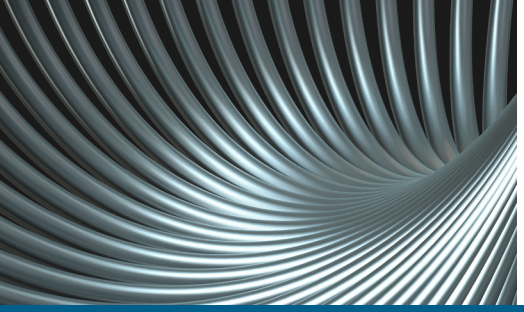

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SIDLEY

ANALYSIS

GETTING YOUR CARVEOUT SALE DONE IN 2019

By Scott R. Williams[1]

Carveout sales are some of the most challenging transactions to execute because of the complexities associated with separating a business that was previously integrated with the other businesses of the seller. Given the rich valuations in the marketplace as well as concerns that the current growth cycle may be coming to an end, sellers should expect certain dynamics on the due diligence front that will make successful execution of these carveout sales more challenging.

First, expect buyers to put more emphasis on thorough diligence before agreeing to a deal. Buyer boards and management teams will have greater focus on avoiding a bad deal that could result in criticism from their investors, particularly those boards and management teams concerned about activist investors publicly questioning their capital allocation choices.

Second, bidders in auction processes involving multiple buyers are likely to delay significant due diligence components into the late rounds of the process, when they have a higher degree of certainty that they have a meaningful chance to prevail in the auction. This delay will make it difficult for sellers to assess the strength of early-round bids, determine which bidders to permit to the final stages of the auction process and move expeditiously from the final round of the auction process to signing a definitive agreement.

This dynamic will make it all the more important for sellers in auction processes to run a competitive process to meet these diligence and timing challenges. While the quality of the business for sale is far and away the most significant factor in creating a competitive dynamic, having a thoughtfully and strategically structured process that is clearly articulated to bidders is also of critical importance.

Present Documents Early

While sellers typically tell bidders that the auction process will move quickly once the field has been narrowed, their actions often belie these assurances. That's because sellers often leave a fair number of the important details, such as completing portions of the separation work—that is, the planning and implementation of the separation of the division for sale from the rest of the seller's businesses—and creating the transition services schedules and purchase agreement disclosure schedules, until after the field has been narrowed to the final group of bidders.

Bidders can often detect that this work has not been completed if the seller presents a purchase agreement to mark up and says the remaining suite of documents will come at a later stage. Bidders know that it takes time to complete this work and that they may well have more time to conduct their due diligence than the seller suggests to them in its bid instruction letter.

Presenting a full suite of transaction documents earlier in the process signals that the seller is ready to move quickly. It tells bidders that they risk getting left behind if they do not keep pace with the milestones set out in the bid instruction letter.

Helping the seller understand early on what documents will be necessary, what workstreams feed into creating those documents, the resources (both internal and external) necessary to complete those workstreams, and anticipated timing goes a long way toward putting a seller in the position to have the full suite of draft transaction documents ready for bidder review early in the process.

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Prepare Early for Due Diligence Concerns

Keeping negotiations moving quickly once bidders have received the draft transaction documents is also critical to running a successful sales process. A seller that understands what issues bidders are likely to find in the due diligence process and raise during negotiations is in a much better position to move the transaction along to a prompt and successful completion.

As an example, complex carveout transactions often address issues raised by bidders that require the seller to consult with a number of different subject-matter experts. That consultation can take time. The more significant the issue, the more time it may take to resolve it.

A seller that disappears from the negotiating table for several days to address an issue internally not only delays the negotiating process and slows momentum, but may also signal that the issue is more serious than the bidder initially believed. On the other hand, a seller that rushes to propose a solution to an issue without expert consultation runs a much higher risk of making a critical mistake.

Sellers can help themselves avoid these types of delays or mistakes by anticipating key issues and working through possible solutions even before engaging in the auction process. In some cases, the matter may be significant enough to impact a bidder's views on value or cause the bidder to push back from the negotiating table to reassess the transaction.

For those types of issues, rather than wonder whether the bidder has spotted the issue and factored it into the offer, sellers are often better served by proactively educating proposed buyers and suggesting the best way to address it. The proposed solution may also be incorporated into the initial draft of the transaction documents.

Anticipate Bidder Pitfalls

Understanding your pool of bidders and what issues they are likely to present is often as important as identifying potential due diligence issues. For example, if the majority of bidders are likely to require the carveout's audited financial statements either for financing purposes or Securities and Exchange Commission (SEC) reporting purposes, that is a workstream that should be identified and addressed early to avoid slowing down the process in later stages or creating unwanted conditionality in the final transaction documents. On the other hand, if only a few potential buyers are likely to require audited financial statements, the seller may view those bidders as less attractive options given the additional time their requirements would add to the process.

Similarly, sellers and their counsel should determine early whether a bidder is likely to present regulatory problems that would make it difficult to complete the transaction. While some regulatory issues can be easy to spot, such as antitrust in a transaction involving a direct competitor in a highly concentrated market, others are not. For example, companies that are generally not considered competitors may have overlap in an area they view as relatively insignificant, but a dearth of participants may nevertheless make antitrust clearance difficult.

Similarly, bidders with significant foreign investors could trigger an unexpected review by the Committee on Foreign Investment in the United States (CFIUS), an interagency committee that can block deals or impose conditions to address national security concerns.

Once regulatory issues have been identified, the seller can determine whether they can be adequately addressed through risk allocation in the transaction documents and, if so, whether to require the bidder to accept that risk allocation as a condition to continuing in the auction process.

Understanding the degree of regulatory risk with a bidder can also help a seller triage how much time to spend with a particular bidder in due diligence and determine whether to withhold sensitive diligence materials until later in the process.

Control Third-Party Workstreams

Critical third-party workstreams, such as financing commitments, representation and warranty insurance, and employee agreement negotiations, have the potential to cause significant delays in an auction process if not closely monitored by sellers. Sellers should understand early on what those workstreams will likely be for each bidder and make sure to include milestones in the auction process for those third-party workstreams.

As an example, in the case of employment or retention agreements with employees of the business to be sold, sellers are often well-served by retaining a single firm to act as counsel for all of the employees and requiring all of them to negotiate from a single form of agreement.

The more a seller can front-load work in its auction process, the better the seller's likelihood of success in moving bidders quickly through the process to a successful completion. Counsel can play an instrumental role in identifying these workstreams and helping the seller set timetables for their completion.

In practice, sellers often have cost concerns of their own that cause them to delay some of the workstreams until later in the process when they feel confident that preliminary bids signify that a deal is likely. In those cases, the seller, its counsel and other advisors should evaluate which of the workstreams can be delayed in light of the overall calendar for the auction process.

RENT-A-CENTER: A $1.365 BILLION REMINDER ON REMINDERS

By Rachel Fridhandler[2]

Vice Chancellor Glasscock: "I am left to the startling conclusion that, having vigorously negotiated a provision under which Vintage was entitled to extend the End Date simply by sending Rent-A-Center notice of election to do so by a date certain, Vintage and [its banker's] personnel, in the context of this $1 billion-plus merger, simply forgot to give such notice."

Following pressure from an activist shareholder to explore strategic alternatives, Rent-A-Center, Inc. (R-A-C) agreed in June 2018 to be acquired in an all-cash merger by affiliates of the private equity firm Vintage Capital Management, LLC (Vintage), in a deal valued at $1.365 billion (including debt). The transaction, which was subject to customary closing conditions and regulatory approvals, included the nearly universal provision entitling either party to terminate the transaction if it did not close by a specified end date, which date could be extended by either party delivering a written notice to the other of its desire to extend. The specified end date came and went without either R-A-C or Vintage giving the other notice of a desire to extend. After complex litigation between the parties about an allegedly simple failure to give notice, Vice Chancellor Sam Glasscock of the Delaware Chancery Court determined that R-A-C need not go through with the sale even though the parties (at the time) had appeared to understand that the end date would be extended and had continued to work on satisfying the other closing conditions. *Vintage Rodeo Parent, LLC, et al. v. Rent-A-Center, Inc.* (Del. Ch. Mar. 14, 2019).

Background

The parties understood that the deal would require antitrust clearance from the Federal Trade Commission (FTC) because Vintage was the controlling stockholder of one of R-A-C's biggest competitors. The Court found that R-A-C and Vintage were aware of, and responsive to, the antitrust law component of the transaction, and vigorously negotiated the termination, notice and breakup fee provisions against this background.

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The merger agreement provided for an end date six months after signing. If the FTC review was ongoing and there was no legal restraint to consummation of the merger, R-A-C and Vintage would each have the right to elect to extend the end date from December 17, 2018 to March 17, 2019. Either could bind the other for this extended term by sending written notice of this election any time before midnight on December 17, 2018. If neither R-A-C nor Vintage elected to extend, the agreement would remain in place with either party having the option, in its discretion, to terminate at any time thereafter. The parties agreed that until the merger agreement was terminated, they would exercise commercially reasonable efforts to consummate the transaction. In conjunction with the termination rights and efforts covenants, the parties also negotiated a breakup fee and reverse breakup fee.

As the end date approached, the board of directors of R-A-C believed that Vintage would exercise its right to extend the term of the agreement given that each party continued to expend efforts to achieve the various approvals necessary to close the transaction. At board meetings held on December 5 and 6, 2018, the board discussed the improvement in R-A-C's financial and operational condition since the merger agreement was signed, and resolved that in the unlikely event Vintage did not elect to extend the agreement by the end date, R-A-C would exercise its right to terminate the merger agreement and collect the reverse breakup fee, which would be owed to R-A-C if Vintage did not extend and either party subsequently terminated the agreement. R-A-C and its counsel waited anxiously for the notice of extension to arrive on the night of December 17, 2018 but Vintage and its advisors simply forgot to give the notice. Having re-evaluated the merits of the proposed merger in light of R-A-C's improved financial and operational performance, R-A-C decided to walk away from the deal and collect the $126.5 million reverse breakup fee (amounting to 15.75% of the equity value of R-A-C). Following R-A-C's termination of the merger agreement the next day, Vintage brought suit in the Delaware Chancery Court to compel R-A-C to proceed with the merger. R-A-C filed a counterclaim seeking payment of the reverse breakup fee from Vintage.

Vice Chancellor Glasscock did not determine whether the $126.5 million reverse breakup fee constituted an "unenforceable penalty" that would create a windfall for Rent-A-Center, but expressed doubt as to whether the parties meant for a reverse breakup fee to apply in this context. He requested supplemental briefing on the interaction between the reverse breakup fee and the implied covenant of good faith and fair dealing before making a decision. The Delaware Chancery Court will not have the occasion to weigh in, however, because in April 2019 Rent-A-Center accepted a $92.5 million settlement from Vintage to resolve the matter.

Strict Compliance With Negotiated Notice Procedures Required

Vintage argued that the Court should find that express or implied notice to extend the end date had been given by its ongoing expenditure of efforts to close the transaction, applying a standard of "substantial compliance" rather than literal compliance. Vintage also argued that R-A-C had in effect waived the requirement for formal notice by providing for a closing several weeks after the end date in a joint timing agreement filed by R-A-C and Vintage with the FTC. The Court rejected both arguments, finding that Vintage's efforts were mostly, if not entirely, required under the covenant to exercise commercially reasonable efforts to get the deal done and conflated an anticipation to close after the end date with an intention to exercise a termination right, if given the opportunity. Vice Chancellor Glasscock explained that "substantial compliance" may be available despite clear and unambiguous contractual language where necessary to avoid a harsh result in cases where the counterparties' bargain may be preserved and the deviation from literal compliance is justified by the purpose of the notice provision having been satisfied. In this case, however, compliance with the notice provision was not impossible, and the purpose of the notice provision—to timely inform a counterparty that it would be bound to an extended end date—had not been satisfied. The Court found that the end date extension mechanics were carefully negotiated, and the very purpose of negotiating and prescribing the extension mechanics was to ensure the parties would have certainty as to their rights and obligations existing past the initial end date.

No Duty to Warn of an Intention to Terminate

Another argument advanced by Vintage was that the obligation to exercise commercially reasonable efforts to close the deal imposed a duty on R-A-C to warn Vintage of its decision to terminate the transaction agreement. In rejecting this argument, the Court found that to hold the opposite, and create a duty to warn, would be inconsistent with the terms of the merger agreement, which set out the manner and content required in order to properly give notice under the agreement.

The Court cautioned that it has left the door open in regard to the question of whether a covenant to exercise reasonable best efforts to get a deal done includes a duty to warn a counterparty that it is operating under a mistaken understanding regarding the contract. In this case, however, R-A-C had no knowledge of Vintage's purported confusion regarding the contract, and could not therefore have been required to work toward consummating the transaction by solving the "problem" (i.e., Vintage's lack of understanding of its explicit rights under the merger agreement). We note that to find such a duty exists would be a major development in the law, complicating the way parties negotiate and carry out contractual terms and with whom they contract in the context of a "reasonable best efforts" clause.

Simple Steps to Ensure Your Transaction Stays on Track

The *R-A-C/Vintage* decision demonstrates that the failure to pay close attention to details can have disastrous consequences. We offer below practical guidance to keep the minutia of a complicated transaction on track.

- Prepare a closing checklist as soon as possible after signing a transaction that identifies the parties (by name wherever possible) responsible for completing each step. Schedule periodic closing checklist calls to ensure that the legal teams on each side of the transaction are communicating regularly.
- Calendar all dates, including estimates and notices prior to closing, end dates and extensions, filing deadlines for particular approvals, waiting period expirations, stockholder meeting dates and proxy mailing deadlines (as applicable).
- Draft templates for pre-closing and closing notices well in advance of their delivery dates to reduce the likelihood of overlooking them.
- Keep the board informed of various end date scenarios and, where appropriate, consider having board resolutions executed in advance of key dates to enable a swift and deliberate response should unlikely events manifest.
- Consider incorporating automatic notice and extension provisions in transaction agreements to reduce the administrative burden of managing end dates. Under the merger agreement between R-A-C and Vintage, it was agreed the end date would be extended if either party sent notice to the other. While that construct is common, parties agreeing to such a provision generally understand that an extension is likely to occur if the transaction is still viable at the end date. Therefore, one possible alternative for the parties to consider would be reversing the presumption by providing for an automatic extension unless both parties object or one party objects. This would not remove human error from the equation, but it would alter the consequences of human error. A determination of which mechanism is the right one to use will depend on the dynamics of each individual transaction, including the nature of the stockholder approvals, governmental approvals and third-party consents that serve as closing conditions.

NEWS

JUDICIAL DEVELOPMENTS

Delaware Chancery Court Endorses Merger Agreement Provision Prohibiting a Buyer from Using the Target Company's Pre-Closing Privileged Communications in Post-Closing Litigation

The Delaware Chancery Court recently held that a buyer could not use the target company's privileged pre-closing attorney-client communications in post-closing litigation against the sellers. *S'holder Rep. Svcs. LLC v. RSI Holdco, LLC* (Del. Ch. May 29, 2019). RSI Holdco, LLC attempted to use approximately 1,200 pre-closing emails between Radixx Solutions International, Inc. and its outside counsel in a post-closing dispute. The Court found that "broad and plain language" in the merger agreement preserved the sellers' ability to assert privilege over the emails and barred RSI Holdco from using them in post-closing litigation.

Provisions addressing the post-closing status of the target company's attorney-client privilege have become standard in private company M&A deals since the Delaware Chancery Court's 2013 decision in *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP*. In that case, the Court held that merger parties can contract out of the default rule that the attorney-client privilege over the target company's pre-closing communications, including deal negotiations, transfers to the surviving corporation upon closing.

Here Radixx and its counsel heeded the Court's guidance in *Great Hill* and included a provision in the merger agreement that (1) preserved any privilege attaching to pre-closing communications as a result of its outside counsel's representation of Radixx in connection with the merger, (2) assigned control over those privileges to the stockholder representative, (3) required the sellers and RSI Holdco to take steps necessary to ensure that the privileges remain in effect and (4) prohibited RSI Holdco and its affiliates from using or relying on privileged communications in any post-closing dispute with the sellers. The Court found that allowing RSI Holdco to use or rely on the emails would "render the express language of [the provision] meaningless." It would also directly contravene the buyer's obligation to "take the steps necessary" to preserve the privilege, and the Court found that "[RSI] Holdco cannot argue that its own failure to preserve privilege should now inure to its benefit."

Finally, the Court rejected RSI Holdco's argument that the sellers had waived privilege because they had not segregated the emails from Radixx's email servers before closing. The Court found that the broad contractual provision preserving the privilege rendered a segregation exercise unnecessary.

A target company and its counsel should insist on a comprehensive contractual provision like the one at issue in *RSI Holdco* to ensure that the sellers (or their stockholder representative) preserve attorney-client privileged communications relating to the transaction post-closing.

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

The Delaware Chancery Court's decision in Olenik v. Lodzinski *was discussed in our Summer 2018 issue of* Sidley Perspectives.

In July 2018, the Delaware Chancery Court applied the procedural framework outlined in *Kahn v. M&F Worldwide Corp. (MFW)* to dismiss fiduciary duty claims against directors after finding that a controlling stockholder transaction was a valid exercise of business judgment. *Olenik v. Lodzinski* (Del. Ch. Jul. 20, 2018). Under *MFW*, a controlling stockholder transaction is entitled to business judgment review (rather than the entire fairness standard) if it satisfies a six-factor test, including that the controller conditions the transaction ab initio on the approval of both a special committee of independent directors and an informed majority of the minority stockholders.

The Chancery Court concluded that the initial offer letter, which explicitly stated that any transaction between the parties would be conditioned on (1) final approval by a special committee and (2) formal approval of a majority of the disinterested stockholders, "marked the first real move in the negotiating bout." The Chancery Court held that "substantial preliminary discussions" that occurred prior to the delivery of the initial offer letter, even if they resulted in a definitive proposal, did not constitute "negotiations" for purposes of the *MFW* analysis. The Chancery Court described the early discussions as "extensive" but "exploratory in nature" and never rising to the "level of bargaining." Applying the business judgment standard of review, the Chancery Court dismissed the complaint.

Months later the Delaware Supreme Court issued a decision that addressed how early in the deal process the *MFW* preconditions must be in place to secure the favorable business judgment standard of review. *Flood v. Synutra Int'l, Inc.* (Del. Oct. 9, 2018), which was summarized in our Fall 2018 issue of *Sidley Perspectives*. In that case, two weeks after its initial letter, the controller sent a second letter expressly conditioning the deal on the requisite *MFW* protections. At that time, the special committee had not engaged its own investment bank or counsel nor engaged in price negotiations (which ultimately did not commence until seven months later).

The plaintiff argued that because the controller did not insist on *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 contended 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 sided with the defendants, clarifying that "from the beginning" need not be taken literally and finding that so long as the commitment to *MFW* preceded any economic bargaining, the standard would be satisfied. In *Synutra*, the Supreme Court warned that the *MFW* protections will not result in dismissal when the "plaintiff has pled facts that support a reasonable inference that the two procedural protections were not put in place early and before substantive negotiations took place."

Olenik provides helpful guidance to practitioners seeking to structure controlling stockholder transactions to fit within the MFW procedural framework to try to receive business judgment review.

Applying the guidance from *Synutra*, in April 2019, the Delaware Supreme Court reversed the Chancery Court's July 2018 *Olenik* decision dismissing the complaint. *Olenik v. Lodzinski* (Del. Apr. 5, 2019). The Supreme Court found that while some of the interactions between the parties over the course of eight months "could be fairly described as preliminary discussion outside of *MFW*'s 'from the beginning' requirement," the record supported a reasonable inference that the parties engaged in substantive economic negotiations before the *MFW* protections were put in place. The Supreme Court found that "preliminary discussions transitioned to substantive economic negotiations when the parties engaged in a joint exercise to value [the entities to be combined]."

In light of the Delaware Supreme Court's decisions in *Synutra* and *Olenik*, controllers and their advisors should be careful to formalize *MFW*'s requirements as early as possible in the deal process and certainly before any economic terms are negotiated.

Delaware Supreme Court Reverses *Aruba* Appraisal Decision and Pegs Fair Value at Deal Price Less Synergies

The Delaware Supreme Court recently reversed a decision of the Delaware Chancery Court that relied on the 30-day unaffected market price to determine the fair value in an appraisal proceeding involving Aruba Networks, Inc. and held that fair value was the deal price less synergies realized in the merger. The Chancery Court's decision in *Aruba* followed

The Delaware Chancery Court's decision in the Aruba Networks *appraisal litigation was discussed in our Spring 2018 issue of* Sidley Perspectives.

the Supreme Court's significant appraisal rulings in *DFC* and *Dell* as discussed in our August 2017 and February 2018 issues of *Sidley Perspectives*. In both cases, the Supreme Court reversed Chancery Court decisions after finding that deal price deserved greater weight in determining fair value.

Dissenting stockholders of Aruba Networks, Inc. challenged whether the $24.67 per share deal price Hewlett-Packard Company (HP) paid to acquire Aruba in 2015 reflected fair value. The price represented a 51% premium to Aruba's closing price one-day pre-announcement and a 49% premium to Aruba's 30-day average market price. Petitioners' valuation expert pegged fair value at $32.57 per share (32% above deal price); Aruba's expert argued for $19.75 (20% below deal price), representing a 52% delta. The Chancery Court analyzed three valuation methodologies in detail: unaffected market price, deal price and discounted cash flow (DCF). It concluded that the best determinant of fair value was Aruba's 30-day average unaffected market price of $17.13 per share before the transaction was publicly announced, which was 30% below the deal price and 13% below the fair value assessment of Aruba's own expert.

The Aruba *decision reiterates the Supreme Court's long-standing deference to deal price as strong evidence of fair value in statutory appraisal actions.*

In April 2019, the Supreme Court reversed the Chancery Court's decision and directed that court to enter a final judgment awarding $19.10 per share, reflecting the deal price minus synergies realized in the merger as estimated by Aruba. The Supreme Court ruled that the Chancery Court abused its discretion by relying exclusively on unaffected market price to determine fair value, primarily because the record did not justify the Chancery Court's decision to reject the deal-price-less-synergies approach because it did not account for unspecified agency costs. The Supreme Court also took issue with the fact that neither of the parties had argued for unaffected market price until Vice Chancellor J. Travis Laster introduced the idea in a request for supplemental briefing.

Although unaffected market price and DCF may be reliable indicators of fair value in some contexts, the Supreme Court found that deal price was the most reliable indicator in this case because HP had prior knowledge of material nonpublic information about Aruba that put it in a strong position to properly value the company. This information had a significant impact on Aruba's stock price when it was eventually disclosed, which rendered the unaffected market price less reliable, particularly because it was measured three to four months prior to the valuation date.

U.S. Supreme Court Declines to Resolve Whether Scienter or Negligence Is the Applicable Legal Standard for Claims Involving Tender Offers

In April 2018, a panel of the U.S. Court of Appeals for the Ninth Circuit held that stockholder plaintiffs asserting claims under Section 14(e) of the Exchange Act—the antifraud provision applicable to tender offers—are required only to establish that defendants acted with negligence rather than scienter (intentional wrongdoing). *Varjabedian v. Emulex Corp.* (9th Cir. Apr. 20, 2018). In doing so, the Ninth Circuit parted ways from the Second, Third, Fifth, Sixth and Eleventh Circuits, which had held that Section 14(e) claims required proof of scienter.

See our Spring 2018 issue of Sidley Perspectives *for more details about the Ninth Circuit's decision in* Varjabedian v. Emulex Corp.

Plaintiff brought a putative class action on behalf of former Emulex stockholders alleging that Emulex and other defendants violated Section 14(e) by failing to include in the statement recommending a tender offer to the stockholders a "premium analysis" prepared by the company's financial advisor that revealed that the stockholders would receive a below-average premium. Following the authorities of five circuits holding that Section 14(e) claims require proof of scienter, the district court dismissed the action, finding that plaintiff failed to plead a strong inference of scienter for defendants' alleged violations of Section 14(e). A panel for the Ninth Circuit reversed and remanded, holding that Section 14(e) claims could be based on the lower standard—mere negligence.

In January 2019, the U.S. Supreme Court granted certiorari to resolve the circuit split over the required mental state for Section 14(e) claims. Thereafter, appellants and those who filed amicus briefs in *Emulex* also asked the Supreme Court to reconsider whether private rights of action are available under Section 14(e).[3] This new issue—whether a Section 14(a) private right even existed—became a hotly contested issue before the Supreme Court although it had not been raised in the lower court proceedings.

After hearing oral argument, the Supreme Court dismissed the case in a one-sentence ruling determining that certiorari had been "improvidently granted," without providing further explanation. *Emulex Corp. v. Varjabedian* (U.S. Apr. 15, 2019). The Supreme Court was presumably unwilling to resolve the narrow issue about the required mental state without deciding the threshold question as to whether the plaintiff in *Emulex* had a right to bring the action under Section 14(e) in the first place. That issue was not ripe for review by the Supreme Court because it had not been litigated in the lower courts.

The effect of leaving the Ninth Circuit's ruling in place may be an increase in the number of Section 14(e) claims filed in the Ninth Circuit. It may also result in a decline in the use of the tender offer structure as a deal mechanism or increased disclosure in tender offer documents.

Consent to Personal Jurisdiction May Be Implied by Adoption of a Delaware Forum Selection Bylaw

Vice Chancellor Laster in Pilgrim's Pride: *"... this case involves the exercise of personal jurisdiction over a non-resident controlling stockholder whose representatives on a Delaware corporation's board of directors comprised a majority of the directors who voted unanimously to adopt a forum selection provision in conjunction with an insider transaction and who selected the courts of this state for precisely the type of litigation in which Parent would be the principal defendant. In my view, under those circumstances, the controlling stockholder consented implicitly to the existence of personal jurisdiction in this state."*

The Delaware Chancery Court recently found that a non-Delaware entity impliedly consented to personal jurisdiction in Delaware when a corporation it controlled adopted a Delaware forum selection bylaw. *In re Pilgrim's Pride Corp. Deriv. Litig.* (Del. Ch. Mar. 15, 2019). JBS S.A., an entity organized under Brazilian law, controlled 78% of the voting power of Pilgrim's Pride Corporation, a Delaware corporation, and designated six of the nine directors on Pilgrim's Pride's board. JBS filled five of the board seats with executive officers of JBS or its controlled subsidiaries. Pilgrim's Pride acquired Moy Park, Ltd., another entity controlled by JBS, for $1.3 billion. On the day it approved the acquisition, Pilgrim's Pride's board voted unanimously to adopt a Delaware forum selection bylaw designating Delaware courts as the exclusive forum for any breach of fiduciary duty litigation involving Pilgrim's Pride.

Minority stockholders in Pilgrim's Pride challenged the acquisition, alleging it was unfair and structured so JBS could raise funds quickly to enable its controlling stockholder to pay a $3.2 billion fine owed to the Brazilian government. JBS moved to dismiss the complaint for lack of personal jurisdiction, arguing that its only connection to Delaware was its ownership of Pilgrim's Pride. The Court rejected the motion, finding that JBS implicitly consented to personal jurisdiction in Delaware for claims falling within the forum selection bylaw.

The Court determined that consent was implied based on the facts of the case—most notably that JBS controlled a super-majority of Pilgrim Pride's voting power and appointed and exercised control over a majority of Pilgrim's Pride's directors who voted to adopt the forum selection bylaw. Furthermore, because the board adopted the forum selection bylaw contemporaneously with approval of the acquisition, the Court inferred that the board intended the bylaw to apply to any Delaware law claims challenging the acquisition and noted that JBS, as a self-interested controller, was the most logical defendant in any such claim.

Vice Chancellor Laster did not opine on the question of whether holding shares in a Delaware corporation with a forum selection clause would, in itself, be sufficient to imply consent to jurisdiction in Delaware. He suggested that may not be enough if the entity has no other ties to Delaware and did not participate in the adoption of the forum selection clause.

3 The U.S. Supreme Court ruled in 1964 that there is an implied private right of action for Section 14(a) claims, but it has never addressed the issue with respect to Section 14(e) claims.

Former Executives Entitled to Advancement of Legal Fees to Defend Clawback Suits Despite Alleged Misconduct

The Delaware Chancery Court recently determined that former officers of Hertz Global Holdings Inc. were entitled to advancement of legal fees to defend against lawsuits brought against them by Hertz because the company's bylaws clearly provide advancement rights for claims arising from actions taken in an officer's corporate capacity. Earlier this year Hertz filed complaints in New Jersey and Florida seeking to recoup more than $70 million of incentive compensation under the company's clawback policy and $200 million in consequential damages from its former CEO, CFO, general counsel and a group president based on alleged accounting errors and other misconduct that contributed to restatement of the company's financial statements and related SEC and class action settlements. After Hertz denied the former officers' requests to pay their legal fees to defend themselves in the actions, they filed suit in the Delaware Chancery Court demanding advancement of expenses, including legal fees, under the company's bylaws.

Hertz argued that the former officers were not entitled to advancement because their claims arose from personal contractual arrangements between the company and the officers pertaining to employee benefits rather than actions taken in the officers' corporate capacities. Vice Chancellor Kathaleen McCormick squarely rejected this argument, noting that "financial statement work is a clear exercise of the officers' corporate responsibilities." The Court was also not persuaded that the former officers should be denied advancement as a matter of public policy. Vice Chancellor McCormick pointed out that depending on the outcome of the clawback suits, if the former officers are found to have committed negligence or misconduct, they may be required to pay Hertz back the amounts they were advanced. Finally, the Court noted that if Hertz did not believe the advancement rights should apply in this context, it could have amended the bylaws to eliminate such rights since the adoption of the clawback policy in 2010.

In light of this decision, the boards or governance committees of Delaware corporations should consider reviewing the expense advancement language in their charters or bylaws to confirm that those provisions address clawbacks in the manner expected.

Generic Statements Affirming the Importance of Regulatory Compliance Cannot Form the Basis of a Fraud Case

In March 2019, the U.S. Court of Appeals for the Second Circuit affirmed a decision by the U.S. District Court for the District of Connecticut dismissing a stockholder class action that alleged securities law violations by Cigna Corporation and certain of its officers. *Singh v. Cigna Corp.* (2d Cir. Mar. 5, 2019). In a unanimous decision affirming the District Court, the appellate panel held that the complaint did not sufficiently allege any material misstatements. Sidley represented Cigna in the matter.

In 2016, Cigna filed a Form 8-K disclosing the imposition of sanctions by the Centers for Medicare & Medicaid Services. Shortly thereafter, Cigna's stock price declined. A stockholder filed a putative class action asserting that Cigna and certain of its officers made material misstatements regarding the state of Cigna's compliance program. Specifically, the plaintiff challenged statements in Cigna's 2013 and 2014 Form 10-Ks that Cigna "expect[s] to continue to allocate significant resources" to its compliance structure and "has established policies and procedures to comply with applicable requirements." The plaintiff also contested statements in Cigna's code of ethics that emphasized the responsibility of Cigna's employees to act with integrity and "handle, maintain, and report on [Cigna's financial] information in compliance with all laws and regulations." The plaintiff argued that a reasonable stockholder would interpret these statements as assurances of legal and regulatory compliance and that the sanctions rendered those statements false.

Singh instructs that "banal and vague corporate statements affirming the importance of regulatory compliance" cannot form the basis of a fraud case.

In September 2017, the District Court dismissed the complaint for failure to plead with particularity any materially false or misleading statement and the plaintiff appealed. The appellate panel found that the complaint did not adequately allege material misstatements. The Court held that a reasonable investor would not rely on the Form 10-K statements as representations of complete compliance with a complicated regulatory scheme. Indeed, the Court emphasized that each of Cigna's "tentative and generic" statements was, in context, framed by Cigna's acknowledgement of the complexity of the regulatory landscape. The Court found the challenged statements "suggest[ed] a company actively working to improve its compliance efforts, rather than one expressing confidence in their complete (or even substantial) effectiveness." With respect to the challenged code of ethics statements, the Court described them as a "textbook example of 'puffery'" and "too general to cause a reasonable investor to reply upon them." The Court emphasized that "such generic statements do not invite reasonable reliance" and thus are not materially misleading and cannot form the basis of a fraud case.

REGULATORY DEVELOPMENTS

SEC Proposes Amendments to Financial Disclosure Rules Relating to Business Acquisitions and Dispositions

The proposed amendment allowing pro forma financial statements to reflect future synergies and efficiencies from a business combination is a significant liberalization of the current rules and would provide management with considerable latitude in incorporating into the pro forma financials management's estimate of the anticipated pro forma impact of the transaction on operating results.

As part of its overall initiative to improve and streamline disclosure, in May 2019 the SEC proposed amendments to the requirements of Regulation S-X for financial statements relating to acquisitions and dispositions of businesses, including the requirements to disclose "target company" financial statements and pro forma financial statements reflecting the transaction. The SEC will accept public comments on the proposal through July 29, 2019.

The proposed changes to the rules would, among other things:

- Revise the "investment test" and "income test" used to determine the "significance" of an acquisition or disposition and expand the use of pro forma financial information in measuring significance.
- Shorten the maximum period for which historical financial statements for an acquired business are required from three fiscal years to two fiscal years (in addition to any interim period disclosure).
- Eliminate any requirement for financial statements of an acquired business once the results of the acquired business have been reflected in the acquiring company's financial statements for a complete fiscal year.
- Reduce the disclosure requirements for individually insignificant acquisitions.
- Increase the significance threshold for dispositions from 10% to 20% to conform with the minimum significance threshold for acquisitions.
- Amend the pro forma financial information requirements to permit, in addition to customary transaction adjustments, "management adjustments" reflecting reasonably estimable synergies and efficiencies resulting from the transaction.

See the *Sidley Update* available here for a comprehensive summary of the proposed amendments.

SEC Will Host a Roundtable This Summer on Potential Regulatory Changes to Address Short-Termism Concerns

Critics of the current quarterly reporting systems argue that it inappropriately drives management to focus on short-term results rather than on long-term strategic goals.

In May 2019, SEC Chair Jay Clayton announced that the SEC Staff will hold a roundtable this summer to consider whether the SEC should modify its quarterly reporting system or regulatory requirements to address concerns that existing requirements cause market participants to disproportionately focus on short-term results. As discussed in the *Sidley Update* available here, the SEC issued a request for comment in December 2018 soliciting input from the public on the content and frequency of earnings releases and quarterly reports made by public companies. The request for comment sought feedback as to how the SEC can reduce the burden on public companies associated with quarterly reporting while preserving the informational needs of investors.

The date and agenda for the roundtable have not been set, but Chair Clayton noted the following potential topics for consideration:

- Whether the pressure on public companies to focus on short-term results is discouraging private companies from going public.
- Whether the SEC can reduce the quarterly reporting burden on public companies while facilitating improved disclosure for long-term investors (including whether the SEC should allow companies to use information in earnings releases to satisfy the core financial disclosure requirements of Form 10-Q).
- Whether SEC rules should allow certain categories of reporting companies flexibility as to the frequency of their periodic reporting.
- Whether there are market practices that could be modified to encourage a longer-term focus.

Chair Clayton's announcement outlines ways in which the public may submit comments before or after the roundtable, all of which will be made publicly available.

DOJ Publishes New Guidance on Evaluating Corporate Compliance Programs

In April 2019, the Criminal Division of the U.S. Department of Justice (DOJ) released updated guidance titled Evaluation of Corporate Compliance Programs that provides insights into how the DOJ will assess the effectiveness of a company's overall compliance program in an enforcement action, focusing on the program's design, implementation and effectiveness. For more information, see the *Sidley Update* available here.

The updated guidance advises that a well-designed compliance program should include thorough due diligence of M&A targets. In analyzing the sufficiency of the diligence review, the DOJ will ask the following questions:

- Was the misconduct or risk of misconduct identified during due diligence? Who conducted the risk review for the acquired/merged entities and how was it done? What is the M&A due diligence process generally?
- How has the compliance function been integrated into the merger, acquisition and integration process?
- What has been the company's process for tracking and remediating misconduct or misconduct risks identified during the diligence process? What has been the company's process for implementing compliance policies and procedures at new entities?

Companies should keep this new guidance in mind as they are acquiring and integrating M&A targets.

Proposed Amendments to Filer Definitions Would Exempt More Issuers From Sarbanes-Oxley 404(b) Auditor Attestation Requirement

In May 2019, the SEC proposed amendments to the definitions of "accelerated filer" and "large accelerated filer" in Exchange Act Rule 12b-2. The key effect of the amendments would be to exempt a greater number of smaller issuers from the requirement to provide an auditor's attestation of management's assessment of internal control over financial reporting (ICFR) under Section 404(b) of the Sarbanes-Oxley Act (SOX 404(b)). The SEC will accept public comments on the proposal through July 29, 2019.

The proposed amendments would exclude from the accelerated filer and large accelerated filer definitions an issuer that is eligible to be a "smaller reporting company" as defined in Rule 12b-2 (SRC) and had annual revenues of less than $100 million in the most recently completed fiscal year. Therefore, SRCs with less than $100 million in revenues would be exempt from accelerated reporting deadlines and the SOX 404(b) auditor attestation requirement. They would still be required to comply with other SOX mandates, including audit committee independence requirements, CEO and CFO certifications, and the requirement to establish and maintain ICFR and have management assess its effectiveness.

Other important proposed changes include (1) increasing the public float transition thresholds for accelerated and large accelerated filers becoming non-accelerated filers from $50 million to $60 million, and for exiting large accelerated filer status from $500 million to $560 million; and (2) adding the SRC revenue test to the public float transition thresholds for exiting both accelerated and large accelerated filer status. For more information, see the *Sidley Update* available here.

CFIUS Imposes Record $1 Million Penalty for Repeated Breaches of a Mitigation Agreement

In April 2019, the Committee on Foreign Investment in the United States (CFIUS), the U.S. interagency committee that conducts national security reviews of foreign investment, published a notice on the U.S. Department of Treasury's website revealing that it imposed a $1 million civil penalty on an undisclosed party in 2018. CFIUS fined the party for "repeated breaches of a 2016 CFIUS mitigation agreement, including failure to establish requisite security policies and failure to provide adequate reports to CFIUS." The notice did not provide any details about the parties or transaction at issue. The severe penalty is a reminder that CFIUS expects parties to abide by the terms of mitigation agreements that they negotiate with CFIUS to resolve national security concerns or face harsh consequences for non-compliance.

SEC Adopts FAST Act Amendments to Modernize and Simplify Its Disclosure Rules

In March 2019, the SEC adopted amendments to Regulation S-K and related rules and forms to modernize and simplify certain disclosure requirements applicable to public companies. The most noteworthy amendments:

- Allow companies to redact confidential information in material contracts without having to first submit a confidential treatment request so long as the information is not material and would likely cause competitive harm to the company if publicly disclosed.
- Permit companies to omit immaterial schedules and attachments from all exhibits—not only plans of acquisition as previously permitted.

The amendments implement several of the recommendations in the SEC Staff's November 2016 Report on Modernization and Simplification of Regulation S-K mandated by the Fixing America's Surface Transportation (FAST) Act.

- Streamline MD&A disclosure by allowing companies, when financial statements in a filing cover three years, to eliminate discussion of the earliest year if such discussion has been included in any of the company's prior filings on EDGAR.

For a more detailed summary of the amendments, see the *Sidley Update* available here.

PCAOB Staff Issues New CAM Implementation Guidance

In 2017, the SEC approved a rule proposal of the Public Company Accounting Oversight Board (PCAOB) to adopt an auditing standard that would require auditors to describe any "critical audit matters" (CAMs) in their audit reports to make the report more useful to investors. A CAM is any matter arising from the audit that was communicated or required to be communicated to the audit committee and that relates to accounts or disclosures that are material to the financial statements *and* involved "especially challenging, subjective or complex auditor judgment." For large accelerated filers, the new CAM disclosure requirements will take effect for audits of fiscal years ending on or after June 30, 2019, and for all other registrants, for audits of fiscal years ending on or after December 15, 2020.

In March 2019, the PCAOB released staff guidance to assist with implementation of the new CAM disclosure requirements. The *Implementation of Critical Audit Matters* guidance took three forms: (1) The Basics, (2) Staff Observations from Review of Audit Methodologies and (3) A Deeper Dive on the Determination of CAMs. The guidance makes clear that CAMs are ultimately the responsibility of the auditor, not the audit committee, although the audit committee is expected to review a draft of the auditor's report and discuss CAMs with the auditor. Accordingly, management and the audit committee may consider reviewing the new guidance as they work with the auditor to prepare for CAM disclosure. For more information, see the December 2017 issue of *Sidley Perspectives* or our *Sidley Update* available here.

CORPORATE GOVERNANCE DEVELOPMENTS

Vanguard Adopts a Rigorous New Policy to Vote Against Overboarded Directors

In recent years, major institutional investors and proxy advisory firms have lowered the number of public company boards that directors may serve on before they will be considered "overboarded," resulting in recommendations and votes against those directors. Vanguard updated its proxy voting policies effective April 1, 2019, adding a new policy to generally vote against (1) a director who is a named executive officer (NEO) who serves on more than one outside public company board and (2) a non-executive director who serves on more than four public company boards. Vanguard will vote against an NEO director at each company where he or she is a non-executive but not where he or she serves as an NEO. Vanguard will vote against a non-executive director at each company except, generally, where he or she serves as board chair. Vanguard may be willing to make an exception to its overboarding policy if a director publicly commits to step down from one or more boards to meet the new thresholds.

Vanguard's new policy is similar to BlackRock's, which sets a limit of two (down from three as of 2018) total public company boards for CEO directors and four total boards for non-executive directors. It is more restrictive than the proxy voting guidelines of ISS and Glass Lewis, which permit service on five public company boards before recommending votes against non-executive directors. For directors who are public company CEOs, ISS permits service on two outside boards (three total). Like Vanguard, for NEO directors, Glass Lewis permits service on one outside board (two total).

Public companies who count Vanguard as a significant shareholder may consider revising their policies on limiting public company directorships to fit within Vanguard's new overboarding thresholds.

SIDLEY RESOURCES

M&A Topics

The American Bar Association recently released a new publication titled The Role of Directors in M&A Transactions: A Governance Handbook for Directors, Management and Advisors. John K. Hughes, a partner in our Washington, D.C. office, was a contributing author on the handbook, which gives directors, management and legal and financial advisors a framework for providing effective oversight of M&A deals.

Corporate Governance Topics

Kai Liekefett, a partner in our New York office, and Leonard Wood, a senior associate in our Houston office, recently published a *Sidley Update* titled Help! I Settled with an Activist! addressing the increase in the number of U.S. public companies entering into settlement agreements as a means to put shareholder activist campaigns to rest.

An article titled Competition and Common Ownership – A Governance Perspective by Holly J. Gregory, a partner in our New York office, was published in the May 2019 edition of *Competition Policy International's Antitrust Chronicle*.

An article titled Board Evaluation Processes and Related Disclosures by Ms. Gregory was published in the April/May 2019 edition of Practical Law's *The Governance Counselor.*

Regulatory; Other

In May 2019, President Donald Trump signed an Executive Order declaring a national emergency with respect to threats against information and communications technology and services (ICTS) in the United States. The order authorizes the Department of Commerce to block certain transactions that involve ICTS designed, developed, manufactured or supplied by persons owned, controlled by or under the jurisdiction or direction of a "foreign adversary." The order could result in substantial restrictions on the procurement of ICTS, even if the products and services are produced by subsidiaries or contractors of U.S. companies. The Department of Commerce must issue implementing regulations within 150 days. For more information, see our *Sidley Update* titled Trump Executive Order May Significantly Disrupt Technology Supply Chains.

SIDLEY EVENTS

Sidley Bay Area Life Sciences Roundtable

July 25 | San Francisco, CA

Sidley will host its Fourth Annual Bay Area Life Sciences Roundtable in San Francisco on July 25. This is an afternoon of provocative discussions addressing cutting-edge trends and hot topics in the life sciences industry. The event is open to executives, investors, general counsel and company counsel. For more information, contact sfevents@sidley.com.

Sidley Chicago Broker-Dealer Compliance Roundtable

July 30 | Chicago, IL

Sidley and ACA Compliance Group will host a broker-dealer-focused program for in-house counsel and compliance officers in Chicago on July 30. In this seminar, expert panelists from Sidley, ACA, FINRA and the industry will discuss topics relevant to the regulatory requirements unique to broker-dealers. For more information, contact chevents@sidley.com.

SIDLEY SPEAKERS

Stanford Directors' College 2019

June 23-25 | Stanford, CA

Holly J. Gregory, a partner in our New York office, will present at the 25th Annual Stanford Directors' College at Stanford Law School on June 23–25. She will participate in the plenary session on June 25 titled *CEO Activism and the Political Corporation*. The panelists will discuss CEO activism—the practice of CEOs taking public positions on environmental, social and political issues not directly related to their business, which is a hotly debated topic in corporate governance. They will analyze frameworks that boards can use to assess the benefits and costs of CEO activism and explain how boards can prepare to respond to criticism that arises when CEOs take public positions or remain silent. Click here for more information on the Directors' College.

SIDLEY SUCCESSES

Sidley has a preeminent global M&A practice comprising nearly 400 lawyers across the firm. We are engaged in the full spectrum of public and private mergers and acquisitions and private equity transactions of all sizes. Our clients include large and small companies, private equity funds and other financial sponsors, boards of directors, special committees, financial advisors and other participants in corporate transactions. Highlighted below are a few large and complex transactions Sidley M&A lawyers worked on in recent months:

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