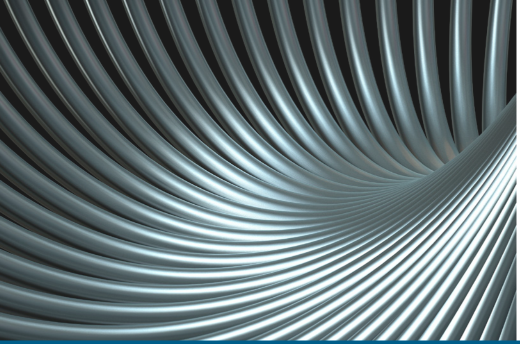

Sidley Perspectives

ON M&A AND CORPORATE GOVERNANCE

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SIDLEY

ANALYSIS

NEW AND HEIGHTENED CONSIDERATIONS FOR M&A EARNOUTS IN THE WAKE OF COVID-19

By Alexis A. Cooper and Sally Wagner Partin[1]

The COVID-19 pandemic's unprecedented impact on the economy and society has introduced significant uncertainty in the M&A world. Buyers and sellers are trying to predict how long these challenging economic conditions will persist, whether they will worsen and how quickly the economy will recover. This uncertainty makes it difficult for buyers and sellers to agree on a transaction's valuation. Many buyers still have access to capital and are open to strategic acquisitions but do not want to assume the economy will quickly recover (or will not worsen) when pricing a transaction. Sellers, on the other hand, do not want to sell at a lower exit price than they would have received in a sale only a few months ago or could receive once the economy stabilizes or improves.

Given the current uncertainty in the marketplace, we anticipate an increase in the use of earnouts in M&A deals in the coming months as a way to resolve mismatched views about a target company's value.

When market conditions result in mismatched views of a company's value, earnouts have long been a solution to bridge the valuation gap. Of course, buyers and sellers must remember that including an earnout in an M&A transaction adds incremental time and resources to craft and negotiate the provision and also necessitates that the parties maintain an ongoing relationship throughout the earnout period. However, given the current environment, we anticipate an increase in the use of earnouts in M&A transactions in the coming months.

Even in more predictable times, earnouts are complicated to draft and always rife with the potential for future disputes. Many factors that result in an earnout failing to achieve the desired results for buyer and seller or that are the basis of common future disputes are magnified at this time. This requires practitioners and business principals to look carefully at earnout provisions with a new lens, both in the context of negotiating new deals and in potentially renegotiating existing provisions.

Identifying the Right Earnout Structure and Metrics

To structure an earnout that resolves the valuation disconnect between a buyer and seller, the parties' motivations need to be understood. From buyer's perspective, an earnout requires proof of the target's sustained value before payment is made and reduces the risk of overpaying for a business, and incentivizes seller and potential key employees to support the business post-closing. From seller's perspective, getting a deal done is a "bird in the hand" that preserves the ability to share in the post-closing upside of a business that seller believes will succeed.

Although the motivations of buyers and sellers differ, there is important overlap—both parties will be more successful if the target business succeeds.

Structure of Earnout—A Move to Sliding Scale or Multiple Payment Levels (but Consider Including a Floor and a Ceiling for Total Earnout Payments)

Earnouts are often structured with all-or-nothing payment terms such that seller receives nothing if the earnout threshold is not met. It is difficult to forecast appropriate earnout benchmarks, and, when a company is performing well or creating value but these all-or-nothing terms are still unattainable, a seller (or former equityholders of seller who are current key employees of the target) may lose motivation to drive company performance.

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Further, key employees of seller may terminate their employment with buyer in the absence of other significant retention mechanisms. Thus, when a company is performing well, but below an earnout threshold, value is lost when both parties would have continued to perform if a lower payout than was previously negotiated were available. In these scenarios, making a reduced earnout payment may be less costly to buyer than the loss of aligned incentives to drive future company performance or the loss of key employees. Similarly, if a threshold for performance is set too low, for example, because the longer-term impacts of COVID-19 are overestimated, seller may take its foot off the gas when it is clear that an earnout will be achieved, even if better performance is achievable.

Given the unexpected downturn in the economy caused by the COVID-19 pandemic, earnouts that were negotiated in 2018 and 2019 assuming in-line 2020 performance may be unachievable now and, without renegotiation, can result in value loss to both buyers and sellers.

Given the unexpected downturn in the economy caused by the COVID-19 pandemic, earnouts that were negotiated in 2018 and 2019 assuming in-line 2020 performance may be unachievable now and, without renegotiation, can result in value loss to both buyers and sellers. In some of these situations, buyer may still want seller's ongoing assistance to navigate the current conditions and may be willing to pay an earnout, albeit in a lesser amount than originally negotiated, or amend the earnout metrics to incentivize continued assistance driving future value.

When earnouts are structured with a sliding scale payout (i.e., setting a floor for minimum performance and a ceiling for a maximum payment, with the payment based on a performance formula) or multiple payment thresholds (i.e., setting multiple payout levels in steps based on performance), this can help preserve some of the value that would have been lost in all-or-nothing payout structures. Because setting an appropriate target for earnout payments is more difficult during unpredictable times, both buyers and sellers may be incentivized to move away from typical all-or-nothing payment terms. As long as a buyer chooses an appropriate floor (below which it deems there is no value in a payment) and a ceiling, a sliding scale or multiple payment structure may increase the likelihood that the parties' objectives remain aligned.

Metrics — Consider Including Non-Financial Metrics That Will Build Future Value and Additional Considerations for the Use of Financial Metrics

Given the heightened difficulty in predicting future financial performance at this time, the always hairy task of setting an appropriate target for earnout payments is made more challenging. Therefore, parties may want to shift to the inclusion of non-financial metrics that buyer believes will build future value and enhance financial performance or use multiple financial and non-financial metrics.

- When financial metrics are used, if the business is operating at less than full capacity at the time the deal is closed due to COVID-19, the metric may be tied to an increase in revenue levels to that of 2019 for a specific period of time.
- When financial metrics, such as EBITDA, are used, the metric must be drafted carefully and it should be clear whether extraordinary or non-recurring items are excluded. For example, if the target business was eligible for a Paycheck Protection Program loan under the recent Coronavirus Aid, Relief, and Economic Security (CARES) Act, the parties should specify whether they intend the amount of any forgiven loan to be included in earnings and determine how to treat any reduction in goodwill due to COVID-19-related company performance. Additionally, when strategic buyers expect cost-savings synergies to drive EBITDA growth, parties may prefer to use revenue-based metrics.

- If there is a concern that customers impacted by the COVID-19 pandemic will be unable to pay, metrics may be tied to collectability of the accounts receivable.
- As laws and regulations are quickly changing (such as the loosening by the CARES Act of the limitations on net operating loss carrybacks imposed in 2017 by the Tax Cuts and Jobs Act), practitioners should consider tying definitions to GAAP or laws as in effect on the date the agreement is signed to prevent future changes in law or GAAP from impacting the earnout calculations.
- For additional non-financial metrics, buyers should consider milestones that would set the stage to drive future value, such as updates to the platform, user experience improvements, reduction in cost of goods sold, specific quantity of unit sales, number of contracts signed or renewed, number of customers and users added and completion of new product launch.

Term of Earnout—A Move to Longer Earnout Periods or a Delayed Starting Point for Measurement

When a business is operating below full capacity or has incurred significant revenue declines during the pandemic, seller may want to push for a longer than normal earnout period to allow the business time to fully rebound to full operational capacity.

Where financial metrics are still viewed as the right earnout measurement, parties may want to reconsider the appropriate time frame for earnout performance. When a business is operating below full capacity or has incurred significant revenue declines during the pandemic, seller may want to push for a longer than normal earnout period to allow the business time to fully rebound to full operational capacity. Although longer earnout periods may heighten the risks of disputes due to the increased possibility of unusual or unexpected events occurring during the measurement periods, parties may still agree on a longer earnout period or a delayed onset for performance measurement to give companies more time to return to more normal operations and achieve the agreed earnout metrics.

Careful Consideration of Operational Covenants and Other Post-Closing Obligations

The operation of the business through an earnout period is a breeding ground for disputes. Generally buyers want the freedom to operate the business in a manner that ensures long-term success, and sellers want to build in contractual protections to maximize their ability to achieve the earnout above all else.

In This Environment, Buyers Require Flexible Post-Closing Covenants

While there has always been some level of conflicting goals between the buyer (focused on long-term success) and seller (largely focused on success within the agreed metrics during the earnout period), the disconnect in these uncertain times can be even greater, and careful attention by both sides in drafting operational covenants is critical.

In this business climate, buyers need substantial flexibility to adjust their operations to respond to local, state and federal orders and guidelines, to respond to the needs of customers in a way that fosters positive business partnerships, and generally to address challenges caused by COVID-19. For that reason, it is more important than ever that buyers carefully consider whether to agree to operational restrictions or affirmative commitments in the purchase agreement that could unduly tie their hands to address to the changing business environment, especially if buyers have agreed to a longer earnout period as discussed above.

The chart below highlights considerations when negotiating the scope of post-closing operating covenants:

BUYER APPROACH TO OPERATING COVENANTS	SELLER APPROACH TO OPERATING COVENANTS
Flexibility to Run the Business the Way It Sees Fit, Such As: ■ Investing in long-term business even if the long-term focus reduces earnout period results ■ Integrating or selling businesses as is best for the stakeholders ■ Making employment changes as necessary— furloughs, reductions in hours, terminations, etc. ■ Modifying the operational plan to comply with safety requirements to minimize the spread of COVID-19 ■ Managing costs or streamlining overhead ■ Revising marketing budgets to tailor spending ■ Delaying new initiatives until there is greater clarity on future profitability	Negative Covenants Restricting Buyer From: ■ Diverting business to another controlled entity or business ■ Making fundamental changes to the target business, such as selling major assets or a line of business ■ Entering into contracts that would hinder payment of the earnout ■ Changing management or key employees or staffing levels ■ Acquiring other companies that may divert funding or management attention ■ Altering marketing or other important budgets and expense items ■ Materially changing accounts receivable payment terms to shift to longer aging
Buyers Also May Want to Address: ■ Any required subordination that buyer's lenders need to reflect that their senior secured position stands ahead of an earnout payment ■ Specific carveouts for likely future changes in the business or anticipated buyer plans	Affirmative Covenants Requiring Buyer To: ■ Operate in the ordinary course consistent with past practice ■ Maintain books and records consistent with past practice ■ Hold the target business separate ■ Use commercially reasonable efforts to maximize the earnout payment (including providing adequate capital resources)

Consider Appropriate Information Rights and Other Post-Closing Concerns

Given the need for buyers to have more discretion in operating the business during these uncertain times, providing seller with interim reports and information rights or the ability to meet with company management may help keep the parties' expectations in line and avoid disputes before the final calculation at the end of the earnout period.

Sellers should note also that, while their businesses may not be performing in line with pre-COVID-19 expectations, the same may also be true of buyer. When agreeing to earnouts, sellers should also consider the future of buyer's business, and in some circumstances, if sellers have concern about future collectability of an earnout that becomes due, they may consider whether it is appropriate for an affiliate of buyer to offer a guaranty of buyer's payment obligations. Similarly, sellers will want to consider whether the earnout payments should accelerate if buyer sells the business or the target division.

Despite the uncertainty throughout the marketplace due to the COVID-19 pandemic, with careful consideration by practitioners and business principals and precise drafting of purchase agreement provisions, earnouts can help creatively solve the valuation gap to close deals that meet the strategic goals of buyers and provide liquidity to sellers.

ANTITRUST IN THE TIME OF COVID-19

By Jim Lowe[2]

Despite reports to the contrary, antitrust enforcement has not disappeared during the current pandemic. Nearly all the regulatory authorities around the world have stated that they are continuing to work, are applying the same standards as before, and are on the lookout for companies or individuals that may try to use the current crisis as an excuse to suppress competition or to complete an anticompetitive transaction. The agencies do take the economic impact of the crisis into account when making enforcement decisions, but they have and will continue to block transactions they believe will harm competition and bring cases challenging illegal conduct they discover during merger investigations. For example, it has been reported that the U.S. Department of Justice (DOJ) will soon file suit against Google alleging various antitrust violations.

Regulatory authorities continue to be on the lookout for companies or individuals that may try to use the COVID-19 crisis as an excuse to suppress competition or to complete an anticompetitive transaction.

The crisis does create some changes, however, that are important to keep in mind, particularly for parties considering strategic transactions or adjusting their competitive behavior or distribution strategies. Key among these are:

- **Complex Merger Reviews Will Take Longer.** While all major reviewing agencies are working, key aspects of their investigations—particularly contacting third parties and reviewing electronic documents—are taking longer. As a result, the agencies are using various techniques to slow review timing. Parties should consult counsel about likely timing and may need to adjust outside dates and financing commitments accordingly.
- **Defenses for Distressed Transactions Are Limited.** Reviewing agencies do take account of the current crisis in investigating particular transactions, but their primary focus remains on the long-term competitive impact of the transaction. However, in the U.S. there is a "failing firm defense" which provides a complete defense if the seller is truly failing. To meet the requirements of the defense, the seller must show that it cannot successfully reorganize in bankruptcy, it has been fully shopped and there is no less anticompetitive offer above liquidation value. This is a very high standard to meet. There is also a less precise "flailing firm defense," which applies where the seller can show that it will be unable to be a significant competitor going forward due to financial or market challenges. The agencies are very skeptical of this defense (the Federal Trade Commission in fact recently expressly called out insufficient flailing firm arguments), so it requires a high level of proof and substantial time to make it successfully. Other jurisdictions have similar defenses but are equally strict in their application.
- **The Agencies Can Act Quickly If Truly Essential.** Most agencies have the ability to speed their processes if essential to the survival of one or more of the parties or to assure that critical markets are able to function. For example, during the last financial crisis, U.S. authorities were able to review bank mergers on very short timelines to keep credit markets open and consumer accounts available. However, absent a true exigency, the agencies will operate on a normal timeline.
- **Expect Enhanced Focus on Gun-Jumping.** Buyers of distressed companies may want to gain immediate control of the seller upon signing to limit further deterioration of the business. But if the transaction is reportable, efforts by the buyer to influence or control the ordinary course operation of the business prior to clearance can constitute gun-jumping which, if discovered, can result in very significant fines (e.g., about $40,000 per day in the U.S.) and delay in receiving clearance. If a buyer seeks enhanced ordinary course covenants from a seller, antitrust counsel should review them prior to signing, as well as any plans to try to change the seller's operations prior to closing.

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- **Transactions That Are Not Reportable Can Be Subject to Antitrust Scrutiny.** A number of major jurisdictions including the U.S., UK and Canada have the ability to investigate and challenge transactions that are not reportable, either before or after they close. In ordinary circumstances the U.S. agencies on average challenge two transactions a year that were not reportable. During past economic crises, that number has increased, in part because the agencies have greater resource availability due to the decline in filings. Parties to non-reportable strategic transactions that raise antitrust issues should consider the risk of antitrust scrutiny before signing. Buyers should also consider the risk of a post-closing investigation that could result in a divestiture order.
- **The Agencies Remain Focused on Non-Merger Anticompetitive Conduct.** The antitrust agencies will continue to pursue criminal and civil antitrust investigations. Conduct of particular interest includes price fixing, bid rigging, market allocation, exclusive dealing, no-poach agreements, boycotts and refusals to deal. For example, the DOJ just announced the indictment of four current and former executives of chicken processors for price fixing. Government investigations often spawn follow-on private treble damage litigation.
- **Conduct Allegations Can Arise From Merger Investigations.** Increasingly government conduct cases begin when an agency discovers illegal conduct during the course of a merger investigation. For example, the packaged seafood industry has been subject to a lengthy criminal price fixing investigation resulting in multiple indictments that began when the DOJ discovered the conduct during the course of investigating the proposed merger of Bumble Bee and Chicken of the Sea. Parties to transactions likely to face in-depth merger investigations should take steps to make sure neither party has engaged in conduct that could result in follow-on investigations.

Parties to transactions likely to face in-depth merger investigations should take steps to make sure neither party has engaged in conduct that could result in follow-on investigations.

EIGHT STEPS FOR AUDIT COMMITTEES TO NAVIGATE THE PANDEMIC

By Hille R. Sheppard, Brian J. Fahrney and David A. Gordon[3]

The COVID-19 crisis presents unprecedented challenges for all of us — and everyone has a role to play. Audit committees should consider the following steps to help their companies weather this storm.

1. **Watch the "Tone at the Top."** Prioritize the health and safety of employees, customers, vendors and counterparties. This is the right thing to do and also mitigates risk for the company. As the company begins to contemplate re-entry of its workforce, health concerns will need to be weighed against business imperatives, and board members can provide an important perspective.
2. **Stay on Top of Operations and Risks.** Decisions during crises are often made at "light-speed," but boards still have oversight duties and must adequately inform themselves about key decisions, all of which can have regulatory, legal or other implications.

   Consider requiring more frequent management updates. Document any additional steps taken. Examine action plans and clearly designate who will handle certain challenges. Ask more detailed questions to facilitate learning about issues that may be harder to understand in an extended period of remote meetings. Consider asking for briefings from a broader array of management or external advisors with specialized knowledge. But also know that management has unusual demands at this time, so don't add to them unnecessarily. Consider, in consultation with management, the enterprise risk management impacts of COVID-19 and its aftermath.

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3. **Stay in Sync With Management on Reporting.** Audit committees should expect to be exceptionally active during this crisis and it is essential that management and the committee (indeed, the full board) are in sync on key reporting issues. The SEC has provided recent guidance to reporting companies to encourage robust reporting in key disclosure areas, including risk factors, MD&A (including liquidity) and forward-looking information and "outlook" sections. If your company previously provided annual earnings guidance, consider withdrawing it or updating with appropriate hedging or cautionary language given the significant uncertainties most companies face in this environment.

   Audit committees and management teams should also be prepared to expend extra time on key accounting judgments that could be impacted in this environment, such as intangible asset impairments, revenue recognition and A/R and tax reserves, in addition to factors that might bear on the company's internal control over financial reporting.

4. **Make Sure Disclosures and Reporting Are Consistent.** Plaintiffs' attorneys are investigating whether COVID-19 disclosure-related issues can support opportunistic securities class actions, with multiple cases already filed. Companies that express public confidence about their general prospects or their supply chain sufficiency despite dismal news about the economy and COVID-19's impacts face heightened risk.

   As always, companies should be careful to have support for statements at the time they are made. Watch for changing circumstances and adverse trends, in particular, as those circumstances change rapidly; describe them accurately as new developments. Ensure that public reporting is consistent with what the board is being told privately.

   Shareholders also may second guess board-level decisions or inaction. So, consider documenting COVID-19-related considerations and responses to create a diligence record. Shareholders looking to file derivative actions often seek books and records before filing or making demands. Having a record of board considerations and responses can be very protective. Shareholder demands and books and records demands often come by mail, so companies should be alert to incoming mail when personnel are out of the office.

5. **Be Aware of Insider Trading Risks.** In a rapidly changing environment like this, be especially vigilant about insider trading in company stock. Stock prices are extremely volatile and events are changing quickly—this is an environment in which an insider can be challenged on a trade with benefit of hindsight. The SEC circulated a notice to be especially careful regarding trading windows given heightened sensitivity of inside information, and extra SEC scrutiny will likely be applied. Companies should take extra care in considering their trading policies, including with respect to insiders putting up or taking down Rule 10b5-1 plans.

6. **Be Prepared for Contract Breaches.** COVID-19 likely will cause breaches and attempted avoidance, and your company may be on either side of those disputes. Examine force majeure clauses and common-law doctrines such as frustration, impossibility and commercial impracticability. Weigh the benefits of performance versus strategic non-performance. TROs or threatening litigation may shield companies from aggressive counterparties, but also consider reputational and long-term relationship issues. Audit committees also should consider financial statement implications around uncertainty in resolution of breaches, including potentially material revenue and expense swings.

7. **Update Crisis Management Plans.** Effective crisis management prevents under- and over-reacting. Consequently, audit committees should consider whether an up-to-date, effective crisis management plan is in place. Elements may include:
   - Cross-functional teams
   - Audit or risk committee involvement
   - Decisive procedure and resource deployment
   - Contingency plans
   - Thoughtful communications, including "holding" statements on likely issues
8. **Conduct Contingency Planning Exercises.** Boards should engage with management on 2020 demand/revenue projections under various scenarios and conduct contingency planning exercises to address downside scenarios. Planning elements include:
   - Conserving liquidity to preserve flexibility
   - Exploring public and private options to enhance flexibility
   - Employee and talent disruption
   - Need for employee workforce and compensation reductions
   - Other expense and cap ex reductions
   - Board/governance continuity (including emergency bylaws and management succession planning)

Certain companies may require more extensive restructuring planning, including liability management or full bankruptcy preparedness planning.

NEWS

JUDICIAL DEVELOPMENTS

Delaware Chancery Court Will Soon Decide Whether COVID-19 Justifies Walking Away From a Deal

In late July, the Delaware Chancery Court will for the first time decide the complex legal and factual questions about whether COVID-19 and its economic repercussions constitute a material adverse effect that allows a buyer to walk away from its agreement to acquire a target company.

Due to the COVID-19 pandemic and its negative effects on target businesses, some buyers have sought to delay, renegotiate or terminate pending M&A transactions. In the past few months, more than 10 lawsuits have been filed by buyers trying to back out of deals or by sellers trying to force buyers to close, and there are more to come. While each dispute is highly dependent on the facts and the explicit language in the acquisition agreement, there are two primary arguments buyers are making to try to walk away from deals.

Some buyers are claiming that the pandemic triggered the "material adverse effect" (MAE) clause in an acquisition agreement, which enables a buyer to terminate the agreement after signing but prior to closing if the target business suffered an MAE. Delaware courts have only very rarely upheld a buyer's right to terminate an acquisition agreement on the basis of an MAE. Among other things, a buyer will have to prove, using detailed financial analysis, that (1) the pandemic has had a disproportionate effect on the target business as compared to other companies in the same industry and (2) the adverse impact of the pandemic on the target's earnings potential will be "durationally significant" (e.g., measured in years rather than months).This argument will be even more difficult—and perhaps unavailable—for buyers where the pandemic was expressly excluded from the MAE definition. For more information on this line of argument and summaries of recent cases, see the Sidley-authored article titled *Buyer's Remorse or Material Adverse Effect? A New Wave of Litigation in the COVID-19 World*.

Buyers may have greater success using another common argument: that termination of the deal is justified because seller breached its covenant to continue operating in the ordinary course of business. For example, a would-be buyer may claim that seller breached that covenant by modifying its business operations in ways that went beyond the minimum required to comply with government shut-down orders. Where the agreement is silent, it is an open question as to whether a court would judge a company's conduct during the COVID-19 crisis at a standard of conduct appropriate during a pandemic or a standard consistent with past practice.

Some of the disputes that have made headlines—such as L Brands/Sycamore Partners—were settled, depriving us of the opportunity to hear the Delaware Chancery Court's reasoning on these issues. But one first-of-its-kind case—filed by a target seeking to force a buyer to close a transaction signed in February 2020—that implicates both the MAE argument as well as the ordinary course of business argument will go to trial in the Delaware Chancery Court beginning on July 20, 2020.

In the meantime, deal parties should pay particular attention to the relevant definitions, covenants, closing conditions and termination provisions in acquisition agreements, bearing in mind COVID-19 and its effects. Furthermore, in light of the Chancery Court recently denying motions for expedited trials in a few cases, if a seller plans to file a lawsuit to compel a buyer to close, it should do so as soon as possible after receiving notice that the buyer plans to walk away from the deal.

Caremark Claim Allowed to Proceed Against Audit Committee Members Based on Oversight Failures

Hughes v. Hu marks the third time in 12 months that a Delaware court has denied a motion to dismiss and allowed a Caremark claim to move forward. These recent cases confirm the serious nature of directors' oversight duties regarding compliance and risk, as well as the litigation risks associated with failure to demonstrate in corporate records that directors are attending to important compliance and other risks facing the company.

The Delaware Chancery Court recently denied a motion to dismiss a shareholder derivative suit against directors and officers of Kandi Technologies Group, Inc., a publicly traded Delaware corporation based in China. *Hughes v. Hu* (Del. Ch. Apr. 27, 2020). The company had persistent problems with financial reporting and internal controls, encountering particular difficulties with related-party transactions dating back to 2010. In March 2014, the company disclosed material weaknesses in financial reporting and oversight, including a lack of audit committee oversight and a lack of internal controls for related-party transactions. The company pledged to remediate these problems. However, in March 2017, the company disclosed that its preceding three years of financial statements needed to be restated and that it continued to lack sufficient expertise and/or controls relating to accounting and SEC reporting.

The plaintiff filed a derivative claim to recover damages from the three directors who comprised the audit committee during the period, the CEO and three CFOs who had served in quick succession. Prior to filing suit, the plaintiff obtained books and records under a Delaware General Corporation Law (DGCL) Section 220 demand and used those records to assert that directors "consciously failed" to establish a board-level system of oversight for the company's financial statements and related-party transactions and simply relied blindly on management, while devoting inadequate time to audit committee matters—leading to the restatement and causing the company harm.

Defendants moved to dismiss the complaint and the Court denied the motion, finding that the books and records produced—and fair inferences from what the company failed to produce—supported a reasonable pleading-stage inference of a bad faith failure of oversight by the director defendants. The Court found that the plaintiff adequately pleaded that the audit committee "met sporadically, devoted inadequate time to its work, had clear notice of irregularities, and consciously turned a blind eye to their continuation" and that "the board never established its own reasonable system of monitoring and reporting, choosing instead to rely entirely on management."

Furthermore, the company failed to produce related-party agreements and review procedures that were referenced in audit committee meeting minutes and were responsive to the DGCL Section 220 demand, suggesting that they either did not exist or did not impose meaningful restrictions on company insiders. The Court explained that what the company produced — or rather "conspicuously failed to produce" — "is telling because '[i]t is more reasonable to infer that exculpatory documents would be provided than to believe the opposite: that such documents existed and yet were inexplicably withheld'" (citing *In re Tyson Foods, Inc.*, 919 A.2d 563 (Del. Ch. 2007)).

Because the Court determined that the defendant directors "face a substantial likelihood of liability under Caremark for breaching their duty of loyalty by failing to act in good faith to maintain a board-level system for monitoring the company's financial reporting," it declined to dismiss plaintiff's claim. For more information on this decision and practical guidance for boards and their advisors to reduce the risk of derivative claims premised on a failure of board oversight, see our Sidley Update titled *Board Oversight in Light of COVID-19 and Recent Delaware Decisions*.

Delaware Supreme Court Upholds the Validity of Federal-Forum Provisions, but Questions Remain

Recently the Delaware Supreme Court, in *Salzberg v. Sciabacucchi* (Del. Mar. 18, 2020), upheld the validity under Delaware law of "federal-forum provisions," in which Delaware corporations mandate that claims brought under the Securities Act of 1933 be filed in a federal court. These provisions promote efficiency and the consistent application of federal law by limiting the adjudication of such claims in state court and reversing the recent growth of parallel state and federal court litigation of 1933 Act claims. The highly anticipated ruling reversed a Chancery Court decision and confirms that Delaware's corporation law grants corporate managers and stockholders significant latitude in choosing the fora for certain types of litigation.

While the decision confirms the facial validity of this particular type of forum provision, other ramifications of this decision remain unclear, and this topic will undoubtedly be the subject of further litigation or possibly legislative action. For example, the Court left open the "down the road" question of whether federal-forum provisions in the charters of Delaware corporations will be respected and enforced by other states, while noting its view that sister states should enforce these provisions. That issue is set to be litigated in state courts outside Delaware in the coming months, particularly in California where similar 1933 Act cases have been stayed in anticipation of this decision from the Delaware Supreme Court. The decision also leaves open the potential adoption of other alternative forum provisions such as mandatory arbitration provisions governing certain securities claims. For more information, see our Sidley Update available here.

We encourage companies to consider adopting federal-forum provisions. More than 65 companies have amended their bylaws to add such provisions since the *Salzberg* decision was issued. Companies should bear in mind that Glass Lewis generally recommends against the governance committee chair at companies that have adopted an exclusive forum provision in the past year without shareholder approval, although it has not issued negative vote recommendations at every company that has recently adopted a federal-forum provision.

Special Committee Must Be Formed *"Ab Initio"* to Cleanse a Transaction With a Majority-Conflicted Board

The Delaware Chancery Court recently held that, for a transaction involving a majority-conflicted board to be entitled to business judgment review (rather than the entire fairness standard), the special committee that approved the transaction must have been sufficiently constituted and authorized *ab initio* (i.e., "from the beginning"). *Salladay v. Lev* (Del. Ch. Feb. 27, 2020). In doing so, Vice Chancellor Sam Glasscock III borrowed from the framework used to cleanse a controlling stockholder transaction under *Kahn v. M&F Worldwide Corp. (MFW),* 88 A.3d 624 (Del. 2014). Under *MFW,* a controlling stockholder transaction is entitled to business judgment review if the controller conditions the transaction *ab initio* on both the approval of an independent special committee and the uncoerced, informed vote of a majority of the minority stockholders.

According to Vice Chancellor Glasscock, the same rationale for imposing *MFW*'s *ab initio* requirement applies to a transaction "where there is no controlling stockholders but the board is conflicted." In either context, "[t]he acquirer — as well as any interested directors — must know from the transaction's inception that they cannot bypass the special committee."

Our June 2019 issue of Sidley Perspectives *discussed the Delaware Supreme Court's decision in* Olenik v. Lodzinski, *which clarified the* MFW *requirement for conditions to be in place "ab initio," including that a special committee must be formed prior to "substantive economic negotiations."*

A former stockholder of Intersections, Inc. brought fiduciary duty claims against three directors (one of whom was also the CEO) claiming that they approved a take-private acquisition of the company at an unfair price and influenced the transaction to divert merger consideration to themselves. The plaintiff argued that the entire fairness standard of review should apply because at least half of the directors (three of the six-member board) were conflicted because they rolled over significant portions of their equity in the merger. The defendant directors contended that business judgment review should apply and the claims should be dismissed because the transaction had been approved by an independent special committee and a majority of the disinterested stockholders.

The Court ruled that the special committee was not properly constituted from the merger's inception in a way that could invoke business judgment review and denied the defendants' motion to dismiss. The Court found that the complaint adequately pleaded that substantive economic negotiations occurred before the special committee was formed, which "deprived the Committee of the full negotiating power sufficient to invoke the business judgement rule."

A potential acquirer expressed interest in the company and began discussions with the conflicted directors and members of company management about a possible transaction. According to the complaint, at one meeting, the company's CEO/board chair suggested to the potential acquirer that the company's board may be receptive to an offer in the range of $3.50 to $4.00 per share. Just over a week later, the board formed the special committee of three independent and disinterested directors and determined to condition its approval of the transaction on the favorable recommendation by the special committee. The acquirer made an initial offer of $3.50 per share. After a few weeks of negotiations, the acquirer increased its offer to $3.68 per share. Upon recommendation from the special committee, the board approved the transaction at that price. Based on the facts alleged, Vice Chancellor Glasscock held that it was conceivable that discussions that preceded the special committee's formation essentially formed a price collar that set the stage for future economic negotiations. In that situation, a " 'bare knuckle contest over price' is unlikely, and the existence of the committee is insufficient to replicate an arms-length transaction." Thus, entire fairness review applied.

The Court also refused to invoke business judgment review under *Corwin v. KKR Fin. Holdings LLC,* 125 A.3d 304 (Del. 2015), which applies when a conflicted transaction not involving a controlling stockholder is approved by a fully informed, uncoerced vote of a majority of the disinterested stockholders. *Corwin* cleansing was not available because the complaint adequately pleaded material misstatements and omissions in the merger proxy

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statement. In particular, the Court took issue with (1) potentially coercive disclosure in the proxy suggesting that a change of control of the company could occur if the stockholders rejected the transaction and (2) insufficient disclosure about the special committee's financial advisors, including the fact that one advisor abruptly resigned days after being engaged.

In light of this decision, companies and advisers working on conflicted transactions should formalize the creation and authorization of the special committee as early as possible in the deal process and certainly before any economic terms are negotiated. They should also make sure that board and committee meeting minutes reflect the committee's formation and actions. Finally, they should ensure that disclosures about the transaction are clear and complete so a stockholder vote will be considered fully informed.

CORPORATE GOVERNANCE DEVELOPMENTS

SEC Under Increasing Pressure to Mandate a Regulated, Uniform Approach to ESG Disclosures

In May 2020, the SEC's Investor Advisory Committee (IAC) recommended that the SEC initiate an effort to update its public company reporting requirements to include "material, decision-useful, ESG factors." The IAC's stated reasons for making the recommendation include:

- Investors need reliable, material environmental, social and governance (ESG) information to make investment and voting decisions. According to the IAC, "despite a plethora of data" on ESG matters, "all with different standards and criteria," "there is a lack of material, comparable, consistent information available upon which to base some of these decisions."
- Public companies should directly provide material information to the market regarding ESG issues used by investors to make investment and voting decisions.
- Requiring material ESG disclosure will level the playing field among public companies of different sizes and capital constraints.
- Requiring material ESG disclosure will facilitate the flow of capital to the U.S. markets and to U.S. public companies of all sizes.
- The U.S. should take the lead on disclosure of material ESG disclosure because it has the largest and deepest capital markets in the world.

To begin the process, the IAC suggests that the SEC solicit input from investors, issuers and other market participants through roundtables, requests for information or similar means. The IAC also proposes that the SEC consider widely-accepted third-party ESG reporting frameworks (e.g., GRI, SASB and TCFD) as it contemplates developing its own ESG disclosure regime.

Despite this most recent call for the SEC to require mandatory ESG disclosure, it is unclear whether there will be much, if any, progress on that front in the near term. Days after the IAC issued its recommendation, SEC Chair Jay Clayton publicly remarked: "I believe I have made it clear that, while I believe that in many cases one or more 'E' issues, 'S' issues, or 'G' issues are material to an investment decision, I have not seen circumstances where combining an analysis of E, S and G together, across a broad range of companies, for example with a 'rating' or 'score,' particularly a single rating or score, would facilitate meaningful investment analysis that was not significantly over-inclusive and imprecise."

Novel Board and CEO Diversity Search Policies Emerge in Response to New York City Comptroller Initiative

The New York City Comptroller's press release cites a 2016 Harvard Business Review *study that found that the odds of hiring a woman or minority candidate were much greater (79 times and 193 times, respectively) when there were at least two of such candidates in the finalist pool.*

As discussed in our [December 2019 issue] of *Sidley Perspectives*, last fall New York City Comptroller Scott Stringer urged public companies to adopt a diversity search policy requiring that qualified female and racially/ethnically diverse candidates be included in the pool of nominees from which directors and CEOs are selected. The initiative was based on the National Football League's "Rooney Rule," which requires the league's teams to interview minority candidates for open senior positions such as head coach or general manager. Comptroller Stringer is the trustee of New York City's five pension funds, which together hold over $200 billion in assets.

Comptroller Stringer launched the initiative in October 2019 by sending form letters to the boards of [56 S&P 500 companies] that did not disclose a diversity search policy that includes Rooney Rule language, requesting that they adopt such a policy. At 17 of those 56 companies that lacked "apparent racial diversity at the highest levels," the group filed shareholder proposals for the 2020 proxy season requesting that the companies adopt a board and CEO diversity search policy.

In April 2020, Comptroller Stringer and the New York City Retirement Systems (NYCRS) issued a [press release] announcing the results of their "Rooney Rule" initiative. They reported that they withdrew shareholder proposals at 13 of the 17 targeted companies (76.5%) after the boards of each company approved and publicly disclosed new policies requiring the board to consider women and people of color for director and external CEO searches. Many companies already disclose such policies with respect to director searches, but the Comptroller's Office believes the 13 companies named in the press release are the first to adopt policies requiring the Rooney Rule to be used in both director and CEO searches.

Two targeted companies adopted diversity search policies that applied to the board but not the CEO so the group did not withdraw the proposal. One of those companies was granted SEC no-action relief to exclude the proposal. At the other company, the proposal went to a vote at the company's annual meeting in May 2020 and achieved 24% support. The proposal also went to a vote at two companies that the NYCRS says "neither of which engaged meaningfully with the NYCRS to discuss the proposal." One passed with 53% of the vote and the other failed to achieve majority support with just 12% of the vote.

Public companies should inform their nominating and corporate governance committees about this campaign and consider how they would respond to shareholder proposals or investor questions about their diversity policies or the composition of their boards and senior management teams. The NYCRS made clear that the board/CEO diversity search policies are not intended to be a substitute for robust internal succession planning and encouraged companies to focus on fostering a diverse talent pipeline for executive management.

SIDLEY RESOURCES

M&A Topics

[SPAC Extensions Hit Record After Coronavirus Freeze] (June 5, 2020). The COVID-19 pandemic did not stop the clock on special-purpose acquisition companies (SPACs), which have a finite amount of time to find a target. Many of them asked investors for an extension, 33 of which have been granted so far in 2020 as of mid-June, already setting a new record from 26 total in 2019. Michael P. Heinz and Jeffrey N. Smith, partners in Sidley's Chicago office, were interviewed and provided research for an article about SPAC extensions that appeared in IPO Edge.

Strategic Acquisitions of Distressed Companies in the COVID-19 Environment (May 4, 2020). Many companies are unprepared to face our challenging economic environment and will not survive the pandemic fallout. But others will persevere and perhaps even seek to strengthen and expand by salvaging promising companies that now find themselves in distress. For buyers that are properly prepared, the current market presents unprecedented opportunities to acquire assets at prices that can be relative bargains. Those deals will look dramatically different from the deals to which most strategic acquirers have become accustomed during the recent bull market. In this article, Jennifer F. Fitchen, a partner in Sidley's Palo Alto office and global co-leader of our Mergers & Acquisitions practice, explains how the rules of the road differ in acquisitions of insolvent companies.

Corporate Governance Topics

Sidley Podcast: COVID-19 Places Corporate Social Responsibility in Sharp Relief. The foregoing link is to the latest episode of The Sidley Podcast, where Samir A. Gandhi, the managing partner of Sidley's New York office, speaks with Holly J. Gregory, a partner in Sidley's New York office and co-chair of our global Corporate Governance and Executive Compensation practice, about what businesses and their boards can do with respect to corporate social responsibility and expanding concerns about social justice in anticipation of the challenges and opportunities posed by the current landscape.

Board Oversight of Compliance Risk. In an article published in the April/May 2020 edition of Practical Law's *The Governance Counselor*, Holly J. Gregory discusses recent developments in the Delaware courts regarding the board's oversight of compliance risk.

The Link Between ESG and Business Continuity — What Boards Need to Know. In an article recently published in Corporate Board Member, Holly J. Gregory cautions that business leaders will be judged by their response to the COVID-19 crisis — not only in managing cash flow, adapting supply chains and tackling business continuity issues — but also in how they factored ESG principles into their decisions, corporate strategies and operations.

SEC Topics

SEC Substantially Improves Financial Disclosure Rules Relating to Business Acquisitions and Dispositions (May 26, 2020). As part of its overall initiative to improve and streamline disclosure, the SEC recently adopted long-expected reforms to Regulation S-X regarding financial disclosure for business acquisitions and dispositions. This Sidley Update discusses the rule amendments which, in our view, will move the relevant U.S. disclosure requirements toward a more principles-based regime. In particular, the change allowing pro forma financial statements to reflect future synergies and other effects of a business combination will now provide management with the ability to provide investors with more meaningful pro forma information that incorporates management's estimate of the anticipated impact of the transaction on pro forma operating results. The rule amendments will become effective on January 1, 2021, but companies are permitted to voluntarily comply with the rule amendments in advance of the effective date.

Regulatory; Antitrust Topics

DOJ Updates Guidance on Evaluating Corporate Compliance Programs (June 4, 2020). The Criminal Division of the U.S. Department of Justice (DOJ) recently publicized an updated version of its Evaluation of Corporate Compliance Programs guidance, which was first issued in 2017 and revised in April 2019. This further revision is another reminder of the DOJ's heightened focus and increasing sophistication regarding evaluating compliance programs during investigations. The latest revisions highlight the importance of an adequately resourced and empowered compliance department, a constantly evolving compliance program based on the company's current risk profile and relevant compliance issues, and the use of key compliance metrics to test the effectiveness of a compliance program.

Antitrust Covenants in the Spotlight Following Recent Failed Mergers. The American Bar Association's *Antitrust Magazine,* Vol. 34, No. 2, Spring 2020, recently published an article by Karen Kazmerzak, Jim Lowe and Joseph Coniglio, members of the Antitrust/Competition practice in Sidley's Washington, D.C. office. When the consummation of a transaction is subject to regulatory clearances or shareholder approvals, merging parties must allocate the risks created by these conditions precedent as part of their broader merger negotiations. Risk allocation clauses can create hazards for both buyers and sellers in transactions with material antitrust issues. In practice, merger agreements among competitors can leave one or both parties exposed if the deal fails to receive antitrust clearance. Although sellers may prefer provisions that place more of the antitrust clearance risk on the buyer, and vice versa, the language on which the parties ultimately agree will depend on their relative bargaining positions, priorities and perceptions of the risk of failing to obtain clearance.

Antitrust Clearance of Distressed Transactions: Don't Assume It Will Be Easy (April 27, 2020). Despite recent press speculation that transactions involving distressed entities may receive more favorable treatment from antitrust authorities during the COVID-19 crisis than they would ordinarily, there is little basis for concluding that agencies in major jurisdictions will take a radically different approach from those they have taken in similar situations.

Legislative Topics

Congress Advances Audit Legislation To Potentially Delist Foreign Companies from U.S. Securities Exchanges (May 21, 2020). In late May 2020, the Holding Foreign Companies Accountable Act passed the U.S. Senate without objection and was introduced in the U.S. House of Representatives. If this bill becomes law, it would prohibit certain companies from listing and trading their securities on any U.S. securities exchanges or through any other method regulated by the SEC if the Public Company Accounting Oversight Board (PCAOB) is prevented from reviewing the companies' audits. This Sidley Update provides a summary of the bill and legislative developments.

General Corporate Topics

An article titled Revisiting the Benefits of An Efficient Contract Breach by Aaron Rigby and Jack Zeringue, lawyers in the M&A/Private Equity practice in Sidley's Dallas office, was published by *Law360* on May 19, 2020. With the recent (and continuing) adverse financial impact of the COVID-19 outbreak, many parties may be considering whether to terminate or amend ongoing contractual obligations, and, relatedly, are forced to think through the damages, and possible benefits, that may result from the nonperformance of a contract.

SIDLEY EVENTS

Sidley has hosted several webinars recently to help our clients navigate the novel and complex issues they are facing as a result of the COVID-19 pandemic. Click on the links below for more information and to access the recordings.

Looking Ahead: A Multidisciplinary Perspective on the U.S. Return to the Workplace (June 9 and 16)

Shareholder Activism in the Technology Sector: Activism in a COVID-19 World—What Tech GCs and Boards Need to Know (June 10)

Pandemic Stimulus Packages—Navigating Risk While Preparing for Inquiries and Investigations (June 8)

Audit Committees and COVID-19 (April 8)

COVID-19—European and U.S. Cybersecurity Issues: Preventing and Responding to Cyber Incidents (March 26 and 27)

Best Practices and Strategies for Managing Business Risks Due to COVID-19 Pandemic (March 18)

SIDLEY SPEAKERS

Antitrust Policy and Enforcement—2021 and Beyond

June 24 | Webinar

Jim Lowe, a partner in Sidley's Washington, D.C. office, will participate in a webinar sponsored by the Antitrust Law Committee of the D.C. Bar Antitrust and Consumer Law Community. The panelists will discuss what antitrust enforcement may look like under a new administration, along with how antitrust policy and enforcement will likely be impacted by the health crisis regardless of the outcome of the Presidential election. Click here for more information.

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