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ANALYSIS

WHERE TO DRAW THE LINE BETWEEN THE ROLES OF MANAGEMENT AND THE BOARD
By Thomas A. Cole and Claire H. Holland

Overview
Over time there has been a greater focus on the role of the Board of Directors as an accountability mechanism distinct from the senior management team, and on corporate governance practices that would effectively position the Board to be an independent and objective oversight body tasked with monitoring managerial performance. A recurring corporate governance question is where to draw the line between the roles of management versus the Board of Directors. The answer to the question comes from a combination of: (i) legal authority, (ii) market expectations, including shareholder activism and (iii) business judgment.

Statutory Guidance
The Delaware General Corporation Law (DGCL) provides little guidance about how to answer this recurring question. DGCL Section 141(a) simply states “[t]he business and affairs of every corporation…shall be managed by or under the direction of a board of directors…” For public companies, the emphasis is largely on the phrase “under the direction of.” There are only a handful of matters where the statute requires a final decision to be made by the Board (or one of its committees) rather than being delegated to management. These include (i) amending the certificate of incorporation and bylaws, (ii) adopting a merger agreement, (iii) declaring a dividend, (iv) issuing stock and (v) appointing officers.

Restating the Question
The line-drawing question can be restated in several ways, such as: When does the Board activity drift from oversight to management? Significant expectations have been created for robust Board “oversight” of compliance and risk (e.g., Caremark²). Expectations about oversight also come from the legal and capital markets, including shareholder activists. For example, governance-oriented activists are promoting enhanced Board oversight over political contributions. Financially-oriented activists are focused on Board oversight of capital allocation. Various corporate governance best practice recommendations also weigh in on the question of the role of management versus the Board as highlighted in the table below.

EXCERPTS FROM KEY CORPORATE GOVERNANCE BEST PRACTICE RECOMMENDATIONS REGARDING THE ROLE OF MANAGEMENT VERSUS THE BOARD

<table>
<thead>
<tr>
<th>Source</th>
<th>Recommendation</th>
</tr>
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<tbody>
<tr>
<td>NACD Key Agreed Principles</td>
<td>“Careful respect should be given to maintaining the distinction between the role of the board and the role of management. Undue board involvement in matters of management may interfere with the board’s ability to provide objective oversight of management performance.”</td>
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<td></td>
<td>“For most companies, the priority focus of board attention and time will be understanding and providing guidance on strategy and associated risk – based on the underlying understanding of the company’s strengths and weaknesses, and the opportunities and threats posed by the competitive environment—and monitoring senior management’s performance in both carrying out the strategy and managing risk.”</td>
</tr>
<tr>
<td>Commonsense Principles of Corporate Governance</td>
<td>“A company is more likely to attract and retain strong directors if the board focuses on big-picture issues and can delegate other matters to management.”</td>
</tr>
<tr>
<td></td>
<td>“The board should minimize the amount of time it spends on frivolous or non-essential matters—the goal is to provide perspective and make decisions to build real value for the company and its shareholders.”</td>
</tr>
</tbody>
</table>

1 Thomas A. Cole is senior counsel in Sidley's Chicago office who served as chair of the firm's Executive Committee for 15 years. Claire H. Holland is special counsel in Sidley's Chicago office. The views expressed in this article are those of the authors and do not necessarily reflect the views of the firm.
“Effective corporate governance requires a clear understanding of the respective roles of the board, management and shareholders; their relationships with each other; and their relationships with other corporate stakeholders...

The board of directors has the vital role of overseeing the company’s management and business strategies to achieve long-term value creation. Selecting a well-qualified chief executive officer (CEO) to lead the company, monitoring and evaluating the CEO’s performance, and overseeing the CEO succession planning process are some of the most important functions of the board. The board delegates to the CEO—and through the CEO to other senior management—the authority and responsibility for operating the company’s business. Effective directors are diligent monitors, but not managers, of business operations. They exercise vigorous and diligent oversight of a company’s affairs, including key areas such as strategy and risk, but they do not manage—or micromanage—the company’s business by performing or duplicating the tasks of the CEO and senior management team. The distinction between oversight and management is not always precise, and some situations (such as a crisis) may require greater board involvement in operational matters. In addition, in some areas (such as the relationship with the outside auditor and executive compensation), the board has a direct role instead of an oversight role.

Management, led by the CEO, is responsible for setting, managing and executing the strategies of the company, including but not limited to running the operations of the company under the oversight of the board and keeping the board informed of the status of the company’s operations. Management’s responsibilities include strategic planning, risk management and financial reporting. An effective management team runs the company with a focus on executing the company’s strategy over a meaningful time horizon and avoids an undue emphasis on short-term metrics...

Effective corporate governance requires dedicated focus on the part of directors, the CEO and senior management to their own responsibilities and...to the shared goal of building long-term value.”

A different way to restate the question is to break it into three parts, as follows:

■ What decisions should be the prerogative of management and the Board is simply told about them after the fact?
■ What decisions should be made in a collaboration between the Board and management?
■ What decisions must be made exclusively by the Board?

Other Legal Considerations

When determining which decisions should be the “prerogative of management,” the Board and its counsel must review the company’s bylaws and the CEO’s employment agreement to determine what responsibilities and authority have been granted to the CEO. In the Disney case,\(^3\) a common bylaw provision was interpreted by the Delaware courts as granting the CEO the authority to fire a senior executive officer, even though the Board had elected that officer to his position.

As a practical matter, when it comes to material issues there are always benefits to a collaborative approach. For example, the NACD 2016 Blue Ribbon Commission Report on Building the Strategic-Asset Board advocates a collaborative—indeed, an iterative—approach to setting strategy. Collaboration is a natural outcome when the CEO adheres to the “don’t get ahead of the Board” philosophy.

As for which decisions must be made “exclusively by the Board,” besides the statutory guidance discussed above, the Delaware case law relating to change-in-control transactions supports the principle that any concrete step to explore the sale of a company should first be authorized by the Board. Delaware courts have admonished Boards to take “an active and direct role...from beginning to end.”\(^4\)

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\(^3\) In re The Walt Disney Co. Deriv. Litig., 906 A.2d 27 (Del. 2006).
Stock exchange listing standards also confer authority for various governance decisions squarely within the exclusive prerogative of independent directors or committees populated solely by such directors. For example:

- The Audit Committee is tasked with addressing anonymous complaints and has the authority to engage its own advisors.
- The Compensation Committee is to determine or recommend to the Board the compensation of the CEO and other executives, and has exclusive authority for appointing and compensating its outside advisors. (The Internal Revenue Code and Section 16 of the Securities Exchange Act of 1934 contain similar mandates.)
- Only the independent directors are to nominate (or recommend that the full board nominate) directors.

Where the line is drawn may be dictated by other company-specific circumstances. If the company has empaneled a special litigation or transaction committee to address conflicts, that committee must be totally independent and have plenary authority in order to be fully effective. If the Board has a Compliance Committee, that committee’s charter would set forth the responsibilities and authority of the committee’s members. Finally, a company may have contractual obligations relating to the governance of compliance, such as those set forth in a settlement agreement or corporate integrity agreement.

One of the most potent elements of the arsenal of director protections is the exculpatory charter provision authorized by DGCL Section 102(b)(7), which immunizes directors (but not officers) against monetary damages for breach of the duty of care. Although there is at least a theoretical possibility, it would take an extreme case where an individual director who persistently takes on an officer-like role could be deemed to be a de facto officer who should be denied exculpation.

Another statutory provision that informs the discussion is DGCL Section 141(e), which states that “a member of the board…shall…be fully protected in relying in good faith upon the records of the corporation and upon such…reports…presented…by any of the corporation’s officers or employees…” or experts. That should encourage the delegation of fact-finding and analytical work from the Board to management and outside experts, bearing in mind that “good faith” still requires appropriate probing of that work by the Board.

**DIRECTOR’S CHECKLIST FOR LEADERSHIP DECISIONS**

*Source: Boards That Lead by Ram Charan*

**When the Board Should Take Charge**
- Central idea
- Selection of CEO
- Board competence, architecture and modus operandi
- Ethics and integrity
- Compensation structure

**When the Board Should Partner With Management**
- Strategy, capital allocation
- Financial goals, shareholder value, stakeholder balance
- Risk appetite
- Resource allocation
- Talent development
- Culture of decisiveness

**When the Board Should Stay Out of Management’s Way**
- Execution and implementation
- Operations
- Areas of delegated authority
- Non-strategic decisions
- Excluded by Board charter
A Practical Approach

Exercise business judgment about what issues go to the Board. We have long advocated that managements and Boards periodically discuss what matters are to be brought to the Board for decision and what information should be provided to the Board for routine oversight, to help the Board discharge its duty of care in making critical decisions.

Where to draw the line depends on the circumstances. We have also long advocated that the correct answer to the question “How intense should our oversight be?” is “It depends.” Increased levels of oversight over normal operations may be appropriate, for example, if the business is not doing well, if it is about to move in a new direction strategically or if there have been material issues in certain functional areas in the past.

Educate directors about where the line has been drawn. The lead director, governance committee chair or general counsel should consider reminding directors from time to time about how their role compares to—and differs from—management’s role. The immediate post-annual meeting period may be a logical time to provide this education, particularly if a first-time public company director or an activist director has recently joined the Board.

Monitor whether directors are drifting over the line. Board and director self-evaluations and periodic interviews with management should include questions that assess whether directors are inappropriately encroaching into management’s role.

NEWS

JUDICIAL DEVELOPMENTS

Delaware Supreme Court Affirms Ruling Allowing Termination of Merger Based on Failure to Deliver a Required Tax Opinion

The Delaware Supreme Court recently affirmed, by a 4-to-1 vote, the Delaware Court of Chancery’s rejection of The Williams Companies, Inc.’s (Williams) request for a judgment requiring Energy Transfer Equity, L.P. (ETE) to close a merger agreement to acquire Williams at a price initially valued at more than $30 billion. The Court of Chancery concluded that a contractual condition to closing—that ETE’s tax counsel furnish an opinion that the contribution of Williams’ assets to ETE should be treated as a tax-free exchange—had validly failed to occur. The Williams Companies, Inc. v. Energy Transfer Equity, L.P. (Del. Mar. 23, 2017).

Shortly after the merger agreement was signed, the energy market—and the value of energy transportation assets and ETE’s publicly traded partnership units—precipitously declined. The Court of Chancery concluded that the tax counsel, “as of the time of trial, could not in good faith opine that tax authorities should treat the…exchange…as tax free under Section 721(a); and [that] because Williams has failed to demonstrate that [ETE] has materially breached its contractual obligation to undertake commercially reasonable efforts to receive such an opinion…[ETE] is contractually entitled to terminate the Merger Agreement, assuming [the tax counsel’s] opinion does not change before the end of the merger period…” The Court of Chancery granted judgment in favor of ETE in June 2016, and ETE terminated the merger agreement days later. Williams appealed to the Delaware Supreme Court.

On appeal, the Delaware Supreme Court held that the lower court had “adopted an unduly narrow view” of the obligations imposed by the merger agreement covenants to use “commercially reasonable efforts” to receive the tax opinion and “reasonable best efforts” to close the deal when analyzing whether ETE breached those covenants. Nevertheless, the Court found that, if ETE were found to have breached those covenants and if the lower court...
had properly placed the burden on ETE to prove that such breaches did not materially contribute to the failure of the tax opinion closing condition, ETE would have met its burden based on the facts adjudicated by the Court of Chancery. The Supreme Court also upheld the lower court’s finding that ETE was not estopped from terminating the merger agreement and affirmed the Court of Chancery’s decision.

In a 19-page dissent, Chief Justice Strine criticized the majority for accepting the Court of Chancery’s “terse conclusion” that the failure to issue the tax opinion was not influenced by ETE’s conduct. The Chief Justice asserted that the Court of Chancery improperly ignored ETE’s “covenant-breaching behavior” that was inconsistent with its duty to act in a commercially reasonable manner and that put “undue professional pressure” on the tax lawyer not to issue the tax opinion, given ETE’s desire to get out of the deal after the market declined. The Chief Justice would have reversed and remanded the case for a new trial at which ETE would be required to prove that its breach did not materially contribute to the tax partner’s failure to provide the tax opinion.

The decision and its implications are discussed in more detail in our Sidley Update entitled Delaware Supreme Court Affirms Ruling Allowing Termination of Merger Based on Failure to Deliver a Required Tax Opinion.

Delaware Court of Chancery Rejects Books and Records Demand Suit by Squeezed-Out Stockholder

The Delaware courts have long held that only a current stockholder may demand to inspect the books and records of a corporation under DGCL Section 220. In Central Laborers Pension Fund v. News Corp., 45 A.3d 139 (2012), the Delaware Supreme Court emphasized that a suit to compel an inspection may not proceed until the stockholder has complied with Section 220(b)’s procedural requirements, including a written demand establishing the plaintiff’s current status as a stockholder. Several decisions, however, have allowed such suits to proceed, even if a subsequent merger has resulted in squeezing out the stockholder after the suit is filed.

In Weingarten v. Monster Worldwide, Inc. (Del. Ch. Feb. 27, 2017), the Delaware Court of Chancery, in an opinion by Vice Chancellor Glasscock, faced the situation in which the stockholder made a timely demand for inspection under Section 220(b) but was squeezed out in a merger before filing suit. The Court noted that Section 220(c) of the statute, which allows suits to enforce an inspection demand, “requires a stockholder seeking records to ‘first establish’ (i) that she ‘has’ complied with the demand requirement of subsection (b), and (ii) that she ‘is’ a stockholder…By requiring that a plaintiff…demonstrate both that it ‘has’—past tense—complied with the demand requirement, and that it ‘is’—present tense—a stockholder, the legislature has made clear that only those who are stockholders at the time of filing [the lawsuit] have standing to invoke this Court’s assistance under Section 220.” The Court of Chancery also rejected the argument that the corporation was equitably estopped from asserting this defense, because it had not responded to the plaintiff’s self-imposed deadline for responding to the demand before closing the merger, noting that the company had not done anything to mislead the plaintiff. Weingarten illustrates that the Delaware courts continue to strictly enforce the procedural requirements of Section 220 for seeking inspection of corporate books and records.

Delaware Court of Chancery Defers to Dispute Resolution Clause in Legal Fee Advancement Ruling

The Delaware Court of Chancery recently granted a defense motion to stay litigation seeking advancement of legal fees and expenses involved in a dispute. Bennett J. Glazer, et al. v. Alliance Beverage Distributing Co., LLC (Del. Ch. Mar. 2, 2017). The Court based its ruling on the parties’ agreement which provided for resolution of all disputes to occur by arbitration in Arizona.
The litigation arose from a dispute over whether an affiliate of one of the two members of Alliance Beverage Distributing Co., LLC usurped a business opportunity of Alliance. Plaintiffs sought advancement of legal fees and expenses. The Court noted Delaware’s limited liability company statute permits advancement, as did Alliance’s limited liability company agreement. The Court found, however, that the LLC agreement contained a broad alternative dispute resolution clause providing that “any controversy or claim arising out of or relating to this Agreement, or the breach thereof” would be settled by arbitration in Arizona. On that basis, defendants moved to have the Delaware action either dismissed based on Delaware’s lack of subject matter jurisdiction or, alternatively, stayed pending resolution of the dispute via arbitration in Arizona.

In ruling in defendants’ favor, Vice Chancellor Montgomery-Reeves noted that “Delaware courts lack subject matter jurisdiction to resolve disputes that litigants have contractually agreed to arbitrate.” The Vice Chancellor further noted that Delaware public policy favors arbitration and that its courts generally interpret arbitration clauses broadly where litigants have contractually agreed to arbitrate—particularly where the agreement to arbitrate is “clear and unmistakable.” As a result, the issue of whether plaintiffs were entitled to advancement itself was subject to arbitration in Arizona, as was the resolution of the underlying dispute. The ruling reminds that broadly drafted dispute resolution clauses will be enforced by the Delaware courts, even as to such matters as advancement of legal fees and expenses.

**Delaware Supreme Court Holds That MLP Agreement Did Not Eliminate the Implied Covenant of Good Faith and Fair Dealing**

In *Dieckman v. Regency* (Del. Jan. 17, 2017), the Delaware Supreme Court reversed a Court of Chancery dismissal of a lawsuit brought by a unitholder of a master limited partnership (MLP) challenging a merger of the MLP into an affiliate of the MLP’s general partner. The MLP agreement eliminated all fiduciary duties and replaced them with specified safe harbors designed to cleanse potentially conflicted transactions. Under the MLP agreement, if any one of the safe harbors was satisfied, the transaction would be deemed to have been approved by all of the unitholders and would not constitute a breach of the MLP agreement or of any duty stated or implied in law or equity.

The two safe harbors at issue were: (i) approval of the transaction by a conflicts committee of independent directors and (ii) approval of the transaction by a majority of the unaffiliated unitholders. Both the conflicts committee and the unaffiliated unitholders had approved the transaction. Nonetheless, because one conflicts committee member had served on the board of the acquired affiliate immediately before the transaction and both members had been appointed to the affiliate’s board immediately following the transaction, the Supreme Court held those committee members were not independent and that the first safe harbor was therefore not satisfied.

When seeking the unaffiliated unitholders’ approval to satisfy the second safe harbor, the general partner had distributed a 165-page proxy statement to the unitholders, which disclosed that a conflicts committee of independent directors had approved the merger. The proxy statement failed to disclose any facts suggesting the committee members’ lack of independence.

The Supreme Court held that under the Delaware Revised Uniform Limited Partnership Act, contractual terms will govern whether the MLP agreement was breached, and that investors “must rely on the express language of the [MLP] agreement to sort out the rights and obligations” among the parties rather than relying on fiduciary standards of conduct. Nevertheless, the Court held the implied covenant of good faith and fair dealing, which cannot be eliminated by contract, may be employed “to handle developments or contractual gaps that…neither party anticipated” to achieve the contracting parties’ reasonable expectations at the time of entering into the contract. The *Dieckman* Court
invoked the implied covenant of good faith and fair dealing to achieve the contracting parties’ reasonable expectations that the safe harbor cannot be satisfied by using false or misleading statements. Although the unaffiliated unitholders had approved the transaction, the Court held that the second safe harbor was not satisfied because the general partner breached an implicit obligation to not obtain the vote of unitholders by using false or misleading statements, in disclosing that the merger was approved by a conflicts committee of independent directors.

Dieckman is a wake-up call that in egregious cases, Delaware courts may apply the implied covenant of good faith and fair dealing to a general partner, even where a MLP agreement (as is typical) disclaims all fiduciary duties of the general partner. Dieckman also serves as a warning that although contractual terms may be facially satisfied, if that occurred in a manner inconsistent with the contracting parties’ reasonable expectations (e.g., by using false or misleading statements), then a court will likely hold that the contractual terms are not satisfied.

Delaware Again Underscores the “Cleansing” Effect of Approval by Disinterested and Fully Informed Stockholders

In previous issues of Sidley Perspectives, most recently our February 2017 issue, we have discussed the impact of the Delaware Supreme Court’s decision in Corwin v. KKR Fin’l Holdings LLC, No. 629, 2014 (Del. Oct. 2, 2015). Corwin held that the business judgment rule bars lawsuits challenging a merger (except in transactions governed by the entire fairness standard due to the involvement of a controlling stockholder) if the merger was “approved by a fully informed, uncoerced majority of the disinterested stockholders.” A recent Delaware Supreme Court decision extended Corwin from mergers to all-cash tender offers under DGCL Section 251(h).

In In re Volcano Corp. S’holder Litig., No. 372, 2016 (Del. Feb. 9, 2017), the Delaware Supreme Court affirmed and adopted the reasoning of the Delaware Court of Chancery in In re Volcano Corp. Stockholder Litig., 143 A.3d 727 (Del. Ch. 2016). There, the trial court dismissed a complaint against a board and its outside financial advisors under Corwin, concluding that “stockholder approval of a merger under Section 251(h) by accepting a tender offer has the same cleansing effect as a vote in favor of that merger.”

Volcano is notable for four reasons. First, it shows that Corwin will be applied to cover a broader range of stockholder actions than a formal stockholder vote. Second, like Corwin, Volcano elevates the importance of disclosure, since the Corwin rule applies only where the stockholders were “fully informed.” Third, the Supreme Court implicitly agreed with the Court of Chancery that the defendant bears the burden of showing that the stockholders were fully informed, but the Court still found that the facts pleaded in the complaint showed that any missing information regarding the financial incentives of the company’s financial advisor was immaterial. And fourth, the Court upheld the dismissal of the complaint against the board as well as the complaint against the outside financial advisor.

Days before the Supreme Court’s decision in Volcano, the Delaware Court of Chancery had issued another in a series of recent decisions underscoring the significance and effect of a fully informed, uncoerced stockholder vote on the viability of post-closing litigation. In re Merge Healthcare Inc. S’holders Litig. (Del. Ch. Jan. 30, 2017) is a reminder to practitioners and deal participants of the importance of full and candid disclosures to create a pathway for early dismissal of post-closing claims alleging inadequate price and process in mergers. Particularly, the decision reiterates that even the presence of a controlling stockholder will not trigger the burdensome “entire fairness” standard of review where the controller had received no personal benefit.
In Merge Healthcare, more than 77% of the stockholders voted in favor of a cash buyout by IBM, at a price representing a nearly 32% premium over the company's stock price the day before the announcement. After the transaction closed, the plaintiff-stockholders alleged that an improper sales process had produced an inadequate sales price. Because Merge Healthcare—unlike many Delaware companies—did not have in its charter an exculpatory charter provision that would otherwise have allowed claims against its directors only for violations of their duty of loyalty, the plaintiffs also alleged violations of the duty of care.

On a motion to dismiss, the plaintiffs argued that the “entire fairness” standard of review applied because the directors were conflicted and beholden to the chairman and controlling stockholder who desired liquidity. The Court of Chancery concluded, however, that it did not need to conduct such an analysis because of the fully informed and uncoerced approval by the stockholders. Citing with approval Vice Chancellor Slights’ “learned discussion” last year in Larkin v. Shah, the Court rejected the claim that the mere presence of a controlling stockholder is sufficient to trigger an entire fairness review. Rather, so long as the controller did not extract a personal benefit different from that obtained by other stockholders, the stockholder vote will “cleanse” any such claim, the business judgment rule will apply, and “dismissal is typically the result.”

Applying these clear-cut principles, the Court of Chancery then rejected both the argument that the chairman’s alleged desire for liquidity constituted a “personal benefit extracted” and the claims of deficient disclosures. Vice Chancellor Glasscock also helpfully repeated the admonition, made in several Court of Chancery decisions in recent years, that the “preferred way of proceeding” is for plaintiffs to assert disclosure claims pre-closing to ensure that stockholders are fully informed.

Delaware Supreme Court Affirms C&J Energy

The Delaware Supreme Court recently affirmed the Court of Chancery’s ruling in City of Miami Gen. Emps. and Sanitation Emps. Ret. Trust v. Comstock (Del. Mar. 23, 2017). The litigation arose from C&J Energy Services’ acquisition of a division of Nabors Red Lion Limited in a $2.8 billion cash/stock merger. The deal involved: (i) a single-bidder process, (ii) no pre-signing market check, (iii) a 2.27% termination fee, (iv) a passive post-signing market check (no-shop with fiduciary out) and (iv) no go-shop. Plaintiff claimed inter alia that C&J sold itself to Nabors (as Nabors would control 53% post-closing) without conducting a pre- or post-signing market check, and that directors ran a flawed sales process involving incomplete disclosure.

The Court of Chancery granted plaintiff’s motion for a preliminary injunction wherein C&J would have 30 days to solicit bids. On appeal, and after the mandated go-shop had commenced, the Supreme Court vacated the injunction and the go-shop. The deal then closed after receiving 97% stockholder approval. Plaintiff then sought post-closing damages based on essentially the same claims.

Chancellor Bouchard dismissed, concluding that the claims were “subject to the business judgment presumption under…[Corwin] because of the legal effect of the stockholder vote, and that judicial review…thus ends there.” His conclusion was premised on a finding “that plaintiff ha[d] failed to plead facts sufficient to demonstrate that the C&J stockholder vote was not fully informed.” In so concluding, the Court of Chancery swept aside allegations regarding CEO and management conflicts and the withholding of management projections and other information from financial advisors—including to a financial sponsor that submitted a preliminary bid and potential bidders before and during the (abbreviated and Court-ordered) go-shop period. Noting the unusual procedural posture given the Supreme Court’s vacating the injunction and the go-shop, Chancellor Bouchard reasoned that the Supreme Court’s action rendered events that had occurred during the injunction period “a nullity,” with the result that questions concerning the integrity of that process logically
would have ceased to be meaningful to stockholders. (One wonders if the same conclusion would have been reached had this been a financial sponsor-led transaction.) On appeal, plaintiff argued that the ruling wrongly overlooked “an extreme set of facts,” misapplied pleading standards and misconstrued disclosure laws in reaching its decision.

In essentially a one-page Order that appears to raise more questions than it answers, the Supreme Court indicated it was affirming based largely on the lower court’s ruling, given the arguments and record presented. The Supreme Court noted, however, that there were two grounds on which it did not fully embrace the lower court’s reasoning. The Supreme Court stated that on appeal, plaintiff had sharpened its disclosure arguments on two points to give more substance to those arguments than it had provided below. Nevertheless, the plaintiff failed to show that the two omitted items were material, given the undisputed record that the go-shop process involved a broad outreach to every plausible bidder, the investment bank conducting the go-shop process had a strong incentive to get a superior deal, and the plaintiff failed to plead facts supporting a rational inference that the one bid received during the go-shop was financially superior. The Supreme Court also noted that, ultimately, the allegations of the complaint are what are relevant to its analysis, and the complaint did not contain pled facts supporting inferences that the proxy statement was materially misleading. On March 27, 2017, plaintiff filed a motion with the Delaware Supreme Court for reargument of the Court’s March 23 order.

Delaware Enjoins Merger Vote Until Buy-Side Financing Fees Disclosed

The Delaware Court of Chancery recently enjoined a buy-side stockholder vote on a merger until the financing fees to be received by an affiliate of the buyer’s financial advisor were disclosed. Vento v. Curry (Del. Ch. Mar. 22, 2017). The litigation arose from Consolidated Communications Holdings, Inc.’s proposed acquisition of FairPoint Communications, Inc. in a stock-for-stock merger. Consolidated agreed to issue to FairPoint stockholders the number of shares of common stock that would result in those stockholders holding 29% of the combined company. Under NASDAQ rules, a stock issuance of that size requires approval by Consolidated’s stockholders. An affiliate of the financial advisor that provided Consolidated’s board with a fairness opinion had also committed to be part of a bank syndicate refinancing $935 million of combined entity debt that was to occur post-closing.

The plaintiff’s sole claim was that Consolidated’s directors had breached their fiduciary duties by failing to disclose any details concerning the fees the financial advisor’s affiliate would earn from the financing. The plaintiff sought to have the stockholder vote enjoined to permit time to correct the faulty disclosure prior to the vote. Consolidated’s disclosure simply stated the advisor or its affiliates “will receive additional fees” for providing a portion of the financing.

In a strongly worded ruling, the Court determined it was reasonably probable that plaintiff would succeed on the merits in demonstrating Consolidated’s existing disclosures on the financial advisor’s potential financial interests were inadequate. The Court cited precedents noting the central role investment banks play in assisting boards in evaluating, exploring, selecting, and implementing strategic alternatives, and holding that full disclosure of banker compensation and potential conflicts is required where those conflicts are material and quantifiable, to enable stockholders to assess factors that might influence the advisor’s analytical efforts and credence.

Although defendants contended the range of financing fees the financing source might receive could be determined by piecing together information from publicly available documents, the Court held that “[d]isclosure is inadequate if [it is] ‘buried’ in the proxy materials.” As the Court noted, one reasonably would expect all material facts concerning a financial advisor’s potential conflicts of interest to be disclosed in plain English in one place, such as in the section disclosing advisory fees the financial advisor is to receive (here $13 million) and fees the advisor received during the prior two years from buyer (here $3–4...
million) and target (here $1 million). Here, the financing fees were $5.6 million. The Court noted that here, a stockholder would need to go on a scavenger hunt to piece together the answer from information buried in a 248-page registration statement and lengthy Form 8-K filed more than 10 weeks earlier.

The Court noted the amount of fees a financial advisor stands to receive for providing financing in connection with the proposed merger is material and quantifiable, and there “is simply no excuse for [failing] to disclose that information in a clear and transparent manner along with related information bearing on its financial advisor’s potential conflicts of interest.”

New York and Disclosure-Only Settlements
Disclosure-only settlements have received significant attention in the past few years. After the Delaware Court of Chancery began treating such settlements with increasing skepticism, New York’s Supreme Court also questioned the benefits of such settlements. During 2015-16, that Court issued three separate rulings rejecting such settlements. On appeal, however, New York has taken a different position.

On February 2, 2017, the New York Appellate Division, First Department, reversed an earlier New York Supreme Court ruling in Gordon v. Verizon Comm’s, Inc. (1st Dept. Feb. 2, 2017). In ruling, the Appellate Division used a different standard for evaluating “disclosure-only” settlements than that established by Delaware in the landmark case In re Trulia S’holder Litig., 129 A.3d 884 (Del. Ch. 2016). The Appellate Division also earlier reversed another New York Supreme Court ruling rejecting a disclosure-only settlement. City Trading Fund v. Nye, 144 A.3d 595 (1st Dept. Nov. 29, 2016).

Gordon arose from Verizon Communications’ 2013 purchase for $130 billion of Vodafone Group PLC’s 45% stake in Verizon Wireless. Plaintiffs alleged Verizon’s directors breached their fiduciary duties by overpaying. Thereafter, the parties agreed to settle the litigation by Verizon providing additional disclosures and agreeing to obtain an independent fairness opinion if it disposed of more than 5% of the acquired assets during the next three years. Verizon also agreed not to oppose a $2 million fee award for plaintiffs’ counsel.

In rejecting the settlement, the trial judge drew heavily from Delaware precedent, which requires supplemental disclosures to “materially enhance” shareholder knowledge. The trial judge found the added disclosures failed to meet that standard and were “unnecessary surplusage.” He also found the fairness opinion requirement of the settlement might “actually curtail” Verizon’s directors from using their informed business judgment and rejected that aspect as well.

On appeal, the Appellate Division noted that Verizon did not have an exclusive forum selection bylaw and that the settlement agreement had a New York choice of law provision. The Court used a five-factor test under New York precedent for evaluating the settlement, and found that all five factors weighed in favor of approving the settlement. The Court also analyzed whether the non-monetary relief was in “the best interests of all members of the putative class,” and found the added disclosures provided “some...albeit minimal” benefits, and that the fairness opinion requirement provided sufficient corporate governance reform to warrant approval. The Court further analyzed whether the settlement “is in the best interests of the company,” and noted that it enabled the company to avoid “additional legal fees and expenses of a trial.” On the fee request, the Court noted the “significant number” of New York cases where fees were awarded even though “the benefits of the derivative litigation [were] ‘scant,’ ‘slight,’ ‘modest’ or even ‘minimal,’” and remanded the case to the trial court to determine the amount of the fee.

Although the Appellate Division claimed its new “enhanced” standard is “comparable” to that of Delaware, the New York standard does not rise to Delaware’s “give versus get” analysis articulated in Trulia. The ruling further reminds there no doubt will be further developments in this area.
Highlights From Recent M&A Litigation Surveys

The following highlights selected findings from three recently released surveys that provide data on M&A litigation trends.

The Shifting Tides of Merger Litigation by Cain, Fisch, Davidoff Solomon and Thomas. This survey reviews public deals from the prior year valued at $100 million or more with an offer price of $5 per share or more (158 deals for 2016). For 2016, the incidence of deals with litigation fell to 73% (96% in 2013). The average number of suits-per-transaction for all jurisdictions dropped to 2.9 in 2016 (4.5 in 2015). Delaware-only suits dropped to 2.3 suits per deal in 2016 (3.7 in 2015). In deals with multi-jurisdictional litigation (Delaware and other states and federal court), the incidence rose from 4.5 to 5.5 suits per deal. For 2016, only 32% of deals eligible for challenge in Delaware were challenged there (half that of 2015), whereas 65% of such deals were challenged in other states (51% in 2015) and 37% of such deals were challenged in federal court (20% in 2015). The survey also found that median attorneys’ fees for all settlements was $275,000 in 2016 ($500,000 for 2014). For disclosure-only settlements, such fees declined to $320,000 in 2016 ($575,000 in 2009). Deals with payment of mootness fees increased to 15% for 2015 and 18% for 2016 (unobserved previously), with median mootness fees in 2016 at $238,000 ($200,000 for 2015).

Cornerstone Research–Federal Securities Class Actions. This Cornerstone survey focused on federal class action securities cases found there were 80 federal class action filings involving M&A deals for 2016, the highest since 2009 and four times as many as in 2015. The increased filings significantly contributed to the 44% overall rise in federal securities filings. There were 53 M&A filings in the second half of 2016 (most in any semiannual period and compared to 143 total filings 2009-15). For 2016, filings in the Third Circuit (11 cases) and Ninth Circuit (24 cases) quintupled on a combined basis over 2015, and accounted for 44% of all federal securities filings involving M&A deals.

NERA Economic Consulting. This NERA survey also focuses on securities class action litigation. For 2016, NERA also observed considerable growth in federal class action filings, driven by 88 federal class action merger objection cases (twice as many as in 2015 and slightly higher than the Cornerstone survey reported). NERA found the increase uncorrelated to M&A deal volumes (down 13%), but correlated to recent rulings (Trulia). NERA also observed that, notwithstanding a significant increase in securities class action litigation in the Second Circuit generally in the past five years, that circuit accepted disproportionately fewer merger-objection cases (9%) in 2016 as opposed to all securities class actions filed there (25%). NERA also found that filings in the Third Circuit (encompassing Delaware) reached 34 in 2016 (21 in 2012) and represented 33% of all filings there. NERA observed that merger-objection cases tend to be dismissed within 221 days (638 days for other cases), and half of merger cases are historically dismissed within 125 days.

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REGULATORY DEVELOPMENTS

DOJ Suit Shows Potential “Gun-Jumping” Risk of Using Tolling Agreement in Conjunction With HSR-Reportable Acquisition

The Antitrust Division of the U.S. Department of Justice recently brought a civil suit against the buyer of a power plant for allegedly violating the Hart-Scott-Rodino Act by acquiring beneficial ownership of the plant through a tolling agreement soon after entering into a term sheet to buy the plant and months before making the required HSR filing. The buyer concurrently settled this “gun-jumping” claim, agreeing to pay a $600,000 fine. A buyer in an acquisition required to be reported to the DOJ and the Federal Trade Commission under the HSR Act violates the statute by taking beneficial ownership of the target before the statutory waiting period expires or is terminated. Various indicia of beneficial ownership may be considered, including operational control and allocation of gains and losses.

In this case, the tolling agreement allegedly gave the prospective buyer responsibility for deciding how much power the plant would generate and for delivering the necessary fuel, and entitled it to receive all output. The buyer allegedly began making all competitively significant decisions. It also allegedly gained profits or took losses from sale of the output and assumed all risk of increased fuel costs or decreased power prices.

The DOJ’s Complaint and Competitive Impact Statement indicate that, in the agency’s view, the combination of the term sheet and tolling agreement caused the violation. The DOJ pointed to the buyer’s application to the Federal Energy Regulatory Commission and testimony of one of its executives before the Florida Public Service Commission as manifesting an intent that allegedly made implementation of the tolling arrangement before completion of the HSR waiting period improper. The FERC application said that the buyer had agreed in principle to purchase power from the plant under the tolling agreement for two years and then purchase the facility; it could terminate the tolling agreement without penalty if FERC rejected the acquisition.

The Complaint alleged, citing the FERC application, the tolling agreement’s purpose was to smooth FERC approval by enabling the prospective buyer to argue that it already controlled the plant and that the acquisition thus could not harm competition.

The policy behind this suit can be traced to 1990s DOJ enforcement actions regarding radio station acquisitions. The issue then was whether the buyer in an HSR-reportable deal could take operational control of a station through a local marketing agreement (LMA) before the HSR waiting period ended. According to a DOJ official, such LMAs improperly gave the prospective buyer control of programming and ad pricing, meaning it was “essentially operating the business.” The official stressed that the HSR Act did not bar parties from using LMAs after the waiting period ended but broadly cautioned that “[p]remature transfer of operating control in the context of an acquisition transfers beneficial ownership in all industries, including radio.”

SEC Brings Enforcement Action for Inadequate Disclosure of Fee Arrangements With Investment Banks in a Control Contest

On February 14, 2017, the SEC announced an enforcement action against CVR Energy Inc. for failing to adequately disclose the material terms of fee arrangements with two investment banks the company retained to assist in defending against an activist investor’s hostile takeover bid. The banks had the potential to be paid the following fees: (i) a $9 million fee if the company remained independent, (ii) a $4 million “discretionary fee” similar to a bonus payment in the discretion of the board, (iii) a $6 million fee for the announcement

The CVR Energy enforcement action follows an increased focus on disclosure of investment bank conflicts of interest by Delaware courts in recent years.

Of the 31 companies that were successful in obtaining no-action relief, four were initially denied relief and then submitted requests for reconsideration with details about institutional ownership, which were granted by the SEC Staff.

of a transaction and (iv) a “sales fee” payable in the event of a sales transaction in an amount equal to 0.525% of the aggregate consideration (the success fee). The banks were entitled to the success fee in the event of any sale of the company, regardless of whether they helped find a different buyer or secure a better deal for the company’s stockholders.

Under SEC Exchange Act Rule 14d-9(b), issuers making a recommendation to stockholders as to whether to accept or reject a tender offer are required to file a Schedule 14D-9, which must include “a summary of all material terms of employment, retainer or other arrangement for compensation” for all persons who have been retained to assist the issuer in making a solicitation or recommendation in response to a tender offer. CVR disclosed in a Schedule 14D-9 that it had retained the two banks as its financial advisors in connection with the company’s consideration of the takeover bid and that it “agreed to pay customary compensation for such services.”

In the enforcement proceeding, the SEC found that the banks’ “expansive” success fee was not “customary” in the case of a hostile tender offer, and that the terms of the fee arrangements were material to investors because they created potential conflicts of interest. Because the success fee was payable regardless of whether CVR’s stockholders received fair value for their shares, “the interests of the Banks and CVR’s stockholders diverged.” Accordingly, the SEC held that “the fee arrangements should have been described in greater detail in order to comply with SEC disclosure rules.” CVR was commended for its “extensive cooperation” with the investigation and was not assessed a civil penalty.

As discussed in our December 2016 issue of Sidley Perspectives, in November 2016 the Staff of the SEC’s Division of Corporation Finance published a new CD&I providing guidance on when companies must disclose compensation payable to financial advisors engaged to advise on tender offers. Specifically, the new CD&I explains that generic disclosure (e.g., a reference to “customary compensation”) will typically not be sufficient to comply with the requirement to disclose a summary of all material terms of a compensation arrangement.

SEC Staff Grants Most—But Not All—Requests to Exclude Proxy Access Shareholder Proposals to Increase the Limit on the Size of the Nominating Group

In February and March 2017, the Staff of the SEC’s Division of Corporation Finance responded to requests from 33 companies seeking to exclude from their 2017 proxy statements a shareholder proposal to amend the company’s proxy access bylaw solely to increase the limit on the size of the nominating group from 20 to 50 (or in two cases, 40 or 50) shareholders. Thirty-one companies successfully argued that the proposals should be excluded on the basis of “substantial implementation” under SEC Exchange Act Rule 14a-8(i)(10). In those cases, the SEC Staff found that the company’s “policies, practices and procedures compare favorably with the guidelines of the proposal and that [the company] has, therefore, substantially implemented the proposal.” The SEC Staff denied no-action relief to two companies under substantially similar circumstances when it was “unable to conclude that [the company] has met its burden of establishing that it may exclude the proposal under rule 14a-8(i)(10).” The reason those companies were denied relief appears to be that their request letters failed to include specific information regarding the ownership of the company’s institutional holders—as opposed to all holders or large holders—when arguing that the existing proxy access bylaw already provides a meaningful proxy access right. This development provides helpful guidance to companies as to their ability to exclude shareholder proposals to amend a single element of an existing proxy access bylaw. The February and March 2017 no-action letters also shed light on how to frame the arguments to obtain no-action relief in future requests to exclude shareholder proposals to amend the limit on the size of the nominating group. Therefore, such proposals may subside and proponents may request revisions to other provisions of existing proxy access bylaws.
SEC Mandates Hyperlinks to Exhibit Filings

On March 1, 2017, in furtherance of its Disclosure Effectiveness Initiative, the SEC published final rules that will require certain registrants to provide a hyperlink to each exhibit listed in the exhibit index to their SEC filings. The rules apply to registrants that file registration statements and periodic and current reports that are subject to the exhibit requirements of Item 601 of Regulation S-K or that file on Forms F-10 or 20-F. The final rules will also require registrants to file the forms that will be subject to the rules in HTML format rather than the text-based ASCII format which does not support active hyperlinks.

Registrants will be required to provide an active hyperlink from the exhibit index in the SEC form to the exhibit itself, whether included with the form or incorporated by reference from another SEC filing. A registrant must provide a hyperlink to the exhibit as filed on EDGAR—it is not acceptable to provide a hyperlink to the exhibit as filed on an external website. According to the SEC, inclusion of hyperlinks to the exhibits themselves is “intended to facilitate easier access to these exhibits for investors and other users of the information” and improve the “time consuming and cumbersome” current process which requires users to search a registrant’s EDGAR filings to locate a referenced exhibit’s original submission.

The rules will take effect on September 1, 2017 for large accelerated and accelerated filers but the SEC explicitly encouraged early compliance in the adopting release. Non-accelerated filers and smaller reporting companies that submit SEC filings in the ASCII format will have until September 1, 2018 to comply with the new filing requirements. Public companies should begin preparing for compliance by identifying a hyperlink to include for each exhibit listed in the exhibit index to its Form 10-K and other applicable SEC filings.

SEC Staff Grants Additional Relief From Conflict Minerals Requirements

The conflict minerals disclosure rule, which was adopted by the SEC pursuant to Section 1502 of the Dodd-Frank Act, requires public companies to disclose whether any “conflict minerals” that are necessary to the functionality or production of their products originated in the Democratic Republic of the Congo or an adjoining country. Since April 2014, the SEC has partially stayed compliance with the rule after the U.S. Court of Appeals for the D.C. Circuit held that a portion of the disclosure required by the rule violated the First Amendment. Specifically companies have not been required to use mandated product descriptions and, in some cases, obtain an independent private sector audit.

In January 2017, SEC Acting Chair Piwowar released a statement announcing that he directed the SEC Staff to reconsider the appropriateness of its 2014 guidance and whether additional relief from the rule is appropriate. Piwowar noted that the partial stay has not deterred the “unintended consequences” of the rule, which he observes have caused a de facto boycott of certain minerals from parts of Africa and negatively impacted legitimate miners. He requested public comments on “all aspects of the rule and guidance” through March 17, 2017.

On April 3, 2017, the U.S. District Court for the District of Columbia entered final judgment in the conflict minerals litigation and remanded to the SEC. That Court and the D.C. Circuit left open the question of whether the description of products as having “not been found to be ‘DRC-conflict free’” is required by the statute versus solely a product of SEC rulemaking. The SEC must now consider whether it is possible to mandate a product description that achieves Congress’ intent without violating the First Amendment.

The issues raised by the public comments and the Court’s remand have created uncertainty as to the future implementation of the rule. Accordingly, the Staff of the SEC’s Division of Corporation Finance released a statement on April 7, 2017 announcing that, pending further review, it would not recommend enforcement action to the SEC if a company fails to comply with the requirements of Item 1.01(c) of Form SD. Many consider these requirements – relating to due diligence on the source and chain of custody of conflict minerals and an
independent private sector audit – to be the most onerous aspects of the rule. Companies will still be required to comply with Items 1.01(a) and (b) of Form SD, including conducting a good faith, reasonable inquiry into the conflict minerals’ country of origin.

Piwowar released his own statement justifying the SEC’s decision to provide further relief: “The primary function of the extensive and costly requirements for due diligence on the source and chain of custody...is to enable companies to make the disclosure found to be unconstitutional.” Piwowar also noted that he has directed the SEC Staff to develop a recommendation for future SEC action on the rule after taking into consideration the public comments received.

SEC Seeks Public Comment on Implementation of CEO Pay Ratio Disclosure Rule

The first steps of deregulation under the Trump administration have already begun, as evidenced by the announcement by SEC Acting Chair Michael Piwowar regarding the reconsideration of the implementation of the CEO pay ratio disclosure rule adopted by the SEC in August 2015. The rule, which was mandated by Section 953(b) of the Dodd-Frank Act, requires public companies to disclose the “pay ratio” between the CEO’s annual total compensation and the median annual total compensation of all other employees. For calendar-year companies, the first disclosure will typically be required in their 2018 annual meeting proxy statements and will be based on 2017 compensation.

On February 6, 2017, Piwowar released a statement soliciting comment from companies subject to the rule as to any unexpected difficulties they have experienced in preparing for compliance. The comment period ended on March 23, 2017. He also announced that he directed the SEC Staff to reconsider the implementation of the rule based on comments received and to determine whether additional guidance or relief may be appropriate. Despite this announcement, public companies should continue to prepare for compliance with the rule.

**SIDLEY EVENTS**

Sidley Privacy & Cybersecurity Roundtable

April 18 | Washington, D.C.

Sidley will host its 3rd annual Privacy & Cybersecurity Roundtable in Washington, D.C. on April 18. Anyone interested in attending should contact Beth Masterson at emasterson@sidley.com.

Sidley Chicago General Counsel Roundtable

June 6 | Chicago, IL

Sidley will host its 10th annual General Counsel Roundtable in Chicago on June 6. This program is limited to general counsel and chief legal officers. Anyone interested in attending should contact chevents@sidley.com.

**SIDLEY SPEAKERS**

On April 27, John Kelsh, a partner in Sidley’s Chicago office, will chair a session entitled Recurring Disclosure Challenges—A Series of Hypotheticals at the 37th Annual Ray Garrett Jr. Corporate & Securities Law Institute at the Northwestern Pritzker School of Law in Chicago. Click here for more information.
SIDLEY RESOURCES

Sidley lawyers authored an article entitled “Mootness Fees” in Deal Litigation: An Argument for a Different Approach which appeared in Bloomberg Law’s Corporate Law & Accountability Report on March 28. The article was drafted by Andrew Stern, a partner in Sidley’s New York office; Jack Jacobs, senior counsel at Sidley who served on the Delaware Supreme Court from 2003-2014 and, prior to that, on the Delaware Court of Chancery since 1985; and Jon Muenz, an associate in Sidley’s New York office.

An article entitled Board Assessment of Compliance Programs by Holly Gregory, a partner in Sidley’s New York office, was published in the March/April 2017 edition of Practical Law’s The Governance Counselor.

Sidley published a client update on March 10 entitled Ninth Circuit Holds Internal Reports Protected by Dodd-Frank Whistleblower Provisions. The update discusses the March 8 decision issued by a divided Ninth Circuit panel finding that a company’s retaliation against a whistleblower is actionable under the Dodd-Frank Act even if the whistleblower reports internally rather than to the SEC. The Ninth Circuit holding highlights the need to be mindful of the continuing expansion of the application of whistleblower protections and the ramifications this may have with respect to personnel decisions. Companies should closely analyze potential risks of employment actions involving individuals who may have made internal complaints in light of recent and pending court decisions.

Sidley published a client update on February 28 entitled Reference Tool: Financial Regulations That Could be Impacted by the New Administration. The reference tool seeks to identify final and proposed rules issued during the post-Dodd-Frank era (many mandated by the Dodd-Frank Act) that are most likely to be subject to reconsideration under the Trump administration which is focused on deregulation. It also highlights the arguments voiced by Commissioners of both the SEC and CFTC relating to those rules that may be persuasive in encouraging the Trump administration to re-evaluate them.

Sidley published a client update on February 23 entitled DOL Interpretive Bulletin 2016-01: Voting Proxies and Exercising Other Shareholder Rights discussing the U.S. Department of Labor (DOL)’s Interpretive Bulletin 2016-01, which was published in the Federal Register on December 29, 2016. The Bulletin provides guidance on the application of ERISA to the responsibilities of fiduciaries of employee benefit plans with respect to proxy voting and other shareholder rights pertaining to securities held by those plans. The Bulletin also provides guidance on investment policy statements for employee benefit plans. Named fiduciaries of plans may want to review whether their plans are compliant with the guidance set forth in the Bulletin. For more information, see our February 2017 issue of Sidley Perspectives for a piece discussing how the new DOL guidance may lead to increased shareholder activism.