Recent Judicial Developments Affecting the M&A and Corporate Governance Landscape

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I. MACs After *Akorn v. Fresenius*

MACs: A Critical Concept in M&A Practice

- Material Adverse Change (MAC) clauses, also known as Material Adverse Effect (MAE) clauses, are critical provisions in acquisition agreements for public and private companies.
- A MAC is a clause that typically protects the buyer in an acquisition from any downside risk of a severe negative effect in the seller's business.
- The clause typically allows a buyer to terminate a merger or a purchase agreement if a severe change or event materially and adversely impacts the seller's overall business or operations.
  - Reflects a change in what the buyer thought it was getting.
- The clause often contains specific exceptions and/or exclusions, such as when the material financial decline at issue results from a general economic or industry downturn. The exceptions and exclusions can protect either the buyer or seller.
- MACs may allocate general market or industry risk to the buyer and company-specific risks to the seller, depending on how the clause is drafted in the merger or acquisition agreement.
- No Delaware court had found a MAC until September of 2018, when the Chancery Court decided *Akorn v. Fresenius*.

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Background: MACs under *Hexion* and *IBP*

- To understand *Akorn*, a quick review of prior cases is helpful.
- Before *Akorn*, under prior Delaware law—namely, *Hexion* and *IBP*—unless specifically defined in the agreement, post-signing adverse developments that were:

  1) short-term, and

  2) foreseeable,

generally did not constitute a MAC.

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In re IBP, Inc. Shareholders Litig. (2001)

- IBP (target) suffered from a **64% drop in quarterly earnings due to a severe winter**, which affected livestock supply and vitality. Tyson (buyer) tried to terminate the merger, claiming IBP had suffered a MAC.
- The Delaware Court of Chancery held that MACs "must be read in the larger context in which the parties were transacting."
  - "[T]he failure of a company to meet analysts' projected earnings for a quarter" would be "less important to an acquiror who seeks to purchase the company as part of a long-term strategy."
  - "**It is odd to think that a strategic buyer would view a short-term blip in earnings as material**, so long as the target's earnings-generating potential is not materially affected by that blip or the blip's cause."
- The Court highlighted that **the target's poor performance was foreseeable**, finding that the target was "a consistently but erratically profitable company struggling to implement a strategy that will reduce the cyclicality of its earnings."
- The Court held that there was **no MAC**.

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Hexion Specialty Chemicals, Inc. v. Huntsman Corp. (2008)

- Huntsman (target) reported disappointing earnings results after the merger was signed. EBITDA was 19.9% down from the time of signing. Hexion (buyer) obtained an insolvency opinion from a valuation firm and argued that the merger could not go through because of a MAC.
- The Delaware Court of Chancery explained:
  - "In the absence of evidence to the contrary, a corporate acquirer may be assumed to be purchasing the target as part of a long-term strategy. **The important consideration therefore is whether there has been an adverse change in the target's business that is consequential to the company's long-term earnings power over a commercially reasonable period**, which one would expect to be **measured in years rather than months**."
- The Court explained that for short-term results to be relevant to a MAC determination, they "must be expected to persist significantly into the future."
- The Court held that there was **no MAC**.

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Because of the high standard for a MAC,
no Delaware case found that a MAC existed until . . .

Akorn v. Fresenius

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Akorn, Inc. v. Fresenius Kabi AG (2018)

- Fresenius entered into a merger agreement to acquire Akorn, Inc., a pharmaceutical company.
- Within two months of signing the agreement, and two days after Akorn's shareholders voted to approve the merger, Akorn published its second-quarter results, revealing a **steep drop in its business performance** (29% revenue decline; 84% operating income decline; 96% EPS decline).
- In the third quarter, results were off again—drops of 29% in revenue, 89% in operating income, and 105% in EPS.
- Six months after the signing, Fresenius received **two whistleblower letters** concerning Akorn's product development and quality control process. Fresenius immediately investigated the allegations and "**serious and pervasive data integrity problems**" at Akorn, including the fact that Akorn had submitted **fabricated data to the FDA**.
- Product launches also fell sharply—instead of anticipating 34 launches with $60 million in sales, only 14 products were launched with $3.3 million in sales.

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Akorn, Inc. v. Fresenius Kabi AG (2018)

- Shortly before the closing date, Fresenius terminated the merger agreement on the grounds that:
  1. a **MAE** had occurred with respect to Akorn's business performance;
  2. Akorn was in breach of its FDA regulatory compliance representation and warranty, and that such breach constituted a **regulatory MAE** that was incurable; and
  3. Akorn had breached its **covenant to operate its business in the ordinary course**.
- Akorn sued Fresenius, seeking an injunction to force Fresenius to consummate the merger.

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Akorn, Inc. v. Fresenius Kabi AG (2018)

- The Delaware Court of Chancery held that Akorn's representations to Fresenius about the company's compliance with FDA regulations were not true and correct, and that "the magnitude of the inaccuracies would reasonably be expected to result in a [regulatory MAE]."
- The Court also found that Akorn had taken several actions that caused it to materially breach its covenant to continue operating the Company in the ordinary course of business.
- The Court found that **a MAE had occurred** based on the severe decline in Akorn's financial performance.
  - Several factors were particularly important to the Court's decision:
    1) **Akorn's long-term financial performance**: Akorn's financial performance fell off a cliff after the merger agreement was signed.
    2) **Akorn's quality controls**: Whistleblower letters alerted Fresenius to severe quality control problems at Akorn that would cost nearly $1 billion to fix. Additionally, the head of Akorn's quality control submitted fabricated data to the FDA.
    3) **Overall Value:** When deal signed, Akorn's financial advisor estimated $32.13 per share. In view of post-signing performance, value was only "$5.00 to $12.00 per share."
  - Court found performance "disastrous."

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Takeaways from *Akorn v. Fresenius*

- Factors that contributed to finding MAEs in *Akorn*:

1. Years of growth before the merger agreement was signed;

2. Followed by **operating income decline** of 84% or greater for two consecutive quarters and EBIT decline of 62% or greater after the merger agreement was signed;

3. Discovery of **severe quality control and regulatory problems**, including submission to the FDA of **fabricated data**; and

4. The problems **could not be reasonably cured**.

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Takeaways from *Akorn v. Fresenius*

- Now we know that what constitutes a MAC.
- But the facts of *Akorn* were so egregious, if the courts didn't find a MAC, it is hard to imagine when they would.
- *IBP* and *Hexion* are still good law.
  - Short term v. "durationally significant"
  - Foreseeability
- Court easily distinguished *IBP* and *Hexion* as arising from industry-wide issues, while Akorn's problems were deeply specific to Akorn.
  - *E.g.*, fabricated data to FDA.
- The Delaware courts will look at a party's conduct to see if it is using a MAC to get out of a bad deal.
- **Best Practice:** Specifically state the conditions for a MAC in the agreement at the time of drafting.
- **Best Practice:** Even if you are a buyer and think a MAC may have occurred, keep complying with your obligations.

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II. Implied Covenant of Good Faith and Fair Dealing

Background: Implied Covenant of Good Faith and Fair Dealing

- What does the implied covenant of good faith and fair dealing require?
  - Is a party to a contract obligated to be "fair" over and above complying with the express requirements of the contract?
  - Put another way, may a party face liability under the contract even though the plaintiff admits that the defendant has complied with its literal and express terms?

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Implied Covenant: Delaware Cases

- In *Dieckman* (2017), the Supreme Court of Delaware stated:
  - "'The implied covenant is **inherent in all contracts** and is used to **infer contract terms 'to handle developments or *contractual gaps that the asserting party pleads neither party anticipated.*'** It applies 'when the party asserting the implied covenant proves that the other party has acted arbitrarily or unreasonably, thereby **frustrating the fruits of the bargain that the asserting party reasonably expected**'" (quoting *Nemec v. Shrader* (Del. 2010)).

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DRIT LP v. Glaxo Group Ltd. (2018)

- In 2008, Glaxo (“GSK”) agreed to pay Biogen Inc. royalties on sales of a certain GSK drug, Benlysta. GSK received certain IP rights as consideration. In 2012, DRIT purchased the royalty stream from Biogen. In 2015, GSK statutorily disclaimed the Benlysta patent and stopped paying royalties to DRIT.
  - A **statutory disclaimer** is a statement in which a patent owner relinquishes legal rights to one or more complete claims of a patent.
- DRIT filed suit against GSK in the Delaware Superior Court in 2016, alleging breach of contract and breach of the implied covenant of good faith and fair dealing.

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DRIT LP v. Glaxo Group Ltd. (2018)

- **Court's Jury Instructions**:
  - "This implied covenant was created to promote the spirit of the agreement and **to protect against one side using tactics to deny the other side the benefits that were agreed to by the parties.** ***When material aspects of an agreement are left to one party's sole discretion, the implied covenant demands that party exercise its discretion reasonably and in good faith***. When conducting this analysis, you must assess the parties' **reasonable expectations at the time the contract was executed**…."
    - "**DRIT** alleges that GSK **disclaimed the '092 Patent unreasonably or in bad faith for the purpose of avoiding paying royalties** to DRIT under the Agreement, and that the good faith explanations offered by Defendants for the disclaimer of the '092 Patent are **pretextual** and should not be credited."
    - **"GSK** asserts that their actions were **reasonable and appropriate and were consistent with good business practices**."
- **An Unanimous Jury Verdict:**
  - In September 2018, a unanimous jury in the Delaware Superior Court found that GSK breached the implied covenant by statutorily disclaiming the patent.

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Oxbow Carbon & Mineral Hldgs. v. Crestview-Oxbow Acquisition, LLC (2019)

- Vice Chancellor Laster ruled that Bill Koch could be forced by minority PE investors Crestview and Load Line Capital ($250 mm investment) to sell Oxbow Carbon, appointed a monitor to oversee the forced sale and held Koch liable for tens of millions in damages arising out of his attempt to block the sale.
- LLC Agreement only permitted forced "Exit Sale" by minority members if the sale price met or exceeded a contractually mandated floor price and if all members received the same terms and conditions in a sale.
  - Effectively gave small, later-admitted minority holders a blocking right if they didn't get the same terms and conditions.
- **The Delaware Court of Chancery** relied on the implied covenant to fill "gaps" in the LLC agreement with respect to whether late-admitted small holders could be "topped up" to the contractual floor price by the PE firms in order to permit a forced "Exit Sale" under the agreement.
- The Court of Chancery found "gaps" because the LLC agreement gave the Board discretion to set terms and conditions of admission of new members and it did not do so.

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Oxbow Carbon & Mineral Hldgs. v. Crestview-Oxbow Acquisition, LLC (2019)

- **The Delaware Supreme Court recently reversed in part**, holding that **“the implied covenant should not be used as ‘an equitable remedy for the rebalancing of economic interests’--particularly where, as here, the parties are sophisticated business persons or entities.”**
- **The Delaware Supreme Court** explained that the **implied covenant** only comes into play in two situations:
  1) Where a “situation has arisen that was **unforeseen** by the parties and where the agreement’s **express terms do not cover what should happen**;” or
  2) “[W]hen a party to a contract is given discretion to act as to a certain subject and it is argued that the **discretion has been used in a way that is impliedly proscribed** by the contract’s express terms.”
- Here, while the relevant provision gave the board discretion to establish different rights for newly-admitted members, it did not require the board to do so, and the default was that all of the otherwise applicable minority rights applied, leaving no “gap.”
- PE firms had board seats and could have negotiated for the rights they sought through litigation.

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Miller v. HCP & Co., C.A. No. 2017-0291-SG, 2018 WL 656378 (Del. Ch. Feb. 1, 2018), *aff'd*, *Miller v. HCP Trumpet Inv., LLC*,193 A.3d 908 (Del. Sept. 20, 2018).

- Court of Chancery dismissed an implied covenant of good faith and fair dealing claim brought by an LLC's minority member against members of the LLC's board—a majority of whom were appointed by HCP & Company, a PE firm, which was the LLC's controlling member.
- Minority member challenged a sale transaction where HCP would receive all of the sale proceeds and the minority members would receive little to no consideration.
- The operating agreement vested the board of managers with ***"sole discretion"*** as to the manner in which a sale of the company would be conducted, so long as the transaction was with an unaffiliated third party. Because the contractual grant of sole discretion carved out transactions with insiders, the Court of Chancery found that there was no "gap" in the sole discretion clause, and that the implied covenant therefore did not apply.
- The Supreme Court held that the sole discretion clause did not address how the company would be sold, but rather the structure of any sale after the board had agreed to sell the company, and did not relieve the board of its obligation to act consistently with the implied covenant.

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Miller v. HCP & Co., C.A. No. 2017-0291-SG, 2018 WL 656378 (Del. Ch. Feb. 1, 2018), *aff'd*, *Miller v. HCP Trumpet Inv., LLC*,193 A.3d 908 (Del. Sept. 20, 2018).

- Critically, however, the Court found that:

  "[a]lthough we do not agree with the Court of Chancery that the terms of [the agreement] displaced the implied covenant altogether, we do believe that it correctly addressed the precise argument made to it. ***The operating agreement's clear elimination of fiduciary duties is inconsistent with the plaintiff's argument that the agreement's implied covenant subsumes the affirmative duties imposed upon corporate boards in the change of control context by Revlon*.**

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III. “Best Efforts” Clauses in M&A Agreements

“Efforts” Clauses

- A qualifier to govern how hard parties must try to achieve pre-closing tasks and post-signing conduct.
- Source of debate and confusion among lawyers and clients over practical differences, if any, over various formulations.
- Examples of “efforts” clauses:
  - Use “best efforts” to obtain HSR antitrust approval
  - Use “reasonable best efforts” to operate company in the ordinary course of business.
  - Use “commercially reasonable efforts” to get customer consents.
  - Earn-outs as well.
- Basically, how hard do you have to try?

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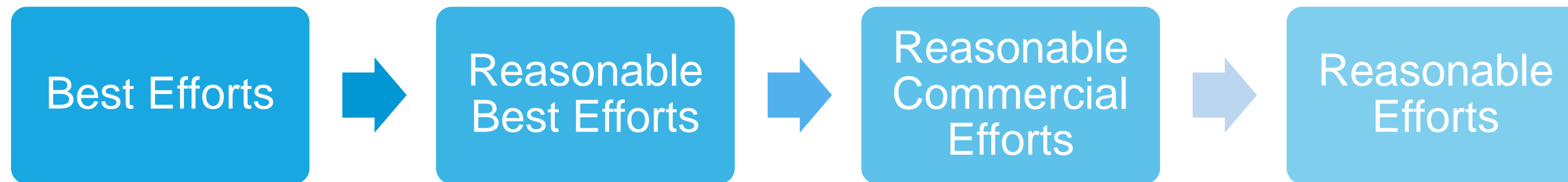
"Efforts" Clauses

- Parties typically use various terms to express the degree of effort required:



- Counsel can sometimes be hard pressed to explain the differences, but it is generally agreed that "best efforts" requires more than "reasonable best efforts," which requires more than "reasonable efforts."
- But courts have not rigorously defined these terms, and sometimes have read them equally.
- Indeed, the Court in *Akorn* stated that all formulations effectively require parties to take "all reasonable steps" to fulfill their obligations.
- Court didn't say more.
- Other recent cases, including *Akorn*, provide a few markers . . . .

Variations of "Efforts" Clauses

Case	Language	Interpretation
Alliance Data System (Del. 2009)	Best Efforts	"implicitly qualified by a **reasonableness** test-it cannot mean everything possible under the sun."
Bloor (2d Cir. 1979)	Best Efforts	Doesn't require bankruptcy or substantial losses.
Alliance Data System (Del. 2009)	Reasonable Best Efforts	"clearly understood . . . to be **less** than an unconditional commitment."
Akorn (Del. 2018) (quoting *Williams*)	Reasonable Best Efforts	"'to take all **reasonable** steps to solve problems and consummate the transaction.'"
Williams's dissent (Strine, C.J.) (Del. 2017)	Commercially Reasonable Efforts	"comparatively strong"
Williams (Del. 2017)	Commercially Reasonable Efforts **and** Reasonable Best Efforts	"take all **reasonable** steps"
BTG (Del. 2017)	Diligent Efforts	Term is defined in the contract

Akorn recognized ABA Committee on Mergers and Acquisitions

ABA Committee on Mergers and Acquisitions' Standards	
"Best Efforts"	requires a party "to do essentially everything in its power"
"Reasonable Best Efforts"	"substantial efforts"
"Reasonable Efforts"	action "typical under the circumstances"
"Commercially Reasonable Efforts"	"not commercially detrimental, including expenditure of material, unanticipated amounts, or management time"
"Good Faith Efforts"	lowest standard, "honesty in fact and observance of reasonable commercial standards of fair dealing"

Akorn

- Chancery Court in *Akorn* then went on to say that Akorn did not use "commercially reasonable efforts" to act in the ordinary course of its business when it:
  - Failed to conduct regular audits for FDA issues
  - Did not maintain its data integrity system for FDA data
  - Submitted data to FDA based on fabricated data
  - Did not conduct "responsive and credible" investigation of whistleblower questions
  - Did not use expert counsel to investigate "whistleblower" matters

The Williams Companies, Inc. v. Energy Transfer Equity, L.P. (2017)

- Williams, an energy infrastructure company that owns natural gas pipelines, and ETE, an owner of tens of thousands of energy pipelines, entered into a merger agreement.
- The parties agreed to use "**commercially reasonable efforts**" to obtain a tax opinion from Latham & Watkins that the transfer of Williams's assets should qualify as a tax-free transfer under Section 721 of the tax code.
- The parties also agreed in the same agreement to use "**reasonable best efforts**" to assist the other party in consummating the merger "in the most expeditious matter practicable," without indicating how the requirements would differ.
- The Supreme Court of Delaware ruled that "[t]hese provisions placed an **affirmative obligation on the parties to take all reasonable steps** to obtain the 721 opinion and otherwise complete the transaction."
  - The Court **did not distinguish** between "commercially reasonable efforts" and "reasonable best efforts."

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The Williams Companies, Inc. v. Energy Transfer Equity, L.P. (2017)

- The Court stated that ETE may have breached the "**commercially reasonable efforts**" provision, because ETE "did not direct Latham to engage earlier or more fully with Williams' counsel, failed itself to negotiate the issue directly with Williams, failed to coordinate a response among the various players, went public with the information that Latham had declined to issue the 721 Opinion, and generally **did not act like an enthusiastic partner** in pursuit of consummation of the [Merger Agreement]."
  - "Enthusiasm" is an element?
- **Dissenting Opinion (Strine, C.J.):**
  - "[I]f a party establishes a breach of a covenant to bring about a condition at closing, **the burden is on the breaching party** to show that the breach did not materially contribute to the failure of that closing condition. In this context, where the Merger Agreement's '**commercially reasonable efforts**' term obligated ETE to take affirmative steps to make sure the 721 opinion condition was satisfied and, instead, ETE did not, **ETE must then prove that the 721 opinion condition would not have been satisfied had it acted appropriately**."
  - Strine notes that a duty to use "commercially reasonable efforts" is "**comparatively strong**."
  - He supports his observation by citing Kling and Nugent's book, *Negotiated Acquisitions of Companies, Subsidiaries and Divisions*. The book observes "that 'best efforts' standards can potentially lead to the party making the promise having to take extreme measures to fulfill it and that **'commercially reasonable efforts' is a strong, but slightly more limited, alternative**."

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BTG International, Inc. v. Wellstat Therapeutics Corp. (2017)

- BTG (distributor) agreed to use its "diligent efforts" to promote, distribute and sell a drug known as Vistogard for Wellstat (manufacturer). The parties defined "diligent efforts" as:
  - "Diligent Efforts means, with respect to a Party, the carrying out of obligations specified in this Agreement in a **diligent, expeditious and sustained manner**…

    using efforts and resources, including **reasonably necessary** personnel and financial resources, that specialty pharmaceutical companies typically devote to their own internally discovered compounds or products of most closely comparable market potential at a most closely comparable stage in their development or product life,…

    taking into account the following factors to the extent reasonable and relevant: issues of safety and efficacy, product profile, competitiveness of alternative products in the marketplace, the patent or other proprietary position of the Subject Product, and the potential profitability of the Subject Product."

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BTG International, Inc. v. Wellstat Therapeutics Corp. (2017)

- The Delaware Court of Chancery held that BTG failed to use its "diligent efforts."
  - One BTG executive said that "all established products are prioritized ahead of [Vistogard]."
  - Against the advice of outside consultants and its own pharmaceuticals division, BTG devoted "far fewer personnel than specialty pharmaceutical companies would have devoted to Vistogard had it been one of their own internally discovered compounds or products."
- BTG argued that it used a similar number of sales representatives when it launched a similar drug, but the Court held that Vistogard required more sales staff because its projected peak sales was $56 million as opposed to $15 million for the similar drug.
- The Court also notee that BTG viewed the launch of the similar drug as unsuccessful and that BTG had internally circulated a presentation that stated that Vistogard was "promotionally sensitive."
- The Court concluded that **"despite warnings from Wellstat, BTG's outside consultants, and its own employees, BTG deployed a sales force that was far too small to achieve Vistogard's revenue potential."**
- Thus, BTD had **failed to exercise its "diligent efforts"** to promote, distribute, and sell Vistogard.

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Overcoming Ambiguity in “Efforts” Clauses

- Did *Akorn* override case law and settle the issue about any differences between the various formulations such that corporate lawyers can be indifferent to the different permutations?
  - Probably not but reference to ABA chart is helpful.
- Deal lawyers seem to believe in a hierarchy of efforts . . . .
  - They “sound” as though they impose different requirements.
- Keep in mind that courts may not recognize perceived distinctions.
- *Anthem v. Cigna* case now pending in Delaware may clarify differences.

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Takeaways for "Best Efforts" Clauses

- Although cases are unclear, assume that "best efforts" requires more than "reasonable best efforts," which in turn requires more than "commercially reasonable efforts."
- **Option for deal lawyers:** Specify exactly what each party must do to satisfy its "best efforts" obligations.
  - Example: a party must do for another's product what it does for its own.
  - Example: a party is not required to make special expenditures, file a lawsuit, or hire new employees to produce a particular result.
  - But be careful: if you specify and fall short, you increase the chance of a finding of liability (*BTG*).
    - Ask yourself if trying to specify conduct will raise new issues and slow negotiation.

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IV. Forum Selection Clauses for Securities Act Claims

Background: Forum Selection Clauses

- In dictum appearing in *Revlon* (2010), Vice Chancellor Laster wrote that "if boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes."
- Before *Revlon*, only **16** publicly-traded companies had forum selection provisions in their charters or bylaws.
- By 2014, **746** publicly-traded companies had adopted them, generally picking Delaware as the forum.
- There are **two primary advantages** to forum selection clauses:
  1) Reduces the possibility of multi-forum litigation; and
  2) Allows the litigation to benefit from Delaware's comparatively more experienced judges and specialized court in business litigation.

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Background: The Securities Act of 1933

- State and federal courts share concurrent jurisdiction to resolve securities claims brought under the Securities Act of 1933. *See Cyan v. Beaver County.*
- Defendants may not remove '33 Act actions filed in state court to federal court. *See Cyan.*
- In *Boilermakers* (2013), the Delaware Court of Chancery held that a Delaware corporation may adopt a forum selection provision in its bylaws for internal affairs claims. But the Court noted that bylaws may **not** regulate "**external matters**."
  - "External matters" include **tort claims** and **commercial contract claims**. It does not matter whether the plaintiff is a stockholder.
  - *Boilermakers* was effectively codified in 2015 in § DGCL 115.

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Background: DGCL § 115

§ 115 Forum selection provisions.

“The certificate of incorporation or the bylaws may require, consistent with applicable jurisdictional requirements, that any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State, and no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State. "Internal corporate claims" means claims, including claims in the right of the corporation, (i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery.”

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Cyan v. Beaver County (2018)

- Investors purchased shares of Cyan in an IPO. After the stock value declined, the investors brought a class action in California state court, alleging violations of the ’33 Act. Cyan moved to dismiss for lack of subject matter jurisdiction.
- The issues were:

1) whether the Securities Litigation Uniform Standards Act of 1998 (“SLUSA”) stripped **state courts** of jurisdiction to adjudicate class actions alleging purely ’33 Act claims; and
2) whether SLUSA authorized **removal** of’33 Act claims to federal court.

- The U.S. Supreme Court unanimously ruled that the class actions brought solely under the ’33 Act may be brought in **state court** and are **not removable to federal court**.

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Sciabacucchi v. Salzberg (2018)

- The issue of whether ‘33 Act claims constitute “external matters” – which, under *Boilermakers*, could not be the subject of a forum selection provision -- was recently decided in *Sciabacucchi v. Salzberg* (2018).
- Blue Apron, Stitch Fix, and Roku adopted “federal forum provisions” in their charters requiring ’33 Act claims to be filed in federal court.
- The Delaware Court of Chancery held that the provisions were **ineffective “because the provision would not be addressing ‘the rights and powers of the plaintiff-stockholder as a stockholder.’”**
- The Court reasoned that **’33 Act claims are external claims**, because:
  - ’33 Act claims are “specialized and wholly statutory causes of action.”
  - Potential defendants are not limited to insiders.
  - The definition of “securities” is broader than common stock, of which a subset is the shares of a Delaware corporation, and there is no necessary connection between a ‘33 Act claim and the shares of a Delaware corporation.
  - “The cause of action does not arise out of or relate to the ownership of the share, but rather from the **purchase** of the share . . . . the plaintiff can sue even if it subsequently sells and is no longer a stockholder.”

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Sciabacucchi v. Salzberg (2018)

- "Under existing Delaware authority, **a Delaware corporation does not have the power to adopt in its charter or bylaws a forum-selection provision that governs external claims.** The Federal Forum Provisions purport to regulate the forum in which parties external to the corporation (purchasers of securities) can sue under a body of law external to the corporate contract (the 1933 Act)."

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Sciabacucchi v. Salzberg (2018)

- The Court held that charter provisions may not bind parties in litigation to a particular forum where the rights at issue do not arise from that corporation's internal affairs.
  - "Because the state of incorporation creates the corporation, the state has the power through its corporation law to regulate the corporation's internal affairs...."
  - "But **the state of incorporation cannot use corporate law to regulate the corporation's external relationships.** . . . Without more, **the corporate contract does not enable Delaware to regulate the activities of parties that are beyond its territorial jurisdiction. Delaware can regulate the internal affairs of its corporate creations, regardless of their location, but only their internal affairs.**"

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Sciabacucchi v. Salzberg (2018)

- As a result, **forum selection provisions requiring '33 Act claims to be litigated exclusively in federal court and nowhere else are invalid**, because such claims are external to the corporation and cannot be regulated by forum selection provisions that apply only to claims arising from the corporation's internal affairs.

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V. Mental State Requirement for Violations of Section 14(e)

Background: Section 14(e)

- **Section 14(e)** of the Exchange Act is the federal antifraud provision applicable to tender offers.

- Like Section 10(b) and Rule 10b-5 promulgated thereunder, Section 14(e) requires a showing that defendants acted with the **requisite state of mind**.

- In *Chris-Craft Industries* (1973), the Second Circuit held that Section 14(e) requires **scienter (*i.e.*, intent or knowledge of wrongdoing)** because its language mirrors the language of Rule 10b-5.

Background: Section 14(e)

- **Section 14(e) provides:**
  - "It shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation."
- **Rule 10b-5 provides:**
  - "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

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Background: Section 14(e)

- In *Ernst & Ernst v. Hochfelder* (1976), the U.S. Supreme Court stated that **Rule 10b-5**, "[v]iewed in isolation . . . could be read as proscribing, respectively, any type of material misstatement or omission . . . **whether the wrongdoing was intentional or not**."

- *Ernst* held, however, that Rule 10b-5 requires scienter because **Section 10(b)**, the authorizing legislation of Rule 10b-5, only allows the SEC to regulate **"manipulative or deceptive device[s],"** and therefore, **negligence is not enough for claims under Rule 10b-5.**

- **Section 14(e)** is not restricted by such similar language.

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Varjabedian v. Emulex Corp. (9th Cir. 2018)

- Avago (buyer) offered to purchase Emulex (target) for $8.00/share, at a 26.4% premium over the market price. Emulex hired Goldman Sachs to issue a customary fairness opinion. The plaintiffs, Emulex stockholders, filed a Section 14(e) claim, asserting that the $8.00/share was inadequate due to “Emulex's significant growth leading up to the tender offer and the company's prospects for future growth” and that a one-page premium analysis showing that the premium was at the low-end (albeit within) the range of comps should have been disclosed in the 14D-9.
- The **district court dismissed the complaint**, holding that the plaintiffs had failed to plead scienter, *i.e.*, **a specific intent to defraud**.
- The **Ninth Circuit reversed** and remanded, ruling that Section 14(e)’s state of mind requirement may be satisfied by **negligence**.

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Varjabedian v. Emulex Corp. (9th Cir. 2018)

- The Ninth Circuit reasoned that **Section 14(e) regulates a broader array of activity** because "'under § 14(e), the [SEC] may prohibit acts not themselves fraudulent under the common law or § 10(b), if the prohibition is 'reasonably designed to prevent . . . acts and practices [that] are fraudulent.'" (quoting *United States v. O'Hagan* (S.Ct. 1997)).

- Lastly, the Ninth Circuit supported its decision based on the Supreme Court case of *Aaron v. SEC* (1980), which addressed Section 17(a)(2) of the '33 Act—a provision similar to Section 14(e)—and held that Section 17(a)(2) does not require scienter.

- On January 4, 2019, the U.S. Supreme Court granted certiorari.

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Takeaways: Section 14(e)

- Since *SEC v. Hochfelder*, scienter has been required under Section 10(b), and all five federal circuits to address the issue before *Emulex* had determined that it was required under Section 14(e), too.
- If *Emulex* is upheld by the Supreme Court, the case would greatly facilitate plaintiffs' claims in Section 14(e) tender offer cases, because they would only need to show **negligence instead of knowledge.**
- For example:
  - Litigation against boards of directors for disclosure claims in tender offer materials could be based on negligence.
    - Ex: "Background of Offer" disclosures
    - Disclosures regarding financial advisor fairness opinions

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VI. Who “Makes” a False Statement: *Lorenzo v. SEC*

Background: Rule 10b-5

- “It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

  (a) To employ any device, scheme, or artifice to defraud,

  (b) **To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading**, or

  (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

  in connection with the purchase or sale of any security."

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Stoneridge v. Scientific-Atlanta (2008)

- Stoneridge sued Charter Communications ("Charter") and both Scientific-Atlanta and Motorola (jointly, "Respondents") as suppliers and customers of Charter.
- Charter allegedly engaged in fraudulent practices so that its quarterly reports would meet investors' expectations regarding cable subscriber growth and cash flow.
- Charter allegedly arranged to overpay Respondents $20 for each digital cable converter box it purchased, "with the understanding that respondents would return the overpayment by purchasing advertising from Charter . . . . Charter would then record the advertising purchases as revenue and capitalize its purchase of the set top boxes, in violation of generally accepted accounting principles . . . . **[T]he transactions would enable Charter to fool its auditor into approving a financial statement** showing it met projected revenue and operating cash flow numbers. Respondents agreed to the arrangement . . . . **Following a request from Charter, Scientific–Atlanta sent documents to Charter stating—falsely—that it had increased production costs.**"

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Stoneridge v. Scientific-Atlanta (2008)

- The Petitioner suggested that the Respondents were liable under **"scheme liability."**
- **The Supreme Court** summarized: "The argument is that the financial statement Charter released to the public was a **natural and expected consequence of respondents' deceptive acts**; had respondents not assisted Charter, Charter's auditor would not have been fooled, and the financial statement would have been a more accurate reflection of Charter's financial condition."
- "In effect petitioner contends that in an efficient market **investors rely not only upon the public statements relating to a security <u>but also upon the transactions those statements reflect.</u>** Were this concept of reliance to be adopted, the implied cause of action would reach the whole marketplace in which the issuing company does business; and there is no authority for this rule."

Stoneridge v. Scientific-Atlanta (2008)

- **The Supreme Court:**
  - "The § 10(b) implied private right of action does not extend to aiders and abettors. **The conduct of a secondary actor must satisfy each of the elements or preconditions for liability** . . . ."
  - "[Reliance] ensures that, for liability to arise, the "**requisite causal connection** between a defendant's misrepresentation and a plaintiff's injury" exists as a predicate for liability . . . . Respondents had no duty to disclose; and their deceptive acts were not communicated to the public."
  - "***<u>No member of the investing public had knowledge, either actual or presumed, of respondents' deceptive acts during the relevant times</u>***. Petitioner, as a result, cannot show reliance upon any of respondents' actions except in an indirect chain that we find too remote for liability."

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Janus Capital v. First Derivative Traders (2011)

- **Issue:** “[W]hether Janus Capital Management LLC (JCM), a mutual fund investment adviser, can be held liable in a private action under . . . Rule 10b–5 for false statements included in its client mutual funds' prospectuses.”
- **Rule 10b-5(b)** creates liability for those who: “**make** any untrue statement of a material fact . . . .”
- **U.S. Supreme Court:** “**One ‘makes’ a statement by stating it** . . . . For purposes of Rule 10b–5, the maker of a statement is the person or entity with ***ultimate authority over the statement***, ***including its content and whether and how to communicate it*** . . . . This rule might best be exemplified by the relationship between a speechwriter and a speaker. **Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it**. And it is the speaker who takes credit—or blame—for what is ultimately said.”

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Lorenzo v. SEC (D.C. Cir. 2017)

- ***Facts:*** Francis Lorenzo, the director of investment banking at Charles Vista, LLC, a mutual fund, sent email messages to investors with allegedly false and material statements about a debenture offering. One of Charles Vista's biggest clients, Waste2Energy Holdings, Inc. ("W2E"), claimed to possess a "gasification" technology that could generate electricity by converting solid waste to gas. Therefore, most of its assets were in "intangibles."
- Lorenzo learned that the intangibles were written-off by around $11 million**. Lorenzo's boss "asked Lorenzo to send the emails, supplied the central content, and approved the messages for distribution."**
- "***Lorenzo separately emailed two potential investors*** 'several key points' about W2E's pending debenture offering. **His emails, however, omitted any mention of the wholesale devaluation of W2E's intangibles.**
  - On the contrary, Lorenzo's emails assured both recipients that the offering came with '3 layers of protection:

    (i) [W2E] has over $10 mm in confirmed assets;

    (ii) [W2E] has purchase orders and LOI's for over $43 mm in orders;

    (iii) Charles Vista has agreed to raise additional monies to repay these Debenture holders (if necessary).'"

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Lorenzo v. SEC (D.C. Cir. 2017)

- “One of Lorenzo's messages said it had been sent ‘[a]t the request of [Lorenzo’s boss],’ and the other stated it had been sent ‘[a]t the request of Adam Spero [a broker with Charles Vista] and [Lorenzo’s boss].’ In both messages, Lorenzo urged the recipients to ‘[p]lease call [him] with any questions.’ And he signed both messages with his name and title as ‘Vice President—Investment Banking.’”
- ***Lorenzo:*** “If memory serves me—I think I authored it and then it was approved by [my boss] and Mike [Molinaro, Charles Vista's Chief Compliance Officer].”
- ***D.C. Circuit:*** Although Lorenzo did not violate **Rule 10b-5(b)** because **he did not “make” the false statements, insofar as “Lorenzo's boss, and not Lorenzo himself, retained ‘ultimate authority’ over the statements”** (quoting *Janus Capital*), he nevertheless committed securities fraud in violation of **Rule 10b-5(a) & (c)** based on **“scheme liability”** principles.
  - “Under the *Janus* test, **a person cannot have ‘made’ a statement if he lacked ultimate authority over what it said** and whether it was said, including if he prepared or published it on behalf of another.”
  - However, unlike the defendants in *Stoneridge*, Lorenzo interfaced directly with investors.

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Lorenzo v. SEC (D.C. Cir. 2017)

- ***SEC's counterarguments on "Maker":***
  - Lorenzo made the statements on his own behalf because he included his signature line in his emails.
    - *The D.C. Circuit disagreed:* "That sort of signature line, however, can often exist when one person sends an email that 'publishes a statement on behalf of another,' with the latter person retaining 'ultimate authority over the statement.'"
  - Lorenzo did not recall discussing the emails or subject matter with his boss.
    - *The D.C. Circuit was unpersuaded:* "That comment, however, is consistent with the understanding that **Lorenzo played a minimal role** . . . . the content of those points evidently had been **supplied by [his boss].** The emails, moreover, began by stating that they were being **sent at [his boss'] request**. Lorenzo testified elsewhere that [his boss] had remarked, 'I want this [to] come from our investment banking division. Can you send this out for me?'"

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Lorenzo v. SEC (S.Ct. 2018)

- The Supreme Court granted cert and heard oral argument on December 3, 2018.
- The SEC's brief:
  - "**Unlike the defendants in *Janus*** and in earlier similar cases, moreover, petitioner did not play an 'undisclosed,' behind-the-scenes role as a preliminary actor. **He sent the messages 'directly' to the prospective investors 'from his account and under his name.**'"
  - "**Unlike the defendants in *Stoneridge***, who did not interact directly with the investors and whose actions 'did not have the requisite proximate relation to the investors' harm,' **petitioner himself sent the false emails to investors and placed his imprimatur on their contents by telling investors to direct any questions to him.**"
- Lorenzo argued that this broad interpretation of **"scheme" liability** would effectively end run *Janus* where the "scheme" is premised solely on a misstatement.
- The Supreme Court has not yet issued its decision, which is expected by June 2019.
- Consider whether decision will impact class of defendants potentially liable for documents that a company distributes to its shareholders (audit reports; reserve reports; fairness anayses), eroding both *Janus* and the well-settled principle under *Central Bank* that there is no private right of action against secondary actors for aiding and abetting under 10b-5.

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VII. Sandbagging: *Eagle Force v. Campbell*

Background: Sandbagging

- **Context:** Buyer brings a post-closing claim against a seller for breach of a rep or warranty.
- **Sandbagging provision**: Allows a buyer to have rights under the reps and warranties section of a contract **regardless of whether the buyer had knowledge** of the facts giving rise to a breach of a rep **pre-closing**.
  - Also known as pro-sandbagging or knowledge savings clauses.
- Historically, "silence was golden" in the Delaware courts, which looked favorably on "sandbagging."
  - There was no need for explicit pro-sandbagging provisions because the courts had generally followed the majority rule that the **buyer's reliance on reps and warranties in the agreement was presumed as a matter of law**, and the buyer's prior knowledge of their inaccuracy was irrelevant to a claim for breach.

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Eagle Force v. Campbell (2018)

- The Delaware Supreme Court—which had never directly addressed the issue—created some upheaval in a footnote.
- The Court suggested that Delaware law may not, in fact, be settled regarding whether a buyer must prove reliance upon a contractual rep or warranty (*i.e.*, lack of prior knowledge of inaccuracy) in order to recover for breach.

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Eagle Force v. Campbell (2018)

- **Footnote 185:**
  - "We acknowledge the debate over whether a party can recover on a breach of warranty claim where the parties know that, at signing, certain of them were not true. Campbell argues that reliance is required, but **we have not yet resolved this interesting question** . . . . And we observe that a majority of states . . . hold[] that traditional reliance is not required to recover for breach of an express warranty: the only 'reliance' required is that the express warranty is part of the bargain between the parties. . . . **We need not decide this interesting issue because such claims are not before the court**."

  - *See also* Strine, C.J., dissenting (Slip Op. at p. 10 & n.39).

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Takeaways from *Eagle Force*

- The current landscape is that Delaware remains a pro-sandbagging state that will still allow buyers with prior knowledge to assert a breach claim.
- It is unclear how Delaware courts will address the implicit rule that buyers' knowledge is irrelevant to breach of rep claims.
- **Best Practice:** Include explicit pro or anti-sandbagging clauses in the contract.
  - Silence may no longer be golden.

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VIII. Takeaways and Practice Pointers

Takeaways and Practice Pointers

MACs

1) **Foreseeability and duration are still key factors to consider before calling a MAC** (*see IBP* and *Hexion)*.
   - *Akorn* met these tests and also included fabricated data submitted to the FDA.

2) **When problems arise, buyers should be careful not to give an impression that they are looking for a reason to walk.**

3) **Enumerate specific MACs in the purchase agreement.**
   - Clarify the parties' expectations at the beginning.
   - May avoid costly litigation over whether a MAC has occurred.

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Takeaways and Practice Pointers

“Best Efforts” Provisions

4) **Do not conflate “best efforts,” “reasonable best efforts,” and other variations thereof.**
   - *Akorn* seems to conflate these terms, but it is not conclusive.
   - Consider ABA hierarchy cited in *Akorn*.
5) **Specify exactly what the other party must do to satisfy its “best efforts” obligations.**
   - Define “best efforts” in the contract.
   - Specify any exclusions and carveouts. *E.g.*, no litigation.
   - What you do for your own products and businesses may be the standard.

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Takeaways and Practice Pointers

Forum Selection Clauses

6) **For Delaware corporations, adopt a forum selection provision in company charters or bylaws for internal affairs claims if you want to litigate them in Delaware.**
   - Subject to the final word from the Delaware Supreme Court, forum selection provisions requiring that '33 Act claims be filed exclusively in federal court are unenforceable and will do you little good.

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Takeaways and Practice Pointers

Implied Covenant of Good Faith and Fair Dealing

7) **Do not leave "gaps," or ambiguities with respect to contractual discretion, or you may be subject to claims that contractually compliant conduct violated the implied covenant.**

- May be used in an effort to combat "gotcha" lawyering, but does not guarantee equitable fairness or provide for equitable rebalancing of economic interests, particularly in contracts among sophisticated businesspeople or entities.
- Act in good faith at all times consistent with the scope, purpose and terms of the contract.

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Takeaways and Practice Pointers

Tender Offer Disclosures

8) **Be aware that statements made in connection with tender offers may be subject to increased litigation risk if the U.S. Supreme Court upholds *Emulex*.**
   - Update risk factors in public filings accordingly.

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Takeaways and Practice Pointers

Rule 10b-5

9) **Those with "ultimate authority" over false or misleading statements or omissions will continue to be held liable as the "maker" of such statements under 10b-5(b) and *Janus*.**
   - The U.S. Supreme Court, however, may broaden "scheme" liability under 10b-5(a) & (C) to, among others, those who perform the act of delivering such statements to investors in the *Lorenzo* case, which is pending before the Court.
   - Consider possible application to a broader group of defendants involved in preparation and dissemination of documents that companies send to shareholders.

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Takeaways and Practice Pointers

Sandbagging

10) Include express pro or anti-sandbagging clauses in contracts.

- Buyers should include pro-sandbagging clauses that allow them to recover for a breach of the seller's reps and warranties, regardless of the buyer's knowledge.
- Sellers should include anti-sandbagging clauses.

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