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ANALYSIS

U.S. ANTITRUST AGENCIES SUGGEST MERGER REVIEW PROCESS CHANGES

By James W. Lowe[1]

Earlier this fall, Makan Delrahim, the Assistant Attorney General in charge of the Department of Justice Antitrust Division (the Division), announced that the Division would implement a number of steps intended to speed merger reviews and modestly reduce the burden on merging parties subject to extended investigations.[2] These changes, outlined below, are designed to reduce some bottlenecks that have developed in extended investigations and to provide presumptively clearer guidance on how the Division will approach timing and scope of production. Notably, the Federal Trade Commission (FTC), which shares merger review responsibility with the Division, has not announced similar charges. This is not the first time one or both agencies have announced "reforms" of the merger review process; indeed, this is at least the fourth "merger process reform" announcement by the agencies since 1995. Whether these proposed changes will be implemented or will have any meaningful effect on the review process is unclear.

Background

The Hart-Scott-Rodino Act (HSR Act) requires that parties to most transactions above a certain value—currently $84.4 million—report them to the Division and FTC and delay closing until after the reviewing agency has completed its investigation. After the parties have made their filing as required under the HSR Act, the agency has, in most cases, 30 days to determine whether the transaction raises sufficiently serious antitrust issues to justify an in-depth investigation. The agency will issue what is known as a Second Request to each of the parties if the agency elects to proceed with an in-depth investigation, requiring each party to produce a vast amount of information including both data and documents. Only a very small percentage of filed transactions receive Second Requests (typically 2-4% in any given year). The Second Request process can be expensive and time-consuming; it often takes months and costs millions of dollars for the parties to respond to the Second Requests, and the antitrust agencies have been demanding increasing amounts of time to review the information they receive during their investigations. Merging parties have, from time to time, complained loudly about the cost and delay imposed by the process. Moreover, others have relied on statistics drawn from public sources to assert that the average time for the agencies to complete a Second Request investigation has increased materially over the past decade.[3] These factors have created pressure on the agencies to reduce the burden of merger reviews.

In response to this pressure, the Division once again has announced changes to its internal processes that purport to reduce both time and cost. In theory, these changes are supposed to benefit both the parties and the Division, both of which have limited resources. But, as described below, to be effective and acceptable to the Division, the proposals require parties to waive certain statutory rights and accept conditions that may not always be in their best interest.

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2 Makan Delrahim, It Takes Two: Modernizing the Merger Review Process (Sept. 25, 2018). See also, Bernard A. Nigro, Jr., A Partnership to Promote and Protect Competition for the Benefit of Consumers (Feb. 2, 2018); and Donald G. Kempf, Jr., Remarks at American Bar Association's Antitrust Fall Forum (Nov. 16, 2017).

3 These statistics, which AAG Delrahim cited in his announcement of the process reforms, are of questionable value because they provide only an average length of investigation rather than a median or mean. Given the limited number of investigations in any given year, the resulting averages are distorted if there happen to be one or more very lengthy investigations in that year. Moreover, factors unrelated to the U.S. merger review process often delay clearances, including reviews in other jurisdictions or delays in finding an acceptable upfront buyer for investigations resolved by a divestiture.

The Proposed Reforms

Process Reforms. Nothing in the Second Request process limits the scope of search or the number of depositions agency staff can demand, and those matters have been the subject of often-contentious negotiations. To reduce both the burden and the time taken by these negotiations, the proposed reforms set presumptive limits (which are subject to modification by a deputy Assistant Attorney General in the Division):

- An assumption that 20 custodians per party will be sufficient in most cases; and
- A presumptive limit of 12 depositions.

To reduce the total time of the investigation and allow parties more notice of what staff will request of them, the Division is willing to do the following:

- Allow the parties to meet with senior officials of the Division early in the process, giving the parties an opportunity to present their key facts and deal rationale;
- Issue a model voluntary request letter to make clear what materials staff is likely to seek during the 30-day preliminary review period;
- Revise its model timing agreement (discussed below) to limit areas of disagreement and purportedly bring the timing agreement closer in line with the requirements of the HSR Act;
- Release redacted timing agreements from prior cases to provide guidance on current and past practice;
- Agree to complete its review and decision-making process, in most cases, within 60 days of the parties' compliance with the Second Request if the parties have entered into a timing agreement; and
- Improve coordination with foreign enforcers to reduce duplication of demands on the parties.

The Division will only offer these new limits and processes where the parties (1) enter into a timing agreement and (2) agree to do the following:

- Produce documents earlier in the investigation and on a rolling basis;
- Review potentially privileged documents early and release nonprivileged documents on a rolling basis;
- Avoid producing the bulk of documents (including those initially withheld as potentially privileged) shortly before certifying compliance with the Second Request;
- Provide early cooperation on identifying relevant data and provide responsive data substantially before the compliance date; and
- Agree to a longer period of pre-trial discovery when the Division challenges a transaction in court.

The reforms also take aim at third parties who receive Civil Investigative Demands (CIDs) during merger investigations. The Division asserts that it will enforce the demands and timelines in its third-party CIDs and will not "hesitate to bring CID enforcement actions in federal court."

In addition, the Division announced the expected withdrawal of the 2011 Policy Guide to Merger Remedies. That Guide indicates that in certain circumstances the Division was willing to accept behavioral (as opposed to structural) remedies to resolve concerns in merger cases. The current Administration has been clear that it largely rejects behavioral remedies, so the 2011 Guide no longer reflects Division policy.

Takeaways

Merger parties always benefit from the reviewing agency making efforts to reduce the time and cost imposed by the investigation, and in that sense the Division's proposals are welcome. However, these reforms may come with hidden costs.

Institutionalizing Timing Agreements. The agencies began using timing agreements nearly two decades ago primarily as a way of giving themselves more time to complete investigations after the parties complied with the Second Request. The HSR Act provides the agencies with 30 days after compliance to reach an enforcement decision. Rather than seek a legislative change to extend the 30-day clock, the agencies instead have been insisting that parties agree to provide the agencies with more time by contract (i.e., the timing agreements). If parties refuse to accept a timing agreement, the agencies assert that they may be unwilling to agree to routine modifications of the Second Request (e.g., custodians, production, data responses) or agree to engage with the parties to discuss their concerns with the merger prior to reaching a final decision on whether to seek an enforcement action. Although the Division here implicitly acknowledges that timing agreements do not comport with the statute, the reforms move further toward effectively making the agreements mandatory and toward a position that the Division's model agreement is non-negotiable.

The Exception May Make the Rule. The agencies have stated in prior reform initiatives that they would limit the number of custodians and provide earlier guidance on the direction of the investigation, subject to certain exceptions. The experience of most practitioners has been that over time, the exceptions have swallowed the rule and the purported limitations have fallen by the wayside. It may be different this time, but history does not bode well. As a result, parties should not assume that the time and scope limits will apply to their transaction.

The Two Agencies Differ. The FTC has not announced any similar process reforms, and in recent remarks, FTC Chairman Joe Simons indicated that the Division did not consult the FTC prior to announcing its reforms. Although the FTC also issued a model timing agreement earlier this year, that agreement is notably different from the one described by the Assistant Attorney General. For example, the FTC timing agreement asks for a minimum of 60 to 90 days after compliance to complete its review and decision-making process. Separately, the FTC reiterated prior guidance that review of a settlement proposed by the parties and staff typically takes four weeks from submission and can take longer. Thus, parties whose transactions are reviewed by the FTC should not expect any of the process changes described above to apply to their investigation.

Ultimately the Statute Rules. Although both agencies have fully embraced timing agreements, those agreements are not authorized by—and in some ways are inconsistent with—the HSR Act and its self-imposed deadlines. If parties find either agency's terms unacceptable, they should reject them and seek responsible terms that allow for a reasonable path to resolution of the investigation.

NEWS[4]

JUDICIAL DEVELOPMENTS

In a First, Delaware Allows Buyer to Terminate Merger Agreement Based on a "Material Adverse Effect"

On December 7, 2018, the Delaware Supreme Court upheld the Court of Chancery's October 2018 ruling that global healthcare group Fresenius SE & Co. was justified in canceling its $4.75 billion acquisition of specialty generics pharmaceutical manufacturer Akorn, Inc. *Akorn Inc. v. Fresenius Kabi AG, et al.* (Del. Dec. 7, 2018). The ruling is the first-ever affirmation of the termination of a merger agreement in a Delaware court based on a contractually defined "Material Adverse Effect" or MAE. The Court of Chancery found both a general MAE as a result of Akorn's financial condition and a regulatory MAE due to breaches of Akorn's regulatory compliance representations. In addition, the Court of Chancery found that Akorn's material breach of its obligation to operate in the ordinary course of business between signing and closing provided Fresenius with a third basis for terminating the merger agreement.

Financial Condition

Immediately after the parties entered into the merger agreement, "Akorn's business performance fell off a cliff," as the Court of Chancery summarized its factual findings. The Court helpfully provided the following commentary and table of Akorn's financial results over the year following the announcement of the transaction:

> "[T]he following table depicts the year-over-year declines that Akorn suffered during each of the three quarters of FY 2017 that took place after signing, plus full-year results for FY 2017, plus first quarter results for FY 2018:

Year-Over-Year Change in Akorn's Performance

	Q2 2017	Q3 2017	Q4 2017	FY 2017	Q1 2018
Revenue	(29%)	(29%)	(34%)	(25%)	(27%)
Operating Income	(84%)	(89%)	(292%)	(105%)	(134%)
EPS	(96%)	(105%)	(300%)	(113%)	(170%)

> Akorn did not report EBITDA or adjusted EBITDA figures on a quarterly basis for 2017. It reported full-year EBITDA of $64 million, a year-over-year decline of 86%. Akorn reported full-year adjusted EBITDA of $241 million, a year-over-year decline of 51%. As these figures show, Akorn's performance declined dramatically, year over year, with positive operating income and positive earnings per share turning to losses.
>
> In addition to representing a dramatic decline on a year-over-year basis, Akorn's performance in FY 2017 represented a departure from its historical trend. Over the five-year span that began in 2012 and ended in 2016, Akorn grew consistently, year over year, when measured by revenue, EBITDA, EBIT, and EPS. During 2017, Akorn's performance fell dramatically when measured by each metric. For example, Akorn's EBITDA and EBIT grew each year from 2012 to 2016, but in 2017, fell by 55% and 62%, respectively."

4 The following Sidley lawyers contributed to the research and writing of the pieces in this section: Phillip Acevedo, Nick Behrens, Jennifer F. Fitchen, Robert M. Garsson, Claire H. Holland, John K. Hughes, Thomas J. Kim, Kai H.E. Liekefett, Daniel A. McLaughlin, James Mendenhall, Charlotte K. Newell, Jorene Ooi, Dustin B. Page, Evan Saunders, Andrew Shoyer and Andrew W. Stern.

Citing the requirement of *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14 (Del. Ch. 2001) (Strine, V.C.) that "the effect should 'substantially threaten the overall earnings potential of the target in a durationally-significant manner,'" the Court of Chancery observed that the material deterioration of Akorn's financial condition had "persisted for a full year and shows no sign of abating" and "[m]ore importantly, Akorn's management team has provided reasons for the decline that can reasonably be expected to have durationally significant effects."

The Court of Chancery then distinguished between the risk of "endogenous, business-specific events" it found as being allocated to Akorn by the MAE definition and "exogenous, systematic risks" that were allocated to Fresenius. The Court found that the underlying causes of the decline were specific to Akorn's business and therefore allocated under the agreement to Akorn. Moreover, the Court found that even if the causes of the decline could be characterized as exogenous, systematic risks, the MAE definition places the risk on Akorn to the extent Akorn was disproportionately affected relative to others in its industry, and found that Akorn was so disproportionately affected. Accordingly, the Court held that Akorn had experienced a general MAE permitting Fresenius to terminate the merger agreement.

Regulatory Compliance Breach

The Court of Chancery also found that an MAE tied to a breach of the regulatory compliance representations had occurred based on "overwhelming evidence of widespread regulatory violations and pervasive compliance problems" that existed at signing and worsened. The Court's opinion contains a detailed account of how, after Fresenius received whistleblower letters following the deal's announcement, Fresenius' investigation into Akorn's regulatory compliance programs led to uncovering "serious and pervasive data integrity problems that rendered Akorn's representations about its regulatory compliance sufficiently inaccurate that the deviation between Akorn's actual condition and its as-represented condition would reasonably be expected to result in a Material Adverse Effect."

Breach of Covenant

Finally, the Court of Chancery found that Fresenius' termination of the merger agreement was warranted because Akorn breached its covenant to continue operating in the ordinary course of business prior to closing in a number of ways: canceling regular audits and inspections; not remediating deficiencies; failing to maintain an adequate data integrity system; submitting regulatory filings to the FDA based on fabricated data; and, after learning of the whistleblower letters, only "shadowing" the investigation being done by Fresenius rather than conducting its own "responsive and credible investigation using counsel with experience in regulatory matters." The Court found that these failures amounted to a failure to meet the closing condition that Akorn have complied with its covenants in all material respects, providing Fresenius with a third basis for terminating the merger agreement.

Delaware Supreme Court Decision

Akorn appealed the decision to the Delaware Supreme Court, which considered the matter on an expedited schedule. Argument was held on December 5, 2018 and the Supreme Court affirmed the Court of Chancery's decision just two days later in a three-page order drafted by Chief Justice Strine. The Supreme Court concluded that the factual record adequately supports the Court of Chancery's findings that (1) Akorn suffered both a general MAE and a regulatory MAE and (2) Fresenius was not in material breach under the merger agreement which would have prevented it from exercising its termination right. Specifically, the Supreme Court upheld the Court of Chancery's determination that Fresenius did not breach its "reasonable best efforts" covenants and that its temporary breach of the "hell-or-high-water" covenant relating to antitrust approval was not material. Importantly, however, the Supreme Court explicitly stated that it was not ruling on the Court of Chancery's finding that Akorn breached its covenant to continue operating in the ordinary course of business, thus leaving several questions about the Court of Chancery's findings in the minds of practitioners such as the proper standard for assessing the materiality of such a breach.

Limitations of this Summary

As discussed [here]() and extensively in the opinion itself, lawyers from Sidley's Food, Drug and Medical Device Compliance and Enforcement practice and litigation group advised Fresenius SE & Co. in the matter and conducted Fresenius' investigation into Akorn's regulatory compliance. Accordingly, the firm is limiting its public statements on the decision. This summary of the case is based solely on the Court of Chancery's findings as described in its opinion without any editorial commentary.

Delaware Supreme Court Clarifies *MFW* Requirement for Conditions to Be in Place "Ab Initio"

Our [Summer 2018]() issue of Sidley Perspectives discussed a Delaware Court of Chancery decision from July 2018 that also clarified the MFW requirements for conditions to be in place "ab initio."

The Delaware Supreme Court recently issued a decision that has further clarified the application of the *Kahn v. M&F Worldwide Corp. (MFW)* doctrine in mergers with controlling stockholders. *Flood v. Synutra Int'l, Inc.* (Del. Oct. 9, 2018). *MFW* provides that the defendant-friendly business judgment rule will apply to a merger proposed by a controlling stockholder if that controller conditions the transaction *"ab initio"* on approval by (1) an independent, properly empowered special committee that fulfills its duty of care and (2) a majority of the minority stockholders in an uncoerced, informed vote. *MFW*, 88 A.3d 635 (Del. 2014). When the business judgment standard of review applies to a transaction, it generally assures an early, pre-discovery dismissal.

Synutra raised questions about how early in the deal process these preconditions must be in place to secure *MFW*'s favorable standard of review. The controller sent an initial letter proposing to purchase all minority shares for $5.91 per share but did not mention *MFW*'s preconditions. One week later, the company's board formed a special committee and agreed that the board would "not substantively evaluate" the proposal. In the interim, the company also agreed to waive conflicts and allow its frequent outside counsel to represent the controller. One week later (i.e., two weeks after the initial letter), the controller sent a second letter expressly conditioning the deal process on the requisite *MFW* protections. As plaintiff admitted, at that point, the special committee had not engaged its own investment bank or counsel, and it had not engaged in price negotiations. In fact, its price negotiations ultimately did not commence until seven months later.

Plaintiff argued, however, that because the controller did not insist upon *MFW*'s preconditions in its initial letter, the business judgment rule could not apply. This rested largely on a literal interpretation of the *MFW* Court's mandate that such procedures be "in place '*ab initio*'" (i.e., "from the beginning"). The defendants proffered that *MFW*'s wording was not meant to place form over substance but rather to require that *MFW*'s protections should "be in place before any substantive economic negotiations take place, so that the proffer of the conditions cannot be substituted for price concessions." The Delaware Supreme Court (like the Court of Chancery before it) sided with the defendants. The Supreme Court candidly explained that previous descriptions of this temporal requirement may have been ambiguous and clarified that "from the beginning" need not be taken literally. The Court reasoned that interpreting "from the beginning" as it is used in everyday speech corresponded with *MFW*'s purpose: to incentivize controllers to replicate a third-party process and that so long as the commitment to *MFW* preceded any economic bargaining, the standard would be satisfied.

Under Synutra*, to benefit from the* MFW *standard of review, a controlling stockholder must condition a transaction on approval by a special committee and a majority of the minority stockholders prior to any economic bargaining.*

Synutra also clarified a second question on appeal: whether the conduct of an *MFW* special committee could be challenged via a claim that the deal price was inadequate. Referencing a footnote in *MFW* explaining that the *MFW* committee had exercised due care, plaintiffs argued that an inadequate price would raise a question about whether the committee had in fact acted with due care and render a pleading-stage dismissal improper. Both the Court of Chancery and the Supreme Court roundly rejected this argument, finding that *MFW* does not permit such an inquiry because to do so wholly undermines its purpose: By making dismissal at the pleading stage more difficult to achieve, controllers will lack incentive to adopt the *MFW* protections for minority stockholders in the first instance. Rather, to challenge due care, a plaintiff must adequately plead gross negligence—a far higher standard.

Synutra is a reminder that *MFW* can offer a meaningful litigation advantage for controlling stockholder defendants so long as they condition a transaction on its preconditions sufficiently early in the deal process. While the Delaware courts have eschewed a bright-line approach, controllers and their advisers should be careful to formalize *MFW*'s requirements as early as possible (and certainly before any economic terms are negotiated).

New York Appeals Court Reverses Injunction of Xerox-Fujifilm Transaction

On October 16, 2018, the New York Appellate Division reversed an injunction that had prohibited Fujifilm from closing its $6.1 billion agreement to combine with Xerox for nearly five months and completely dismissed all related claims against Fujifilm.[5] The Court's decision in *In re Xerox Corp. Consol. S'holder Litig.* and *Deason v. Fujifilm Holdings Corp.* reaffirms the longstanding rule that a plaintiff must establish that a majority of the directors on a corporate board is interested or lacks independence with respect to a decision in order to rebut the business judgment rule.

On January 31, 2018, Xerox and Fujifilm announced a transaction pursuant to which (1) Fujifilm would take a 50.1% stake in Xerox, (2) Fujifilm would contribute its 75% interest in Fuji Xerox Co. Ltd., Fujifilm and Xerox's longstanding joint venture, and (3) existing Xerox stockholders would receive a $2.5 billion special dividend. After the transaction was announced, putative stockholder class plaintiffs, along with Xerox's largest stockholder, Darwin Deason, sought to enjoin the deal, primarily arguing that Xerox's CEO negotiated an unfair transaction for the purpose of securing continuing employment for himself. In addition to pleading breach of fiduciary duty claims against Xerox and its directors, plaintiffs also asserted aiding and abetting claims against Fujifilm. Carl Icahn publicly supported the stockholders' efforts. On April 27, 2018, following a two-day evidentiary hearing, the New York Supreme Court preliminarily enjoined the transaction and simultaneously denied Fujifilm's motion to dismiss.

Fujifilm appealed the decision and asserted primarily that the trial court had improperly concluded that a majority of the Xerox board was conflicted based solely on a finding that, pursuant to the terms of the transaction agreements, five directors would continue to serve after the closing. Fujifilm successfully argued to the contrary, pointing to longstanding New York law holding that the prospect of retaining a directorship is not necessarily a material interest sufficient to rebut the business judgment rule.

The appellate court agreed. It noted that the board had engaged outside advisers and considered the transaction on numerous occasions and had "not engage[d] in a mere post hoc review, nor was the transaction unreasonable on its face." Therefore, a unanimous court ordered a complete reversal of the trial court's decisions "on the law and the facts," dissolving the injunction and dismissing all claims against Fujifilm.

5 Sidley represented Fujifilm in its appeal from the trial court's injunction decision.

Delaware Appraisal Developments

As discussed in previous issues of Sidley Perspectives, during the past several years, appraisal jurisprudence in Delaware has evolved rapidly, with the Court of Chancery and the Supreme Court issuing a number of rulings refocusing how they will evaluate statutory appraisal claims. The Court of Chancery recently issued two new rulings that add to the appraisal jurisprudence in Delaware.

After Reargument, AOL's Appraised Fair Value Gets Lowered Further Below the Deal Price

We highlighted the Court of Chancery's initial ruling in In re Appraisal of AOL Inc. *in our Spring 2018 issue of* Sidley Perspectives.

Earlier this year, the Court of Chancery issued its opinion in *In re Appraisal of AOL Inc.* (Del. Ch. Feb. 23, 2018). That action arose when dissenting stockholders of AOL sought appraisal in connection with Verizon Communications Inc.'s acquisition of AOL in 2015 for $50 per share ($4.4 billion). Post-trial, the Court set AOL's appraised fair value at $48.70 per share—$1.30 below the deal price.

In his opinion, Vice Chancellor Glasscock acknowledged that the Supreme Court had previously directed trial courts to consider a transaction that results in fair market value as persuasive when determining the statutory fair value—provided the transaction is what the Vice Chancellor described as "*Dell*-compliant." The Vice Chancellor determined that the AOL transaction was not *Dell*-compliant due to certain deal protections, informational advantages between bidders and statements by the parties that inhibited potential bidders for AOL. As a result, he assigned no weight to the deal price and instead used a DCF analysis to set appraised fair value at 2.63% below the deal price. When performing the DCF analysis, he also expressed concern about the reliability of certain figures he used to calculate the present value of two unconsummated transactions that he found were "part of AOL's operative reality."

Post-ruling, each of the parties moved for reargument. The parties also asked the Court to reconsider its calculation of the value of the two pending AOL transactions as well as the perpetuity growth rate that the Court adopted when performing its DCF analysis.

In August 2018, Vice Chancellor Sam Glasscock issued a letter ruling in which he revised his initial DCF determination and lowered AOL's appraised fair value still further. *In re Appraisal of AOL Inc.* (Del. Ch. Aug. 15, 2018). The Vice Chancellor noted that when performing the DCF analysis on AOL's overall value in his initial ruling, he had used certain factual assumptions on the accretive value of one of AOL's unconsummated transactions that turned out to be incorrect. After revisiting technical aspects of the initial DCF analysis and the valuation models used by each of the parties' experts, the Vice Chancellor determined that the accretive value attributable to that transaction was actually lower than what he had initially determined, which in turn affected the calculation of the present value of AOL's future cash flows. The Court determined that correcting the calculation had the effect of reducing the appraised fair value of AOL still further, to $47.08 per share, or an additional 3.3% reduction. The Court declined to revisit its other findings and determinations from its initial ruling. The latest *AOL* ruling serves as another reminder of the risk that dissident stockholders face in appraisal actions that they may receive less than the offered deal price —even after reargument.

Contractual Waiver of Appraisal Rights Upheld

The Manti Holdings *decision is particularly relevant to private equity and venture capital firms that typically include drag-along provisions in stockholder agreements.*

In another recent appraisal-related case, the Court of Chancery ruled for the first time that a contractual provision in a stockholders' agreement where stockholders agreed to refrain from exercising their statutory appraisal rights in certain types of transactions was enforceable against those stockholders when they sought to exercise those rights in a subsequent merger. *Manti Holdings, LLC v. Authentix Acquisition Co.* (Del. Ch. Oct. 1, 2018).

The litigation arose out of the merger of Authentix Acquisition Co. with a third party. Petitioners were minority common stockholders in private equity-controlled Authentix. The

Court determined the cash merger consideration was to be distributed to various holders pursuant to a waterfall provision in the company's charter. The Court also found that petitioners and the private equity firm (which held preferred stock) would receive little or no consideration in the merger. Post-merger, petitioners sought statutory appraisal under Delaware General Corporation Law (DGCL) Section 262. The narrow issue before the Court was whether Authentix could enforce the stockholders' agreement provision against the petitioners.

The Court noted that "[d]emonstrating a waiver of the statutory right to appraisal requires language evincing the clear intent to waive…" Petitioners raised several arguments trying to overcome the contractual waiver. First, petitioners claimed the stockholders' agreement terminated at the time of sale, and any agreement refraining from seeking appraisal post-closing had terminated then. But Vice Chancellor Glasscock determined that the agreement provision was clear and unambiguous, and petitioners' argument would render the stockholders' agreement clause a nullity.

Second, petitioners claimed that even if enforceable, the waiver was not enforceable *by the company*. The Court rejected this argument as well, noting it was the company that had the most interest in enforcing the provision, especially given that any duty to pay petitioners would fall on the company. Third, petitioners argued that enforcing the provision ran against public policy since DGCL 151(a) requires any limitation on a class of stock to be set out in the corporate charter, and the provision essentially limited a right inherent in company stock. The Court dismissed this argument, noting that enforcing a contractual provision by which petitioners had voluntarily agreed to forbear from exercising their appraisal rights was not a limitation on a class of stock.

Finally, petitioners argued that the transaction structure did not satisfy the requirements of the stockholders' agreement in order for the drag-along and the forbearance to apply. Under the agreement, if the sale were structured as a transfer of equity, the agreement required common stockholders to consent to and raise no objection to the sale, and to refrain from seeking appraisal, so long as the stockholders received the same price per share as certain preferred holders. If the sale were structured as a merger, however, the stockholders' agreement required common stockholders to consent to and raise no objection to the sale, and to refrain from seeking appraisal rights, regardless of whether the consideration received by common stockholders and preferred holders differed.

In *Manti Holdings*, the petitioners received less consideration per share than the private equity preferred holders, and the mix of preferred and common shares held by the parties was dissimilar, such that petitioners attempted to assert that the same-price condition had not been satisfied, and thus the agreement to forbear from seeking appraisal had never been triggered. The Court determined, however, that the transaction was structured as a merger. As a result, it upheld the right of Authentix to enforce the contractual provision where petitioners had voluntarily agreed at the time of investment to refrain from exercising appraisal rights in certain transactions, and the Court denied petitioners' attempts to avoid the contractual provision.

Activist Investor Aided and Abetted a Target Board's Fiduciary Duty Breaches

The Delaware Court of Chancery recently found that an activist investor aided and abetted the board of a target company in breaching its fiduciary duties. *In re PLX Tech. Inc. S'holders Litig.* (Del. Ch. Oct. 16, 2018). However, the plaintiff stockholders did not adequately prove any causally related damages.

Activist investor Potomac Capital Partners II, L.P. launched a successful proxy contest against PLX Technology Inc. resulting in three Potomac nominees being added to the PLX board. One

In In re PLX Tech. Inc. S'holders Litig.*, the Delaware Court of Chancery found that a director appointed by an activist "succeeded in influencing the directors to favor a sale when they otherwise would have decided to remain independent" and noted evidence that the incumbent PLX directors improperly deferred to the director and allowed him "to take control of the sale process when it mattered most."*

of the nominees was a co-managing member and agent of Potomac who would serve as chair of the PLX board's special committee exploring a future sale of PLX. After stepping into this role, Potomac's agent learned through PLX's financial advisor that a certain buyer would be ready to proceed with an acquisition in a few months after closing a separate deal. Neither Potomac's agent nor the financial advisor informed the PLX board or management of this tip. The buyer eventually approached PLX with an offer lower than PLX's internal valuation. In an effort to reach a deal quickly, Potomac's agent instructed PLX management to prepare a lower set of projections to use in a revised valuation that was compatible with the buyer's offer. The PLX board signed off on use of the lower projections without review. In recommending the deal to stockholders, the board did not disclose the tip received by the financial advisor and claimed the lower projections occurred in the ordinary course of business.

The Court found the PLX directors violated their fiduciary duties in two ways, paving the way for an aiding and abetting claim against Potomac. First, they breached their fiduciary obligations by allowing Potomac's agent to lead the sale effort while having a conflicting interest in selling the company quickly. Also, the board breached its duty of disclosure by failing to disclose the tip and misleading stockholders into believing that the lower projections occurred in the ordinary course of business. Potomac, through the actions of its agent, aided and abetted the board's breaches by withholding information from the rest of the PLX board. The Court found that this failure to disclose the tip fatally undermined the sale process. Nevertheless, the Court extended its reasoning from the recent *Dell* and *DFC* appraisal decisions to hold that the valuation present in an arm's length transaction is entitled to "heavy, if not overriding, probative value." Accordingly, although the Court determined that Potomac aided and abetted the PLX directors' fiduciary duty breaches, it did not impose damages because the plaintiffs failed to demonstrate that the standalone value of PLX exceeded the deal price.

This decision serves as a reminder for directors to disclose all conflicts and material facts to both stockholders and other directors. In addition, the ruling marks an increased deference to the deal price in evaluating damages, extending *Dell* and *DFC* to fiduciary duty and aiding and abetting claims.

In Klein*, the Second Circuit stressed that a derivative suit, like a class action, involves a representative party and thus remains a live case in federal court even if the representative plaintiff's claim is moot so long as some party whose interests are at stake comes forward. Therefore, the decision provides an opening for derivative suits to continue in federal court after a merger or sale of stock eliminates the named plaintiff.*

Second Circuit Allows Derivative Suit to Continue After Merger by Substituting Company for Former Shareholder

The U.S. Court of Appeals for the Second Circuit, in *Klein v. Cadian Capital Mgmt., L.P.* (2d Cir. Oct. 2, 2018), held that a derivative suit should have been allowed to continue after a cash-out merger that eliminated the representative plaintiff's financial interest in the case. While *Klein* was a suit under Section 16(b) of the Securities Exchange Act against a shareholder group for "short-swing" trading profits, the Court's reasoning could apply to any derivative suit in federal court.

Typically, a representative plaintiff's derivative suit becomes moot when a merger deprives the representative of a continuing ownership stake in the company. The Second Circuit agreed that the representative plaintiff's claim in *Klein* was moot after the merger. However, the new owners of the company wished to continue the suit, and the Court allowed them to substitute the company as the plaintiff under Federal Rule of Civil Procedure 17(a)(3). The Court stressed that a derivative suit, like a class action, involves a representative party and thus remains a live case in federal court even if the representative plaintiff's claim is moot so long as some party whose interests are at stake comes forward. The Court held that Rule 17(a)(3) permits another plaintiff, including the company acting on its own behalf, to intervene so long as the plaintiffs are not acting in bad faith or imposing unfairness on the defendants.

One member of the panel dissented, arguing that a 2018 Supreme Court decision narrowed exceptions to the mootness rules to apply only to class actions and that Section 16(b) cases should not be treated like class actions. The dissent also argued that plaintiffs should be required to demonstrate that they made an "honest mistake" in not joining the company as a party in the first place.

Unless and until other courts disagree with the Second Circuit, *Klein* provides an opening in some cases for derivative suits, under Section 16(b) and otherwise, to continue in federal court after a merger or sale of stock eliminates the named plaintiff.

Delaware Court of Chancery Finds That Properly Exercised Put Rights Survived Merger

The Delaware Court of Chancery recently held that certain put rights survived a merger as a contractual claim of the granting company. *QC Holdings, Inc. v. Allconnect, Inc.* (Del. Ch. Aug. 28, 2018). The Court granted plaintiff QC Holdings' motion for summary judgment, finding that QC Holdings was entitled to the $5 million put price in exchange for its properly exercised, but not yet satisfied, put rights rather than the considerably lower amount it would have received as merger consideration.

Because QC Holdings effectively transferred its rights of ownership associated with the put shares upon exercise, it was no longer considered a stockholder with the right to receive the merger consideration but instead held a contractual claim against Allconnect as the surviving entity in the merger.

Under a 2013 put agreement, Allconnect granted QC Holdings the right to cause Allconnect to repurchase 18.6 million shares of its common stock in exchange for $5 million in cash. Allconnect was not obligated to pay the put price unless it had sufficient funds legally available and it had no senior debt outstanding. In 2015, QC Holdings exercised the put right in accordance with the terms of the put agreement but, when Allconnect's obligation to pay the put price matured in 2016, Allconnect lacked the funds to pay the put price and had senior debt outstanding. Allconnect was acquired via a reverse triangular merger in 2017, with Allconnect surviving as a wholly-owned subsidiary of the acquirer.

Vice Chancellor J. Travis Laster reasoned that "the outcome turns on the status of the Put Shares…If they remained outstanding, then they were converted into the right to receive the merger consideration." However, the Court held that "the Put Shares had been transferred to [Allconnect], and the resulting contractual commitment to pay the Put Price survived the [m]erger as an obligation of the surviving corporation under Section 259 of the DGCL." Because QC Holdings tendered the stock certificates, provided assignments and transferred title to Allconnect (including any associated economic and voting rights), the shares were indeed deemed to have been transferred, resulting in the put rights surviving the merger as a contractual claim.

This decision highlights that the language in the put agreement—and especially the status of the put shares at the time of the merger—will determine whether the put rights survive as a contractual obligation of the granting company post-merger. The Court seems to suggest that if stockholders retain rights associated with exercised put shares (e.g., economic and voting rights) until the redemption is complete, in the case of a merger, their right to receive the put price may be extinguished and they may be limited to the right to receive the merger consideration. Therefore, put agreements should clearly identify the nature of the put rights, the procedures necessary for exercise and payment, and the effect that future transactions will have with respect to the rights being granted.

REGULATORY DEVELOPMENTS

Takeaways From the SEC Roundtable on Reforming the Proxy Process

In a December 2018 speech, SEC Chair Jay Clayton highlighted improving the proxy process as a significant SEC initiative for 2019.

On November 15, 2018, the SEC Staff held a roundtable to assess whether the SEC should update its rules governing proxy voting mechanics and the shareholder proposal process, and strengthen the regulation of proxy advisory firms. These issues have been under consideration since the SEC solicited public comment on the proxy system in 2010. Topics discussed at the roundtable included the following:

- *Proxy Voting Mechanics and Technology*. Panelists agreed that the current proxy voting system needs to be modernized and simplified, for example, by:
  - Implementing a vote confirmation process so shareholders may verify before the vote deadline that voting instructions were followed and their votes were counted;
  - Using technology to encourage wider participation and reduce costs and delays in the voting process;
  - Studying why retail shareholder participation has fallen and whether more direct communication channels would improve information flow and participation; and
  - Mandating use of universal proxy cards in proxy contests.
- *The Shareholder Proposal Process*. Some panelists asserted that the current shareholder proposal process functions well, while others identified areas for reform including:
  - Revisiting the ownership thresholds and holding period required to submit a shareholder proposal (currently, the lesser of $2,000 or 1%, and one year);
  - Increasing resubmission thresholds to address reappearance of a proposal even though a majority of shareholders vote it down year after year;
  - Providing more SEC guidance and explanation of no-action decisions and rationales; and
  - Requiring proxy disclosure of the name of the shareholder proponent (and its proxy, if any) and its level of shareholdings.
- *The Role and Regulation of Proxy Advisory Firms.* While no significant consensus emerged regarding whether proxy advisors should be subject to further SEC regulation, areas under discussion included:
  - Improving accuracy of proxy advisor reports and affording all companies opportunities to review and verify information in advance of publication; and
  - Improving procedures to monitor and manage, and enhancing disclosure of, conflicts of interest.

In anticipation of the roundtable, in September 2018, the SEC withdrew no-action letters that the SEC Staff had issued to ISS and Egan Jones in 2004. The letters essentially permitted registered investment advisers to rely on a proxy advisory firm's general conflict of interest policies, without the need to conduct due diligence as to any conflicts that may affect an advisor's independence with respect to any particular voting recommendation.

It remains to be seen whether the SEC will incorporate input from the roundtable into future rulemaking or new Staff guidance or practice. The SEC is more likely to focus on proxy reform as a priority than on regulation of proxy advisors absent pressure from Congress.

Two bills seeking SEC regulation of proxy advisory firms were introduced in the 115th Congress. In June 2018, the Senate Committee on Banking, Housing, and Urban Affairs held a hearing on The Corporate Governance Reform and Transparency Act, H.R. 4015 which was sent by the House of Representatives to the Senate in December 2017 for consideration. In addition to subjecting proxy advisory firms to SEC regulation, the bill would mandate maintenance of certain staffing levels and annual reporting relating to recommendations. In November 2018, The Corporate Governance Fairness Act, S. 3614 was introduced in the Senate to amend the Investment Advisers Act of 1940 (IAA) to expressly require proxy advisory firms to (1) register as investment advisers under the IAA, thereby subjecting them to enhanced fiduciary duties and SEC oversight, including regular Staff examinations into their conflict of interest policies and programs, and (2) disclose whether they knowingly have made false statements to clients or have omitted to state material facts that would be necessary to make statements to clients not misleading. Neither bill is likely to be passed into law by the end of the current session of Congress.

SEC Cautions Public Companies to Address Cyber Threats as Part of Internal Accounting Controls

The SEC chose not to take action against the nine companies, but the Enforcement Division's findings are a reminder that effective cybersecurity measures include training employees to follow policies and procedures and to apply common sense and skepticism in the face of red flags.

In October 2018, the SEC took the unusual step of issuing a Report of Investigation cautioning public companies that they should consider cyber threats and related human vulnerabilities when designing and implementing their internal accounting controls. The report is an outgrowth of an investigation conducted by the SEC's Enforcement Division into whether certain public companies that were victims of cyber fraud complied with the federal securities laws requiring public companies to implement and maintain internal accounting controls. The investigation reviewed controls at nine companies that had been victims of two variants of cyber schemes, both having to do with wire transfers. Both schemes involved fraudulent or spoofed emails, or what is known as "business email compromise." As a result of these schemes, each company lost at least $1 million, and, together, the companies lost nearly $100 million.

The report makes clear that the SEC is looking more closely and with a more questionable eye at the cybersecurity practices of public companies. As a result, public companies should ensure that their policies and procedures are appropriately tailored to the cyber threats they face and the related human vulnerabilities of their workforce. They should also implement controls sufficient to provide reasonable assurances that transactions occur (e.g., purchasing equipment), and access to assets is permitted (e.g., checking accounts, warehouses), only in accordance with management's authorization. For more information, see our Sidley Update available here.

SEC Staff Issues Further Guidance on Excludability of Shareholder Proposals

In October 2018, the Staff of the SEC's Division of Corporation Finance issued Staff Legal Bulletin No. 14J (CF), which provides additional guidance on the excludability of shareholder proposals under Exchange Act Rule 14a-8. SLB No. 14J clarifies and expands upon the guidance provided by the Division Staff in November 2017 in Staff Legal Bulletin No. 14I. The new guidance sets forth a helpful roadmap for drafting the discussion of the board's analysis expected in no-action requests under Rule 14a-8(i)(5) (the "economic relevance" exception) and Rule 14a-8(i)(7) (the "ordinary business" exception). Specifically, the Division Staff proposed the following non-exhaustive list of factors that may be included in the board's analysis:

- The extent to which the proposal relates to the company's core business activities;
- Quantitative data, including financial statement impact, related to the matter that illustrate whether or not a matter is significant to the company;
- Whether the company has already addressed the issue in some manner, including the difference between the proposal's specific request and the actions the company has already taken, and an analysis of whether the difference presents a significant policy issue for the company;
- The extent of shareholder engagement on the issue and the level of shareholder interest expressed through that engagement;
- Whether anyone other than the proponent has requested the type of action or information sought by the proposal; and
- Whether the company's shareholders have previously voted on the matter and the board's views as to the related voting results.

While it is not necessary for the board's analysis to cover all of the factors listed above, going forward the Division Staff expects a well-developed discussion of the board's analysis to address any previous shareholder voting results related to the subject matter of the proposal.

The guidance also should expand the number of shareholder proposals that may be excludable under Rule 14a-8(i)(7) by clarifying when certain proposals may be excluded on the basis of micromanagement. For example, it clarifies that a proposal seeking an intricately detailed study or report may be excludable if the underlying substance of the report relates to the imposition or assumption of specific timeframes or methods for implementing complex policies. The new guidance is summarized in our Sidley Update available here.

FIRRMA Pilot Program Requires National Security Filings for Some Investments in U.S. Businesses Involving Critical Technologies

In August 2018, President Donald Trump signed into law the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA). FIRRMA expands the jurisdiction and powers of the Committee on Foreign Investment in the United States (CFIUS), the U.S. interagency committee that conducts national security reviews of foreign investment.

FIRRMA authorizes CFIUS to conduct pilot programs to implement provisions of the legislation that did not become effective immediately upon enactment. On October 10, 2018, the U.S. Department of the Treasury issued interim regulations to conduct a FIRRMA-related pilot program to address specific risks to U.S. critical technologies. The pilot program expands the scope of transactions subject to review by CFIUS to include certain non-controlling investments made by foreign persons in U.S. businesses involved in critical technologies related to specific industries. It also requires parties to file a mandatory declaration (an abbreviated CFIUS notice) for all transactions that fall within the scope of the pilot program. The pilot program, discussed in further detail in our Sidley Update available here, affects all transactions with a completion date on or after November 10, 2018.

U.S. Launches Review of Export Controls on Emerging Technologies

The U.S. Department of Commerce, Bureau of Industry and Security (BIS) has published an advance notice of proposed rulemaking (ANPRM) initiating a 30-day public comment process regarding export controls for certain emerging technologies. The notice launches the implementation of a key provision of the Export Control Reform Act of 2018 (ECRA), part of the National Defense Authorization Act (NDAA) for fiscal year 2019. In the ECRA, Congress authorized BIS to establish controls on the export, reexport and transfer (in country) of "emerging and foundational technologies."

Pursuant to ECRA, an interagency process will determine the scope of controls on emerging and foundational technologies. To assist in identifying emerging technologies and applying appropriate controls, the ANPRM proposes the following "representative technology categories" for public comment:

1. Biotechnology
2. Artificial intelligence and machine learning technology
3. Position, navigation and timing technology
4. Microprocessor technology
5. Advanced computing technology
6. Data analytics technology
7. Quantum information and sensing technology

8. Logistics technology
9. Additive manufacturing (e.g., 3D printing)
10. Robotics
11. Brain-computer interfaces
12. Hypersonics
13. Advanced materials
14. Advanced surveillance technologies

The ANPRM seeks comments from the public by December 19, 2018 on how BIS should control emerging technologies; in a separate notice BIS will address the process to define and control foundational technologies. Following the 30-day public comment period, BIS will publish a proposed rule outlining specific controls on particular emerging technologies. This proposed rule will be subject to another public comment period, likely only 30 days due to political pressure to expeditiously implement export control reform. Then BIS may publish more than one round of proposed rules or may issue a final rule. Therefore, any resulting controls will not be implemented for several months.

With respect to the 14 representative technology categories, BIS has specifically requested comments on "1) how to define emerging technology to assist identification of such technology in the future; 2) criteria to apply to determine whether there are specific technologies within these general categories that are important to U.S. national security; 3) sources to identify such technologies; 4) other general technology categories that warrant review to identify emerging technologies that are important to U.S. national security; 5) the status of development of these technologies in the United States and other countries; 6) the impact specific emerging technology controls would have on U.S. technological leadership; 7) any other approaches to the issue of identifying emerging technologies important to U.S. national security, including the stage of development or maturity level of an emerging technology that would warrant consideration for export control." For a discussion of five key takeaways arising from this development, see our Sidley Update available here.

Investors and Senators Urge the SEC to Mandate ESG Disclosures

A group representing more than $5 trillion in assets under management, including CalPERS and the New York State Comptroller, petitioned the SEC to mandate ESG disclosures.

The push for mandatory reporting of environmental, social and governance (ESG) information is gaining momentum as investors increasingly seek to incorporate this information into their risk assessment analyses and investment strategies. In a petition for rulemaking filed with the SEC on October 1, 2018, a group of institutional investors and legal scholars called for the development of a framework requiring public companies to disclose identified ESG matters affecting their operations.

The petition criticizes voluntary reports, which many companies already produce, as insufficient to meet investor demand for ESG information that is reliable, comprehensive and easily comparable across companies. The petition notes that there are several promising frameworks for reporting ESG information, including those developed by the Global Reporting Initiative (GRI) and the Sustainability Accounting Standards Board (SASB). The petition, however, suggests the Framework and Technical Guidance published by the Financial Stability Board's (FSB) Task Force on Climate-Related Financial Disclosure as an initial model for the SEC to use in developing a mandatory reporting framework.

The petition follows the recent introduction of a Senate bill sponsored by Senator Elizabeth Warren (D-MA), the Climate Risk Disclosure Act, which would direct the SEC to issue rules within one year requiring public companies to disclose climate change-related risks. The bill directs the SEC to tailor these rules to different industries. Generally, however, every public

A group of 29 activist organizations and asset managers issued a letter supporting Senator Warren's proposed legislation.

company would be required to disclose its greenhouse gas emissions, total fossil fuel-related assets, risk management strategies relating to climate change, and the effect of certain climate change scenarios on its valuation. Companies engaged in the commercial development of fossil fuels would be subject to additional disclosure requirements as determined by the SEC.

Public companies that currently produce voluntary ESG reports should review their reporting metrics against existing frameworks, particularly the FSB's framework and guidance. Public companies that do not produce ESG reports should familiarize themselves with these frameworks and consider developing procedures for collecting and disclosing ESG data.

SEC Rule Amendments to Streamline Disclosure Requirements Take Effect

In August 2018, the SEC adopted rule amendments to eliminate or update certain disclosure requirements that have become redundant, duplicative, overlapping, outdated or superseded as a result of more recently updated SEC or GAAP requirements or changes in the information environment. The amendments, which became effective on November 5, 2018, are part of the SEC's ongoing Disclosure Effectiveness Initiative and its efforts to implement the Fixing America's Surface Transportation (FAST) Act.

The amendments affect various Regulation S-K items, Regulation S-X rules and other SEC rules and forms. The most significant amendments relevant to U.S. public companies are summarized in the Sidley Update available here. Personnel responsible for SEC reporting should familiarize themselves with the amendments, which will affect the disclosures made in future periodic reports and registration statements.

The SEC is also referring certain disclosure requirements that overlap with GAAP to the Financial Accounting Standards Board (FASB) for consideration to be incorporated into GAAP reporting requirements.

The amendments adopted in August 2018 are separate from the rules proposed by the SEC in October 2017 to modernize and simplify certain Regulation S-K requirements as mandated by the FAST Act. As discussed in a previous Sidley Update, the most noteworthy of those proposals would (1) streamline MD&A disclosure by eliminating discussion of the earliest of three years covered in the financial statements and (2) significantly reduce the need to submit confidential treatment requests when public companies omit information from their exhibit filings.

Whistleblower's Failure to Promptly Report to the SEC and Culpability Result in "Severely Reduced" Award

In September 2018, the SEC awarded $1.5 million to a whistleblower whose critical information and ongoing assistance helped the agency bring an enforcement action. Under the SEC's whistleblower program, individuals who provide original, timely and credible information to the SEC that results in an enforcement action with monetary sanctions exceeding $1 million can receive an award ranging from 10-30% of such sanctions. The SEC's whistleblower rules explicitly include the culpability of the whistleblower as a factor that the SEC may consider to reduce an award. The rules also require a whistleblower to provide "original information" (i.e., not previously known to the SEC) to be eligible for an award, which should encourage whistleblowers to report promptly.

In its order determining the award, the SEC indicated that it "severely reduced" the amount of the award after finding that the whistleblower "unreasonably delayed" in reporting the information to the SEC and was culpable in the violation. After learning of the misconduct, the whistleblower waited more than one year before reporting the potential violation to the SEC. During this period, the whistleblower continued to receive "a significant and direct financial benefit." The SEC warned that whistleblowers acting in a similar manner "should expect to receive a severely reduced award—indeed, even one as low as the minimum statutory threshold—in future cases."

The SEC and Commodity Futures Trading Commission (CFTC) Offices of the Whistleblower recently issued their Fiscal Year 2018 Annual Reports to Congress on the agencies' respective whistleblower programs. Both reports document dramatic increases in the numbers of whistleblower tips and dollar amounts of awards and punctuate the increasing role of whistleblowers in the enforcement programs at both agencies. For more information, see our Sidley Update available here.

CORPORATE GOVERNANCE DEVELOPMENTS

ISS and Glass Lewis Release Updated Proxy Voting Policies for the 2019 Proxy Season

As described in a recent Sidley Update, Institutional Shareholder Services (ISS) and Glass Lewis & Co. have each released updates to their proxy voting policies for the 2019 proxy season. ISS' policy updates will apply to shareholder meetings held on or after February 1, 2019 and Glass Lewis' policy updates will apply to shareholder meetings held on or after January 1, 2019. The key policy updates relate to the following topics:

- Board gender diversity;
- Management proposals to ratify existing charter or bylaw provisions;
- Conflicting management and shareholder special meeting proposals;
- Director performance evaluations;
- Shareholder proposals on environmental and social issues;
- Board oversight of environmental and social risks;
- Virtual-only shareholder meetings; and
- Compensation-related matters.

The appendix to that Sidley Update identifies the various circumstances in which ISS and Glass Lewis may recommend voting against one or more directors in an uncontested election. In a previous Sidley Update, we discussed updates ISS recently made to its QualityScore corporate governance ratings tool, including the addition of eight factors that are new or newly applicable to U.S. companies.

Leaders of Prominent Public Companies and Institutional Investors Update Commonsense Principles of Corporate Governance

In October 2018, a group of 21 prominent business and investment leaders published Commonsense Principles 2.0, an update to its 2016 predecessor, the Commonsense Principles of Corporate Governance. The revised Principles are a set of corporate governance best practices designed for "sound, long-term-oriented corporate governance." In an open letter, the signatories to the Principles criticized the "unhealthy short-termism" that permeates the public markets. Many of the new recommendations thus reflect a renewed commitment to long-term value creation.

The signatories to the Commonsense Principles 2.0 are leaders of major public companies and large institutional investors, including Berkshire Hathaway's Warren Buffett, DowDuPont's Ed Breen, General Motors' Mary Barra, BlackRock's Larry Fink, J.P. Morgan's Jamie Dimon and Vanguard's Bill McNabb.

Significant updates include:

- ***Board Elections.*** The Principles now suggest that individual directors who do not receive a majority of votes cast "for" in an uncontested election should offer to resign. The board should either accept the resignation or explain its rationale for rejecting the resignation. According to the revised Principles, annual director elections are generally preferable, and if a board is classified, the rationale for that structure should be explained.
- ***Shareholder Proposals.*** A new section in the Principles recommends early engagement with shareholders on both shareholder and management proposals. The company should implement shareholder proposals that receive majority support, or explain why implementation would not serve the company's long-term interests. For shareholder or management proposals that receive significant but not majority support, the company should continue discussions with shareholders, while keeping in mind that a majority of shareholders opposed the proposal.
- ***Proxy Access.*** While the 2016 version did not take a position on proxy access, the Principles now recommend that public companies allow for some form of proxy access.
- ***Anti-takeover Measures.*** The revised Principles note that, because anti-takeover measures such as poison pills can reduce accountability to shareholders, these measures should be subject to a shareholder vote and ongoing review.
- ***Earnings Releases.*** The Principles allow for the use of non-GAAP measures in financial reporting, but recommend that companies provide a bridge from non-GAAP items to GAAP items. Additionally, a company should evaluate whether releasing quarterly earnings guidance "does more harm than good."
- ***Board Leadership.*** Under the Principles, if the chair and CEO roles are combined, the board should have a lead independent director. The revised Principles clarify that the role and responsibilities of the lead independent director should be sufficiently robust, clearly defined and agreed upon by the board and disclosed to shareholders.
- ***Executive Compensation.*** To promote a long-term outlook, the Principles clarify that performance benchmarks used in determining executive compensation should include non-financial factors. Additionally, grants of special compensation awards should be "reserved for special circumstances."
- ***Disclosure of Reliance on Proxy Advisors.*** The Principles recommend that asset managers disclose their reliance on recommendations from proxy advisors and use proxy advisors that have protocols for avoiding or mitigating conflicts of interest.

Counsel should compare a public company's corporate governance practices to the revised Principles, while being mindful that every company is unique and that the Principles allow for variation. Nevertheless, public companies should be prepared to explain departures from the Principles, particularly if any of the nine large institutional investor signatories is a significant shareholder.

California-Based Corporations Must Have Female Directors by the End of 2019

Pursuant to a California law enacted on September 30, 2018, California-based publicly held domestic or foreign corporations must have at least one female director by December 31, 2019, and, depending on board size, up to three female directors by December 31, 2021. The California Secretary of State may impose a fine of $100,000 for a failure to timely file required board member information or for the first violation of the new law (meaning a director seat required to be held by a female is not held by a female during at least a portion of a calendar year) and $300,000 for any subsequent violation.

In 2019, if a company headquartered in California does not have at least one female director, Glass Lewis will generally recommend voting against the nominating committee chair unless the company has disclosed a clear plan for addressing the issue by the end of 2019.

The new California law is intended to be a significant, proactive step toward gender parity on public company boards. However, it may face constitutional and other challenges. Nevertheless, public companies headquartered in California should evaluate their board composition in light of the new law. Such companies with fewer than three female directors should begin preparing for compliance with the new law by seeking out qualified female director candidates and considering whether to expand the size of their boards. They should take into account what approvals may be required (e.g., charter or bylaw amendments to increase the maximum size of the board, the timing of any board changes in relation to any upcoming annual meeting) and the related timing implications. For more information, see our Sidley Update available here.

Corporate Communications After Elon Musk's "Funding Secured" Tweet

Elon Musk, Tesla Inc.'s then Chairman and CEO, invited SEC scrutiny when he tweeted to 22 million followers on August 7, 2018 that he was "considering taking Tesla private at $420" per share. His offense, the SEC alleged, was not that he used social media to announce material non-public information, but rather that he tweeted materially misleading information. As a result, the SEC accused Musk of violating the Exchange Act's antifraud provisions under Section 10(b) and Rule 10b-5 because Musk "falsely indicated that…he could take Tesla private at a purchase price that reflected a substantial premium" over Tesla's then-current share price. Two days later, the SEC charged Tesla with violating Exchange Act Rule 13a-15 because Tesla "did not have disclosure controls or procedures [DCPs] in place" to review Musk's tweets for accuracy and compliance with securities laws.

Following the charges brought by the SEC, Tesla stockholders filed a derivative suit in the Delaware Court of Chancery charging Tesla's directors with fiduciary duty breaches and "gross mismanagement" in failing to maintain adequate systems to ensure that Musk's statements were accurate and compliant with securities laws.

Musk and Tesla settled with the SEC only days later, each paying a $20 million fine. Additionally, Musk resigned as board chair (for at least three years) and must obtain board pre-approval for future Tesla-related communications. Moreover, Tesla must retain permanent securities law counsel and establish a committee of independent directors to implement the settlement terms.

This incident underscores the need for public companies to ensure their corporate communications policies avoid the following securities law pitfalls:

- ***Antifraud Risk***. Management must ensure that any public disclosure made by the company and its executives and directors does not contain a material misrepresentation or fail to disclose material information that would trigger liability under Exchange Act Section 10(b) or Rule 10b-5. Under Rule 10b-5, public company disclosures must be materially accurate and not contain a material omission.
- ***Disclosure Controls and Procedures***. Tesla was charged with failing to have DCPs in place to determine whether the information Musk tweeted on August 7, 2018 was (1) accurate and complete and (2) required to be reported under the Exchange Act. Management should test its DCPs to ensure that information required to be disclosed under the Exchange Act is in fact processed, summarized and reported as required under Rule 13a-5.
- ***Selective Disclosure Risk***. If the company intends to disseminate material non-public information on its website or social media accounts, management should follow the SEC's 2008 Guidance and 2013 Guidance to properly designate the website and social media accounts as forums for material public disclosures. By failing to do so, companies risk violating Regulation FD, which prohibits companies from selectively disclosing material non-public information to certain investors without making a contemporaneous public disclosure. The SEC does not object to public disclosures made on company websites or social media platforms so long as management has reasonably concluded that its chosen method of disclosure qualifies as a "recognized channel of distribution" per the SEC guidance.

Initiative Targets "Anti-competitive" Employment Agreement Terms

In an initiative launched in August 2018, CtW Investment Group (CtW) sent letters to the boards of directors of over 30 of the largest public companies asking them to reconsider their use of what CtW considers "anti-competitive employment practices" such as non-competes, "no-poach" agreements, non-disclosure agreements and mandatory arbitration provisions. CtW is an activist investor group that works with union-sponsored pension funds with over $250 billion in assets.

Specifically, CtW asked the board of each targeted company to (1) review the company's employment contracting practices, including the use of any of the provisions listed above, (2) report the board's findings to shareholders before the company's next annual meeting and (3) commit to increased human capital management disclosure going forward. CtW asked for responses by September 30, 2018, none of which have been publicly disclosed.

CtW argues that non-competes reduce the job opportunities and earning potential of employees and have negative economic consequences for the economy at large. CtW claims that non-compete provisions limit entrepreneurship and cause a lack of worker mobility that has led to a "skills shortage" and other recruiting difficulties reported by employers.

As discussed in a previous Sidley Update, the Antitrust Division of the U.S. Department of Justice filed an action in the spring of 2018 sending a clear message that no-poach agreements violate the antitrust laws and will be pursued aggressively.

The CtW initiative also follows heightened scrutiny of no-poach agreements, which opponents argue exploit low-wage workers by preventing franchisees from hiring workers employed by other franchisees in the system. In the summer of 2018, investigations led by attorneys general from 11 states and the District of Columbia resulted in several of the country's largest fast-food chains agreeing to end the use and enforcement of no-poach provisions.

The initiative by CtW comes on the heels of the #MeToo movement, which focused a national spotlight on workplace harassment. CtW linked non-disclosure agreements and mandatory arbitration provisions to "insulating abusive employees and managers from exposure" and the decline in employees reporting incidents of sexual harassment.

Going forward, public companies, and franchisors in particular, should monitor their use and enforcement of non-competes, no-poach agreements, non-disclosure agreements and mandatory arbitration provisions. Blanket use of these provisions in employment agreements and policies could have, at a minimum, reputational consequences.

SIDLEY RESOURCES

M&A Topics

An article entitled Possible Shift in Delaware Law: Buyer's Silence on Sandbagging is Not Golden by Sara Garcia Duran and Sacha Jamal, lawyers in our Dallas office, was published in the ABA Business Law Section's *Business Law Today* on September 28, 2018. The article discusses a footnote in a May 2018 Delaware Supreme Court decision that calls into question whether Delaware should still be presumed to be a pro-sandbagging state. The authors encourage buyers not to be silent on the point and to explicitly include a knowledge savings clause in purchase agreements (model clause provided).

Corporate Governance Topics

An article entitled *Board Composition, Diversity, and Refreshment* by Holly Gregory, a partner in our New York office, was published in the October 2018 edition of Practical Law's *The Governance Counselor.*

Regulatory; Other Topics

In a recent speech, Deputy Attorney General Rod Rosenstein announced important limitations to the policies regarding individual accountability for corporate wrongdoing set forth in the 2015 Yates Memo. He announced a revised policy which signals the Department of Justice's attempt to resolve some of the ambiguities and difficulties in the original Yates Memo. Our Sidley Update titled DOJ Announces Important Changes to Yates Memo discusses the new changes to the Yates Memo policy.

On October 31, 2018, the U.S. Internal Revenue Service and the Department of the Treasury released proposed regulations excluding corporate U.S. shareholders from the application of Section 956 of the Internal Revenue Code of 1986, as amended, to the extent necessary to maintain symmetry between the taxation of actual versus deemed repatriations. In many circumstances, this change will allow U.S. corporate borrowers with valuable foreign subsidiaries to provide significantly more credit support to their lenders than is currently market practice in the U.S. credit market. For more information, see our Sidley Update titled New Proposed Treasury Regulations May Significantly Change U.S. Cross-Border Lending Practices.

Three Sidley lawyers contributed to the 2019 edition of the Chambers global guide to *Data Protection & Cyber Security*. Alan Raul, a partner in our Washington, D.C. office, wrote the introduction, and William Long and Geraldine Scali, lawyers in our London office, wrote the section on UK Law & Practice.

SIDLEY EVENTS

Shareholder Activism & Proxy Fight Boot Camps

Sidley is hosting a series of Shareholder Activism Boot Camps, which include a mock proxy contest and discussion of best practices during "peacetime" to prepare for an activist attack. The final 2018 boot camp will take place in Century City on December 13. For more information, contact chevents@sidley.com.

Annual Sidley Chicago Alumni Celebration

February 2019 | Chicago, IL

Sidley's Chicago office will host its fourth annual alumni celebration in February. We invite all members of the Sidley Chicago Alumni family to join us for a fun evening of celebration and networking with colleagues and peers. Invitation coming soon. For more information, contact chevents@sidley.com.

Life Sciences College

February 21, 2019 | Brussels (Belgium)

Sidley will host its annual Life Sciences College in Brussels, Belgium on February 21. The program's agenda includes updates on the latest legal and regulatory developments in EU law that will affect companies operating in the life sciences space. We will bring together senior members of the European Commission and regulatory and business community to address the potential impact of new pharmaceutical and medical devices legislation and regulation. For more information, contact brevents@sidley.com.

SIDLEY SPEAKERS

Gun-Jumping Goes Global

January 7, 2019 | Teleconference

Jim Lowe, a partner in our Washington, D.C. office, will moderate an ABA Antitrust Section program titled *Gun-Jumping Goes Global* on January 7. The speakers will address recent developments in antitrust enforcement against premature implementation of transactions subject to merger review. Click here for more information.

Disclosure Matters and Other SEC Considerations in M&A

January 11, 2019 | New York, NY

John K. Hughes, a partner in our Washington, D.C. office, will moderate a panel titled *Disclosure Matters and Other SEC Considerations in M&A* as part of the Mergers & Acquisitions 2019: Advanced Trends and Developments program hosted by the Practicing Law Institute (PLI) in New York City on January 10-11. Click here for more information.

Recurring Disclosure Challenges | Defense Perspective on the SEC's Enforcement Priorities

January 29-30, 2019 | Coronado, CA

The Northwestern Pritzker School of Law is sponsoring the 46th Annual Securities Regulation Institute in Coronado, California on January 28-30. Tom Kim, a partner in our Washington, D.C. office, will chair a session titled *Recurring Disclosure Challenges* at the conference on January 29 and will serve as the Vice Chair of the Institute. On January 30, Stephen Cohen, a partner in our Washington, D.C. office, will participate in a panel titled *Defense Perspective on the SEC's Enforcement Priorities*. Click here for more information.

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