INSIGHTS

The Corporate & Securities Law Advisor

VOLUME 34, NUMBER 6, JUNE 2020

DEPARTMENTS

Wolters Kluwer

www.WoltersKluwerLR.com

INSIGHTS

The Corporate & Securities Law Advisor

Editor-in-Chief
AMY L. GOODMAN
(phone) 301-908-0938
agoodman16@verizon.net

EDITORIAL OFFICE
28 Liberty Street,
New York, NY 10005
212-771-0600

Wolters Kluwer
Richard Rubin, Publisher
Kathleen Brady, Managing Editor

INSIGHTS (ISSN No. 0894-3524) is published monthly by Wolters Kluwer, 28 Liberty Street, New York, NY 10005. POSTMASTER: Send address changes to **INSIGHTS,** 7201 McKinney Circle, Frederick, MD 21704. To subscribe, call 1-800-638-8437. customer service, call 1-800-234-1660 or visit www.wolterskluwerlr.com.

For article reprints and reprint quotes contact *Wrights Media* at 1-877-652-5295 or go to *www.wrightsmedia.com.*

www.WoltersKluwerLR.com

MERGERS AND ACQUISITIONS

SEC Adopts Changes to Financial Disclosure Requirements for Acquisitions and Dispositions

The SEC has adopted significant changes to the financial disclosure requirements for business acquisitions and dispositions. While they ease disclosure requirements, they do so in a manner that ensures investors continue to have access to meaningful information.

By Andrew Brady, Michael Zeidel, Laura Kaufmann Belkhayat, and Michelle Gasaway

On May 21, 2020, the Securities and Exchange Commission (SEC) adopted extensive changes to the financial disclosure requirements for business acquisitions and dispositions.[1] The amendments are intended to reduce the complexity and costs associated with the preparation of historical financial statements and *pro forma* financial information, primarily by amending Rule 3-05 and Article 11 of Regulation S-X. The amendments are welcome developments that represent an additional example of the SEC taking concerted action to ease disclosure requirements with respect to capital formation in a manner that ensures investors continue to have access to meaningful information. The amendments will be effective on January 1, 2021, but voluntary compliance will be permitted in advance of the effective date.

Among the more prominent changes, the amendments will:

- Revise the "investment test" and "income test" used to determine the significance of an acquisition or disposition, conform the significance threshold and tests for a disposed business, and expand the use of *pro forma* financial information in measuring significance;
- Reduce the number of audited and interim periods for which historical financial statements must be presented if an acquisition is determined to be significant to a maximum of the two most recent fiscal years;
- Permit abbreviated financial statements of a target business carved out of a broader entity that did not maintain separate financial statements of the target business;
- No longer require separate financial statements for any acquired business once it has been included in the registrant's audited post-acquisition financial statements for nine months or a complete fiscal year, depending on significance of the acquired business;
- Expand the use of, or reconciliation to, International Financial Reporting Standards as issued by the International Accounting Standards Board (IFRS-IASB);
- Ease the requirement to provide financial statements and *pro forma* financial information for "individually insignificant acquisitions"; and
- Modify the form and content of *pro forma* financial information by replacing the current restrictive criteria imposed on *pro forma* adjustments with two new categories of mandatory adjustments to be presented as separate columns: (1) "transaction accounting adjustments" that will reflect the estimated purchase accounting under U.S. generally accepted accounting principles (GAAP) or IFRS-IASB; and (2) "autonomous entity adjustments" that will reflect the operations and financial position of the [registrant] as an autonomous entity if the [registrant] was previously part of another entity. Additionally, registrants may elect to

Andrew Brady, Michael Zeidel, Laura Kaufmann Belkhayat, *and* **Michelle Gasaway** *are attorneys at Skadden, Arps, Slate, Meagher & Flom LLP.*

disclose certain "management's adjustments," which would include reasonably estimable synergies, dis-synergies, and other transaction effects that have occurred or are reasonably expected to occur, so long as certain requirements are met.

The amendments will not apply to target company financial statements required to be included in a proxy statement or registration statement on Form S-4 or Form F-4; however, the amendments will apply to the *pro forma* information provided therein pursuant to Article 11 and any financial information for other acquisitions and dispositions that is required to be disclosed in the registration statement pursuant to Rule 3-05 or Rule 3-14 (*e.g.*, registrant or target company acquirees).

Background

When a registrant acquires a significant business, other than a real estate operation, Rule 3-05 historically has required disclosure of separate audited annual and unaudited interim pre-acquisition financial statements of that business if it is significant to the registrant (Rule 3-05 Financial Statements). Significance is determined by applying investment, asset and income tests set forth in Rule 1-02(w) of Regulation S-X. Similar rules apply to real estate operations and are set forth in Rule 3-14 of Regulation S-X.

Article 11 of Regulation S-X also has provided that registrants required to file Rule 3-05 or Rule 3-14 historical financial statements were additionally required to file unaudited *pro forma* financial information relating to an acquisition or disposition, which typically included a *pro forma* balance sheet and *pro forma* income statements based on the historical financial statements of the registrant and the acquired or disposed business. *Pro forma* financial information included adjustments intended to show how the acquisition or disposition might have affected those financial statements.

Updates to Significance Tests

The amendments revise the significance tests in Rule 1-02(w) that are used to determine whether a registrant is required to provide the historical financial statements of a business it acquires and, if so, how many periods must be presented. The changes, which revise the calculation of significance under the Investment Test and the Income Test of Rule 1-02(w) while leaving the Asset Test substantively unchanged, are aimed at helping registrants make more meaningful significance determinations and reducing the need for registrants to seek SEC Staff relief under Rule 3-13 of Regulation S-X in the case of anomalous results.[2]

Investment Test

Currently, the Investment Test compares the registrant's investment in the target business to the registrant's total assets to determine significance. The revised test aims to align itself more closely with the economic significance of the acquisition to the registrant by comparing the registrant's investment in the target business to the "aggregate worldwide market value of the registrant's voting and non-voting common equity," when available. Aggregate worldwide market value (which includes common equity held by affiliates) will be averaged over the last five trading days of the registrant's most recently completed month ending prior to the earlier of the registrant's announcement date or agreement date of the acquisition or disposition. Where a registrant does not have an aggregate worldwide market value, the SEC will retain the existing Investment Test.

Income Test

Historically, the Income Test has evaluated significance by comparing the target and the registrant's income from continuing operations before taxes, extraordinary items, and cumulative effects of changes in accounting principles. The current Income Test is subject to anomalous results because it focuses only on a single component: net income, which can include infrequent expenses, gain,s and losses.

The revised Income Test adds a new revenue component, which will compare the target's revenue to the registrant's revenue. To satisfy the Income Test under the final amendments, the tested subsidiary must meet both the revenue component and the net income component when the revenue component applies and, for purposes of the application of Rule 3-05, may use the lower of the revenue component and the net income component to determine the number of periods for which Rule 3-05 Financial Statements are required. Where a registrant or target does not have recurring annual revenues in each of the two most recently completed fiscal years, only the net income component will apply.

While the SEC initially proposed moving from a pre-tax method to an after-tax method of calculation of net income to simplify calculations by permitting line-item disclosure from a registrant's financial statements, the final rules included in the amendments retain the before-tax framework. In maintaining the existing method of calculation, the SEC agreed with commenters that after-tax calculations were susceptible to distortions such as entity tax status and income tax volatility, which would tend to make the after-tax number less meaningful to investors.

Significance Threshold and Tests for Dispositions

Currently, *pro forma* financial information is required upon the disposition or probable disposition of a significant portion of a business either by sale, abandonment or distribution to shareholders by means of a spin-off, split-up or split-off, if that disposition is not fully reflected in the financial statements of the registrant. A disposition of a business is considered significant if it meets the conditions of a significant subsidiary under Rule 1-02(w), using a 10 percent significance threshold.

The amendments will raise the significance threshold from 10 percent to 20 percent to align with the threshold for acquisition significance. In addition, the tests used to determine significance of a disposed business will be conformed to those used to determine significance of an acquired business.

Pro Forma Financial Information to Measure Significance

Currently, significance determinations generally are required to be made by comparing the most recent annual financial statements of the target to those of the registrant prior to the date of the acquisition. A registrant, however, is permitted to use *pro forma*, rather than historical, financial information to determine significance if the registrant has made a significant acquisition subsequent to the last fiscal year and has filed the target's historical financial statements and *pro formas* on a Form 8-K. Prior to adoption of the amendments, there was no analogous provision in Rule 3-05 for registrants to use *pro forma* financial information depicting significant dispositions or for registrants filing initial public offerings (IPOs).

The amendments expand the circumstances for using *pro forma* financial information in measuring significance. In addition to significant acquisitions, the amendments allow registrants to measure significance using filed *pro forma* financial information if the registrant has made a significant disposition subsequent to the last fiscal year, as long as *pro forma* information has been filed for the disposition. In addition, the amendments permit the use of such *pro forma* information for significance testing in IPOs. The changes, however, will not permit registrants to include "autonomous entity adjustments" or "management's adjustments," described below, when using *pro forma* financial information to determine significance. Rather, the *pro forma* financial information must be limited to the applicable subtotals that combine historical financial information of the registrant and the acquired business, as well as "transaction accounting adjustments." Once a registrant uses *pro forma* financial information to measure significance, it must continue to use *pro forma* financial information to do so until its next annual report.

Financial Statements of Significant Acquisitions—Periods to Be Included

Under the current rules, Rule 3-05 Financial Statements may be required for up to three years depending on the relative significance of the acquired or to-be-acquired business. The amendments reduce the number of years of required Rule 3-05 Financial Statements from three years to up to two years, depending on the relative significance. According to the SEC, two years of pre-acquisition financial statements "[is] sufficient to allow investors to understand the possible effects of the acquired business on the registrant," and "older financial statements, such as the third year of Rule 3-05 Financial Statements, can be less relevant for evaluating an acquisition because, due to their age, they are less likely to be indicative of the current financial condition, changes in financial condition and results of operations of the acquired business."

Under the new rules, Rule 3-05 Financial Statements will be required as shown in Exhibit 1.

Abbreviated Financial Statements for Partial Components of an Entity

Registrants frequently acquire a component of an entity, such as a product line or a line of business contained in more than one subsidiary of the selling entity that is a "business" as defined in Rule 11-01(d) of Regulation S-X but does not constitute a separate entity, subsidiary or division. These businesses may not have separate financial statements or maintain separate and distinct accounts necessary to prepare Rule 3-05 Financial Statements because they often represent only a small portion of the selling entity. Historically, registrants have needed to seek relief from the SEC staff or rely on informal guidance to provide abbreviated financial statements in such situations.

Recognizing that making relevant allocations of the selling entity's corporate overhead, interest and income tax expenses necessary to provide Rule 3-05 Financial Statements for the target business may be impracticable, the amendments add a new rule, Rule 3-05(e). This rule will allow companies to provide audited statements of assets acquired and liabilities assumed, as well as statements of revenues and expenses that exclude allocations of certain corporate overhead, interest and income tax expenses,

Exhibit 1—Target Financial Statements Required

Significance Level	Current	Amended
Less than 20 percent	No financial statements required	No financial statements required
Greater than 20 percent, but not 40 percent	One year of audited financial statements, and unaudited financial statements for most recent interim period and the corresponding prior year interim period	One year of audited financial statements, and unaudited financial statements for most recent interim period **without** the corresponding prior year interim period
Greater than 40 percent but not 50 percent	Two years of audited financial statements, and unaudited financial statements for most recent interim period and the corresponding prior year interim period	Two years of audited financial statements, and unaudited financial statements for most recent interim period and the corresponding prior year interim period
Greater than 50 percent	Three years of audited financial statements, and unaudited financial statements for most recent interim period and the corresponding prior year interim period	

which the SEC refers to as "abbreviated financial statements," if the following requirements are met:

- The total assets and total revenues (both calculated after intercompany eliminations) of the acquired—or to be acquired—business constitute 20 percent or less of such corresponding amounts of the seller and its subsidiaries, consolidated as of and for the most recently completed fiscal year;
- The acquired business was not a separate entity, subsidiary, operating segment (as defined in US GAAP or IFRS-IASB, as applicable) or division during the periods for which the acquired business financial statements would be required;
- Separate financial statements for the business have not previously been prepared; and
- The seller has not maintained the separate accounts necessary to present financial statements that include the omitted expenses, and it is impracticable to prepare such financial statements.

A registrant may not exclude from abbreviated financial statements various items such as interest expense for debt assumed from the seller or various operating expenses paid by or on behalf of the business during the pre-acquisition period, such as selling, distribution, marketing, general and administrative, and research and development, and depreciation and amortization expenses. The notes to the abbreviated financial statements also must include disclosure about the type of omitted expenses, the reasons why they were excluded and how the statements are not indicative of the acquired business going forward, as well as available information about the operating, investing and financing cash flows of the business.[3]

Omission of Acquired Business Financial Statements

Currently, Rule 3-05 Financial Statements are not required in a registration statement or proxy statement once the operating results of the target business have been reflected in the audited consolidated financial statements of the registrant for a complete fiscal year, unless (1) the financial statements have not been previously filed (as often is the case with an IPO company), or (2) even if previously filed, the acquired business is of major significance (*i.e.*, significant at the 80 percent level) to the registrant. In the former case, an IPO company will need to go back and obtain (or create) audited historical financial statements for any target business, even after the target has been consolidated in its financial statements for more than a year. In the latter case, the registrant will need to include historical financial statements of a now-consolidated target business that may no longer be as significant to the registrant as it was at the time of the acquisition.

Under the amendments, financial statements no longer will be required in registration statements and proxy statements once the target business is reflected in the registrant's audited post-acquisition financial statements for nine months, if the target company has 20-40 percent significance, and if significant at greater than 40 percent, for a complete fiscal year. The SEC observed that the nine-month period applicable to target businesses significant at the 20-40 percent level has the advantage of aligning Rule 3-05 with Rule 3-06, which permits the filing of nine months of financial statements to satisfy the one-year financial statement requirement for target businesses at this significance level.

The amendments also eliminate the requirement to provide financial statements when they have not previously been filed or when they have but the acquired business is of major significance.

Foreign Businesses

The test to determine whether a target is a "foreign business"—permitting Rule 3-05 Financial Statements to be presented in IFRS-IASB instead of US GAAP—is more stringent as it relates to certain equity ownership requirements than the "foreign private issuer" definition. The divergent definitions have created a circumstance where an acquired business that does not meet the definition of foreign business, but would otherwise be permitted to present its financial statements using IFRS-IASB as a foreign private issuer, is not permitted to use financial statements prepared in accordance with IFRS-IASB for its Rule 3-05 Financial Statements even when those financial statements are already available. Instead, the Rule 3-05 Financial Statements must be prepared in accordance with US GAAP, which can result in a significant cost to the registrant.

The amendments permit Rule 3-05 Financial Statements to be prepared in accordance with IFRS-IASB without reconciliation to US GAAP if the acquired business would qualify to use IFRS-IASB if it were a registrant. The amendments also will permit foreign private issuers that prepare their financial statements using IFRS-IASB to provide Rule 3-05 Financial Statements of foreign businesses prepared using home country GAAP to be reconciled to IFRS-IASB rather than US GAAP. Acquired businesses that do not meet the definition of a foreign business, but would qualify as foreign private issuers if they were registrants, will be allowed to reconcile to IFRS-IASB rather than US GAAP if the registrant is a foreign private issuer that uses IFRS-IASB. This will provide investors with more comparable information and avoid a one-time presentation of the US GAAP reconciling information in Rule 3-05 Financial Statements of the target.

Individually Insignificant Acquisitions

Under the current rules, if a registrant acquires unrelated businesses that do not individually meet the significance test but that together would exceed 50 percent significance, it must file historical audited financial statements and related *pro forma* financial information for those businesses constituting the mathematical majority of the group. The practical effect of this requirement is that registrants often provide separate, audited historical financial statements for acquired businesses that are individually not material to the registrant as well as *pro forma* financial information that does not fully depict the aggregate effect of the "individually insignificant businesses."

Historical financial statements only will be required for those businesses whose individual significance exceeds 20 percent.

The amendments still require *pro forma* financial information depicting the aggregate effects of all such acquisitions that together exceed 50 percent significance, but historical financial statements only will be required for those businesses whose individual significance exceeds 20 percent (but are not yet required to file financial statements). Commenters expressed concern that auditors may be reluctant to provide negative assurance to underwriters on the combined *pro forma* financial information where historical financial statements included in the *pro forma* financial information for individually insignificant acquisitions have not been reviewed or audited. The SEC acknowledged the concern, but stated that while an auditor may need to perform additional steps to meet its "reasonable care" and "reasonable investigation" standards, these additional steps do not outweigh the need to simplify and improve the usefulness of information provided to investors.

Pro Forma Financial Information

Pro forma financial information is intended to reflect the impact of an acquisition on an ongoing basis, and typically includes the most recent balance sheet and most recent annual and interim period income statements. *Pro forma* financial information for a business acquisition combines the historical financial statements of the registrant and the target business, and is adjusted for certain items provided specified criteria are met. The current rule permits balance sheet adjustments only if they are directly attributable to the transaction and are factually supportable. In the income statement, any adjustments also must be expected to have a continuing impact on the registrant.

The amendments will replace the existing adjustment criteria with simplified requirements, creating two categories of mandatory *pro forma* adjustments: (1) Transaction Accounting Adjustments; and (2) Autonomous Entity Adjustments. These new adjustment categories are required to be presented in separate columns after the presentation of the combined historical information of the registration. Additionally, the amendments recognize a category of Management's Adjustments, which a registrant may elect to present in the notes to the *pro forma* financial information, if certain requirements are met.

Transaction Accounting Adjustments and Autonomous Entity Adjustments

Transaction Accounting Adjustments will depict, in the *pro forma* balance sheet and income statement, the required accounting (GAAP or, if applicable, IFRS-IASB) of the acquisition, disposition or other transaction. Autonomous Entity Adjustments are adjustments necessary to reflect the operations and financial position of the registrant as an autonomous entity when the registrant previously was part of another entity.

Management's Adjustments

Management's Adjustments may be included to depict the synergies and dis-synergies identified by management in determining to consummate or integrate a transaction. Management's Adjustments may include forward-looking information, such as the anticipated effects of closing facilities, discontinuing product lines, terminating employees, executing new agreements or modifying existing agreements. Such disclosures benefit from a safe harbor and highlight for investors the potential effects of the acquisition and the post-acquisition plans to be undertaken by management.

Each Management's Adjustment must meet certain criteria, including that

- There is a reasonable basis for the adjustment;
- The adjustment is limited to the effect of such synergies and dis-synergies on the historical financial statements that form the basis for the *pro forma* statement of comprehensive income as if the synergies and dis-synergies existed as of the beginning of the fiscal year presented. If such adjustments reduce expenses, the reduction shall not exceed the amount of the related expense historically incurred during the *pro forma* period presented; and
- The *pro forma* financial information reflects all Management's Adjustments that are, in the opinion of management, necessary to a fair statement of the *pro forma* financial information presented and a statement to that effect is disclosed. When synergies are presented, any related dis-synergies also shall be presented.

Further, Management's Adjustments must meet certain presentation criteria, including:

- Management's Adjustments must be presented in the explanatory notes to the *pro forma* financial information in the form of reconciliations of *pro forma* net income from continuing operations attributable to the controlling interest and the related *pro forma* earnings per share data to such amounts after giving effect to Management's Adjustments;
- Management's Adjustments included or incorporated by reference into a registration statement, proxy statement, offering statement or Form 8-K should be as of the most recent practicable date prior to the effective date, mail date, qualified date or filing date, as applicable, which may require that they be updated even if previously provided in a Form 8-K that is appropriately incorporated by reference;
- If Management's Adjustments will change the number of shares or potential common shares, the change must be reflected within

Management's Adjustments in accordance with U.S. GAAP or IFRS-IASB, as applicable, as if the common stock or potential common stock were outstanding as of the beginning of the period presented (*i.e.*, the number of shares used in the calculation of the *pro forma* per share amounts must be based on the weighted average number of shares outstanding during the period adjusted to give effect to the number of shares issued or to be issued to consummate the transaction, or, if applicable, whose proceeds will be used to consummate the transaction as if the shares were outstanding as of the beginning of the period presented); and

- The explanatory notes also must include disclosure of the basis of calculation and any material limitations for each adjustment. In addition, registrants should disclose: material assumptions; uncertainties; an explanation of the method of calculation, if material; and the estimated time for achieving the synergies and dis-synergies disclosed.

  The final rules make clear that any forward-looking statements contained in Management's Adjustments will benefit from safe harbor protections in Securities Act Rule 175 and Exchange Act Rule 3b-6.

Other Changes

In addition to the changes described above, the SEC also adopted a variety of smaller changes. While this article does not cover these in detail, some of the more notable changes include the following.

Real Estate Operations

The amendments generally will align Rule 3-14 of Regulation S-X relating to financial statements for acquired real estate operations with the above-described amendments to Rule 3-05 (where no unique industry considerations exist).

Smaller Reporting Companies

The amendments make corresponding changes to the smaller reporting company requirements in Article 8 of Regulation S-X. Rule 8-05 has been revised to require that the preparation, presentation and disclosure of *pro forma* financial information by smaller reporting companies substantially complies with Article 11. Rule 8-04 has been revised to direct registrants to Rule 3-05 for the requirements relating to the financial statements of businesses acquired or to be acquired, other than for form and content requirements for such financial statements, which would continue to be prepared in accordance with Rules 8-02 and 8-03. Because Part F/S of Form 1-A refers to Rule 8-05, the revisions to Rule 8-05 apply to issuers relying on Regulation A.

Notes

1. Release No. 33-10786 (May 20, 2020).
2. In addition to the changes to the significance tests, the SEC has adopted clarifying amendments to the definition of "significant subsidiary" to label the conditions as the "Investment Test," the "Asset Test" and the "Income Test."
3. The amendments create similar requirements in new Rule 3-05(f) for businesses engaged in oil-and gas-producing activities.

SECURITIES MARKETS

Navigating Down-Round Financings

The COVID-19 pandemic and its economic fallout raises the possibility of an increase in private company financings in which the company has a reduced valuation from its prior fundraising round. Such down rounds raise a number of issues for companies and their investors.

By Amy Simmerman, Steve Bochner, and Becki DeGraw

Although we all hope for a quick return to stability, the current environment raises the possibility of an increase in down-round financings—private company financings in which the company has a reduced valuation from its prior financing round. In recent weeks, we have observed pressure on valuations and the emergence of more onerous, less company-friendly terms in several, though certainly not all, financing rounds. Down rounds raise a number of delicate and important issues for companies and investors, including impacts on employees and investors; fiduciary duty considerations for the company's board (and others), along with a heightened risk of stockholder litigation; and oftentimes complex structuring considerations. Recognizing these issues in advance can help a company and investors significantly mitigate the risk that can inhere in a down round.

Employee and Stockholder Considerations

A down round can raise several issues for a company's employees and existing stockholders. Many private companies attract human capital using stock options or other equity awards. Raising capital at a declining price can signal to employees that the company is less valuable and may be unable to achieve a favorable exit event, which, along with the resulting dilution, can substantially reduce the retention value of outstanding awards. Depending on how the down round is structured and which stockholders participate in the down round, the financing may be dilutive to existing stockholders as well. A down round also can alienate existing investors who choose not to participate but whose cooperation and additional investment a company may desire or need in the future.

Amy Simmerman, **Steve Bochner**, *and* **Becki DeGraw** *are attorneys at Wilson Sonsini Goodrich & Rosati.*

Fiduciary Duty Considerations and Stockholder Litigation Risks

Down-round financings involve significant fiduciary duty considerations for the board—and potentially for members of management and large investors as well. From a business standpoint, a down round has significant implications for a company. In addition, we have seen an uptick in private company stockholder litigation in recent years, including in the context of a down round. Without a doubt, the majority of private company deals and financings do not result in litigation, but when they do, the litigation can be lengthy, expensive, and challenging.

In any decision, a board is obligated to exercise its fiduciary duties of care and loyalty. The duty of care focuses on process and whether a board acted in an informed and deliberate manner—for example, by considering all reasonably available information, being appropriately engaged, and evaluating available alternatives. The duty of loyalty focuses on a board's motivations and possible conflicts of interest, requiring all members of the board to act for the purpose of advancing the interests of the corporation and stockholders as a whole rather than some separate interest or allegiance. All directors owe these duties to the company and its stockholders, regardless of whether they are appointed by a particular stockholder or a class or series of stock. So long as a company is solvent, fiduciary duties run only to the benefit of stockholders.

Beyond these fundamentals, down rounds frequently involve situations that Delaware courts may view as actual or potential conflicts of interest, which can increase the pressure on the board and its process. There are two common ways in which a conflict of interest can arise under Delaware law. The first is where half or more of the board has a special interest in a transaction. This analysis requires a director-by-director review of interests and relationships. Common examples of board conflicts in the down-round context include:

- A director is a principal of a venture or private equity fund and the fund is participating in the financing round.
- A director directly participates in the round.
- A director has a close personal or economic relationship to a party participating in the transaction—bearing in mind that (1) Delaware courts have found such a relationship to exist in several circumstances in recent years (such as a pattern of co-investing together, prior employment with a conflicted party, directors vacationing together, and directors co-owning a plane together), and (2) such relationships can be common in the private company context and are scrutinized carefully by courts.
- A director is a member of management who receives special benefits in the financing round—such as new equity awards—or is viewed as beholden to other directors who have a conflict.

There are certain related principles to have in mind when assessing board conflicts. When a director is a principal of a fund and the fund participates in a transaction or receives special benefits, the director is viewed as a "dual fiduciary" with competing obligations, to the fund and to the portfolio company. Under Delaware law, a director's fiduciary duties to a corporation are viewed as unwavering and Delaware courts generally are unsympathetic to the difficulties posed by divided loyalties. In addition, several Delaware decisions from the past decade have stated that where preferred stock terms address a given transaction, the rights of preferred stockholders are contractual in nature and directors should prefer the interests of common stockholders in many circumstances. When directors or their funds hold preferred stock, this principle can be another basis for a conflict.

Down rounds frequently involve situations that Delaware courts may view as actual or potential conflicts of interest.

The second common way that a disabling conflict of interest can exist under Delaware law is when a controlling stockholder (or group of controlling stockholders) participates in a transaction or receives special benefits in a transaction. Control can exist at sometimes surprisingly low thresholds. For example, in one case, a prominent founder who held only 22 percent of a company's stock was found potentially to be a controller based on his personality and influence over the company, his relationships across the boardroom, and his involvement in related transaction discussions. In another case, in a dispute over a financing and related recapitalization, a private equity fund that held 26 percent of a company's stock was found potentially to be a controlling stockholder based on its board seats and relationships to other board members. Delaware law also recognizes the concept of a control group in certain circumstances, where stockholders are connected in sufficiently "legally significant" ways. Based on these concepts, where a fund or other stockholder has a meaningful equity stake and certain other indicia of control—and participates in or receives special benefits in a transaction—a controlling stockholder conflict potentially may exist.

Where these types of disabling conflicts of interest arise and there is a risk of stockholder litigation, the implications can be significant. The default rule under Delaware law is the business judgment rule, which provides that courts will not second guess a board's business decision and will instead defer to the board, as long as the board appears to have acted with care, without a disabling conflict of interest, in good faith, and with a rational business purpose. Where, however, a disabling conflict of interest exists and litigation arises, the business judgment rule generally falls away and a reviewing court will instead apply the more stringent and less deferential "entire fairness" standard of review.

Under the entire fairness standard, the court examines all aspects of a board's decision to determine if it was fair to stockholders—particularly relating to (1) the process surrounding the board's decision and (2) the terms of the transaction and all relevant financial considerations. The underlying question in an entire fairness case is whether the board and others breached their duty of loyalty and should be liable for monetary damages. Satisfying this standard is extraordinarily difficult at the motion to dismiss stage, which means that the case is likely to proceed to discovery. Thereafter, if a plaintiff is successful at trial and damages are awarded, it is possible that indemnification and directors and officers liability (D&O) insurance may not be available (and in any event many private companies, particularly those facing the types of challenges that lead to a down round, do not have D&O insurance or sufficient assets to provide full indemnification).

Stockholder plaintiffs who assert a conflict of interest generally target a number of defendants. They will name most or all members of a company's board and, frequently, members of management. They also frequently name large stockholders—including funds—on the basis that they either are controlling stockholders or, short of that, aided and abetted a board's breach of fiduciary duty by "knowingly participating" in the breach. Aiding and abetting is an increasingly common and successful claim. Because entire fairness litigations are fact intensive, they tend to be protracted, expensive, and difficult to dismiss at an early stage.

Practical Process Suggestions

Given this backdrop, the central question is what exactly a board and its investors should do when considering a down-round financing. As an initial matter, there are some significant "headline" measures a company can consider implementing. We also note that many of these considerations apply in a variety of transaction contexts that involve board or controlling stockholder conflicts.

- *Independent board committees and disinterested stockholder votes.* A board can consider forming an independent board committee to negotiate the financing round and/or seeking a disinterested stockholder vote. Where a board conflict exists, either mechanism can cleanse the conflict under the Delaware case law and return the transaction to the business judgment rule. Where a controlling stockholder conflict exists, both mechanisms are needed to cleanse the conflict under the Delaware case law and restore the protections of the business judgment rule. In any event, several considerations apply. Either mechanism must be done properly and carefully to satisfy the Delaware case law and should be discussed with counsel (for example, relating to whether the committee can be implemented early enough in the process and be given sufficiently broad powers to have cleansing effect). As for an independent board committee, it is important to consider whether any independent board members even exist, taking into account the various types of factors outlined above that can undermine independence, and whether the board is prepared to delegate authority to a committee. As for a disinterested stockholder vote, a company will want to consider factors such as whether such a vote is even obtainable, which stockholders qualify as "disinterested," and whether the company is prepared to make adequate disclosures.
- *Rights offerings.* A common question is whether a conflict in a financing round can be cleansed by offering all stockholders the opportunity to

participate in the round—an approach known as a "rights offering." A rights offering provides an opportunity to communicate with stockholders and to attempt to undertake the round with some even-handedness. There is some suggestion in the case law that such an offering, if done properly, can return a financing round to the protection of the business judgment rule. At the same time, Delaware judges have, at least in some circumstances, recently expressed skepticism about rights offerings, including in a litigation over a down round—particularly relating to whether stockholders have the financial ability to participate and have adequate time and information to participate on equal terms.

Whether or not a company can implement the use of an independent board committee, a disinterested stockholder vote, or a rights offering, there are a number of process steps that *all* companies can and should take to build the best board process and record possible. These steps will help a board arrive at an optimal decision and can prove critical in an entire fairness litigation where defendants are required to show the fairness of their decision.

- *Evaluate litigation risk.* The company should assess the likelihood of litigation based on the company's stockholder base, keeping in mind two factors: (1) it only takes one stockholder to bring a lawsuit; and (2) in many recent stockholder litigations, dilutive financing rounds were challenged after a company turned itself around and engaged in a sale of control. A company is particularly vulnerable to the second scenario if it made no or inadequate disclosures in connection with the earlier financing round, because a complaining stockholder may assert that the stockholder previously was unaware of the basis for asserting a claim. If the company, with the help of counsel, determines that there is meaningful litigation risk, that determination may impact which types of process mechanisms the company chooses to pursue.
- *Understand fiduciary duties.* The board should understand its fiduciary duties, the potential conflicts of interest that exist, and the importance of taking into account the interests of unaffiliated stockholders. In many litigations, the courts have been critical of directors for not understanding the fundamentals of their fiduciary duties. These discussions should be reflected appropriately in the board minutes. When investors have designees on the board, those designees should understand when they are wearing their fiduciary "hat" and acting on behalf of the company and properly separate that role from the fund's interests.
- *Deliberate.* The board should meet and not act exclusively or largely by written consent, in order to reflect a deliberative process. Although recusals may be appropriate in some circumstances, the board should not wrongly exclude certain directors (such as independent directors) from board discussions.
- *Assess information.* The board should consider all reasonably available information including about the business and its financial condition and future. In a down round, the board's deliberations and record should reflect the company's challenging financial situation giving rise to the need for the down round.
- *Assess alternatives.* The board should consider all reasonably available alternatives—including other financing sources, other types of transactions, and whether a down round is necessary. The record should reflect why the down round was necessary.
- *Negotiate.* The board should negotiate the round and arrive at the best transaction possible for stockholders as a whole, particularly unaffiliated stockholders. The board should take into account its fiduciary duties, the impacts of the round on unaffiliated and common stockholders, the practical business needs of the company weighed against the alternatives available, and the demands of investors. If the board's ability to negotiate is limited by such factors as the urgent need for funds or investor demands, those realities should be documented.

- *Approach valuation thoughtfully.* The board and the company should assess carefully the company's valuation, with deliberation and appropriate input from management. The courts have been critical of casual approaches to valuation. Plaintiffs and courts also have focused on prior 409A valuations that suggest a higher value for the company than is used in a financing round. If such 409A valuations exist, it may be advisable to proactively address and explain the change in circumstances in the record. Finally, if a company cannot afford a financial advisor, the board should discuss the issue, and that reality should be contemporaneously reflected in the board record.
- *Consider management benefits.* If management will receive benefits in the down round—such as through refresh grants—the board should evaluate carefully and document the need for such benefits, including as to their size and terms and the proper participants. This is particularly true if members of management serve on the board. In several cases, the courts have viewed the receipt of management benefits as a further diversion of value away from unaffiliated stockholders and as exacerbating the conflicts of members of management who serve on the board. A board could very well determine that such benefits are necessary from a business standpoint and should not be dissuaded from making sound business decisions because of litigation risk—but the board record should carefully reflect the board's decision.
- *Make appropriate disclosures.* If the company seeks a stockholder vote from stockholders who lack insider information, the board is expected to disclose all information material to the stockholders' decision. In any event, a down round generally will necessitate providing a notice to stockholders under Delaware law. In the down-round context, Delaware courts have stressed the importance of making appropriate disclosures in such a notice, particularly relating to the nature and extent of insider benefits.
- *Have good minutes and board records.* All of the company's efforts, particularly as to the matters outlined above, have to be appropriately documented in board minutes and related materials. Minutes are go-to evidence for judges when reviewing a board decision, as numerous stockholder litigations have shown. Accordingly, boards and investors will be at a significant disadvantage if minutes do not proactively (and honestly) tell the company's story. Similarly, where minutes do not reflect a board's efforts or the circumstances the board faced, defendants can face an uphill battle in convincing a court that the board actually took those efforts or faced those circumstances—especially because litigation often occurs many months or years after the board's decision. At the same time, because minutes are the appropriate forum for memorializing the board record, board members and their affiliates should be extremely mindful of the emails and text messages they send, as such electronic communications figure heavily into stockholder litigation.

Structuring and Technical Considerations in Down Rounds

A down-round transaction can involve a number of complex technical and structuring points, particularly depending on the terms of a given transaction. For a company and investors, it is important to work with capable counsel who understand these issues.

At a minimum, a down-round financing may trigger the anti-dilution provisions of existing preferred stock terms, which generally allow the relevant preferred stockholders to receive a more favorable conversion rate (for purposes of converting into common stock) if new stock is sold below a certain price. Such adjustments typically also involve a correlative improvement in the affected stock's voting power. A company and investors considering a down round will want to consider the impacts of such adjustments. Many certificates of incorporation provide that preferred stockholders can waive the application of such adjustments upon a specified vote of the existing stockholders, which may be of interest if the vote is obtainable. Where such a provision does not exist but there is a desire to avoid the application of anti-dilution adjustments, the company's certificate of incorporation potentially can be amended to alter or avoid the adjustments. In that case, however, it is important to consider whether such an amendment triggers particular stockholder votes—including on a class- or series-wide basis—under the company's existing protective provisions or under the Delaware corporate statute.

Down-round financings are oftentimes structured as "pay-to-play" transactions—although they do not need to be unless the structure is necessary to achieve the required levels of investment. A pay-to-play structure essentially provides that existing preferred stockholders must participate in the new round at a specified amount or else suffer some negative effect on their existing holdings. For example, a pay-to-play structure may provide that non-participating holders of preferred stock have their shares converted into common stock, while participating stockholders either retain their preferred stock or receive some "better" series of preferred stock in place of their preexisting stock.

Pay-to-play structures raise complex, though oftentimes surmountable, technical issues. For example, if non-participants' preferred stock will be converted into common stock, the parties and their counsel will need to determine how that conversion will occur: Does the company's certificate of incorporation allow preferred stockholders to trigger a conversion to common stock upon a specified vote of stockholders, and is that vote achievable? Or will the certificate need to be amended? A charter amendment, again, could trigger certain votes under a company's existing protective provisions or under the Delaware statute. If the certificate is amended, conversations frequently arise over whether the disparate treatment of participating versus non-participating stockholders should be imposed directly in the charter or outside of the charter—with different technical issues attending to each approach. Parties sometimes negotiate additional complexity—for example, reverse stock splits, the conversion of preferred stock into a harsher ratio than 1:1, applying the pay-to-play to only certain stockholders, or the conversion of existing and non-participating preferred stock into a new series—which will raise additional but related types of technical issues.

How to arrive at the appropriate structure for a down round relates back to the themes discussed earlier in this article. From a fiduciary and process standpoint, a board will want to evaluate which terms actually are needed to accomplish the financing round. Investors leading the round naturally will require that the round be conducted on certain terms, but they will want to be cognizant of the potential litigation risk that they and the company face and how those terms will look in hindsight should litigation arise. If the entire fairness standard is applied in a stockholder litigation, a reviewing court will examine all of the terms of the transaction to determine if they actually were fair to existing stockholders, particularly the unaffiliated stockholders.

Conclusions

Down-round financings could appear with increasing frequency in the current environment. They may be necessary from the vantage point of the company and investors, but all parties will want to be highly aware of the implications of a down round—on employees and existing stockholders, for fiduciary and process issues, and as to technical and structuring issues. Very importantly, companies and investors can significantly mitigate the risk to the transaction and to themselves by implementing common-sense and achievable process mechanisms. A good board process—including a documentary record supporting that process—and a careful approach to structuring also will better position the company for the future, as the company undertakes additional transactions and potentially needs further investment or support from existing stockholders.

MERGERS AND ACQUISITIONS

Determining the Likely Standard of Review Applicable to Board Decisions in Delaware M&A Transactions

The standards of review applied by Delaware courts to reviewing the conduct of boards of directors in addressing merger and acquisition transactions will vary based on various fact patterns.

By Robert B. Little, Steve J. Wright, and Kiel Sauerman

Mergers and acquisition (M&A) practitioners are well aware of the several standards of review applied by Delaware courts in evaluating whether directors have complied with their fiduciary duties in the context of M&A transactions. Because the standard applied will often have a significant effect on the outcome of such evaluation, establishing processes to secure a more favorable standard of review is a significant part of Delaware M&A practice. The chart below identifies fact patterns common to Delaware M&A and provides a preliminary assessment of the likely standard of review applicable to transactions fitting such fact patterns. However, because the Delaware courts evaluate each transaction in light of the transaction's particular set of facts and circumstances, and due to the evolving nature of the law in this area, this chart should not be treated as a definitive statement of the standard of review applicable to any particular transaction.

Robert B. Little, Steve J. Wright, *and* **Kiel Sauerman** *are attorneys at Gibson, Dunn & Crutcher LLP.*

No.	Facts	Likely Standard of Review[1]
1.	Fully independent and disinterested[2] board of directors; no controlling stockholder[3]	Business judgment[4]
2.	Majority of board is independent and disinterested; no controlling stockholder	Business judgment[5]
3.	Board is evenly split between directors who are independent and disinterested and directors who are not independent and disinterested; no controlling stockholder	Entire fairness[6] Business judgment if transaction is approved by a properly functioning special committee[7] or a fully-informed, uncoerced stockholder vote[8]
4.	Majority of board is not independent and disinterested; no controlling stockholder	Entire fairness[9] Business judgment if transaction is approved by a properly functioning special committee[10] or a fully-informed, uncoerced stockholder vote[11]
5.	None of the board members is independent and disinterested; no controlling stockholder	Entire fairness[12] Business judgment if transaction is approved by a fully-informed, uncoerced stockholder vote[13]

6.	Transaction with a controlling stockholder where majority of the board is independent and disinterested	Entire fairness, but *either* (a) a properly functioning special committee *or* (b) approval of a majority of the minority will shift the burden of proof to the plaintiff[14] Business judgment if *both* (a) a properly functioning special committee *and* (b) approval of a majority of the minority[15]
7.	Transaction with a controlling stockholder where a majority of the board is *not* independent and disinterested	Entire fairness, but *either* (a) a properly functioning special committee *or* (b) approval of a majority of the minority will shift the burden of proof to the plaintiff[16] Business judgment if *both* (a) a properly functioning special committee *and* (b) approval of a majority of the minority[17]
8.	Controlling stockholder; majority of the board is independent and disinterested with respect to the controlling stockholder; controlling stockholder is *not* the counterparty in the transaction; and controlling stockholder is treated the same as other stockholders	Business judgment[18]
9.	Controlling stockholder; majority of the board is *not* independent and disinterested with respect to the controlling stockholder; controlling stockholder is *not* the counterparty in the transaction; and controlling stockholder is treated the same as other stockholders	Business judgment[19]
10.	Controlling stockholder; majority of the board is independent and disinterested with respect to the controlling stockholder; controlling stockholder is *not* the counterparty in the transaction; and controlling stockholder receives different treatment in the transaction than other stockholders	Entire fairness, but *either* (a) a properly functioning special committee[20] *or* (b) approval of a majority of the minority will shift the burden of proof to the plaintiff[21] Business judgment if *both* (a) a properly functioning special committee *and* (b) approval a of majority of the minority[22]
11.	Controlling stockholder; majority of the board is *not* independent and disinterested with respect to the controlling stockholder; controlling stockholder is *not* the counterparty in the transaction; and controlling stockholder receives different treatment in the transaction than other stockholders	Entire fairness, but *either* (a) a properly functioning special committee[23] *or* (b) approval of a majority of the minority will shift the burden of proof to the plaintiff[24] Business judgment if *both* (a) a properly functioning special committee *and* (b) approval of a majority of the minority[25]

Notes

1. Assumes duty of care is discharged. In addition to the standards of review identified in this chart, a transaction is subject to enhanced judicial scrutiny under Revlon, Inc. v. Macandrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) "when a company embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control." Lyondell Chem. Co. v. Ryan, 970 A.2d 235, 242 (Del. 2009). However, under the so-called Corwin doctrine, if a transaction (other than a transaction in which a controlling stockholder extracts personal benefits) has been ratified by a vote of a "fully informed, uncoerced majority of the disinterested stockholders," it will be subject to business judgment review even if Revlon would otherwise apply. Corwin v. KKR Financial Holdings LLC, 125 A.3d 304, 305–06 (Del. 2015); see also, e.g., Morrison v. Berry, 191 A.3d 268, 274 (Del. 2018) (explaining the *Corwin* doctrine).
2. "Independence means that a director's decision is based on the corporate merits of the subject before the board

rather than extraneous considerations or influences." Aronson v. Lewis, 473 A.2d 805, 816 (Del. 1984), *overruled in part on other grounds by* Brehm v. Eisner, 746 A.2d. 244, 254 (Del. 2000). "Such extraneous considerations or influences may exist when the challenged director is controlled by another." Orman v. Cullman, 794 A.2d 5, 24 (Del. Ch. 2002). Thus, a "lack of independence can be shown when a plaintiff pleads facts that establish that the directors are beholden to [the controlling person] or so under [that person's] influence that [the directors'] discretion would be sterilized." *Id.* (first alteration in original) (internal quotation marks omitted). "Put differently, a director is not independent if particularized facts support a reasonable inference that she would be more willing to risk her reputation than risk the relationship with the [controlling] person." Sciabacucchi v. Liberty Broadband Corp., 2018 WL 3599997, at *11 (Del. Ch. 2018). Disinterestedness means that "directors can neither appear on both sides of a transaction nor expect to derive any personal financial benefit from it in the sense of self-dealing, as opposed to a benefit which devolves upon the corporation or all stockholders generally." *Id.* at 23.

3. A stockholder is a controlling stockholder under Delaware law where the stockholder (1) owns more than 50% of the voting power of a corporation or (2) exercises control over the business affairs of the corporation. Kahn v. Lynch Commc'ns Sys. (Kahn I), 638 A.2d 1110, 1113–14 (Del. 1994). When evaluating whether a stockholder exercises the requisite control, Delaware courts will evaluate whether the stockholder controlled the board "such that the directors . . . could not freely exercise their judgment" with respect to a transaction. In re KKR Fin. Holdings LLC S'holder Litig., 101 A.3d 980, 993 (Del. Ch. 2014); *see also* In re Crimson Exploration Inc. S'holder Litig., 2014 WL 5449419, at *10–*12 (Del. Ch. Oct. 24, 2014) (analyzing Delaware case law concerning controlling stockholders). "A group of stockholders, none of whom individually qualifies as a controlling stockholder, may collectively be considered a control group that is analogous, for standard of review purposes, to a controlling stockholder." Frank v. Elgamal, 2014 WL 957550, at *18 (Del. Ch. Mar. 10, 2014). However, "[a] plaintiff must provide that the group of stockholders 'was connected in some legally significant way—*e.g.,* by contract, common ownership, agreement, or other arrangement—to work together toward a shared goal.'" In re Nine Systems Corp. Shareholders Litigation, 2014 WL 4383127 (Del. Ch. Sept. 4, 2014).
4. *See* In re Trados Inc. S'holder Litig., 73 A.3d 17, 36 (Del. Ch. 2013) (explaining that the business judgment rule applies to decisions by board members who are "disinterested and independent"); *see also* In re PLX Technology Inc. S'holders Litig., 2018 WL 5018535, at *30–*31 (Del. Ch. 2018).
5. The business judgment rule is generally the applicable standard of review where a majority of the board is disinterested and independent. *See* Cinerama, Inc. v. Technicolor, 663 A.2d 1156, 1170 (Del. 1995). Nonetheless, a transaction must be "approved by a majority consisting of the disinterested directors" in order for the business judgment rule to apply. *See* Aronson v. Lewis, 473 A.2d at 812, *overruled in part on other grounds by Brehm v. Eisner*, 746 A.2d. at 254; *see also In re Trados Inc.*, 73 A.3d at 44 ("To obtain review under the entire fairness test, the stockholder plaintiff must prove that there were not enough independent and disinterested individuals among the directors making the challenged decision to comprise a board majority. . . . To determine whether directors approving the transaction comprised a disinterested and independent board majority, the court conducts a director-by-director analysis."); Chaffin v. GNI Group, Inc., No. 16211-NC, 1999 WL 721569, at *5–*6 (Del. Ch. Sept. 3, 1999) (holding that where a board had three independent and disinterested members and two interested members, and the board approved a merger by a vote of 4-1, with one of the independent and disinterested directors voting against the merger, the merger approval "was one vote short of the required disinterested majority").
6. "A board that is evenly divided between conflicted and non-conflicted members is not considered independent and disinterested." Gentile v. Rossette, No. 20213-VCN, 2010 WL 2171613, at *7 n.36 (Del. Ch. May 28, 2010); *see also* Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1046 n.8 (Del. 2004). "[T]he business judgment rule has no application" to a merger transaction that is "not approved by a majority consisting of the disinterested directors," *Aronson v.*

Lewis, 473 A.2d at 812, *overruled in part on other grounds by Brehm v. Eisner*, 746 A.2d. at 254, and where the business judgment rule has been "rebut[ted]" this "lead[s] to the application of the entire fairness standard," In re Crimson Exploration Inc., 2014 WL 5449419, at *20; *see also* In re PLX Technology Inc., Litig., No. 9880-VCL, 2018 WL 5018535, at *30 (explaining that the entire fairness test applies to director decision-making when "directors making the decision did not comprise a disinterested and independent board majority").

7. "[I]n the instant context, where there is no controlling stockholder but the board is conflicted…a fully constituted, adequately authorized, and independent special committee can cleanse such a transaction…remov[ing] the malign influence of the self-interested directors, and thus should result in business judgement review." Salladay v. Lev, 2020 WL 954032, at *9 (Del. Ch. Feb. 27, 2020) (also noting the special committee must be formed *ab initio* and "prior to substantive economic negotiations, which include valuation and price discussions if such discussions set the field of play for the economic negotiations to come"). However, the Delaware Supreme Court has not definitively resolved the question of which standard of review applies when a special committee approves a transaction and there is no controlling stockholder because there is some precedent that could be read to suggest that a properly functioning special committee does no more than shift the burden of the proof to the plaintiff, *see* In re Tele-Commc'ns, Inc. S'holders Litig., No. 16470, 2005 WL 3642727, at *8 (Del. Ch. Dec. 21, 2005), although the better reading of this precedent may be that it involved a controlling stockholder, *see* In re John Q. Hammons Hotels Inc. S'holder Litig., No. 758-CC, 2009 WL 3165613, at *11 (Del. Ch. Oct. 2, 2009) (interpreting *In re Tele-Commc'ns* as having involved a controlling stockholder).

8. *See Corwin*, 125 A.3d 304 (holding that, in the absence of a controlling stockholder, an uncoerced, informed stockholder vote causes the application of the business judgment standard of review even where enhanced scrutiny would otherwise apply); *see also* Vice Chancellor J. Travis Laster, "The Effect of Stockholder Approval on Enhanced Scrutiny," 40 *Wm. Mitchell L. Rev.* 1443 (2014) (providing substantial discussion of the interplay between stockholder approval and the standard of review prior to the decision in *Corwin*). Note, however, that the failure to disclose all material information to stockholders can prevent a stockholder vote from being fully informed, and would thus prevent the vote from "ratifying" the transaction. *See* Chen v. Howard-Anderson, 87 A.3d 648, 669 (Del. Ch. 2014) (noting that, even if defendants had argued that the stockholder vote ratified the challenged transaction, "disclosure deficiencies" would undermine the vote and render the ratification ineffective); In re Saba Software, Inc. S'holder Litig., No. 10697-VCS, slip op. at 20–23 (Del. Ch. Mar. 31, 2017) (concluding that material omissions from a proxy statement "undermined the stockholder approval"); *see also Morrison v. Berry*, 191 A.3d at 274–75 (overturning a decision applying the ratification doctrine, stating "stockholders cannot possibly protect themselves when left to a vote on an existential question in the life of a corporation based on materially incomplete or misleading information").

9. *See In re Trados Inc.*, 73 A.3d at 45 (holding that entire fairness was the applicable standard of review in scrutinizing a board's approval of a merger where "the plaintiff proved at trial that six of the seven . . . directors were not disinterested and independent"); In re Tele-Commc'ns, Inc., 2009 WL 3165613, at *6–*8 (explaining that an "entire fairness analysis" is required whenever "evidence in the record suggests that a majority of the board of directors were interested in the transaction" and providing several examples).

10. *See supra* n.8.

11. *See supra* n.9.

12. *See* In re PNB Holding Co., 2006 WL 2403999, at *12–*15 (concluding that all of the members of the board were interested and that entire fairness was the standard of review, recognizing that stockholder approval for the merger was accordingly "the only basis for the defendants to escape entire fairness review," but ultimately concluding that "[b]ecause a majority of the minority did not vote for the Merger, the directors cannot look to our law's cleansing mechanism of ratification to avoid entire fairness review").

13. *See supra* n.9.

14. *See Kahn I*, 638 A.2d at 1117 (the "standard of judicial review in examining the propriety of an interested

cash-out merger transaction by a controlling or dominating shareholder is entire fairness. . . . However, an approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof . . . to the challenging shareholder-plaintiff.").

15. The detailed requirements for the business judgment review to apply to a controlling-stockholder transaction are set forth in Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014) as follows: "(i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority." *Id.* at 645. *See also* Flood v. Synutra International, Inc., 195 A.3d 754 (Del. 2018) (clarifying that "so long as the controller conditions its offer on [the approval of both a Special Committee and a majority of the minority stockholders] at the germination stage of the Special Committee process, when it is selecting its advisors, establishing is method of proceeding, beginning its due diligence, and has not commenced substantive negotiations with the controller, the purpose of the pre-condition requirement of *MFW* is satisfied.").
16. *Kahn I*, 638 A.2d at 1117.
17. *See supra* n.16.
18. *See* In re Synthes, Inc. S'holder Litigation, 50 A.3d 1022, 1046 (Del. Ch. 2012) (applying business judgment review despite pled facts that a majority of the board was not independent with respect to the controlling stockholder because the controlling stockholder "received equal treatment in the Merger").
19. "Entire fairness is not triggered solely because a company has a controlling stockholder. The controller also must engage in a conflicted transaction." In re Crimson Exploration Inc., 2014 WL 5449419, at *12. A conflicted transaction exists if the controlling stockholder is the counterparty to, or otherwise "stands on both sides of," the transaction. Gamco Asset Mgmt. Inc. v. iHeartMedia Inc., No. 12312-VCS, 2016 WL 6892802, at *15 (Del. Ch. Nov. 23, 2016). A conflicted transaction also exists if the controlling stockholder receives different treatment or "competes with the common stockholders for consideration" in the transaction. *Id.* In some cases, such as when a controlling stockholder receives disparate consideration, it is relatively simple to conclude that the controlling stockholder was not treated the same as other stockholders. *See* In re Delphi Fin. Grp. S'holder Litig., No. 7144-VCG, 2012 WL 729232, at *3 (Del. Ch. Mar. 6, 2012) (controlling stockholder negotiated a substantial premium for his shares); In re Tele-Commc'ns, Inc., 2005 WL 3642727, at *6–*8 (controlling stockholder received more valuable high-vote stock). In other cases, however, where the controlling stockholder receives a unique benefit (other than disparate consideration) or a continuing stake in the acquiring entity, the question is more complex. *Compare* New Jersey Carpenters Pension Fund v. infoGROUP, Inc., No. 5334-VCN, 2011 WL 4825888, at *9–*11 (Del. Ch. Sept. 30, 2011) (controlling stockholder received "desperately needed liquidity"), *and* In re John Q. Hammons Hotels Inc. S'holder Litig., 2009 WL 3165613, at *1 (controlling stockholder received "an array of private benefits" including a continuing stake in the acquiring entity), *with* Larkin v. Shah, No. 10918-VCS, 2016 WL 4485447, at *15 (Del. Ch. Aug. 25, 2016) (rejecting plaintiffs' assertion that a venture capital firm's desire to exit its investment was a hurried attempt to sell the company and extract a unique benefit).
20. *See* In re John Q. Hammons Hotels Inc. S'holder Litig., No. 758-CC, 2011 WL 227634, at *2 (Del. Ch. Jan. 14, 2011) ("[P]laintiffs bear the ultimate burden to show the transaction was unfair given the undisputed evidence that the transaction was approved by an independent and disinterested special committee of directors.").
21. Although we have not identified any Delaware cases explicitly addressing the effect on the standard of review of approval by a majority of the minority stockholders in this factual scenario, it would be reasonable to conclude that the reasoning of *Kahn I*, 638 A.2d 1110, would apply.
22. *See* In re John Q. Hammons Hotels Inc. S'holder Litig., 2009 WL 3165613, at *12 (in transaction where controlling stockholder receives different consideration than minority stockholders, "business judgment would be the applicable standard of review if the transaction were (1) recommended by a disinterested and independent

special committee, *and* (2) approved by stockholders in a non-waivable vote of the majority of all the minority stockholders").

23. In re Tele-Commc'ns, Inc., 2005 WL 3642727, at *8 (explaining that because of the directors' interested status "[t]he initial burden of proof rests upon the director defendants to demonstrate . . . fairness," but further explaining that "[r]atification by a majority of disinterested directors, generally serving on a special committee, can have the effect of shifting the burden onto the plaintiff shareholders to demonstrate that the transaction in question was unfair. In order to shift the burden, defendants must establish that the special committee was truly independent, fully informed, and had the freedom to negotiate at arm's length.").
24. *See supra* n.22.
25. *See supra* n.23.

IN THE COURTS

Delaware Court of Chancery Holds that Demand Futility May Be Pleaded with Less "Particularity"

By Joel Kurtzberg and Peter J. Linken

Delaware law is clear that a shareholder generally may not bring a derivative action on behalf of a corporation unless the shareholder pleads that (1) it made a pre-litigation demand upon the board of directors of the corporation or (2) such demand upon the board would have been futile.[1] Chancery Court Rule 23.1, which is modeled after Fed. R. Civ. P. 23.1, requires that these predicate facts must be "allege[d] with particularity," which is a higher standard than typical notice pleading under Rule 8(a).

The Delaware Chancery Court's recent decision in *Elburn* v. *Albanese*,[2] squarely addressed for the first time "what is required to plead a fact 'with particularity' under Rule 23.1."[3] Relying primarily upon federal decisions construing the particularity requirement of Fed. R. Civ. P. 9(b) in the context of fraudulent omission cases, the Court found that Rule 23.1 does not require the pleading of classic "newspaper facts"—for example, the "'who, what, when, where and how' concerning the alleged fiduciary wrongdoing"— to allege demand futility adequately.[4] Accordingly, the Court allowed the claim in *Elburn* to proceed, despite the fact that the plaintiff "has not identified the specific discussions that comprised the [allegedly wrongful] agreement"; the plaintiff merely "described the agreement 'with detail sufficient to apprise the defendant of the basis for the claim,'" which the court deemed sufficient.[5]

Joel Kurtzberg *and* **Peter J. Linken** *are attorneys at Cahill Gordon & Reindel LLP. The views expressed herein are the views solely of the authors and are not necessarily the views of the firm or its clients.*

Background

Investors Bancorp (Bancorp) is a Delaware holding company for Investors Bank, a New Jersey chartered savings bank. In 2015, Bancorp stockholders approved an equity incentive plan (EIP) adopted by Bancorp's board of directors (Board). Following the approval, Board members granted themselves substantial stock options and restricted stock units under the EIP (2015 Awards). Bancorp's CEO, Kevin Cummings (Cummings), and President/COO, Domenick Cama (Cama), were the largest beneficiaries of the 2015 Awards.

In 2016, Robert Elburn (Elburn) commenced a derivative action, alleging that the Board had breached its fiduciary duties by approving the 2015 Awards. Elburn sought rescission of the 2015 Awards, including the substantial amounts awarded to Cummings ($16.7 million) and Cama ($13.4 million). The case was settled before trial. Cummings and Cama agreed to forfeit the entirety of their awards, and Chancery Court approved the settlement in June 2019.

Bancorp filed a proxy statement for its 2019 annual stockholders meeting in April of 2019. The statement informed stockholders that the Board "intended to consider the issuance of new awards to Cummings and Cama under the previously approved EIP" (Replacement Awards).[6] The Replacement Awards took effect in July 2019 after approval of the settlement of the original derivative action and granted Cummings and Cama awards "similar in scope" to their 2015 Awards.[7]

Elburn commenced a new derivative litigation that sought to rescind the Replacement Awards. Elburn alleged that the Replacement Awards were part of a broader *quid pro quo* between nonemployee board members on one hand, and Cummings and Cama on the other. According to Elburn, the Replacement Awards enabled the defendants "in the 2016 [derivative action] to settle the claims against them by appearing to agree to substantial concessions when, in fact, Cummings and Cama gave up very little."[8]

Defendants moved to dismiss the second derivative action, arguing that Elburn did not satisfy the exacting standards of Rule 23.1 for pleading demand futility. Defendants urged the Chancery Court to

> construe the "with particularity" language in Rule 23.1 just as it construes the same language in Rule 9(b). That is, the court should require Plaintiff to support his demand futility allegations with the so-called "newspaper facts"—who, what, when, where and how—just as the court requires of plaintiffs who attempt to plead fraud.[9]

The Delaware Chancery Court Rejects Defendants' Argument

The Chancery Court began its analysis by observing that Defendants and Elburn fundamentally disagreed about the "degree of particularity" required by Rule 23.1. Defendants pressed for application of Rule 9(b)'s heightened standard of particularity, while Elburn argued that

> unlike a plaintiff alleging fraud, who is likely a witness to (if not the recipient of) the fraudulent overture, the derivative stockholder plaintiff rarely, if ever, is witness to, or has direct knowledge of, the breaches of fiduciary duty he alleges in his complaint.[10]

Given the wide chasm between the parties' positions, the Court deemed it appropriate "to dilate on Rule 23.1's 'with particularity' pleading standard"[11] before eventually adopting what the Court stated were the less rigorous Rule 9(b) pleading requirements typically applied in cases concerning fraudulent omissions—for example, requiring some degree of "particularity," but dispensing with the need to plead all of the "newspaper facts."

The Chancery Court commenced its analysis by observing that Delaware courts typically require different degrees of adherence to Rule 9(b)'s particularity requirement depending upon the context of the particular case. According to the Court, "nothing in [Delaware's] Rule 9(b), or the cases interpreting the rule, say that newspaper facts must be pled in every fraud case, come what may."[12] Citing to *LVI Group Investors, LLC* v. *NCM Group Holdings LLC*,[13] the Court reasoned that Rule 9(b) requires "only that 'a plaintiff [] allege the circumstances [of the fraud] with detail sufficient to apprise the defendant of the basis for the claim."[14] The Court stated explicitly that it saw no reason to "depart from, or enhance" the standard used by Delaware courts in the context of Rule 9(b).[15]

The Chancery Court then analyzed what degree of particularity was required for Elburn to plead demand futility. It invoked public policy considerations to observe that the "rationale for requiring a plaintiff to plead newspaper facts describing an alleged fraud under Rule 9(b) falls away, however, when a stockholder attempts to plead a derivative breach of fiduciary claim under Rule 23.1."[16] The Court distinguished between a fraud plaintiff — "who was likely a witness to (if not the recipient of) the fraudulent overture"[17] and thus "is witness to, or has direct knowledge" of. the facts necessary to plead fraud with particularity[18] — and shareholders, who are not present at board meetings, often are not privy to board discussions, and "[e]ven with Section 220" books and records request "documents in hand . . . would be hard pressed to plead . . . 'who, what, when, where and how' facts about fiduciary wrongdoing."[19]

Based on the distinction between fraud plaintiffs and shareholders proceeding derivatively, the Chancery Court decided the more appropriate lens through which to evaluate demand futility is that deployed by federal courts when considering fraudulent omission claims.[20] The Court reached this determination, despite acknowledging that "derivative plaintiffs frequently seek to hold fiduciaries liable for their actions, not their omissions."[21] This difference is significant because Rule 9(b) is relaxed in omission cases specifically because "a plaintiff cannot plead either the specific time of [an] omission or the place, as he is not alleging an act, but a failure to act."[22]

Applying this framework to the case at hand, the Chancery Court concluded that Elburn "plainly describe[d] the specific misconduct in which each Defendant is alleged to have participated and the bases upon which Plaintiff alleges that an illicit *quid pro quo* arrangement led to the Replacement Awards."[23] The Court was swayed particularly by the allegations found at Paragraph 100 of the Complaint, which alleged:

> As described above, each of these directors were able to retain a substantial portion of their challenged awards *only* because Cummings and Cama had agreed to forfeit *all* of their awards as part of the Settlement. As it turned out, Cummings and Cama's agreement came with strings attached: *Before Agreeing to the Settlement*, Cummings and [Cama] sought, and received, an undisclosed assurance from the Board's non-employee directors that they would "replace" the awards Cummings and Cama were agreeing to give up, in an amount acceptable to Cummings and Cama.

While not a dispositive factor, it is worth observing that the Chancery Court appeared to consider that "[t]argeted discovery is likely to reveal *rather quickly* if the *quid pro quo* agreement alleged in the Complaint was actually reached."[24] Given the stated concerns that shareholders are at an informational disadvantage *vis-à-vis* board members, it appears that the Court in essence balanced the costs of targeted discovery against the costs of imposing too high a standard for pleading the requisite demand futility.

It also is worth noting that federal decisions applying a relaxed standard pursuant to Rule 9(b) typically require the pleading of something more to ensure that fraud claims do not proceed based upon mere speculation and conclusion. For example, the Court of Appeals for the Third Circuit—along with numerous other federal appellate courts—has found repeatedly that the relaxation of Rule 9(b) is not license to dispense with the pleading of particular facts.[25] The Chancery Court in *Elburn* appears to have focused more upon whether the allegations put the defendants on notice of the challenged conduct, rather than whether the claims were supported by adequate facts establishing the elements of the claim or why a relaxed pleading standard should be applied.

Implications

The *Elburn* decision, if more widely adopted in cases before the Court of Chancery, could lead to an increased number of shareholder derivative actions surviving a motion to dismiss in Delaware courts. Relatedly, shareholders of Delaware corporations may be emboldened to forgo demands upon a company's board, choosing instead to plead demand futility as the *de facto* norm. It will be interesting to see how *Elburn's* rationale is received by the Delaware Bar and the Chancery Court more generally, given some of the analytical reasoning employed by the Court in *Elburn*, including its reliance on federal omissions cases and its conclusion that fraud plaintiffs are typically witnesses to the fraud. Delaware corporations should monitor the progress of this case through any subsequent appeals and be watchful for the invocation of *Elburn's* analysis by other members of the Chancery Court in future cases.

Notes

1. *See* Del. Ct. Ch. R. 23.1.
2. Elburn v. Albanese, C.A. No. 2019-0774-JRS, 2020 WL 1929169 (Del. Ch. Apr. 21, 2020).
3. Elburn v. Albanese, 2020 WL 1929169, at *2 (Del. Ch. Apr. 21, 2020).
4. *Id.* at *8, *8 n. 95.
5. *Id.* at *3.
6. *Id.* at *1.

7. *Id.*
8. *Id.*
9. *Id.* at *2.
10. *Id.* at *2.
11. *Id.* at *7
12. *Id.* at *3.
13. LVI Grp. Invs., LLC v. NCM Grp. Hldgs. LLC, 2017 WL 1174438 (Del. Ch. Mar. 29, 2017).
14. *Elburn*, 2020 WL 1929169, at *3; *see also id.* ("While newspaper facts *often* will be necessary to meet this standard in the fraud context, the lack of this 'specificity' when pleading either fraud or demand futility is not, *de jure*, 'fatal' to the claim.").
15. *Id.*
16. *Id.* at *8.
17. The Chancery Court's decision to characterize fraud plaintiffs as present for, and thus aware of, the particular newspaper facts supporting a claim for fraud is noteworthy. The apparent basis for this conclusion is the line of Delaware cases finding that, where "a plaintiff's claim for fraud is based on a written contractual representation, it is relatively easy [for a plaintiff] to plead a particularized claim of fraud. In such a situation, the plaintiff can readily identify who made what representations where and when [and] what the defendant gained, which was to induce the plaintiff to enter into the contract." LVI Grp. Invs., LLC v. NCM Grp. Hldgs. LLC, 2017 WL 1174438, at *4 (Del. Ch. Mar. 29, 2017) (citations and quotation marks omitted). Numerous courts interpreting and applying the analogous Fed. R. Civ. P. 9(b) have reached the divergent conclusion that, "[p]articularly in cases of corporate fraud, plaintiffs cannot be expected to have personal knowledge of the details of corporate internal affairs." Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 645 (3d Cir. 1989); *see also* Wexner v. First Manhattan Co., 902 F.2d 169, 172 (2d Cir. 1990) ("Despite the general rigid requirement that fraud be pleaded with particularity, the allegations may be based on information and belief when facts are peculiarly within the opposing party's knowledge.") (citations omitted). As detailed herein, courts faced with such fraud claims have articulated a balancing of Rule 9(b)'s requirement to ensure claims do not proceed on mere speculation and conclusions.
18. *Id.* at *2, *8.
19. *Id.* at *8.
20. *See id.* at *8 ("In my view, the better paradigm in which to assess particularity in the Rule 23.1 context is the one in which courts contextually evaluate allegations of fraudulent omissions. Where the plaintiff alleges fraud by omission, courts generally 'relax Rule 9(b)'s fraud pleading requirement.'"). The Chancery Court cited JP Morgan Chase Bank, N.A. v. Ballard, 213 A.3d 1211, 1245 n.201 (Del. Ch. 2019) (quoting Wright & Miller § 1298), as support for this proposition. The referenced footnote from the decision, however, cites to Wright and Miller for the proposition that "under Fed. R. Civ. P. 9(b), which is identical to Del. Ch. Ct. R. 9(b), 'courts may relax Rule 9(b)'s fraud pleading requirement if the defendant *is alleged to have concealed* the facts that would permit the plaintiff to plead fraud with particularity'") (emphasis added). The key requirement of this provision is that the relaxation of Rule 9(b)'s requirements must be accompanied by pleading of concealment by the defendant.
21. *Elburn*, 2020 WL 1929169, at *8.
22. Ashgari v. Volkswagen Grp. of Am., Inc., 42 F. Supp. 3d 1306, 1325 (C.D. Cal. 2013).
23. *Elburn*, 2020 WL 1929169, at *9.
24. *Id.* (emphasis added).
25. *See, e.g.*, Craftmatic Sec. Litig. v. Kraftsow, 890 F.2d 628, 645-46 (3d Cir. 1989) ("[C]ourts have relaxed [Rule 9(b)] when factual information is peculiarly within the defendant's knowledge or control. . . . Nonetheless, even under a non-restrictive application of the rule, pleaders must allege that the necessary information lies within defendant's control, and their allegations must be accompanied by a statement of the facts upon which the allegations are based. . . . [P]laintiffs must accompany their allegations with facts indicating why the charges against defendants are not baseless and why additional information lies exclusively within defendants' control.") (citations omitted); *see also* Wexner v. First Manhattan Co., 902 F.2d 169, 172 (2d Cir. 1990) ("This exception to the general rule must not be mistaken for license to base claims of fraud on speculation and conclusory allegations. Where pleading is permitted on information and belief, a complaint must adduce specific facts supporting a strong inference of fraud or it will not satisfy even a relaxed pleading standard.").

STATE CORNER

Delaware Court of Chancery Sustains *Caremark* Claim against Audit Committee

By J. Timothy Mast, Dave Meyers, Jason Norinsky, and Mary Weeks

The Delaware Court of Chancery recently sustained a *Caremark* claim filed by a stockholder of Kandi Technologies Group, Inc., a publicly-traded Delaware corporation based in Jinhua, China (Company).[1] The derivative suit sought to recover damages from (1) the three directors who comprised the Audit Committee during the period of persistent problems, (2) the Company's Chief Executive Officer, and (3) the three chief financial officers who served in quick succession during the years leading up to the Company's March 2017 financial restatement. The complaint alleged that the defendants breached their fiduciary duties by willfully failing to maintain an adequate system of oversight, disclosure controls and procedures, and internal control over financial reporting. The defendants moved to dismiss the claim pursuant to Chancery Court Rule 23.1, on the grounds that the plaintiff did not make a pre-suit demand on the board before filing a derivative claim and failed to plead that a demand would have been futile. Disposing of the defendants' arguments, the Court denied their motion to dismiss under Rule 23.1 and Rule 12(b)(6) for failure to state a claim.

J. Timothy Mast, Dave Meyers, Jason Norinsky, *and* **Mary Weeks** *are attorneys at Troutman Sanders LLP.*

Caremark Claims

A *Caremark* claim is conceptualized as flowing from an overarching failure by the directors to take the action necessary to protect the corporation and is historically one of the most difficult corporate law claims to plead. As articulated in *Caremark*,

> the board of a Delaware corporation has a fiduciary obligation to adopt internal information and reporting systems that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance.[2]

Delaware courts previously have determined that "[t]he mere existence of an audit committee and the hiring of an auditor does not provide universal protection against a *Caremark* claim."[3]

Though rare, Delaware courts have found that directors face a substantial threat of liability under *Caremark* where the directors either utterly failed to implement any reporting or information system or controls; or, having implemented such a system or controls, consciously failed to monitor or oversee its operations, thus, disabling themselves from being informed of risks or problems requiring their attention.[4] Delaware courts have stated that "a showing of bad faith conduct is essential to establish director oversight liability" and that a plaintiff can establish bad faith by "showing that the directors knew that they were not discharging their fiduciary obligations."[5] Under *Caremark*, "[g]enerally where a claim of directorial liability for corporate loss is predicated upon ignorance of liability creating activities within the corporation . . . only a *sustained* or *systemic* failure of the board to exercise oversight . . . will establish the lack of good faith that is a necessary condition to liability." As the Delaware Supreme Court opined in the recent case *Marchand v. Barnhill*, "failing to make that good faith effort breaches the duty of loyalty and can expose a director to liability."[6]

The *Hughes* Case

The Court in *Hughes* found that the complaint's allegations support a pleading-stage inference that "the Company's Audit Committee met sporadically, devoted inadequate time to its work, had clear notice of irregularities, and consciously turned a blind eye to their continuation."[7] According to the allegations of the complaint, the Company had experienced persistent struggles with its financial reporting and internal controls, dating as far back as 2010. The complaint further alleged, by way of example, that the Company had instructed its internal auditor to conceal certain related-party transactions (including transactions with a company owned by the CEO's son) and that the Company's auditor discovered but failed to investigate the Company's parking of large amounts of cash in the personal bank accounts of its officers and employees.

Subsequently, in March 2014, the Company publicly announced the existence of material weaknesses in its financial reporting and oversight systems, including a lack of oversight by the Audit Committee and a lack of internal controls for related-party transactions, but pledged to remediate these problems. Yet, after this announcement, according to the complaint, the Company's Audit Committee went on to meet only when prompted by the requirements of the federal securities laws and such meetings were short and regularly overlooked important issues and irregularities. After three more years of such behavior, in March 2017, the Company disclosed that its preceding three years of financial statements needed to be restated and disclosed that it lacked sufficient expertise related to GAAP and SEC disclosure requirements, the proper disclosure of related-party transactions, the accuracy of accounting-related disclosures, effective controls to ensure proper classifications and financial reporting, and other matters.

Significantly, the Court also determined that, in response to plaintiff's books and records request pursuant to Section 220 of the Delaware General Corporation Law, the Company could have produced documents that would have rebutted this inference, concluding that the absence of those documents was telling because, as the Delaware Chancery court previously has acknowledged,

> it is more reasonable to infer that exculpatory documents would be provided than to believe the opposite: that such documents existed and yet were inexplicably withheld.[8]

Additionally, the documents that the Company produced indicated that the Audit Committee never met for longer than one hour and typically only once per year. Each time, the Audit Committee purported to cover multiple agenda items that included a review of the Company's financial performance in addition to reviewing its related-party transactions. On at least two occasions, the Audit Committee missed important issues that it then had to address after the fact through action by written consent.

Thus, the Court found it apparent that the board of directors had failed to establish a reasonable system of monitoring and reporting in the first instance, choosing instead to rely entirely on management. As a result, the Court determined that the plaintiff was entitled to the inference that the board was not fulfilling its oversight duties.

Hughes also reaffirmed, however, that Delaware directors are at risk of *Caremark* liability only if they "utterly fail to implement any reporting or information system or controls" or, "having implemented such a system or controls, consciously fail to monitor or oversee its operations."[9] The Court went on to state that while such a bar is indeed high, it was met in *Hughes* only because the complaint alleged that the Audit Committee met infrequently and briefly, routinely overlooking important issues, and that the board had chronic deficiencies that supported a reasonable inference that the board, acting through its Audit Committee, failed to provide any meaningful oversight.

Conclusion

The decision of the Court in *Hughes* reinforces the connection between good corporate governance, accurate and detailed recordkeeping, and *Caremark* liability risk, with the Court stating that

> the board is obligated to establish information and reporting systems that allow management and the board, each within its own scope, to reach informed judgements concerning both the [Company's] compliance with law and its business performance.[10]

It is critical that companies implement reporting systems that provide directors with timely information regarding key risks and that directors react promptly when these reporting systems suggest the need for remedial action. Furthermore, it is essential that these processes be well-documented in order to provide stockholders and courts a fair and accurate picture of the work done by directors. To that end, companies should be reminded by this decision that they must be thoughtful and measured when responding to a Section 220 demand for corporate books and records, as not only what is produced may be critiqued by plaintiffs and courts alike, but also what is not produced may prove to be just as important.

Notes

1. Hughes v. Hu, C.A. No. 2019-0112-JTL, 2020 WL 1987029 (Del. Ch. Apr. 27, 2020).
2. *Id*. at *13.
3. *Id*. at *14.
4. *Id*.
5. *Id*.
6. Marchand v. Barnhill, 212 A.3d 805, 820 (Del. 2019).
7. *Hughes*, 2020 WL 1987029, at *14.
8. *Id*. at *17 (*citing* In re Tyson Foods, Inc., 919 A.2d 563, 578 (Del. Ch. 2007)).
9. *Id*. at *14.
10. *Id*. at *16.

CLIENT MEMOS

A summary of recent memoranda that law firms have provided to their clients and other interested persons concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of the listed memoranda should contact the firms directly.

Akin, Gump, Strauss, Hauer & Feld LLP
Washington, DC (202-887-4000)

Second Circuit Holds Section 16 Plaintiff Needs to Identify an Issuer-Specific Agreement to Establish Creation of a Group Among Clients (May 22, 2020)

A discussion of a Second Circuit decision affirming two lower court decisions dismissing complaints alleging violations of Section 16(b) of the Securities Exchange Act of 1934 and holding that an investment adviser's client does not become a member of a Section 16 "group" with its adviser's other clients merely by delegating general discretionary investment authority to a common investment adviser.

Arnold & Porter Kaye Scholer LLP
Washington, DC (202-942-5000)

Considerations for Acquisitions and Investments Involving Companies that Have Taken CARES Act Funding (May 27, 2020)

A discussion of the various funding programs under the Coronavirus Aid, Relief and Economic Security Act, various due diligence issues that acquirors and investors should consider and how these programs will be enforced and the risks to which acquirors and investors will be exposed.

Baker & Hostetler LLP
Denver, CO (303-861-0600)

SEC and Kik Present Competing Arguments on Application of Securities Laws to Blockchain Tokens (May 2, 2020)

A discussion of the briefing in a case in which the Securities Exchange Commission challenges Kik's actions in raising funds through Simple Agreements for Future Tokens and Kik's 2017 public sale of Kin tokens.

Bryan Cave Leighton Paisner LLP
St. Louis, MO (314-259-2000)

SEC Reinforces the Importance of Cost Transparency (May 9, 2020)

A discussion of a SEC order released in advance of the June 30 effective date for Regulation BI requirements relating to the transparency of fees, inaccurate communications and conflicts about services and fees by a dual-registered broker-dealer/investment adviser.

Cahill Gordon & Reindel LLP
New York, NY (212-701-3000)

ISS and Glass Lewis Provide Policy Guidance on Impact of COVID-19 (May 8, 2020)

A discussion of guidance issued by Institutional Shareholder Services, Inc. and Glass Lewis & Co. for investors and companies to navigate a number of voting policy issues that are likely to be impacted directly by the pandemic.

Cleary, Gottlieb, Steen & Hamilton LLP
New York (212-225-2000)

SDNY Holds Syndicated Loans Are Not Securities (May 26, 2020)

A discussion of a Southern District of New York decision, *Kirschner v. Chase, et al.*, reaffirming the widely held understanding that syndicated loans are not securities.

Covington & Burling LLP
Washington, DC (202-662-6000)

Nasdaq Temporary Shareholder Approval Relief (May 7, 2020)

A discussion of Nasdaq's adoption of temporary relief through June 30 from shareholder approval requirements pertaining to the so-called 20 percent rule.

Davis Polk & Wardwell LLP
New York, NY (212-450-4000)

SEC Issues FAQs Relating to COVID-19 Reporting Relief (May 6, 2020)

A discussion of FAQs issued by the SEC Staff relating to its March 25th order which extends filing deadlines for companies who require additional time to comply with such deadlines as a result of COVID-19.

SEC Orders SROs to Implement Changes to NMS Plan Governance (May 11, 2020)

A discussion of a SEC order directing the national securities exchanges and the Financial Industry Regulatory Authority (FINRA) to propose a new National Market System equity market data plan.

Dechert LLP
Philadelphia, PA (215-994-4000)

Delaware Court of Chancery Adopts New Framework for Determining Whether to Join Minority Stockholder with a Controlling Stockholder (May 2020)

A discussion of a Delaware Court of Chancery decision establishing a new framework for purposes of determining whether minority stockholders should be deemed part of a control group with a stockholder that is already a controller on its own.

Dorsey & Whitney LLP
Minneapolis, MN (612-340-2600)

SEC COVID Investigations (May 2, 2020)

A discussion of two types of current SEC investigations related to COVID: (1) firms that are actively marketing COVID related products; and (2) firms that have applied for or obtained funds under the recent COVID legislation.

Fenwick West LLP
Mountain View, CA (650-988-8500)

SEC Enforcement Division: "Business as Usual" as Securities Enforcement Leaders Gather Virtually for Securities Enforcement West 2020 (May 9, 2020)

A discussion of the Securities Enforcement West 2020 panels that took place virtually May 12.

Gibson, Dunn & Crutcher LLP
Los Angeles, CA (213-329-7870)

Investor Communications by Private Equity and Real Estate Fund Managers in Light of COVID-9 (May 7, 2020)

A discussion of the need for managers of private equity and real estate funds to consider their disclosure obligations and determine appropriate steps in communicating evolving circumstances to investors in light of COVID-19.

2019 Year-End Activism Update (May 11, 2020)

A discussion of shareholder activism activity involving NYSE and Nasdaq listed companies with equity market capitalizations in excess of $1 billion and below $100 billion during the second half of 2019.

Holland & Knight LLP
Tampa, FL (813-227-8500)

SEC Office of Compliance Inspections and Examinations Issues Regulation Best Interest Risk Alert (May 7, 2020)

A discussion of the issuance by the SEC Office of Compliance Inspections and Examinations of an "Examinations that Focus on Compliance with Regulation Best Interest" Risk Alert that provides broker-dealers and investment advisers information about the expected scope and content of the SEC's upcoming examinations for compliance with Best Interest.

Jenner & Block LLP
Chicago, IL (312-222-9350)

Poison Pills during COVID-19 Pandemic (May 1, 2020)

A discussion of the use of shareholder rights plans (often referred to as poison pills) during the COVID-19 pandemic, including the views of the proxy advisory firms.

K&L Gates LLP
Pittsburgh, PA (412-355-6500)

A Program for Compliance with the Exchange Traded Fund Rule 6c-11 (May 2020)

A step-by-step guide for compliance officers of exchange-traded funds (ETFs) to assess compliance with new Rule 6c-11 and related amendments to disclosure requirements for ETFs that went into effect in December 2019.

KattenMuchinRosenman LLP
Chicago, IL (312-902-5200)

SEC Enforcement Actions against Fund Advisers Continues (May 15, 2020)

A discussion of recent SEC enforcement actions against investment advisers and fund managers relating to conflicts of interest and disclosures to fund investors and clients.

Mayer Brown LLP
Chicago, IL (312-782-0600)

New York Proposes Investment Industry Modernization and "Finder"/"Solicitor" Registration and Exam Requirements (May 7, 2020)

A discussion of a proposal by the New York State Investor Protection Bureau to update its rules for broker-dealers and investment advisers. The proposal defines and classifies "finders" and "solicitors" and explicitly requires registration and exam requirements for both.

McDermott, Will & Emery, LLP
Chicago, IL (312-372-2000)

Debt Buybacks (May 26, 2020)

A discussion of debt buybacks, including key considerations for borrowers, sponsors, and lenders.

Mintz, Levin, Cohn, Ferris, Glovsky & Popeo P.C.
Boston, MA (617-542-6000)

Does the Coronavirus Change the Material Adverse Event Clause for Mergers & Acquisitions (May 7, 2020)

A discussion of the purpose of the material adverse change (MAC) provision and its function to date, noting that while the significance of COVID-19 is undeniable, the question of materiality for the MAC clause remains unsettled in mergers and acquisitions.

SEC Is Sued to Stop Collection of Personal Data of Retail Investors (May 19, 2020)

A discussion of a suit filed by the American Securities Association, a financial industry trade association representing regional and small financial services companies, against the SEC to prevent the SEC from using the Consolidated Audit Trail initiative to gather personal data of retail investors.

FINRA Shares Best Practices by Firms to Supervise in a Remote Work Environment (May 29, 2020)

A discussion of a FINRA regulatory notice that shares certain common practices they have seen taken by member firms to enhance supervision in the remote work environment due to COVID-19.

Morgan, Lewis & Bockius LLP Philadelphia, PA (215-963-5000)

Boards of Directors Must Continue to Meet Fiduciary Duties during Pandemic (April 27, 2020)

A discussion of key considerations and best practices that a board of directors should implement during the COVID-19 pandemic in order to fulfill its fiduciary duties.

SEC Announces Temporary Rules to Enhance Availability of Regulation Crowdfunding (May 9, 2020)

A discussion of temporary relief provided by the SEC focusing on the financial statements and timing and cancellation requirements of Regulation Crowdfunding.

Nixon Peabody LLP Rochester, NY (585-263-1000)

SEC Releases Coronavirus Disclosure Guidance for Issuers of Municipal Securities (May 1, 2020)

A discussion of a public statement issued by SEC Chairman Clayton and Director of the Office of Municipal Securities Olsen entitled "The Importance of Disclosure for Our Municipal Markets," paralleling guidance recently issued to public companies.

Paul, Weiss, Rifkind, Wharton & Garrison LLP New York, NY (212-373-3000)

SEC Charges Company with COVID-19 Securities Fraud (May, 2020)

A discussion of the SEC's first enforcement action arising out of the COVID-19 pandemic alleging that a Florida company and its CEO misled investors by falsely stating that the company was able to acquire and supply fewer quantities of masks when it never had any.

NYSE Provides Temporary Relief or the 20% Shareholder Approval Requirement (May 9, 2020)

A discussion of SEC approval of a proposed NYSE rule change that provides NYSE-listed companies with a temporary exception to the shareholder approval requirement for private placements and a related narrow exception for any affiliated purchaser's participation in these placements.

Perkins Coie LLP Seattle, WA (206-359-8000)

Conflicted Transactions (May 1, 2020)

A discussion of a Delaware Court of Chancery decision, *Salladay v. Lev*, illustrating the need to rigorously follow case law guidance to achieve the benefits of conflict-cleansing procedures.

SEC Proposes Regulations or Determining Fair Value of Securities Held by Investment Companies (May 5, 2020)

A discussion of a SEC proposal to update its guidance in the form of a proposed regulation on determining the fair value of securities under the Investment Company Act of 1940.

Pillsbury Winthrop Shaw Pittman LLP
New York, NY (212-858-1000)

Finding the Proper Balance of Legal and Consulting Advice for Compensation Committees (May 4, 2020)

A discussion of the benefits to a compensation committee of being advised by both its compensation consultant's benchmarking and peer group data and its legal advisor's *pro forma* proxy disclosures and related investor relations consequences.

Proskauer Rose LLP
New York, NY (212-969-3000)

Alternative Equity Offerings for Volatile Markets (May 1, 2020)

A discussion of four alternative equity offering types that public companies may consider in addressing their capital raising and liquidity needs.

Ropes & Gray LLP
Boston, MA (617-951-7000)

Portfolio Company Director Role & Duties in the COVID-19 Era (May 1, 2020)

A discussion of the roles and duties of portfolio company board members.

Seyfarth Shaw LLP
Houston, TX (713-225-2300)

District Courts in New Jersey and New York Dismiss Securities Class Actions against Life Science Companies (May 5, 2020)

A discussion of decisions dismissing putative class actions complaints against life sciences companies making it clear that the duty to disclose does not cover all conceivable information investors may find or consider relevant and that life sciences companies are not prohibited from expressing optimism about the prospects of Federal Drug Administration approval for products because of less-than-positive feedback from the regulator during the review process.

Sidley Austin LLP
Chicago, IL (312-853-7000)

Nasdaq Targets Emerging Market Companies with Proposed Listing Standards (May 8, 2020)

A discussion of three Nasdaq proposed rules designed to tighten listing standards for certain companies based in emerging markets, in particular jurisdictions that have secrecy laws, blocking statutes, national security las or other laws restricting access to information by US regulators.

Simpson, Thacher & Bartlett LLP
New York, NY (212-455-2000)

COVID-19 Considerations for Employee and Director Compensation Reductions (May 7, 2020)

A discussion of key issues employers should consider when contemplating compensation reductions for employees and non-employee directors during this challenging period.

Skadden, Arps, Slate, Meagher & Flom LLP
New York, NY (212-735-3000)

IPO Costs Are Nondeductible Even When a Corporation Later Goes Private (May 27, 2020)

A discussion of an internal memorandum of the Internal Revenue Service recently released indicating that a corporation may not deduct previously capitalized costs that facilitated an initial public offering even when it ceases to be a publicly traded company.

Troutman Sanders LLP
Atlanta, GA (404-885-3000)

Delaware Court Declines to Circumvent Shareholder Representative Structure to Add Individual Stockholders or Compel Discovery (May 27, 2020)

A discussion of a Delaware Court of Chancery decision, *Fortis Advisors LLC v. Allergan W.C. Holding Inc.*, holding that a party in a dispute over whether stockholders are entitled to certain post-closing milestone consideration under a merger agreement could not compel the stockholders themselves to participate in discovery as real parties in interest when the merger parties had negotiated expressly for a single shareholders' representative.

Venable LLP
Baltimore, MD (410-244-7400)

SEC and DOJ Bring FCPA Enforcement to Consumer Lending (May 26, 2020)

A discussion of the settlement of a SEC FCPA investigation in connection with a consumer lender's operations in Mexico.

Wilmer Cutler Pickering Hale and Door
Washington, DC (202-663-6000)

US Court of Appeals Denies Petition of Mandamus Seeking to Protect Privilege (May 4, 2020)

A discussion of two decisions of the US Court of Appeals for the District of Columbia granting mandamus petitions vacating district court orders compelling disclosure of documents generated during an internal investigation, as well as one denying such a petition.

Renewed Interest by Public Companies in NOL Rights Plans (May 27, 2020)

A discussion of consideration by companies with depressed stock prices as a result of the COVID-19 pandemic and significant net operating loss carryforwards (NOLs) of a NOL rights plan.

Winston & Strawn LLP
Chicago, IL (312-558-5600)

COVID-19-Spawned "Busted Deal" M&A Litigation and MAEs (May 1, 2020)

A discussion of recent cases and practical takeaways for buyers and sellers in transactions significantly impacted by the pandemic where the buyer's obligation to close the transaction may be at issue.

June / 10041527-0420