U.S. is closed to Chinese investment or even that all Chinese investments in the technology space are doomed. Each transaction must be assessed on its own merits. That was true before, and it will remain true in the future. But Chinese investors should learn from the Micron experience (whatever the outcome) to assess the types of the investments that are feasible in today's environment.

NEWS[5]

JUDICIAL DEVELOPMENTS

Delaware Supreme Court Affirms *Rural Metro*

Delaware Supreme Court: "Adhering to the trial court's amorphous 'gatekeeper' language would inappropriately expand our narrow holding here by suggesting that any failure by a financial advisor to prevent directors from breaching their duty of care gives rise to an aiding and abetting claim against the advisor."

The Delaware Supreme Court recently issued its much-anticipated ruling in *RBC Capital Markets, LLC v. Jervis,* No. 140, 2015 (Del. Nov. 30, 2015) *(Rural Metro)*. In short, the Court affirmed the principal legal holdings of the Delaware Court of Chancery's earlier rulings determining that RBC aided and abetted breaches of fiduciary duty by former directors of Rural/Metro Corporation in connection with the sale of the company to a private equity firm, and finding RBC liable for $76 million. The Court was careful to limit a cause of action for aiding and abetting a board's breach of its duty of care to situations where a financial advisor commits "fraud on the Board" and acts with scienter. The Court also clarified some uncertainty in the aftermath of the Court of Chancery's 2014 decision as to whether financial advisors have a quasi-fiduciary responsibility to act as "gatekeepers" and monitor their client boards to ensure they were both adequately informed and exercising due care in their deliberations and decisions. The Court squarely rejected that view of the financial advisor's role. The Court emphasized and cautioned that its ruling should be read narrowly based on the unique and complex facts involved, stating: "our holding is a narrow one that should not be read expansively to suggest that any failure on the part of a financial advisor to prevent directors from breaching their duty of care gives rise to a claim for aiding and abetting a breach of the duty of care." Our Sidley Update summarizing the decision and providing key lessons for target company boards and financial advisors is available here.

Approval of Merger by Fully Informed Disinterested Stockholders Invokes Business Judgment Review

The Delaware Supreme Court recently issued a decision clarifying the standard of review when a transaction not subject to entire fairness is approved by a vote of the disinterested stockholders. *Corwin v. KKR Fin. Holdings LLC,* No. 629, 2014 (Del. Oct. 2, 2015). In such a situation, the business judgment rule, and not a heightened standard of scrutiny, presumptively applies.

The *Corwin* case arose from a stock-for-stock merger of KKR Financial Holdings LLC (KKF) and KKR & Co. L.P. (KKR). A majority of KKF's disinterested stockholders voted in favor of the merger. The plaintiff stockholders challenged the transaction arguing that KKR was a controlling stockholder and thus entire fairness, or another form of heightened scrutiny, applied in evaluating the transaction. The Delaware Court of Chancery dismissed the case, finding that the complaint did not plead facts sufficient to show that KKR had the power to prevent the KKF board from exercising independent judgment. The plaintiffs appealed.

On appeal the plaintiffs argued that because a KKR affiliate managed KKF through a restrictive contractual agreement, KKR was KKF's controlling stockholder. The Delaware Supreme Court determined that KKR was not a controlling stockholder—it owned less than one percent of KKF's stock and had neither the ability to appoint directors nor the right to veto board actions. Accordingly, the Delaware Supreme Court unanimously affirmed the Delaware Court of Chancery's decision and found that entire fairness did not apply.

The Delaware Supreme Court held that where disinterested stockholders vote to accept or reject a transaction, the business judgment rule is the presumptively correct standard of review. The Delaware Supreme Court noted that "Delaware corporate law has long been

5 The following Sidley attorneys contributed to the research and writing of the pieces in this section: Sara B. Brody, Jennifer F. Fitchen, Jack B. Jacobs, Kelly L.C. Kriebs and Laura E. Seaton. We appreciate their contributions.

reluctant to second-guess the judgment of a disinterested stockholder majority that determines that a transaction with a party other than a controlling stockholder is in their best interests." The Court also noted that *Revlon*'s and *Unocal*'s standards of review were designed to provide stockholders the ability to obtain injunctive relief prior to closing and not to address post-closing damages.

> A DELAWARE INSIDE VIEW

Thoughts on the Corwin decision from Jack B. Jacobs, senior counsel in our Wilmington office who served on the Delaware Supreme Court from 2003 to 2014 and, prior to that, on the Delaware Court of Chancery since 1985:

"Corwin augments and reinforces an important initiative by the Delaware Supreme Court—first begun in Kahn v. M&F Worldwide, 88 A.3d 635 (Del. 2014)—to facilitate review of corporate mergers under the fiduciary-friendly business judgment standard. The M&F Worldwide decision articulates when business judgment review will be available to controlled mergers that would ordinarily be reviewed under the non-deferential, litigation-intensive entire fairness standard. The Corwin decision broadens the availability of business judgment review to mergers that would otherwise be subject to enhanced scrutiny review under Revlon or Unocal. The initiative represented by these cases is intended both to reduce the cost of litigation and to afford clearer guidance to transaction planners."

One More Step Towards Unified Business Judgment Review of Mergers

On November 19, 2015, the Delaware Supreme Court affirmed a Delaware Court of Chancery order dismissing a complaint attacking a cash-out merger of SynQor, Inc., a privately held Delaware corporation, into an entity controlled by SynQor's management group, which held 46% of the company's stock. *Swomley v. Schlecht,* No. 9355-VCL (Del. Ch. Aug. 27, 2014). Our Sidley Update summarizing the decision is available here. The decision marks the first application of *Kahn v. M&F Worldwide,* 88 A.3d 635 (Del. 2014), which held that a merger that would otherwise be subject to entire fairness review would be reviewed under the business judgment standard if the following criteria are met: (1) the controller conditions the transaction on the approval of both a special committee and of a majority of the minority stockholders; (2) the special committee is independent and is empowered to freely select its own advisers and to "just say no" to any transaction proposal; (3) the committee discharges its duty of care in negotiating a fair price; and (4) the vote of the minority stockholders is fully informed and is not coerced. The Delaware Court of Chancery held that the plaintiffs in *SynQor* failed to plead facts sufficient to call into question any of the *M&F Worldwide* elements and overcome the business judgment review presumption that the board, in approving the merger, properly discharged its fiduciary duties. The *SynQor* decision also establishes that *M&F Worldwide* can be applied to private as well as public corporations, and can be applied at the motion to dismiss stage, without the need for discovery, a summary judgment proceeding or a trial.

> A DELAWARE INSIDE VIEW

Thoughts on the SynQor decision from Jack B. Jacobs:

"SynQor is significant because it affords predictable and reliable guidance for avoiding highly expensive and time-consuming entire fairness review of controlled, non-arm's length corporate acquisitions. The case also marks a defendant-friendly departure from the prior case law, and is part of a broader effort by the Delaware Supreme Court to reduce the costs of litigating corporate acquisitions generally."

Controlled Corporations Must Still Follow Corporate Formalities

In a case of first impression, the Delaware Court of Chancery, in considering a derivative suit brought by a Facebook stockholder against Facebook's board of directors, confronted the following question: "Can a disinterested controlling stockholder ratify a transaction approved by an interested board of directors, so as to shift the standard of review from entire fairness to the business judgment presumption, by expressing assent to the transaction informally without using one of the methods the Delaware General Corporation Law (the DGCL) prescribes to take stockholder action?" *Espinoza v. Zuckerberg et al.*, C.A. No. 9745-CB (Del. Ch. Oct. 28, 2015).

Chancellor Bouchard: "The controlling stockholder of a Delaware corporation wields significant power, including the power in some circumstances to ratify interested directors' decisions and thereby limit judicial scrutiny of such actions. But a controlling stockholder should not, in my view, be immune from the required formalities that come with such power."

In other words, can Mark Zuckerberg, in his capacity as the 61% controlling stockholder of Facebook (he is also its CEO and chairman), ratify an increase in cash and equity compensation for non-employee directors unanimously approved by Facebook's board of directors (75% of which are non-employee directors), so as to shift the standard of review for this self-dealing action from entire fairness to the business judgment presumption, by expressing his support to the transaction with his favorable vote as a board member or through affidavits and deposition testimony in connection with the lawsuit?

The Court, in an opinion written by Chancellor Bouchard, answered the question with a clear "no." The Court found that the burden shift from entire fairness to business judgment review could only have been achieved if Mr. Zuckerberg approved the action through a formal written consent pursuant to Section 228 of the DGCL or a stockholder vote conducted in accordance with Delaware law.

Though the Court did raise a question about the parameters of Mr. Zuckerberg's expression of support, it wasn't due to doubt regarding his intentions that the Court found that corporate formalities must be followed. Rather, the Court emphasized that controlling stockholders wield "significant power" and thus should not "be immune from the required formalities that come with such power." These formalities "serve to protect the corporation and all of its stockholders by ensuring precision, both in defining what action has been taken and establishing that the requisite number of stockholders approved such action, and by promoting transparency, particularly for non-assenting stockholders." Importantly, though Section 228 would permit a sole controlling stockholder to take action by written consent, notice of such action must be promptly provided to the non-assenting stockholders.

The Court allowed the claim for breach of fiduciary duty and unjust enrichment to proceed, though dismissed a third claim of corporate waste for failure to state a cognizable claim that Facebook received no consideration in exchange for compensation paid to non-employee directors.

Ratification of Defective Acts Under Delaware Corporate Law

Sections 204 and 205 of the Delaware General Corporation Law (the DGCL) were enacted in April 2014 and provide a mechanism by which certain void or voidable corporate actions can be ratified. Section 204 permits a board to ratify these defective actions and Section 205 grants the Delaware Court of Chancery jurisdiction to evaluate such ratifications, as well as determine the validity of a defective act. The Delaware courts recently have issued two rulings that help refine the scope and purpose of these statutes.

In re Genelux Corporation (Del. Ch. Oct. 22, 2015) clarifies that Section 205 cannot be used to invalidate corporate action or stock, as it "was intended to be a remedial statute designed, in conjunction with Section 204, to cure otherwise incurable defective corporate acts." In this case, the plaintiffs sought a declaration from the Court of Chancery that certain prior stock issuances to the company's co-founder were invalid (and therefore the voting of such stock in favor of two directors similarly invalidated their election). The attempt to use Section 205 to *invalidate* prior corporate action was unsuccessful, as the Court ruled that these statutes instead were meant to provide a means of *validating* "technically defective acts or stock."

Chief Justice Strine in In re Numoda Corporation: "Section 205 gives the Court of Chancery substantial leeway to shape an appropriate remedy."

On the same day, in *In re Numoda Corporation* (Del. Oct. 22, 2015), the Delaware Supreme Court stymied another attempt to invalidate a stock issuance. Here, two of three sibling founders challenged the lower court's determination of the company's capitalization, despite having previously executed documents evidencing the board's intention to effect the issuance in question. This decision emphasizes the DGCL statutes' equitable purpose, stating that "a core motivation for [their] adoption" was to rectify the previous inability of the Court of Chancery to "validate stock, even when inequity would result by falling to do so…" Here, principles of fairness guided the Court to validate the stock issuance and rule against the parties that were "complicit in failing to comply with the DGCL's requirements" and then declined to ratify such defective actions "because they have come to have personal reasons to wish to disclaim their prior promises and actions."

SEC & REGULATORY DEVELOPMENTS

SEC Issues New Guidance on Excludability of Shareholder Proposals

A shareholder proposal seeking proxy access on terms different from management's proxy access proposal will generally not be excludable because a shareholder that supports proxy access could logically vote in favor of both proposals.

On October 22, 2015, the Staff of the SEC's Division of Corporation Finance issued Staff Legal Bulletin No. 14H (CF), which provides new guidance on the excludability of shareholder proposals under Exchange Act Rules 14a-8(i)(9) (proposals that "directly conflict" with management proposals) and 14a-8(i)(7) (proposals that relate to a company's "ordinary business operations"). Our Sidley Update summarizing the new guidance is available here. For the 2016 proxy season and beyond, the SEC Staff will permit a company to exclude a shareholder proposal as directly conflicting with a management proposal only if a reasonable shareholder could not logically vote in favor of both proposals. In the past, companies often have attempted to exclude shareholder proposals relating to proxy access, special meeting rights and shareholder action by written consent by putting forth a management proposal on the same topic but with terms more favorable to the company. The new guidance makes clear that going forward a company will generally not be able to exclude a shareholder proposal using this tactic.

The guidance also provides that the SEC Staff will not permit a company to exclude a shareholder proposal on "ordinary business operations" grounds if the proposal transcends the company's day-to-day business matters by raising a policy issue so significant that it would be appropriate for a shareholder vote. The guidance clarifies that "a proposal may transcend a company's ordinary business operations even if the significant policy issue relates to the 'nitty-gritty of its core business.'" That clarification resolved some uncertainty arising from the *Trinity Wall Street v. Wal-Mart Stores, Inc.* (3d Cir. Jul. 6, 2015) case discussed in our August 2015 issue of *Sidley Perspectives on M&A and Corporate Governance*.

SEC Provides Guidance on "Unbundling" Proposals in M&A Proxy Statements

On October 27, 2015, the Staff of the SEC's Division of Corporate Finance posted two new compliance and disclosure interpretations (CDIs) relating to the "unbundling" under Exchange Act Rule 14a-4(a)(3) of separate matters to be voted on by shareholders in the context of mergers and acquisitions. Rule 14a-4(a)(3) requires that a form of proxy "identify clearly and impartially each separate matter intended to be acted on" at a shareholder meeting and provide a means for shareholders to specify a choice with respect to each separate matter on the proxy card.

In M&A transactions in which target shareholders are to receive equity securities of the acquiror, the transaction agreement often requires the acquiror to amend provisions in its organizational documents relating to corporate governance or control. Under existing SEC guidance, if material amendments to the acquiror's organizational documents would require the approval of its shareholders under state law, stock exchange rules or its organizational documents if presented on a standalone basis, the acquiror must present them to its shareholders separately from the vote on the transaction itself. The SEC Staff has provided the following examples of provisions that generally must be unbundled from the vote on the transaction: classified boards, limitations on the removal of directors, supermajority voting provisions, delaying the annual meeting more than a year, eliminating the ability to act by written consent or changes in minimum quorum requirements. Restatements of charters, name changes and other technical changes likely will not be considered material amendments.

Under the new guidance, if an acquiror must unbundle the proposed material governance amendments from the vote on the transaction, then the target must also provide its shareholders with a separate non-binding vote on the amendments to the acquiror's organization documents. The SEC Staff believes that unbundling such amendments is appropriate because they could effect a material change to the equity securities that the target shareholders are receiving in the transaction. The new guidance also provides that parties are free to condition completion of a transaction on shareholder approval of any separate proposals if clearly disclosed and indicated on the form of proxy. Because the target shareholders' separate vote on the material governance amendments is non-binding, the transaction and the amendments may be effected without their approval unless the parties conditioned the transaction on such approval.

CORPORATE GOVERNANCE DEVELOPMENTS

Plaintiffs' Lawyers Increasingly Target Dead Hand Proxy Puts in Credit Agreements

Recently, we are witnessing a significant number of DGCL Section 220 books and records demands from shareholder plaintiffs' firms directed against companies which have purported dead hand proxy put provisions in their debt agreements. If the company and its lenders then amend the debt agreements to remove such provisions, it is likely that the plaintiffs' firms will seek attorneys' fees from the company.

Plaintiffs' attorneys have been scrutinizing "dead hand proxy puts" in public companies' credit agreements following last year's decision by the Delaware Court of Chancery in a case captioned *Healthways.* In the context of rejecting the defendants' motion to dismiss, Vice Chancellor Laster echoed sentiments from previous Delaware rulings suggesting that such provisions may conflict with a director's fiduciary duties. *Pontiac General Employees Retirement Fund v. Healthways, Inc.,* C.A. No. 9789-VCL (Del. Ch. Oct. 14, 2014).

Credit agreements commonly contain a "change of control" definition, which outlines the events that a lender would deem to be a significant change in the ownership or governance of a borrower. Frequently, such a change of control constitutes an event of default under the credit agreement which entitles a lender to exercise certain rights and remedies, including acceleration of the debt, such that a lender has an opportunity to re-evaluate or terminate the lending relationship upon the occurrence of a significant change of control of a borrower.

A number of bond indentures also include change-of-control provisions designed to allow bondholders the right to exit the investment by putting the bonds back to the company upon the occurrence of certain events. In 2013, a precedent Delaware case had considered a change-of-control provision in a bond indenture known as the "proxy put," under which a change of control is deemed to have occurred when continuing directors cease to constitute a majority of a borrower's board of directors. *Gerald Kallick v. SandRidge Energy, Inc.,* C.A. No. 8182-CS (Del. Ch. Mar. 8, 2013). "Continuing directors" could include (1) the directors who are in place on the loan closing date; and (2) the directors who are nominated or otherwise approved by a majority of the directors that (a) were serving on the loan closing date or (b) whose nomination or election was previously approved. This proxy put formulation gives the original board of directors an approval right over potential replacement directors. The Delaware Court of Chancery had cautioned that, while a board has the power to approve dissident directors for the purposes of avoiding a change-of-control event of default under a credit agreement, the board must use that power to further the company's best interests, which includes approving new directors, unless a good faith reason, such as the new directors' stated intent to implement risky business plans, exists to reject the new directors.

After *SandRidge*, loan parties began to increase usage of a variation of the change-of-control proxy put provision known as the "dead hand proxy put," which excludes directors elected as result of an actual or threatened proxy contest from the definition of "continuing directors" and removes an outgoing board's power to ratify a dissident slate for purposes of the credit agreement.

As the dead hand proxy put became more common in public company credit agreements, *Healthways* challenged the formula as "highly suspect" and found a "recognized entrenching effect" that kept the directors who were in place at the loan closing in power. Further, the Court suggested that liability may be extended to a lender for aiding and abetting a board of directors in breaching its fiduciary duties by approving a credit agreement containing a dead hand proxy put.

Following *Healthways*, lenders will often prefer to eschew the dead hand proxy put and the potential liability that accompanies it, while borrowers may prefer the removal of any proxy put provision from a "change of control" definition. In any event, when negotiating a proxy put provision, loan parties should establish a written record that reflects their understanding of the issue and the borrower's board's understanding of its fiduciary obligations with respect to change-of-control provisions.

ISS and Glass Lewis Release Updated Proxy Voting Policies for the 2016 Proxy Season

Institutional Shareholder Services Inc. (ISS) and Glass Lewis have each released updates to their proxy voting policies for the 2016 proxy season. Our Sidley Update summarizing the policy updates and their practical implications is available here. The key policy updates are summarized below:

Overboarded Directors. Under a revised policy, ISS will issue negative vote recommendations against directors who are not CEOs of public companies who sit on more than five (down from six) public company boards. Glass Lewis similarly updated its policy on overboarded non-executive directors to impose a limit of five (down from six) public company boards. Under a revised policy, Glass Lewis will issue negative vote recommendations against directors who are executives of public companies who sit on more than two (down from three) public company boards, with the negative vote recommendations applying only at the outside boards. ISS and Glass Lewis will note overboarding under their revised policies as a concern for the 2016 proxy season but will not issue negative vote recommendations until 2017.

Unilateral Bylaw/Charter Amendments Adversely Impacting Shareholders. For 2016, ISS updated its policy with respect to bylaw and charter amendments made by the board without shareholder approval that materially diminish shareholders' rights or could adversely impact shareholders. Under the revised policy, ISS will evaluate such unilateral amendments differently based on whether they were made before or after the company completed its IPO. ISS generally will issue negative vote recommendations against individual directors, committee members or the entire board if the company or board adopts bylaw or charter provisions adverse to shareholders' rights prior to or in connection with the IPO, considering specified factors, including (1) the level of impairment of shareholders' rights caused by the provision, (2) the rationale for adopting the provision, (3) the ability of shareholders to change the governance structure in the future, (4) whether the company has a declassified board and (5) whether the company has publicly committed to put the provision to a shareholder vote within three years of the IPO. ISS will recommend case-by-case on director nominees at annual meetings following completion of the IPO until the provision is either reversed or ratified by shareholders.

For non-IPO companies, ISS generally will issue negative vote recommendations against individual directors, committee members or the entire board if the board unilaterally amends the company's bylaws or charter in a way that adversely impacts shareholders, considering specified factors. ISS will recommend case-by-case on director nominees at subsequent annual meetings following the amendment until the adverse provision is reversed or ratified by shareholders; except that ISS generally will recommend votes against director nominees in subsequent years if the unilateral amendment classified the board, established supermajority vote requirements to amend the bylaws or charter or eliminated the shareholders' right to amend the bylaws.

Conflicting Management and Shareholder Proposals. Glass Lewis specified the factors it will consider when making vote recommendations with respect to conflicting management and shareholder proposals, including (1) the nature of the underlying issue, (2) the benefit to shareholders from implementation of the proposal, (3) the materiality of the differences between the terms of the proposals, (4) whether the provisions are appropriate given the company's shareholder base, corporate structure and other relevant circumstances and (5) the company's overall governance profile, including its responsiveness to previous shareholder proposals and adoption of "progressive shareholder rights provisions."

Exclusive Forum Provisions. Glass Lewis will no longer automatically recommend votes against the governance committee chair if a company adopts an exclusive forum provision in its charter or bylaws in connection with an IPO. Under those circumstances, Glass Lewis will weigh the exclusive forum provision in conjunction with other governance practices that Glass Lewis considers unduly limit shareholder rights including supermajority vote requirements, a classified board or a fee-shifting bylaw. Glass Lewis has not updated its policy of recommending votes against the governance committee chair if a company adopts an exclusive forum provision without shareholder approval in the past year other than in connection with a spin-off, merger or IPO.

Executive Compensation at Externally Managed Issuers (EMIs). Under a new policy, ISS will consider it a "problematic pay practice" that generally will result in an adverse vote recommendation on the say-on-pay proposal if an EMI, such as an externally managed REIT, fails to provide sufficient disclosure to enable shareholders to reasonably assess the EMI's executive compensation programs and practices.

Pressure Increasing to Compel Disclosure of Corporate Political Spending

2015 BDO Board Survey: "53% of public company board members [surveyed] believe that the SEC needs to develop mandatory disclosure rules for corporate political contributions."

Despite an uptick in voluntary corporate disclosure and support for mandatory disclosure coming from within the boardroom, the SEC has yet to respond to calls for rulemaking to compel public companies to disclose their expenditures on political activities. This year's CPA-Zicklin Index of Corporate Political Disclosure and Accountability, which for the first time reviewed the policies and practices of all S&P 500 companies, reports that 87% of such companies have some sort of policy regarding political spending disclosure (whether detailed or brief) and 54% have webpages or space on their websites addressing political spending and disclosure. Interestingly, the index notes that those companies "engaged by shareholders, and reaching an agreement, had significantly better disclosure and accountability policies." These shareholder proposals for transparency were cited as a possible reason that public company boards seem to be warming to the notion of political spending disclosure. In the 2015 BDO Board Survey, a majority of the 150 public company directors surveyed indicate support of mandatory disclosure.

Advocacy of mandatory political spending disclosure is likely to be a focal point of the confirmation hearings of Lisa Fairfax and Hester Peirce, both recently nominated to fill open SEC Commissioner positions.

More direct calls for the SEC to draft political spending disclosure rules have come via letter from 58 House Democrats urging action by SEC Chair White, from members of the Senate Banking Committee and in over a million comment letters from the public in response to a 2011 rulemaking petition on the subject. However, in late 2013 the SEC shelved political expenditure disclosure and Chair White confirmed in the Fall of 2014 that that had not changed. It remains to be seen whether this will continue be the case for the SEC's regulatory agenda in the upcoming year—a year in which the presidential election campaign likely will only increase the pressure for more transparency in corporate political expenditures.

SIDLEY EVENTS AND SPEAKERS

Women in Leadership Event: An Evening with the Author of *Fast Forward*

January 14, 2016 | Chicago, IL

Sidley will sponsor its annual Women in Leadership event in Chicago on January 14th. Kim K. Azzarelli, the author of *Fast Forward: How Women Can Achieve Power and Purpose*, will discuss ways in which the world's most powerful women are using their growing economic power to create success and meaning in their lives while building a better world. Sidley clients interested in attending the book discussion and networking reception should contact Shannon Reith at sreith@sidley.com or (312) 456-5883.

Current Trends and Developments in Private Equity

January 15, 2016 | New York, NY

PLI is sponsoring a program entitled *Mergers & Acquisitions 2016: Trends and Developments* in New York City on January 14-15, 2016. John Hughes, a partner in our Washington, D.C. office, will moderate a panel entitled *Current Trends and Developments in Private Equity* at the conference on January 15th. Click here for more information.

Recurring Disclosure Challenges

January 27, 2016 | Coronado, CA

Northwestern University School of Law is sponsoring the 43rd Annual Securities Regulation Institute in Coronado, California on January 25-27, 2016. Tom Kim, a partner in our Washington, D.C. office, will moderate a panel entitled *Recurring Disclosure Challenges* at the conference on January 27th. Click here for more information.

SIDLEY RESOURCES

Sidley recently published a Tax Update entitled *Treasury and IRS Issue New Guidance Further Restricting the Tax Benefits of Inversions*. The Update describes a notice issued by the Treasury Department and the IRS on November 19, 2015 announcing that they intend to issue regulations making it more difficult for companies to avoid the application of the existing anti-inversion rules (inversions are transactions in which U.S. companies attempt to reduce their U.S. tax liabilities by transforming themselves into foreign corporations). In addition, the regulations would further limit tax benefits from post-inversion transactions and provide some relief from the existing rules in certain circumstances. The new rules will generally be effective for transactions occurring on or after November 19, 2015.

Sidley recently published a Tax Update entitled *New Partnership Tax Audit Rules Will Affect M&A Transactions Involving Partnerships*. The Update describes how the newly enacted Bi-partisan Budget Act of 2015 will transform partnership audit procedures and discusses the potential implications of the new rules on M&A transactions involving partnerships.

Sidley recently published an Antitrust/Competition Update entitled *EU and China Issue Practical Guidance for Cooperation on Merger Reviews.* The Update explains that the European Commission and the Ministry of Commerce of the People's Republic of China have bolstered their cooperation when reviewing mergers. This enhanced cooperation may well lead to more efficient, consistent and non-conflicting reviews of international mergers given the important role that each authority has in reviewing such mergers and the fact that each authority has separate bilateral arrangements with the U.S. antitrust agencies.

Forbes online recently published a guest post by Beth Flaming, a partner in our Chicago office. The post, entitled *Best Defense Against 'Wolf Pack' Investors Is to Anticipate Their Attack*, aims to demystify the wolf pack phenomenon in connection with shareholder activism.