SIGNIFICANT 2020 DECISIONS AFFECTING PRIVATE COMPANY M&A

arnoldporter.com

Arnold & Porter

Table of Contents

Arnold & Porter

March 2021

Significant 2020 Decisions Affecting Private Company M&A

By Nicholas O'Keefe, Ben Fackler, Michele Rowland, Therese Fox, Philip Hurst, Nate Klein, Jennifer McLellan, Bianca Prikazsky, Stefan Weidemann, Carlyn S. Williams.

This newsletter is our seventh annual review of significant state court decisions relevant for private company M&A transactions and related governance matters and disputes.

Hallisey v. Artic Intermediate, LLC , C.A. No. 2019-0980-MTZ (Del. Ch. Oct. 29, 2020)

Summary

Acquiror was not entitled to a post-closing purchase price adjustment in its favor due to having delivered its Closing Statement after the contractually agreed deadline.

Background

This decision involved a motion for judgment on the pleadings filed by Hallisey, as seller representative (Seller Rep) under a Securities Purchase and Exchange Agreement (SPA), on the basis that the acquiror (Buyer) had lost its ability to obtain a purchase price adjustment for the $20 million deal as a result of having delivered a Closing Date Report after the deadline provided for in the SPA.

The SPA provided Buyer with six months after closing in order to deliver a Closing Date Report setting forth Buyer's good faith determination of closing cash and closing net working capital, as part of the purchase price adjustment mechanism. Buyer delivered the Closing Date Report almost three months after the deadline, and sought a $12 million purchase price adjustment. Buyer maintained that the delay was valid and justified, given manipulations and misrepresentations by the target's Chief Financial Officer, which led to him being terminated about a month before the Closing Date Report was due. The Seller Rep sought judgment on the pleadings based on the language of the SPA. Buyer opposed the motion, alleging that the Seller Rep had unclean hands.

The court rejected Buyer's unclean hands argument as inapplicable given that the Seller Rep was appealing based on contract law and not to equity. Similarly, the court held that where the dispute involves a documented contract supported by valid consideration, equitable estoppel is not applicable. The court held that under the plain language of the SPA, failure to timely deliver a Closing Date Report obviated the rest of the purchase price adjustment process. The court held that given there were no material disputed facts, judgment on the pleadings was warranted in favor of the Seller Rep.

Takeaways

The decision is an important reminder that failure to meet bargained-for deadlines can have drastic consequences under Delaware's pro contractarian approach. It is not uncommon for acquirors to struggle to meet the deadline to deliver a Closing Statement in connection with purchase price adjustment mechanics, given unforeseen problems with a target company's financials. Reasoning that the target stockholders would not be prejudiced by a short delay, and therefore it is ok to deliver the Closing Statement late because there would be no damages, is an incorrect analysis. Acquirors should either timely deliver the Closing Statement based on the best information they have at their disposal under the circumstances, or negotiate for an extension. Simply delivering the Closing Statement late, as in *Hallisey*, could result in a complete loss of a purchase price adjustment in the acquiror's favor.

AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC, Mirae Asset Capital Co., Ltd., Mirae Asset Daewoo Co., Ltd., Mirae Asset Global Investments, Co. Ltd., and Mirae Asset Life Insurance Co., Ltd., No. 2020-0310-JTL (Del. Ch. Nov. 30. 2020)

Summary

The court held that whether or not a seller's business was conducted in the ordinary course consistent with past practice during the executory period of an acquisition agreement depended on whether there had been a change in the routine operations of seller's business under normal circumstances, regardless of whether such changes were in response to outside factors beyond the control of the seller.

Background

AB Stable VIII LLC (Seller) and MAPS Hotels and Resorts One LLC (Buyer) entered into a Purchase and Sale Agreement (Agreement) on September 10, 2019, pursuant to which Buyer agreed to acquire all of the membership interests in Strategic Hotels & Resorts LLC (Strategic). Strategic owned 15 limited liability companies, each of which owned a luxury hotel. Buyer notified Seller on April 17, 2020, the scheduled closing date for the acquisition of Strategic, that a number of Seller's representations and warranties were inaccurate and that Seller had failed to comply with its covenants under the Agreement. As a result, Buyer claimed it was not obligated to close and that Seller's failure to cure the breaches by May 2, 2020 would give Buyer a termination right. Seller initiated litigation on April 27, 2020, seeking, among other things, specific performance of the Agreement. After the suit was filed, Buyer terminated the Agreement and then filed counterclaims seeking various determinations, including that Seller had breached its obligations under the Agreement and failed to satisfy certain conditions to closing. This summary focuses on Buyer's allegation that Seller failed to satisfy the interim operating covenant that required Seller to operate its business only in the ordinary course, consistent with past practice in all material respects.

The Alleged Breach of the Interim Operating Covenant

On March 24, 2020, during the executory period, Strategic temporarily closed two of its hotels, the Four Seasons Palo Alto and the Four Seasons Jackson Hole, in response to low demand and governmental orders due to the COVID-19 pandemic. This accelerated the standard seasonal closure of the Four Seasons Jackson Hole by two weeks. Around this time, Strategic significantly reduced operations at its other hotels as well in response to the pandemic. Buyer argued that these actions deviated from the ordinary course of business in breach of the interim operating covenant, which in turn gave rise to the failure of a closing condition.

Section 7.3(a) of the Agreement provided that, as a condition to Buyer's obligation to close, "Seller shall have performed in [all] material respects all obligations and agreements and complied in all material respects with all covenants and conditions required by this Agreement. The interim operating covenant provided that:

> "Except as otherwise contemplated by this Agreement or as set forth in Section 5.1 of the Disclosure Schedules, between the date of this Agreement and the Closing Date, unless the Buyer shall otherwise provide its prior written consent (which consent shall not be unreasonably withheld, conditioned or delayed), the business of the Company and its Subsidiaries shall be conducted only in the ordinary course of business consistent with past practice in all material respects, including using commercially reasonable efforts to maintain commercially reasonable levels of Supplies, F&B, Retail Inventory, Liquor Assets and FF&E consistent with past practice, and in accordance with the Company Management Agreements."

Court's Finding that Seller Breached the Interim Operating Covenant

Seller argued that for purposes of the interim operating covenant, the "business" was the business of Seller as an asset management firm and a manager of managers who in turn operated the hotels. It contended that in that capacity, it continued to operate its business as it always had, letting the managers of the hotels make the decisions. The court rejected Seller's interpretation of "business" based on the plain language of the interim operating covenant which referenced the business of the Company and its Subsidiaries and detailed that operating the "business" in the ordinary course included using commercially reasonable efforts to maintain reasonable levels of certain supplies and inventory consistent with past practice.

Seller argued that the "ordinary course of business" meant it should have flexibility to address changing circumstances in unforeseen events and that this covenant would be satisfied so long as it engaged in "ordinary responses to extraordinary events." Seller argued that its hotel closures and reduced operations were ordinary course responses to the COVID-19 pandemic. The court rejected this interpretation and agreed with Buyer that "ordinary course of business" involved comparing how the business routinely operated under normal circumstances, without regard to any extraordinary event, such as the COVID-19 pandemic.

The court also considered the meaning of the words "only in the ordinary course of business consistent with past practice." The court noted that there are two potential reference points for determining whether the company has operated in the ordinary course: (i) how the company has operated in the past, and (ii) how comparable companies operate. Here, the wording "only" and "consistent with past practice" meant that the court should just consider the former.

The court rejected Seller's argument that the interim operating covenant imposed only an obligation to use commercially reasonable efforts, as opposed to an absolute and unqualified contractual obligation. The court held that breach of contract under common law is based on strict liability, but this can be modified by efforts-based language in the contract. The court held that there was no such language applicable here, even though efforts-based language appeared elsewhere in the contract.

Seller argued that the interim operating covenant incorporated a material adverse effect (MAE) overlay. Elsewhere in its opinion, the court held that pandemics were the kind of systematic risk that fit within the MAE carve-out for "calamities." Therefore, an MAE overlay to the interim operating covenant would mean that the covenant had not been breached. Seller argued that a contrary interpretation would negate the risk allocation under the Agreement. Rejecting this argument, the court held that the interim operating covenant could have included language providing for an MAE overlay, but did not.

The court held that Seller breached the interim operating covenant because "[o]verwhelming evidence demonstrates that Strategic departed form the normal and customary routine of its business as established by past practice. In response to the COVID-19 pandemic, Strategic closed two of the hotels entirely and limited operations at the other thirteen severely."

Seller argued that there was no breach because Seller was contractually obligated to depart from ordinary course operations, given its representations that operations were in compliance with law. The court noted the public policy considerations and associated Delaware law that does not permit a court to enforce a contract prohibited by law. Rejecting Seller's argument, the court noted that a contractual condition operates differently from a covenant. It allocates the risk associated with operating outside the ordinary course to Seller, but does not force anyone to violate law. The court noted that had Seller argued that Strategic deviated from operating in the ordinary course because it was required to do so by government order, and that discharged its obligation to operate in the ordinary course in all material respects, and thus satisfied the condition, that would have been a credible argument. However, Seller did not describe any such government orders or otherwise prove any such illegality. The court noted that many of the changes in Strategic's business were implemented before states imposed stay-at-home orders, and there was also no evidence that stay-at-home orders required hotels to close.

The court also rejected Seller's argument that no breach occurred because Seller could deviate from the interim operating covenant with Buyer's consent, which "shall not be unreasonably withheld," and so had Seller requested consent, Buyer would have had to have given it. While the court's rejection was based on Seller having merely raised the argument in a footnote and not have properly briefed it, the court made clear its skepticism that such an argument was legally supportable.

Takeaways

Before this decision, most deal practitioners assumed that the pandemic was the type of systematic risk that would be picked up in the typical carve-outs form the MAE definition, so the court's confirmation of that is unsurprising. But many practitioners did not also focus on the need to carve out the pandemic-related business changes from the interim operating covenants. This decision makes clear that sellers who want to shift the pandemic risk (or other systematic risk) to buyers need to include language to that effect in the purchase agreement.

The decision also contains an important reminder of the pro-contractarian nature of Delaware law, and that if an agreement provides for notice in order to trigger certain consequences under the agreement, the notice provisions are not immaterial formalities and need to be complied with.

Ashland LLC v. The Samuel J. Heyman 1981 Continuing Trust for Lazarus S. Heyman, C.A. No. N15C-10-176 EMD CCLD (Del. Super. Nov. 10, 2020)

Summary

Buyer was not entitled to legal fees and costs in direct indemnity claim, despite customary "Losses" definition that included attorneys' fees "whether or not involving a Third Party Claim", because indemnification language was held not to evidence a clear and unequivocal intent to override the "American Rule" that each party pay its own legal fees.

Background

The *Ashland LLC* case involved motions for summary judgment in an action in the Superior Court of Delaware stemming from an indemnity claim brought by Ashland LLC, et al. (Ashland) in connection with its acquisition of

International Specialty Products Inc. and affiliated entities from The Samuel J. Heyman 1981 Continuing Trust for Lazarus S. Heyman, et al. (Heyman). In a prior decision, the court held Heyman liable for certain environmental liabilities under the stock purchase agreement governing the acquisition. The question before the court in the present case, was whether Ashland was entitled to be indemnified for the legal fees it incurred in connection with enforcing its indemnity rights.

The stock purchase agreement provided two bases for indemnification that applied, both covering indemnification for "Losses" actually suffered or incurred by Ashland and related parties. The stock purchase agreement defined "Losses" broadly as:

> ". . . with respect to any Indemnified Party, and all losses, liabilities, claims, obligations, judgments fines, settlement payments, award or damages of any kind actually suffered or incurred by such Indemnified Party after Closing (together with all reasonably incurred cash disbursements, costs and expenses, including costs of investigation, defense and appeal and reasonable attorneys' and consultants' fees and expenses), whether or not involving a Third Party Claim."

The stock purchase agreement, in turn, defined "Third Party Claim" as:

> ". . . any written claim or demand for which an indemnifying party (an "Indemnifying Party") may have liability to any Indemnified Party hereunder, other than those relating to Taxes . . . asserted against or sought to be collected from any Indemnified Party by a third party . . . ."

The Parties' Arguments

Ashland argued that it was entitled to attorneys' fees under the plain language of the stock purchase agreement, given that it was entitled to indemnification for "Losses", the definition of which included reasonable attorneys' fees.

Heyman argued that that the stock purchase agreement language was not sufficiently clear and unequivocal to evidence an intent by the parties to deviate from the "American Rule", pursuant to which each party pays its own legal fees whether or not it is the prevailing party. Heyman contrasted the indemnity language with language in the termination section of the stock purchase agreement, which contained express legal fee-shifting language. That section, which applied in the event that Heyman brought an action to recover a reverse termination fee, provided:

> "The parties acknowledge that the agreements contained in Section 8.2 are an integral part of the Transactions, and that, without these agreements, the parties would not enter into this Agreement; accordingly, if Buyer fails to promptly pay the amount due pursuant to Section 8.2(b), and, in order to obtain such payment, the Seller Parties commence a suit that results in a judgment against Buyer for the amount set forth in Section 8.2(b), *Buyer shall pay to the Seller Parties their costs and expenses (including attorneys' fees) in connection with such suit, together with interest on such amount or portion thereof at the Interest Rate in effect on the date such payment was required to be made through the date of payment*."

(emphasis added). According to Heyman, this clear and unequivocal legal fee-shifting language supported the conclusion that the less clear language in the indemnity provision was not intended to override the American Rule with respect to direct indemnity claims.[1]

[1] The court referred to direct indemnity claims as "first party claims."

The Court's Decision

The court held that indemnification provisions "are presumed not to require reimbursement for legal fees incurred as a result of substantive litigation between . . . parties to an agreement absent a clear and unequivocal articulation of that intent."[2] The court held that while no specific language has to be used, in order for a party to be entitled to attorneys' fees under an indemnification provision there must be specific language covering fee shifting. According to the court, "the parties must have intended clearly and unequivocally to overcome the presumption against fee-shifting under the American Rule."

The court held that the stock purchase agreement did not evidence any such clear and unequivocal intent. The court noted that the definition of "Losses" provided for attorneys' fees "whether or not involving a Third Party Claim." The court then considered the definition of "Third Party Claim", and held that it had a specified meaning involving a written demand against an indemnified party, and should not be interpreted generically as any claim of a third party. As a result, the court reasoned, the language "whether or not involving a Third Party Claim" does not clearly and unequivocally indicate that attorneys' fees are available in direct claims. The court found support in a Court of Chancery decision that involved similar language.[3] The court also held that the explicit fee shifting language in the termination section, noted above, created a negative inference that the absence of such language in the indemnity section indicated that fee shifting was not intended for direct claims.

Takeaways

The language used by the parties was similar to that commonly found in acquisition agreements. Indemnity sections are typically drafted from the perspective that claims are either direct claims or third party claims, and thus the phrase providing for reasonable attorneys' fees "whether or not involving a third party claim" can logically be assumed to mean that reasonable attorneys' fees are available for both third party indemnity claims and direct indemnity claims. In light of the Ashland decision and the precedent it invokes, buyers would be well advised to avoid such an approach. Instead, buyers should include language that expressly references direct claims, such as the following: "with respect to any indemnification claim hereunder (including for the avoidance of doubt any Direct Claim or any Third Party Claim)." Appropriate definitions for "Direct Claim" and "Third Party Claim" could be included elsewhere.

Quarum v. Mitchell Int'l, Inc., C.A. No.: N19C-03-087 AML CCLD (Del. Super. Jan. 21, 2020)

Post-closing earnout covenant requiring buyer to avoid taking action that would be reasonably likely to materially reduce the earnout payment could only be breached by positive action and not inaction.

Background

The *Quarum* case involved a motion to dismiss a claim in the Superior Court of Delaware brought by Dr. Merrit Quarum (Dr. Quarum), in his capacity as sellers' representative, for breach of an earnout agreement in connection with Mitchell International, Inc's (Mitchell) acquisition of QMedtrix Systems, Inc. (QMedtrix). QMedtrix developed streamlined review and approval processes for physicians' reimbursement claims with

[2] Citing *TranSched Sys. Ltd. v. Versys Transit Sols., LLC*, C.A. No. 07C-08-286 WCC, 2012 WL 1415466, at *2 (Del. Super. Mar. 29, 2012).
[3] *See Nasdi Holdings, LLC v. N. Am. Leasing, Inc.*, No. 2017-03999-KSJM, 2020 WL 1865747, at *6 (Del. Ch. Apr. 13, 2020).

insurance companies related to workers compensation and automobile insurance claims (the Solutions). The acquisition of QMedtrix was governed by a stock purchase agreement and an earnout agreement, which provided for additional consideration based on sales of the Solutions to Mitchell's customers during the first two years after the closing.

One of the questions before the court was whether Dr. Quarum had sufficiently alleged breach of Section 6(a) of the earnout agreement, which read as follows:

> "The Sellers acknowledge and agree that [Mitchell], as the ultimate owner of [QMedtrix] from Closing, has the power to direct the management, strategy and decisions of [QMedtrix]. Notwithstanding the foregoing, [Mitchell] agrees it will, and it will cause [QMedtrix] to and its affiliates to, act in good faith and in a commercially reasonable manner to avoid taking actions that would reasonably be expected to materially reduce the Contingent Payment Amounts or otherwise materially impede or delay the calculation of Revenue and Net Margin in accordance with Appendix B[.]"

In support of its motion to dismiss, Mitchell argued in relevant part that Section 6(a) was a negative covenant, and Dr. Quarum had not pleaded any affirmative action by Mitchell that would breach it. Dr. Quarum argued in relevant part that the second sentence of Section 6(a) constituted an affirmative covenant that was breached by Mitchell having failed to act in good faith and use commercially reasonable efforts to promote the solution.

The Court's Decision

Acknowledging the distinction between affirmative and negative covenants, the court held that liability from a negative covenant only arises from action, and that an allegation that the contracting party failed to do things does not state a breach of a negative covenant.[4] The court held that, by its plain meaning, Section 6(a) contained a negative covenant. The court reasoned that avoiding taking an action is the same as not taking an action, and Dr. Quarum's attempt to differentiate the two, and position Section 6(a) as a positive covenant, was convoluted.

The court held that Section 6(a) allocated to Mitchell the sole authority to direct the management and strategy of QMedtrix, with the caveat that Mitchell had to "act in good faith and in a commercially reasonable manner to avoid taking actions that materially would reduce the earnout amount." The court noted that avoiding action is different from avoiding inaction.

The court held that "Dr. Quarum's reading of the contract would swallow Section 6(a)'s first sentence and effectively place the power to manage the company in his own hands." The court noted that the earnout agreement contained other affirmative covenants, and if the parties had wanted Section 6(a) to set forth an affirmative covenant they could have drafted it that way.

Accordingly, the court only sustained those parts of Dr. Quarum's claim concerning prohibited actions by Mitchell (e.g., sabotaging marketing efforts, improperly applying threshholds and baselines in billing, and diverting customers), but dismissed those parts based on alleged business decisions, strategies and actions that Mitchell did not pursue (e.g., failing to consult on marketing and promotion matters, failing to involve Dr. Quarum in customer presentations and failing to provide information that would enable Dr. Quarum to promote the solutions to Michell's customers).

[4] Citing *All. Data Sys. Corp. v. Blackstone Cap. Partners V L.P.*, 963 A.2d 746, 766 (Del. Ch. 2009).

Takeaways

This decision illustrates a classic challenge for parties when drafting earnout covenants. Buyers will typically want to make clear that they have ultimate control in running the acquired business, and will often agree to act in good faith and refrain from taking action that is intended, or reasonably likely, to reduce the earnout payment, but resist affirmative covenants. Sellers, on the other hand, typically try to include as many affirmative obligations on buyers as possible, sometimes including a covenant that buyers will take action to maximize the earnout payment (although that is very rarely agreed to). Here, sellers tried to take the position that a covenant "to avoid taking actions that would reasonably be expected to materially reduce" the earnout payment was effectively the same as a covenant "to take all action that, if not taken, would reasonably be expected to materially reduce" the earnout payment. The court made clear the two are not the same. Accordingly, when drafting earnout covenants, buyers and sellers should be mindful that courts will not interpret negative covenants like positive covenants.

MTA Canada Royalty Corp. v. Compania Minera Pangea, S.A. de C.V., C.A. No. N19C-11-228 AML CCLD (Del. Super. Ct. Sept. 16, 2020)

Summary

The right to a contingent payment under a purchase agreement was lost due to the seller having completed the functional equivalent of a forward merger, which resulted in a transfer of the right in violation of a prohibition on assignments in the purchase agreement.

Background

This decision involved a motion to dismiss a claim for a $1 million conditional payment in connection with the sale by 1570926 Alberta Ltd. (Seller), to Compania Minera Pangea, S.A. de C.V. (Buyer) of certain mineral rights in a mine. The conditional payment under the Assignment and Assumption Agreement (the Purchase Agreement) was due on June 30, 2018, if the mine continued to operate on that date. On July 1, 2017, Seller entered into an amalgamation transaction with Alberta Royalty Corp. (Global), in which Global survived and changed its name to MTA Canada Royalty Corp. (MTA). Buyer sought to dismiss the action for the conditional payment on the basis that MTA lacked standing to bring it because the amalgamation, in which MTA purportedly acquired the right to the conditional payment, constituted an assignment in violation of a prohibition on assignments in the Purchase Agreement.

The assignment prohibition in the Purchase Agreement provided in relevant part as follows:

> “Neither this Agreement nor any of the rights, interests or obligations under this Agreement may be assigned or delegated, in whole or in part, by operation of law or otherwise, by [Seller] without the prior written consent of each other party, and any such assignment without such prior written consent shall be null and void.”

The court held that under Delaware law, unambiguous language in assignment clauses referencing transfers “by operation of law” is commonly understood to apply to mergers in which the contracting party does not survive. If parties want to avoid that result, they can structure the transaction as a reverse triangular merger or other transaction in which the contracting entity retains its corporate existence. Here, Buyer and Seller did not do that. The court held that the assignment language in the Purchase Agreement was unambiguous, and accordingly granted Buyer's motion to dismiss.

Takeaways

The decision provides a cautionary note to both buyers and sellers to consider anti-assignment provisions in purchase agreements when doing post acquisition entity consolidation. This decision involved the loss of a contingent payment. Other rights could also be lost, such as rights to purchase price adjustments, or under indemnity provisions.

Skye Mineral Investors, LLC v. DXS Capital (US) Limited (Feb. 24, 2020).

Summary

Minority investors' use of blocking rights in ways that amount to actual control and intentionally harm the investors' company can lead to a finding of breach of fiduciary duties by such minority investors.

Background

The *Sky Mineral Investors* case involved a motion to dismiss in an action in the Delaware Court of Chancery in which plaintiffs and majority members Skye Mineral Investors, LLC and Clarity Copper, LLC, directly and derivatively on behalf of Skye Mineral Partners, LLC (SMP), alleged, among other things, that the minority members of SMP breached their fiduciary duty by orchestrating a scheme to divest SMP wrongfully of its sole operating subsidiary. As alleged by the plaintiffs, a critical part of that scheme was the minority members' repeated exercise of their contractual approval rights over new financings to veto all additional capital raising opportunities, intentionally pushing SMP's operating subsidiary into a bankruptcy sale process in which affiliates of the minority members acquired the subsidiary's assets at a steep discount.

DSX Capital (US) Limited and PacNet Capital (US) Limited (together, the Minority Members) held a 28% ownership interest in SMP, with the plaintiffs holding the remaining membership interests. In 2014, SMP's wholly-owned operating subsidiary, CS Mining, LLC (CSM), entered into a senior secured financing with Noble Americas Corp. (Noble) to finance a capital project to develop CSM's mineral deposits. SMP's LLC Agreement vested the Minority Members with certain approval rights, including over any debt or equity financings at the company.

The plaintiffs alleged that the Minority Member's designee on SMP's board of managers learned in his capacity as a manager that the mineral deposit assets of CSM were considerably more valuable than previously believed. Instead of disclosing this to the other managers, he allegedly informed the Minority Members and their affiliates, whereupon the defendants allegedly devised a scheme to deprive SMP of its sole asset at a deep discount. The plaintiffs alleged that the defendants decided to starve SMP of capital by vetoing all financing opportunities and cause CSM to burn through remaining funds and increase its obligations under the Noble debt. After CSM defaulted on the Noble debt, an affiliate of the Minority Members acquired the Noble debt at a discount, pushed CSM into bankruptcy and acquired its assets in the ensuing bankruptcy sale for pennies on the dollar.

Plaintiffs brought suit against the Minority Members, their designee on the SMP board of managers, and various other entities and individuals for, among other things, breach of contract, breach of the implied covenant of good faith and fair dealing and breach of fiduciary duty.

The Court's Decision Regarding the Minority Members' Fiduciary Duties

The court examined whether the Minority Members could be found to have fiduciary duties to SMP, notwithstanding their minority ownership position in the company. The court rejected the Minority Members' claim that, under SMP's LLC Agreement, they owed no fiduciary duties to the company and its other members. The court found that while SMP's LLC agreement eliminated any obligation for the Minority Members to present corporate opportunities to the company or its members, the LLC agreement did not clearly and unambiguously eliminate or restrict their fiduciary duties in any other respect. In fact, the court noted that the LLC agreement adopted the same fiduciary principles that apply to Delaware corporations. The court also rejected the defendant's contention that the LLC Agreement's express language allowing the Minority Members to exercise their approval rights in their "sole and absolute discretion" effectively waived any fiduciary duty with respect to such determinations. The court found that only a clear and express disclaimer of fiduciary duty would produce that result, and that the right to make decisions in one's sole and absolute discretion wasn't sufficient to do so.

The court agreed with the plaintiffs that if the Minority Members exercised their approval rights to effectively wield control over the company, they could be found to be controllers subject to fiduciary duties to the company. Importantly, the fact that the Minority Members had veto power was not sufficient in this regard; they had to have actual control over SMP. The court held that if the Minority Members participated in a concerted effort to place SMP in an unstable financial condition and then used their approval rights in a manner that "amounted to a self-destruct button" by vetoing all proposed financings and pushing CSM into bankruptcy for their personal gain, they could be found to be controllers with fiduciary duties and to have breached those duties. As the court stated, the Minority Members' approval rights could reasonably be seen as "an on/off switch for SMP that could be, and allegedly was, manipulated by [the Minority Members] to serve their interests at the expense of SMP."

The court also refused to dismiss fiduciary duty claims against the Minority Members' designee on SMP's board of managers, claims concerning both aiding and abetting, conspiracy, and tortious interference allegations against individuals and entities affiliated with the Minority Members, including parent entities and the purchaser in the bankruptcy sale, and claims for breach of confidentiality obligations in SMP's LLC agreement in connection with the improper sharing of information relating to the value of CSM's assets.

Key Takeaways

The Skye Mineral Investors decision raises three critical points for principals and attorneys involved in minority investor situations.

First, minority investors can, through the exercise of their approval rights, make themselves fiduciaries of the company, even when the majority investor(s) otherwise have the levers of control over the company. While having contractual approval rights does not in and of itself make a minority investor a fiduciary of the company, if a minority investor exercises those rights in a manner that effects actual control—in this case by allegedly vetoing every financing opportunity that would have provided necessary capital to the company—the minority investor could be a controller vested with fiduciary duties to the company and its other investors. And if it is using that control in order to gain personally at the expense of the company, it could be found to breach those duties.

Second, the court's ruling regarding minority investor fiduciary duties applies equally to corporations as well as limited liability companies. SMP's LLC Agreement expressly adopted the fiduciary framework applicable to Delaware corporations, which the court then applied in its analysis. As such, venture investors, who are routinely granted protective approval rights in companies they invest in, should be aware that how they exercise those rights could vest them with fiduciary duties to the company and other investors, leading to increased exposure from other investors and shareholders.

Third, for practitioners engaged in drafting operating agreements for limited liability companies, a key takeaway is the necessity of clear and unambiguous language in the operating agreement if the drafters intend to modify background fiduciary principles in any respect. Courts will read any purported modifications narrowly. For example, "sole discretion" approval standards will not implicitly waive fiduciary obligations with respect to the decision at issue. The operating agreement must expressly waive or modify those fiduciary duties in order to be effective.

Stream TV Networks, Inc. v. SeeCubic, Inc., C.A. No. CV 2020-0310-JTL (Del. Ch. Dec. 8, 2020)

Summary

In ruling on competing motions for preliminary injunction in a dispute between a family that controlled a financially distressed corporation and an entity controlled by secured lenders to which the assets of the financially distressed corporation were transferred, the Delaware Court of Chancery provided useful guidance on corporate law issues, including regarding the valid appointment of directors and the inapplicability of DGCL §271 to failing businesses.

Background

Stream TV Networks v. SeeCubic, Inc. involved competing motions for preliminary injunction, both of which turned on the validity of an agreement among Stream, its two secured lenders, and fifty-two of its stockholders (the Equity Investors). This agreement, which provided for a restructuring of Stream in which its assets would be transferred to a newly formed entity, SeeCubic, under the control of Stream's secured lenders, was referred to as the "Omnibus Agreement."

The Rajan family—brothers Mathu and Raja—controlled Stream and served as officers and directors of the company. Stream was heavily indebted to two secured lenders, which held security interests on all of Stream's assets. When Stream became financially distressed, and after earlier restructuring discussions had failed, the Rajan brothers invited four independent, outside directors to join the board: Krzystof Kabacinski, Asaf Gola, Kevin Gollop, and Frank Hodgson (collectively, the Outside Directors). Each of the Outside Directors accepted their offer. From March through May 2020, the Outside Directors participated in Board meetings, voted on resolutions, and approved minutes and other corporate actions. The Rajan brothers and Stream employees referred to them as "directors" and "members of the Board" and held them out as such to third parties.

At a May 4, 2020, Board Meeting, the Board voted on and passed three resolutions, one of which is significant to this case. Under this resolution, the Board created a Resolution Committee that would have:

> the full power and authority of the full Board of Directors to resolve an existing or future debt defaults or claims, and any existing or future litigation, or threats thereof, on behalf of [Stream],

without further action being required from the Board of Directors or any executive of the [C]ompany.[5]

Two of the independent directors, Asaf Gola and Kevin Gollop, would serve as the committee's members.

Soon after the creation of the Resolution Committee, two things happened. First, on May 6, 2020, the Resolution Committee approved the Omnibus Agreement. Some of the parties to the agreement signed on that date and others signed later. The Omnibus Agreement provided that: (1) the secured lenders would not foreclose on Stream's assets and they would accept delivery of Stream's assets in satisfaction of their debts; (2) the assets would be transferred to a newly formed entity, SeeCubic, controlled by the secured lenders; and (3) upon transfer of the assets, the secured lenders would extinguish the secured promissory notes they held.

Second, the Rajan brothers took actions in an attempt to undermine the validity of the committee. The brothers drafted and circulated a written consent of stockholders to remove the Outside Directors (the May Stockholder Consent) and notified the Outside Directors of their removal on May 9 and May 11. Despite the claim by Stream and the Rajan brothers that the May Stockholder Consent was executed prior to the committee approval of the Omnibus Agreement, the evidence showed that the May Stockholder Consent was signed, at the earliest, on the evening of May 8, and was then backdated to May 6 in an effort to nullify the Omnibus Agreement. The Rajan brothers also tried taking the position that Outside Directors had never actually assumed their positions on the board because they had not formally accepted their offers to join the bord through signing a "Director Services Agreement."

Stream filed this litigation on September 8, 2020, and moved for a temporary restraining order to bar SeeCubic from seeking to enforce the Omnibus Agreement. In response, SeeCubic filed counterclaims and third-party claims and moved for a temporary restraining order preventing Stream or any third-party defendants from taking action to interfere with the Omnibus Agreement.

The Court's Decision

The court ultimately denied Stream's motion for a preliminary injunction and granted SeeCubic's motion. This outcome turned on the validity of the Omnibus Agreement, which the court found to be valid.

Authority of the Resolution Committee

Stream first argued that the Omnibus Agreement was invalid because the Resolution Committee did not have authority to bind Stream to the agreement. In support, Stream asserted that the Outside Directors were not validly appointed, and even if they were, the May Stockholder Consent removed the Outside Directors before they approved the Omnibus Agreement. In rejecting these arguments, and holding that the new directors were validly appointed and authorized the Omnibus Agreement before the effective date of the May Stockholder Consent purporting to remove them, the court discussed a number of issues.

Valid Appointment of Directors

The court held that the Outside Directors were validly appointed by the Rajan brothers, who were then Stream's sole directors, pursuant to a unanimous written consent that increased the board size from two to six, and then filled the vacancies with the Outside Directors. In dicta, the court discussed that this outcome could have become "more complicated" if the Rajan brothers had instead filled three vacant seats on a five-member board. Under this alternative scenario, the Rajan brothers' ability to act would be limited: they would not have

[5] *Stream TV Networks, Inc. v. SeeCubic, Inc.*, C.A. No. CV 2020-0310-JTL, 2020 WL 7230419, at *5 (Del. Ch. Dec. 8, 2020) (citing Dkt. 101 Ex. 56 at 1057).

the power to act unanimously by written consent or take action at a meeting because they would not satisfy the majority quorum requirement. Although they could have filled the three vacant seats, they could not have validly appointed all four of the Outside Directors to the board because they lacked the power to enlarge the size of the board, given the inability to satisfy the quorum requirement. Moreover, they could not have enlarged the board in their capacities as stockholders, because under the charter, only the board had the power to change the size of the board. They could not have amended the charter because that would have required board action, which was impossible without a quorum. The court noted that, under this same scenario, the Rajan brothers could have still achieved their desired outcome by filling at least one of the vacancies so that they could satisfy the quorum requirement and then acting with the newly appointed director(s) to enlarge the board.

Stream claimed that the board appointments were not effective because the Outside Directors were only appointed as "Interim Directors", and because they did not satisfy certain conditions to their becoming directors. Rejecting these arguments, the court held that the role of "Interim Directors" was not recognized under Delaware law or Stream's constitutive documents. The court posited that such a role could perhaps be accomplished under Section 141(d) of the Delaware General Corporation Law (DGCL), dealing with classified boards, but Stream's charter did not contain any such language.

The court also held that under DGCL §141(b), any director qualifications must appear in the certificate of incorporation or the bylaws. Even if Stream's charter and bylaws had contained such provisions, the provisions must be reasonable. Here, both the offer letter and the Director Services Agreement sent to the Outside Directors were deemed "unreasonable." The offer letter had two key flaws: (1) it provided for a three-year term when the board was not classified and thus all directors served for one-year terms and (2) it purported to allow both parties to the contract to "renew", which is contrary to the way directors are appointed or remain on the board under Delaware law. Under Delaware law, a director holds office until the director's successor is elected and qualified, or the director earlier resigns or is removed. Directors are either elected by stockholders or appointed by the board to fill a vacancy. But, contrary to the approach in the offer letter, corporations don't elect or appoint their own directors. The Director Services Agreement proved no better. The Director Services Agreement purported to impose on the directors a contractual confidentiality obligation and other mandatory obligations to support Stream (the Contractual Obligations). The directors' fiduciary duties rendered the Contractual Obligations redundant and ineffective. Imposing the Contractual Obligations was redundant because a director's fiduciary duties already encompass these obligations. The contractual obligations were also ineffective: making a disclosure may, at times, be in the corporation's best interest and thus align with the director's fiduciary duties. Relatedly, contractually requiring certain obligations may require a director to act in direct contrast to what the director believes to be in the best interest of the corporation. This redundancy and ineffectiveness led the court to deem the offer letter and Director's Services Agreement unreasonable.

De Facto Directors

The court held that even if the Outsider Directors were not validly appointed, the court would have concluded that the Outside Directors were *de facto* directors. Stream and the Rajan brothers treated the Outside Directors as directors and held them out as such to third parties. The Outside Directors performed the duties of directors, including attending eight board meetings during which they were asked to vote on corporate actions. As de facto directors, their acts would have been valid and binding on the corporation for purposes of its interactions with third parties. Consequently, the Omnibus Agreement would have been valid and binding on Stream.

No Stockholder Approval Required under DGCL §271 or Charter

Stream next argued that the Omnibus Agreement required stockholder approval, and since it did not receive that approval, the Omnibus Agreement was ineffective. In support of this, Stream directed the court's attention to Section 271 of the DGCL and the class vote provision of the company's charter.

DGCL §271

Stream argued that the transaction constituted a sale of all or substantially all of Stream's assets that triggered the stockholder approval requirements under DGCL §271. Rejecting this argument, the court first looked at the history of DGCL §271 and held that it retained the "failing business" exception to the common law prohibition on the sale of all of a corporation's property without unanimous stockholder approval. The court also considered the 1967 revisions to the DGCL, which added DGCL §272 in order to clarify that the mortgage or pledge of a corporation's assets does not require stockholder approval, unless provided for in the charter. The court reasoned that it would not make sense to require stockholder approval to foreclose on such arrangements because it would give stockholders leverage against creditors and undermine the value of the security arrangement. The court also noted that while DGCL §271 had evolved over time with respect to the type of consideration that was permissible under the rule, the amendments never included forgiveness of indebtedness. Accordingly, transfers of assets in consideration for forgiveness of secured loans should not fall within DGCL §271.

Class Vote under Charter

Stream claimed that the Omnibus Agreement required approval of the Class B Voting Stock pursuant to a class voting provision under Stream's charter that applied to asset transfers. The court noted that the language in the class voting provision closely tracked DGCL §271. Accordingly, the court held that it should be interpreted consistently with DGCL §271, and therefore was not triggered by the transactions at issue.

Takeaways

This decision provides useful reminders and guidance on the following corporate law matters.

- **"Failing Business" Exception to DGCL §271**. While DGCL §271 requires stockholder approval for the sale of all or substantially all of a corporation's assets, there is an unwritten "failing business" exception. In addition, and consistent with that, DGCL §271 does not apply in the context of the mortgage or pledge of a corporation's assets, or the transfer of assets in connection with the foreclosure on those security interests.
- **Interim Directors.** Delaware law does not generally recognize the concept of "interim directors". Note that the court did not rule out the possibility that an interim director could be validly created through a classified board structure.
- **Imposing Director Qualifications**. Director qualifications must appear in the corporation's charter or bylaws. Additionally, these qualifications must be reasonable. Imposing redundant or ineffective obligations may render such qualifications unreasonable.
- **Authority of De Facto Directors**. Actions of de facto directors are valid and will bind a corporation for purposes of its interactions with third parties.
- **Board Quorums.** Directors cannot take action, whether at a meeting or through unanimous written consent, without there existing a quorum of the board. The one exception is that directors can fill vacancies without there being a board quorum. This serves as a reminder for boards to monitor the relationship between the number of vacancies on the board and the authorized number of directors.

In re Anthem-Cigna Merger Litigation, C.A. No. 2017-0114-JTL (Del. Ch. Aug. 31, 2020)

Summary

Another example of a merger-of-equals-type deal falling apart over social issues, and a few drafting tips along the way.

Background

In re Anthem-Cigna Merger Litigation arose from the ill-fated attempt of Anthem, Inc. (Anthem) and Cigna Corporation (Cigna) to merge. In an opinion spanning more than 300 pages, the Delaware Court of Chancery paints a colorful picture of a contentious years-long battle between the health insurer giants which resulted in a sprawling record and billions of dollars in damages claims.

The Merger Agreement

Anthem and Cigna entered into a merger agreement in July 2015, pursuant to which Anthem agreed to acquire Cigna for more than $54 billion, reflecting a 38.4% premium over Cigna's unaffected market capitalization. The merger agreement contained the following pre-closing covenants (the Efforts Covenants):

- a "Reasonable Best Efforts Covenant" that obligated the parties to use their reasonable best efforts to satisfy all closing conditions and consummate the merger;
- a "Regulatory Efforts Covenant" which required the parties to take any and all actions necessary to avoid legal impediment to the merger raised by a governmental entity;
- a "Regulatory Cooperation Covenant" which obligated the parties to cooperate in certain ways with respect to regulatory approval, and gave Anthem the lead in communicating with regulators;

The merger agreement also contained several closing conditions, including a condition regarding the absence of any injunction or legal restraint from a governmental entity that would prevent consummation of the merger (the No Injunction Condition). As the second and third largest health insurers in the United States at the time, the parties knew that they would face regulatory scrutiny and anticipated a lengthy regulatory review process.

The merger agreement provided that in the event of termination of the agreement, neither party would be liable for damages except in the case of fraud or Willful Breach of the merger agreement. "Willful Breach" was defined as "a material breach of [the merger agreement] that is the consequence of an act or omission by a party with the actual knowledge that the taking of such act or failure to take such action would be a material breach of [the merger agreement]." In addition, the agreement required Anthem to pay Cigna a reverse termination fee (RTF Fee) of $1.850 billion in certain limited instances.

Case History

The United States Department of Justice (DOJ) sued to block the merger in July of 2016. The DOJ had concluded that the merger would have anticompetitive effects. In February 2017, the United States District Court for the District of Columbia (District Court) issued a permanent injunction, preventing the deal from closing. While Anthem's appeal of that decision was pending, Cigna delivered notice that it was terminating the merger agreement on the basis that the transaction had not closed by the original termination date. Simultaneously, Cigna filed suit seeking a declaratory judgment that it could terminate the merger agreement, recover the RTF Fee and obtain damages for breach of contract. Later that day, Anthem filed suit seeking a temporary restraining order that would block Cigna from terminating the merger agreement, so that Anthem could continue the appeal of the District Court decision. The Delaware Court of Chancery granted a temporary restraining order to preserve Anthem's appeal right. In April 2017, the United States Court of Appeals for the District of Columbia Circuit (DC Circuit Court) affirmed the District Court's entry of a permanent injunction. Thereafter, the Delaware Court of Chancery denied Anthem's request to convert the temporary restraining order into a preliminary injunction, but stayed its ruling to enable Anthem to appeal to the Delaware Supreme Court. Anthem elected not to appeal, sent Cigna notice of termination of the merger agreement, and filed suit for breach of contract. Later that day, Cigna delivered a second termination notice to Anthem. Cigna's and Anthem's Delaware lawsuits were ultimately consolidated.

Each party claimed that its counterparty had breached the Efforts Covenants. Anthem sought expectation damages of $21.1 billion. Cigna sough expectation damages of $14.7 billion, plus recovery of an RTF Fee of $1.85 billion.

The Court's Decision

Cigna's Breach

The court found that after signing the merger agreement, when it became clear that the Cigna executive leadership team (the Cigna ELT) would not have the senior leadership roles in the combined entity that they sought, the Cigna ELT engaged in a number of efforts to derail the deal. The Court held that Anthem satisfied its burden of proving that Cigna breached the Efforts Covenant by engaging in conduct that fell into five categories: (1) conducting a covert communications campaign against the merger, (2) withdrawing from integration planning, (3) opposing a divestiture, (4) resisting mediation during the antitrust litigation, and (5) undermining Anthem's defense in the DOJ investigation and subsequent litigation in a manner that was "so obvious that the District Court described it as the 'elephant in the courtroom.'"

Despite the fact that Anthem proved Cigna breached the Efforts Covenants, the court determined that Anthem was not entitled to a damages award. The court reasoned that even if Cigna had complied with its obligations under the Efforts Covenants, the DOJ would still have successfully sued to enjoin the merger, and the No Injunction Condition would have prevented the merger from closing.

Anthem's Breach

The court rejected Cigna's allegations that Anthem breached the Regulatory Efforts Covenant by failing to take sufficient action to change rules of the association that owns the Blue Cross and Blue Shield trademarks, which were an impediment to the deal, and by omitting certain synergies from its white paper submitted to the DOJ. Regarding the former, the court held that Anthem selected a viable strategy and pursued it in a logical way, and thus fulfilled its obligations under the Regulatory Efforts Covenant. Regarding the white paper, the court held that it did not give rise to a breach because the alleged synergies were based on unverifiable data.

The court further held that even if Cigna had succeeded in showing that Anthem breached the Regulatory Efforts Covenant, Cigna would not have been entitled to recover damages because the breach would not have constituted a "Willful Breach." The court noted that this defined term required actual knowledge that the taking of the action would be a material breach. The court contrasted this with the common law standard for willful breach, discussed in *Hexion Spec. Chems., Inc. v. Huntsman Corp.*[6], that simply requires knowingly taking action that results in a breach, as opposed to knowledge that the action would constitute a breach. The court

[6] 965 A.2d 715 (Del. Ch. 2008)

held that Cigna failed to show "Willful Breach" by Anthem because the record indicated that Anthem acted at all times with the belief that it was complying with the merger agreement.

The court also considered Cigna's claim that Anthem was liable for an RTF Fee. Generally stated, the RTF Fee was due following termination on either of two bases. The first basis for termination was, subject to exceptions, where the No Injunction Condition was not satisfied and the associated legal restraint had become final and nonappealable. The second basis for termination was, subject to exceptions, where the merger hadn't closed by the drop dead date, and the terminating party's conduct did not proximately cause the merger to close by that date. In light of various interpretive issues, whether the RTF Fee was due turned on whether Cigna validly terminated the merger agreement on this second basis. The court held that Cigna's first termination notice was ineffective because the drop dead date had not passed. The court held that Cigna's second termination notice was ineffective because it was delivered after Anthem had delivered its termination notice.

Takeaways

- The factual background of the case reads like a merger of equals that failed for social reasons. Even though Anthem was paying a significant premium, Cigna appears to have treated the transaction like a merger of equals and balked when it realized that Anthem was behaving like an acquiror. In that sense, one takeaway is that while mergers of equals are difficult to complete, they can be even more difficult when faced with significant regulatory challenges.

- The decision provided a reminder of the potential significance of the "willful breach" definition, which came into focus in the *Hexion* decision. Since that case, many practitioners have used a definition that requires proof that the breaching party knew that the action taken would constitute a breach of the merger agreement. That establishes a high burden and proof, which Cigna fell well short of meeting.

- The decision is another cautionary tale of drafting that can create a race to terminate. Cigna's inability to collect a reverse termination fee turned on the fact that Anthem terminated hours before Cigna did. Anthem winning the race to terminate may have saved it $1.85 billion. A similar situation occurred in the 2019 *Vintage Rodeo* decision,[7] where the target company had an incentive to terminate the merger agreement before the acquiror delivered an extension notice, in order to collect a $126.5 million reverse termination fee. Acquirors should ensure that the interplay between reverse termination fee language and the termination provisions does not create such an incentive.

Agspring Holdco, LLC v. NGP X US Holdings, L.P., C.A. No. 2019-0567-AGB (Del. Ch. July 30, 2020)

Summary

Projections that are not corrected when it is clear they are overly optimistic can give rise to fraud claims against both management and controlling stockholders; controlling stockholders should be

[7] *Vintage Rodeo Parent, LLC v. Rent-a-Ctr., Inc.*, C.A. No. 2018-0927-SG, 2019 WL 1223026 (Del. Ch. Mar. 14, 2019). A summary of the decision is available at: https://www.arnoldporter.com/-/media/files/perspectives/publications/2020/02/significant-2019-decisions-affecting-private-compa.pdf?

mindful of fraud exposure based on representations of portfolio company management in agreements to which the controlling stockholders are not party.

Background

The decision involved a motion to dismiss a fraud action brought by American Infrastructure MLP Funds (AIM) and certain debt investors against the two most senior officers of Agspring, LLC (Agspring or the Company), and NGP X US Holdings, L.P. (NGP), a private equity fund that controlled Agspring, in connection with AIM's acquisition of Agspring for approximately $300 million. The acquisition closed in December 2015 pursuant to a Membership Interest Purchase and Contribution Agreement (the Purchase Agreement), to which NGP was one of the parties. The debt investors entered into a term loan agreement (the Loan Agreement) with Agspring as part of the financing for the transaction.

Prior to the Purchase Agreement's signing, Agspring's management twice notified AIM that, as a result of market conditions, Agspring would fall short of its EBITDA projections. As a result, AIM and NGP agreed to purchase price reductions. Following the purchase price adjustments the financial conditions of Agspring continued to deteriorate. In November 2015, Agspring's management again lowered their internal EBITDA projections. However, this time they did not inform AIM. In fact, through the closing date, Agspring's management sent financial information and models to AIM that omitted the reduced EBITDA forecast.

Following the consummation of the transaction, the two officers (who retained management positions with Agspring after closing), continued to report a positive financial outlook despite their contrary internal projections. Finally, at the end of Agspring's fiscal year in May 2016, Agspring reported EBITDA of $701,000, which was only "a tiny fraction of the $33 million in total EBITDA reflected in the forecast that Agspring provided to AIM" before the transaction closed.

The two officers immediately resigned from the company following the EBITDA announcement. Despite being told to preserve documents related to Agspring's business, one officer purged his work computer of all documents and company records.

Agspring continued to struggle financially and defaulted on its loans shortly thereafter, including on a pre-transaction term loan of $22 million (the Tubbs Note). As a result of these post-closing events, AIM decided to pursue legal action against NGP and the two officers for fraud.

The Court's Decision

The court first dispensed with defendants' claims that the plaintiffs' claims were barred under the three year statute of limitations, given that the action was filed more than three years after the acquisition closed. The court held that actions taken by the officers to conceal their fraud tolled the statute of limitations.

The court then considered plaintiffs' claims of fraud, which required allegations of "(i) a false representation, (ii) the defendant's knowledge of or belief in its falsity or the defendant's reckless indifference to its truth, (iii) the defendant's intention to induce action based on the representation, (iv) reasonable reliance by the plaintiff on the representation, and (v) causally related damages."[8] Plaintiffs based their fraud claims on representations made under the Purchase Agreement and the Loan Agreement.

Plaintiffs' fraud claims were based on three different representations under the Purchase Agreement. The court first considered plaintiff's fraud claims based on the material contracts representation in the Purchase Agreement. That representation was to the effect that "no event has occurred or circumstance exists that . . . may . . . result in a material violation or material breach of . . . any Material Contract." The court noted that it was undisputed that the Tubbs Note constituted a material contract. The court held that Agspring's deteriorating financial situation prior to closing was evidence of a situation that "put [Agspring] on a downward spiral that would cause a default of the Tubbs Note." In refusing to dismiss plaintiff's claim, the court distinguished case law cited by defendants in support of their argument that the material contracts representation could not give rise to an actionable fraud claim because it constitutes a prediction about the future.[9] According to the court, that case involved revenue projections which were not actionable because they were not knowable at the time. The representations here, however, was "rooted in Agspring's financial condition at the closing based on historical events . . . and were not only knowable, but allegedly known, at closing."

The court also refused to dismiss plaintiffs' claims based on the absence of changes representation in the Purchase Agreement, which provided that there had not been a Material Adverse Effect since May 31, 2015. The court held that the applicable standard at the pleadings stage was that the facts pled "support a reasonable inference that the misrepresentations 'could product consequences that are materially adverse to the Company.'"[10] Rejecting defendants' claims that plaintiffs were complaining about lower internal forecasts, which were carved out from the Material Adverse Effect definition, the court held that plaintiffs' arguments went to the causes underlying the failure to meet forecasts, which were not carved out. The court held that plaintiffs sufficiently plead facts regarding circumstances concerning the failure to meet forecasts in order to survive a motion to dismiss.

The court dismissed plaintiffs' claims that were based on the sufficiency of assets representation, on the basis that plaintiffs were basing their argument on an incorrect interpretation that the representation meant that the assets of the Company were sufficient to generate financial returns consistent with historic returns.

The court rejected NGP's contention that the pleadings did not sufficiently allege knowledge of NGP. In so doing, the court relied on factors such as NGP's 98% ownership of Agspring's membership interest, attendance at board meetings by NGPs designees, NGP's close involvement in, and understanding of the dynamics of, the sale process, NGP's constant communications with the two officers, and NGP having pushed management to close the deal.

The court then considered the fraud claims by certain of the plaintiffs based on representations under the Loan Agreement regarding the reasonableness of the projections and Agspring's solvency. The

[8] Quoting *Prairie Cap. III, L.P. v. Double E Holding. Corp.*, 132 A.3d 35, 49 (Del. Ch. 2015)
[9] *See Edinburgh Holdings, Inc.* v. *Educ. Affiliates, Inc.*, C.A. No. 2017–0500–JRS, 2018 WL 2727542, at *12 (Del. Ch. June 6, 2018).
[10] Quoting *EMSI Acq. Inc. v. Contrarian Funds, LLC*, No. CV 12648-VCS, 2017 WL 1732369, at *15 (Del. Ch. May 3, 2017), in turn quoting *Osram Sylvania Inc. v. Townsend Ventures, LLC*, No. CV 8123-VCP, 2013 WL 6199554, at *7-9 (Del. Ch. Nov. 19, 2013).

two officers did not challenge the sufficiency of the fraud pleadings based on the representations. NGP argued that NGP could not be liable on the basis of those representations because it was not a party to the Loan Agreement. The plaintiffs based their claims against NGP on theories of aiding and abetting, and conspiracy. The court held that the elements for aiding and abetting a fraud claim are: "(i) the underlying tortious conduct, (ii) knowledge, and (iii) substantial assistance." The court held that the first element was conceded, and the second element, regarding defendant's knowledge of something, just requires "well-pleaded facts from which it can reasonably be inferred that this something was knowable and that the defendant was in a position to know it."[11] The court held that the allegations in the complaint were more than sufficient to satisfy this element. Regarding the "substantial assistance" element, the court held that this required assistance or participation in aid of the unlawful acts. The court held:

> "[T]h Complaint alleges that NGP Board Members provided "specific feedback to improve the [Agspring's consolidated financial] statements," "encouraged Agspring "employees to add back amounts to EBITDA calculations," and advised Agspring "employees to modify financial documents that were later disclosed to investors so that the company would look more attractive to potential investors." The Complaint further alleges that NGP negotiated two price reductions directly with AIM during the sale process; "constantly communicated" with Clark and Linville during the sales process and gave them "significant heat" to "get the deal done;" and was contractually obligated to "provide advice and consultation" to Agspring concerning various subjects—including "mergers and acquisitions . . . and financing alternatives"—which, it is reasonable to infer, would have put NGP in the thick of the Company's negotiation strategy and tactics throughout the sale process.

The court held that this was sufficient to satisfy the substantial assistance element. The court held that these factors were also sufficient to support a claim for civil conspiracy against NGP.

Takeaways

Defendants tried to frame the key issue as failure to meet overly rosy projections delivered prior to signing. Such a claim would be vulnerable to dismissal for two reasons: first, the typical purchase agreement does not contain representations as to projections, and there is typically nonreliance language (as there was here) that disclaims reliance on representations outside the four corners of the purchase agreement. Second, as invoked by defendants here, predictions about the future will not typically give rise to fraud claims. However, the *Agspring* decision makes clear that projections, and the assumptions underlying them, can be used to show fraud based on other representations. In *Agspring*, the background surrounding the lowering of management numbers was used as evidence that the material contracts and absence of changes representations were fraudulently made. Accordingly, sellers should be cautions of using aggressive projections in sales processes, and of failing to provide buyers with an update when it is clear that these projections will not be met. Sellers should not assume that they are fully protected by a nonreliance clause.

Agspring also serves as a reminder that private equity firms may be sued for the fraudulent actions of their portfolio companies in connection with representations made in agreements to which the private

[11] Quoting *Great Hill Equity P'rs, LP v. SIG Growth Equity Fund I, LLLP*, No. CV 7906-VCG, 2014 WL 6703980, at 20* (Del. Ch. Nov. 26, 2014).

equity funds are not parties. In this instance, the court found that NGP had sufficient knowledge of the fraud, and sufficiently participated in aid of the unlawful acts, for the court to deny the motion to dismiss. Private equity funds and other controlling stockholders should be mindful of this risk when conducting sales processes.

In re Nine West LBO Sec. Litig., 20 MD. 2941 (JSR) (S.D.N.Y. Dec. 4, 2020)

Summary

Officers and directors of companies sold in LBO transactions should evaluate the risk of post-closing insolvency in order to mitigate exposure to breach of fiduciary duty, fraudulent conveyance and other claims if the companies ultimately fail.

Background

This decision involved a motion to dismiss claims brought by the trustee for the Nine West Litigation Trust (the Litigation Trust) representing unsecured creditors, and Wilmington Savings Fund Society, FSB, as successor indenture trustee for notes issued by Nine West, against former officers and directors of The Jones Group, Inc. (the Company), stemming from the bankruptcy of the Company following its sale to a private equity fund, Sycamore Partners Management, L.P. (Sycamore).

After a lengthy sales process commenced in 2012, the Company negotiated with Sycamore to be acquired by an affiliate of Sycamore for $15 per share in cash in a leveraged buyout. In connection with the sale, it was contemplated that Sycamore would contribute $395 million of equity financing, and the Company, which would be renamed Nine West Holdings, Inc. (Nine West), would increase its debt from $1 billion to $1.2 billion. Promptly after closing, certain crown jewel and other assets would be sold to Sycamore affiliates for $641 million (the Carve-Out Transactions). The court noted that this was substantially below the fair market value of the crown jewel assets of $1 billion, and the $800 million that the Company had paid for them a few years previously. In the Company board's unanimous approval of the deal on December 19, 2013, the board excluded approval of the increase in debt and the Carve-Out Transactions.

Prior to closing, Sycamore changed the deal terms by reducing its equity contribution to $120 million and increasing the debt financing to $1.55 billion. This amount of debt corresponded to 7.8 times Adjusted EBITDA, calculated by the Company's management, which was significantly higher than the 5.1 times Adjusted EBITDA that Citigroup Global Markets, the Company's financial advisor, had previously advised the board that the Company could bear if the Company retained the crown jewel assets. Sycamore had Duff & Phelps perform a valuation of the Nine West businesses that would remain after the Carve-Out Transactions (RemainCo). Duff & Phelps valued RemainCo at $1.57 billion, slightly over the $1.55 billion of debt it would support. In connection with closing, most of the Company's officer and certain other employees received change of control payments.

Approximately four years after closing, Nine West filed for bankruptcy. In connection with the bankruptcy court's approval of the bankruptcy plan, Nine West settled its claims against Sycamore. The bankruptcy plan established the Litigation Trust, overseen by a liquidation trustee, and authorized the litigation trustee to pursue claims against officers, directors and certain others, for the benefit of the Company's creditors. The bankruptcy plan authorized the indenture trustee to pursue various claims.

The *Nine West* decision involved motions to dismiss by both the director and officer defendants in consolidated actions brought by the indenture trustee and litigation trustee. The directors moved to dismiss claims for breach of fiduciary duty, aiding and abetting breach of fiduciary duty, and certain statutory claims for which dismissal was granted. The officers moved to dismiss the claims for breach of fiduciary duty, aiding and abetting breach of fiduciary duty and unjust enrichment, and fraudulent conveyance in connection with the change of control payments. Pennsylvania law governed the fiduciary duty claims against the directors, given that the Company was incorporated in that state.

The Court's Decision

Fiduciary Duty Claims Involving the Director Defendants

In considering the director defendants' motion to dismiss the fiduciary duty claims, the court noted that under Pennsylvania law, directors are protected in M&A deals by the business judgment rule if a majority of disinterested directors approves the transaction, "unless it is proven by clear and convincing evidence that the disinterested directors did not assent to such act in good faith after reasonable investigation."[12] The court noted that overcoming the business judgment rule therefore required an allegation that either a majority of the board was not disinterested or the directors did not approval the sale of the Company in good faith after reasonable investigation.

The court held that the litigation trustee had failed to plead that the directors were not disinterested, but had sufficiently alleged, for purposes of withstanding a motion to dismiss, that the directors failed to make a reasonable investigation into whether the sale would render the Company insolvent. The court noted that the complaints alleged that the directors did not conduct any investigation into whether the increase in debt or the Carve-Out Transactions would render the Company insolvent, even when Sycamore revised the deal to increase the amount of indebtedness, and even though the board could have terminated the merger agreement under a "fiduciary out" provision. The court rejected the defendant directors' claims that they had no duty to investigate insolvency for the increase in debt or the Carve-Out Transactions because those matters were approved by a new board. The court held that "[m]ultistep transactions can be treated as one integrated transaction where, as here, the plaintiff pleads that the transaction 'reasonably collapse[s] into a single integrated plan' and 'where the plaintiff pleads a cause of action for breach of fiduciary duty based on the foreseeability of the alleged harm.'".[13]

The court considered whether director liability was nonetheless limited under a Pennsylvania law that permits shareholder-adopted bylaws to limit director liability to situations involved self-dealing, willful misconduct or recklessness.[14] The court declined to interpret the term "self-dealing" expansively, and held that it was not implicated here. The court held, however, that the complaints adequately alleged that the directors were reckless in approving the sale of the Company. The court based this finding on the complaints' allegations that the directors specifically excluded the increase in debt and the Carve-Out Transactions from their assessments, and disregarded red flags regarding insolvency risk. The court noted that subtracting the historic cost of the carved-out businesses from the deal enterprise value, which yields $1.4 billion, and comparing that to the $1.55 billion of post-closing indebtedness, was a red flag. Similarly, comparing the post-closing Adjusted EBITDA multiple of 7.8 to the 5.1 multiple that Citigroup had advised the board was sustainable if the Company retained its crown jewel assets was another red flag. According to the court, the board having not only failed to inquire into RemainCo's solvency given these red flags, but having also expressly disclaimed any view on the additional debt and the Carve-Out Transactions, was reckless.

---

[12] 15 Pa Cons. Stat. §1715(d).
[13] Quoting *In re Hechinger Inv. Co.*, 274 B.R. 71, 91 (D. Del. 2002).
[14] *See* 15 Pa. Const. Stat. §1713(a).

The court also considered the litigation trustee's cause of action against the directors for aiding and abetting breach of fiduciary duty by the new board installed by Sycamore. This claim was governed by Delaware law, given that Nine West was incorporated in Delaware. The court noted that the elements of a aiding and abetting are "(i) the existence of a fiduciary relationship, (ii) a breach of the fiduciary's duty, (iii) knowing participation in that breach by the defendants, and (iv) damages proximately caused by the breach".[15] The defendant directors sought to dismiss the aiding and abetting claims on the basis that (a) acts taken before the new board members had become directors could not form the basis of an aiding and abetting claim, and (b) the plaintiffs had not adequately alleged knowing participation. The court summarily rejected the first argument as being based on an artificial distinction not supported by case law. The court rejected the directors' second argument and denied the motion to dismiss the aiding and abetting claim on the basis that the directors approved the sale, knowing that the Carve-Out Transactions would be completed, leaving the Company insolvent.

Fiduciary Duty Claims Involving the Officer Defendants

In considering the defendant officers' motion to dismiss, the court held that under Pennsylvania law, officers do not owe fiduciary duties to a corporation with respect to matters that are not within their responsibility or are the exclusive responsibility of the board. The court granted the officers' motion to dismiss the fiduciary duty claims against them because, the court found, the allegations "do not plausibly support the inference that the officers had the power to prevent the [sale transaction]." The court also granted the officers' motion to dismiss the aiding and abetting claims against them. The court held that the substantial assistance element was not adequately alleged because "the officer defendants, at most, participated in certain actions that helped the [sale transaction] along."

Fraudulent Conveyance Claims

The court rejected in part, and granted in part, the motion to dismiss the litigation trustee's fraudulent conveyance claims seeking to avoid change in control payments made to officers and certain employees. The court denied the motion to dismiss claims based on constructive fraudulent conveyance, on the basis that plaintiffs had sufficiently alleged that the Company was insolvent when it made the change of control payments. The court denied the motion to dismiss claims against the officers based on intentional fraudulent conveyance, given that the complaint alleged the requisite relationship between the officers and the Company and other relevant facts, but granted the motion to dismiss with respect to other employees.

Key Takeaways

The decision provides a warning to boards that they should evaluate the risk of post-sale insolvency in LBO transactions. The evaluation should encompass actions they know the acquiror plans to take after closing. This is particularly the case where red flags are raised, such as leverage ratios in excess of levels their own financial advisor warns is supportable. Acquirors can buttress their diligence with appropriate representations, warranties and pre-closing covenants in the acquisition agreement.

[15] Citing *RBC Cap. Mkts., LLC v. Jarvis*, 129 A.3d 816, 862 (Del. 2015).

In re WeWork Litig., C.A. No. 2020-0258-AGB (Del. Ch. Dec. 22, 2020)

Summary

Employees of Sprint, a company controlled by SoftBank, who assisted SoftBank on WeWork matters, held to have waived privilege with respect to legal advice related to WeWork because the advice was communicated through their Sprint email accounts.

Background

This decision involved a ruling on a motion to compel defendant SoftBank Group Corp. (SoftBank) to produce documents in litigation stemming from the alleged breach by SoftBank of its contractual obligation to complete a tender offer for shares of The We Company (WeWork). During the period relevant to the litigation, SoftBank owned 84% of Sprint, and some of the Sprint executives and employees performed services for Softbank relating to WeWork. Two individuals used their Sprint email accounts to receive legal advice from SoftBank's internal and external counsel that was relevant to the WeWork litigation and that did not relate to Sprint's business. The motion turned on whether they nonetheless had a "reasonable expectation of privacy" sufficient to preserve the attorney-client privilege.

The Court's Decision

The court considered the following four-factor test set forth in *In re Asia Global Crossing, Ltd.*,[16] which had been used to analyze privilege waiver through use of work email accounts for non-work purposes:[17]

> "(1) does the corporation maintain a policy banning personal or other objectionable use, (2) does the company monitor the use of the employee's computer or e-mail, (3) do third parties have a right of access to the computer or e-mails, and (4) did the corporation notify the employee, or was the employee aware, of the use and monitoring policies?"

The court noted that Sprint's Code of Conduct provided that employees should have no expectation of privacy in information transmitted via Sprint's computer systems or network, and that Sprint reserved the right to review employee emails. The court viewed this as the type of clear policy restricting personal use of emails, and reserving employer monitoring rights, that has been considered, for purposes of the first factor, to weigh in favor of requiring document production.

The court found that the second factor also weighed in favor of requiring document production because Sprint reserved the rights to monitor employee emails, regardless of whether there was any indication that they had ever exercised that right. The court found that the third factor was duplicative of the first two, thus also weighing in favor of document production, because Sprint had the right to access the computer or emails. The court found that the fourth factor also favored requiring document production because, as officers and senior employees of Sprint, the two individuals were presumed to have knowledge of Sprint's email policies, and the record indicated they were aware of them.

---

[16] 322 B.R. 247 (Bankr. S.D.N.Y. 2005).
[17] The *WeWork* court noted that this was the test used in *In re Info. Mgmt. Servs., Inc. Deriv. Litig.*, 81 A.3d 278 (Del. Ch. 2013).

The court rejected Softbank's argument that the motion should be denied because the two individuals owed contractual confidentiality obligations to SoftBank. The court held that this did not mean that the individuals had a reasonable expectation of privacy when using Sprint emails for non-Sprint matters. The court also rejected Softbank's argument that the *Asia Global* test did not apply in this situation where it was not Sprint, but a third party, that was seeking to overcome the privilege. The court also noted that there was no argument that the use of Sprint emails was inadvertent, because it had occurred on a large number of occasions.

Takeaways

The *WeWork* decision is relevant for boards with outside directors who are employees of other entities, e.g. the CEO of Company A, who sits on the board of an unrelated Company B. If the CEO uses his or her Company A email account to communicate on Company B matters, there is a risk that any privilege attached to those communications could be deemed waived. As a result, assuming Company A has customary monitoring rights over employee emails, the CEO should ideally only engage in written communications regarding Company B through an email account established by Company B, through a Company B board portal, or through a personal email account that would provide a reasonable expectation of privacy.

An interesting question is how far the *WeWork* holding extends. Does *WeWork* mean that an investment professional at a private equity or venture fund, who is the fund's designee on the boards of several of the fund's portfolio companies, cannot use the email account he or she has with the fund to communicate on portfolio company matters, but should only do so through separate email accounts held with each portfolio company? Arguments can be made that this may be extending *WeWork* too far.[18] For one thing, the *WeWork* facts were more akin to the precedent situation of an employee using his or her work account (here, Sprint) for a non employment-related purpose, rather than the investment professional situation. The latter is different in that it would involve use of a fund email account for a purpose that was aligned with the purposes of both the fund and the company. This may be more conducive to the employee having a reasonable expectation of privacy, or there otherwise being a sufficient alignment of interests that no privilege waiver is deemed to arise. As a second point, such an interpretation would be in tension with Delaware case law which, as applied to investors with designees on the board, holds that a director has very broad rights both to access company information, and to share company information with the investor that designated him or her.[19] As a third point, the *WeWork* decision relied heavily on another decision that went to great lengths to caution about over-extending the *Asia Global* test.[20] But until a court gives more guidance on the issue, it would be prudent for boards to take a cautious approach when dealing with matters, like M&A transactions, that present a heightened risk of litigation, where privilege may become an issue.

[18] The validity of these arguments may depend on the facts and the type of litigation. For example, it may be more difficult for the portfolio company to maintain that information emailed to the fund's director using a fund email account is privileged company information in litigation between the company and the fund.
[19] See, e.g. *Kalisman v. Friedman*, C.A. No. 8447-VCL, 2013 WL 1668205, at *3-4 (Del. Ch. Apr. 17, 2013); *Moore Business Forms, Inc. v. Cordant Holdings Corp*., C.A. Nos. 13911, 14595, 1996 WL 307444 (Del. Ch. June 4, 1996).
[20] See *In re Info. Mgmt. Servs.*, 81 A.3d at 296-98.

DLO Enterprises, Inc. v. Innovative Chemical Products Group, LLC, C.A. No. 2019-0276-MTZ (Del. Ch. June 1, 2020)

Summary
In asset purchase transactions, attorney-client privilege relating to pre-closing matters generally remains with the seller, absent an express agreement to the contrary.

Background

In January 2018, DLO Enterprises, Inc. and certain other parties (Sellers) entered into an asset purchase and contribution agreement with Innovative Chemical Products Group, LLC and certain other parties (Buyers), pursuant to which Buyers acquired substantially all of the assets of Arizona Polymer Flooring, Inc. Following the closing of the transaction, a dispute arose between the parties related to certain defective adhesive products that were sold prior to consummation of the transaction.

During litigation regarding the defective products, Buyers requested certain documents from Sellers, including their pre-closing communications with legal counsel. This discovery process led to a dispute as to whether these pre-closing communications (Category 1 Documents) and other emails that were stored in email accounts transferred to Buyers as part of the transaction (Category 2 Documents) were covered by attorney-client privilege.

The Court's Decision

With respect to Category 1 Documents, the court looked to then-Chancellor Strine's guidance in the *Great Hill* case,[21] and extrapolating to the asset purchase situation, held that "the seller will retain pre-closing privilege regarding the agreement and negotiations unless the buyer clearly bargains for the waiver or a waiver right." The court held that in this case, there was no such bargained-for waiver. The purchase agreement gave Buyers the right to assert or waive privileges relating to "Assets and Assumed Liabilities." The term "Assets" excluded, among other things, Sellers' rights under or pursuant to the purchase agreement and agreements entered into pursuant to it. The court held that this exclusion meant that Buyers did not purchase documentation or privileges relating to Sellers' rights under the purchase agreement. Accordingly, Buyer did not have the right to assert a privilege waiver.

The Category 2 Documents consisted of pre-closing and post-closing emails between Sellers and their counsel. Buyers argued that Sellers waived the privilege by allowing the emails to be transferred to Buyers. With respect to the post-closing emails, the court held that the test set forth in *Asia Global*,[22] relating to whether employees have a reasonable expectation of privacy, and thus confidentiality, in their work governed. That test involves an inquiry into corporate policies and practices regarding emails. However, the *DLO* court remanded for supplemental briefing on whether a

[21] *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP*, 80 A.3d 155 (Del. Ch. 2013).
[22] *In re Asia Global Crossing Limited*., 322 B.R. 247 (Bankr. S.D.N.Y. Mar. 21, 2005).

controlling jurisdiction had a statute on the confidentiality of work emails that governed. The court also requested supplemental briefing on the proper test to apply for the pre-closing emails.

Takeaways

Practitioners should ensure that the post-closing rights for attorney-client privilege are clearly and explicitly defined in asset purchase agreements. The language should cover emails that are transferred to Buyer at closing. Moreover, sellers who become employees of buyer at closing should refrain from using buyer email systems to communicate with their counsel after closing.

In re Appraisal of Panera Bread Company, C.A. No. 2017-0593-MTZ (Del. Ch. Jan. 31, 2020)

Summary

To avoid accruing liability for significant interest under Delaware's appraisal statute (8 Del. C. § 262), a surviving company can prepay dissenting stockholder(s) in a merger an amount in cash. The surviving company, however, bears the risk of overpayment; there is no statutory right to a refund in the event fair value is judicially determined to be less than the prepaid amount.

Background

Panera Bread was an appraisal action filed by certain dissenting stockholders (Dissenting Stockholders) of Panera Bread Company (Panera), in connection with the acquisition of Panera by JAB Holdings B.V. (JAB) in a cash-out merger at a price of $315 per share.

Panera is a fast-casual bakery-café with locations throughout the United States and Canada. It was founded in 1981 by Ronald M. Shaich, who, at the time of the JAB acquisition, was Panera's Chief Executive Officer and a member of the Board of Directors (Board). After preliminary discussions with Starbucks Corporation towards the end of 2016, Shaich began discussions with JAB, with Board authorization, in February 2017. The parties negotiated over the course of less than two months, with JAB making, and Panera's Board rejecting, two offers— at $286 per share and $296.50 per share, prior to JAB making its "best and final" offer of $315 per share on April 3, 2017. Panera's Board approved that offer on April 4, 2017, after a day-long meeting.

Panera's stockholders approved the merger at a special meeting on July 11, 2017 and the transaction closed on July 18, 2017. Stockholders holding 1,863,578 shares of Panera's common stock filed five separate appraisal actions. The appraisal actions were ultimately consolidated in the above-referenced action, in which, following the dismissal of certain stockholders, only the Dissenting Stockholders (who collectively held 785,108 shares) remained.

The court held a six-day trial in April 2019, and following supplemental briefing, heard post-trial arguments in October 2019. The Dissenting Stockholders argued that fair value of their shares was $361 per share, which they supported with a discounted cash-flow model, a comparable companies analysis and a precedent transaction analysis, all prepared by the their expert witness. They gave no weight to deal price. Panera, on the other hand, contended that fair value was deal price ($315 per share) less synergies. Panera had, prior to trial, prepaid the Dissenting Stockholders the full amount of the merger consideration plus statutory interest, in cash, in accordance with Section 262 of the Delaware General Corporation Law (the Appraisal Statute). Panera sought a refund of the amount by which its prepayment exceeded fair value.

The Court's Decision

The court held that in this case, deal price was the best indicator of fair value. The court explained that while Delaware courts must undertake an independent determination of fair value based on all relevant factors, with no presumption attaching to either side's position, "[t]he appraisal exercise occurs in the context of the efficient market hypothesis," with the price determined by an efficient market a more reliable indicator of fair value than an after-the-fact assessment by an expert witness who prepares her valuation based on the litigation objectives of her client. However, there is no presumption in favor of deal price, and if the process that produced such price was not reliable, Delaware courts will not afford it any weight.

Analyzing Panera's sale process, the court found multiple indicia of reliability, including: (1) that the parties engaged in arms-length negotiations (Panera's board was independent and lacked conflicts), (2) JAB's determination of price was based on extensive public information and very robust confidential information provided by Panera, (3) Panera's efforts to extract a higher price and the fact that, based on those efforts, JAB raised its price twice, (4) that no other potential bidders came forward in the sale process, despite a pre-signing leak and deal protections that would not preclude post-signing overtures by other bidders, and that Panera solicited all logical buyers.

The court also analyzed, but ultimately rejected, the Dissenting Stockholders' contention that purported weaknesses undermined the reliability of the sale process. Among other things, the Dissenting Stockholders claimed that Panera's Board failed to exercise sufficient oversight. The court rejected that argument, finding that the Board was actively engaged in the process, including by directing Shaich's negotiations with JAB. The Dissenting Stockholders also argued that the Board acted without sufficient knowledge of Panera's value given that Panera's financial advisors did not deliver their valuation until the day after JAB made its final offer. In rejecting that argument, the court noted that the Board had a deep understanding of the Company's value based on its continual review of a five-year strategic plan developed by management in 2015, which it reviewed at each meeting and used in negotiations with JAB, and that the Board ultimately considered its financial advisors' valuation prior to accepting JAB's offer. The Dissenting Stockholders further argued that Shaich, who had, prior to the commencement of negotiations with JAB, expressed to the Board his desire to retire, had rushed the process and left value on the table, but the court rejected that argument, in part, on evidence that Shaich had worked intently in negotiations with JAB to drive up the price. The court also rejected arguments that the Board's financial advisor undermined the sale process.

The court held that under the Appraisal Statue, it is required to exclude from any appraisal award, the amount of value the buyer expects to extract from synergies created by operation of the target company as part of a larger enterprise post-closing. Here, the court found that JAB had taken into account certain working capital, cost and tax savings in determining deal price, which the court was required to deduct from the market price in determining fair value. The court held that synergies amounted to $11.56 per share, and thus Dissenting Stockholders were entitled to $303.44 per share as fair value, which represented the $315 per share deal price less the $11.56 per share in synergies.

The court then turned to Panera's request for a refund of the difference between the amount it had prepaid the Dissenting Stockholders ($315 per share) and judicially determined fair value ($303.44 per share). Under the Appraisal Statute, a surviving corporation may prepay dissenting stockholders an amount in cash, after which statutory interest will only accrue on the delta between the prepaid amount and fair value, as determined by the court, rather than on the full fair value amount.

The court held that Panera was not entitled to a refund of its prepayment. The court noted that the Dissenting Stockholders had not contractually agreed to any such refund. The court found no basis in the Appraisal Statute for one. Since the "appraisal remedy is entirely a creature of statute," the court could not "engraft upon a statute language which has been clearly excluded therefrom by the Legislature." Further analyzing the Appraisal Statute, the court determined that the omission of a refund mechanism therefrom was intentional.

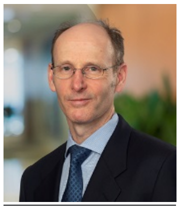
Takeaways

- The statutory mechanism in Section 262(h) of the Delaware General Corporation Law for prepaying amounts in order to cut off interest accrual in appraisal actions is a useful mechanism for limiting the appeal of appraisal actions. However, *Panera Bread* makes clear that there is no statutory clawback right if fair value is determined to be less than the amount prepaid. Accordingly target companies should ensure that either contractual clawback agreements are entered into with appraisal petitioners, or the prepayment amount is no greater than the amount the target company argues represents fair value.

- The decision also reaffirms Delaware's commitment to use of deal price, net of synergies, as a reliable indicator of fair value where a robust sale process has been run.

Arnold & Porter

Contacts



Nicholas O'Keefe
Partner, Silicon Valley
nicholas.okeefe@arnoldporter.com

+1 650.319.4522

Ben Fackler
Partner, San Francisco
ben.fackler@arnoldporter.com

+1 415.471.3125

Michele Rowland
Partner, Denver
michele.rowland@arnoldporter.com

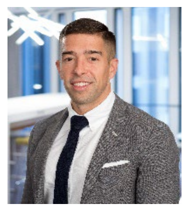
+1 303.863.2374

Therese Fox
Associate, Denver
therese.fox@arnoldporter.com

+1 303.863.2324

Philip Hurst
Associate, Silicon Valley
philip.hurst@arnoldporter.com

+1 650.319.4509

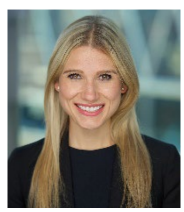


Nate Klein
Senior Associate, San Francisco
nate.klein@arnoldporter.com

+ 1 415.471.3113

Jennifer McLellan
Senior Associate, New York
jennifer.mclellan@arnoldporter.com

+1 212.836.7016



Bianca Prikazsky
Senior Associate, New York
bianca.prikazsky@arnoldporter.com

+1 212.836.7760

Stefan Weidemann
Associate, Denver
stefan.weidemann@arnoldporter.com

+1 415.471.3304

Carlyn Williams
Senior Associate, Denver
carlyn.williams@arnoldporter.com

+1 303.863.2364