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Forum Selection Bylaws: The New Frontier

By David J. Berger, a Partner of Wilson Sonsini Goodrich & Rosati

Since Delaware Chancellor Strine's decision in *Boilermakers Local 154 Retirement Fund v. Chevron Corp. et al* ("*Chevron*") affirming the right of companies to adopt forum selection bylaws, many corporate advisers have urged companies to immediately adopt such bylaws.[1] The argument in support of adoption of such a bylaw is quite simple: the bylaw is meant to address the clear problem caused by the growth of multi-forum litigation (primarily arising in the M&A context) which, by definition is wasteful and costly, while the solution of selecting Delaware is easy given the Chancery Court's extensive experience in corporate law disputes and the fact that most companies are incorporated in Delaware.[2]

Yet as Chancellor Strine recognized in his careful and thoughtful opinion (as well as in conferences when the notion of the bylaw was first being discussed), there is a great difference between the statutory validity of the bylaw and its use in practice. In this way, a forum selection bylaw is similar to a shareholder rights plan, advance notice provision or many other corporate tools available to boards of Delaware companies. Such tools are, as a general matter, legal under Delaware law as consistent with the broad enabling authority of the Delaware General Corporation Law ("DGCL"); however a board's decision to invoke these types of corporate devices is always subject to challenge, to determine whether the board is complying with its equitable obligations to the company's shareholders.[3]

The Chancery Court's decision is currently on appeal to the Delaware Supreme Court.[4] However, even assuming that the lower court's decision is affirmed, critical issues concerning the bylaw will remain unresolved, much as litigation over shareholder rights plans was not resolved by the Delaware Supreme

[1] *Boilermakers Local 154 Retirement Fund v. Chevron*, C.A. No. 7220-CS (Del. Ch. June 25, 2013)("*Chevron*"). Wilson Sonsini Goodrich & Rosati represents Chevron in this litigation. For an example of how the defense bar has responded to this decision, see David A. Katz & Laura A. McIntosh, *Corporate Governance Update: Implementing Exclusive Forum Bylaws,* New York Law Journal, July 25, 2013 ("Katz & McIntosh").

[2] See, *e.g.,* Katz & McIntosh, *supra*, at 3-7.

[3] *Chevron*, supra, slip. Op. at 30

[4] See *Boilermakers Local 154 Retirement Fund v. Chevron*. In response to the court's questioning at oral argument on defendants' motion for judgment on the pleadings, the parties admitted that they would appeal the Court's decision—and in August, the plaintiffs filed a notice of appeal with the Delaware Supreme Court.

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Court's decision validating the board's authority to adopt such plans.[5] In particular, a number of practical issues remain outstanding, including: when should a board invoke the bylaw, the standard of review for a challenge to the board's decision, and the potential that courts outside of Delaware may be reluctant to enforce the provision.

In addition to these issues, a board considering whether or not to adopt a forum selection bylaw must also consider the breadth of the bylaw and which forum should be chosen. While a Delaware corporation can certainly choose to follow the example set by *Chevron*, and there can be no question about the Delaware Court of Chancery's experience and expertise at handling corporate litigation—particularly intra-corporate disputes and/or expedited M&A litigations—other companies may believe that the bylaw should be more limited and/or that courts in their principal place of business are equally well suited to handle these types of issues.

As Chancellor Strine noted at the time the forum bylaw idea was still in the conceptual stage, it "says something about the way management teams are regarded in their own communities that plaintiffs would think of it as an attractive place to sue a company." While it is certainly true that many companies recognize the benefits that come with having litigation in Delaware, there are also many companies who may believe that their own communities are, in fact, the best place to have any litigation—and this issue should certainly be considered as part of any decision by the board to adopt a forum selection bylaw.

More broadly, and as with any corporate law question, a management team and board considering this type of issue must weigh many factors before coming to the conclusion of what works best. The forum selection bylaw is not a "one size fits all" solution, and just as a board's decision in adopting and/or using a forum selection bylaw may be challenged on a fiduciary basis, so too should the board's consideration and implementation of any such bylaw be based on what is best for the particular needs of a company.

The Problem and the Bylaw Solution

A number of practitioners, courts and scholars had recognized the growing trend of multi-forum litigation, particularly in the M&A context, for several years. Within the last few years a number of academic studies confirmed this trend. For example, a recent analysis by a distinguished scholar found that, on average, more than five shareholder lawsuits were filed in more than 90% of deals valued at $500 million or more in 2012.[6]

In response, by 2010, a number of scholars and practitioners proposed that companies consider adopting some type of amendment to their charter or bylaw to limit multi-forum litigation. This movement was accelerated by a comment from Vice Chancellor Laster of the Delaware Chancery Court, who suggested that a forum selection provision in a company's articles and/or bylaws may be a valid and easy way to handle this issue.[7]

Following this trend, a number of companies adopted a forum selection provision, similar to that at issue in *Chevron*. However, in 2011, a federal court held that a forum selection bylaw adopted by Oracle was invalid under federal common law.[8] Although the decision was not based upon Delaware law, the practical impact of this decision was that many companies stopped adopting these types of bylaws and none tried to enforce such a provision.

In 2012, a dozen companies were sued in the Delaware Court of Chancery for their decision to adopt the forum selection bylaws without shareholder approval.[9] The complaints were, according to the court, "substantively identical", seeking both "a declaration that the bylaws were invalid" and a "salmagundi of other claims, alleging hypothetical ways in which the forum selection bylaws could potentially be enforced in an unreasonable and unfair manner."[10]

As is by now well known, the court ruled definitively on plaintiffs' declaratory relief claims, finding that the bylaws are facially valid under the DGCL and as a matter of contract law.

[5] *Moran v. Household Intern'l.*, 500 A.2d 1386 (Del. 1985) (upholding a board's right to adopt a "poison pill" in response to a takeover bid);

[6] See Robert M. Daines and Olga Komrian, "Shareholder Litigation Involving Mergers and Acquisitions," Cornerstone.com, Feb. 2013.

[7] See, *In re Revlon, Inc., S'holders Litig.*, 990 A.2d 940, 960 (Del. Ch. 2010)

[8] See *Galaviz v. Berg*, 763 F. Supp.2d 1170 (N.D. Cal. 2011).

[9] 10 of the 12 defendants repealed their bylaws and the complaints against these companies were dismissed. *Chevron, supra*, slip. Op. at 14.

[10] *Id.*, slip. Op. at 13-14.

Next Steps and What the Decision Means for Practitioners

Chancellor Strine's ruling is currently on appeal to the Delaware Supreme Court, and a decision on that appeal is not expected for several months. Until such a ruling, the validity of the bylaw remains uncertain. However, both while the case is pending and probably even after the appeal (even assuming the lower court's opinion is affirmed), there are several issues that companies and practitioners should consider in connection with the decision about whether or not to adopt a forum selection bylaw. These issues include the following:

1. *Should a company that does not currently have a forum selection bylaw provision adopt one now?*

   A number of commentators and practitioners have suggested that, based upon Chancellor Strine's thoughtful opinion, there is no significant risk to adopting a forum selection bylaw at this time. Others have suggested waiting until after the Delaware Supreme Court provides its guidance on the issue so that any questions about the legality of these provisions under Delaware law can be definitively decided. Again, this is not a "one size fits all" solution. The board, working with management and counsel, need to consider the specifics of the company.

   Among the issues to consider are the risks of multi-forum litigation in the foreseeable future, the harms to the company from such litigation, the impact of adopting such a bylaw on the company's stockholders and potential stockholder reaction to adoption of such a bylaw, and whether adopting such a bylaw could impact other corporate actions being considered by the company. In this way, consideration of a forum bylaw is again analogous to adoption of any other bylaw amendment or even a shareholder rights plan; while a board certainly has the authority under Delaware law to adopt various bylaws and a rights plan, a properly functioning board will consider the impact of any such action as it impacts a variety of corporate constituencies, including how it helps the company achieve broader strategic goals.

2. *Should a forum selection amendment be in the bylaws or charter?*

   For most companies that are already public, a forum selection provision will typically go in the bylaws rather than in the charter, just because—as a practical matter—it is an easier way to proceed. However, for companies considering going public, the decision still remains open as to whether to adopt a forum selection provision, and if so, whether this provision should be in the bylaws or charter?

   The initial decision by the federal court in California rejecting the bylaw amendment included language that seemed to imply that a charter amendment may be more valid than a bylaw, since a charter amendment has to be approved by the company's shareholders as well as its board while bylaws can be unilaterally adopted by the board.

   However, Chancellor Strine's opinion identified at least one big advantage to the company's stockholders having a forum selection clause in the bylaws rather than the charter: the stockholders have the right to unilaterally repeal a bylaw but not a charter amendment.[11] In addition, because boards can also unilaterally amend the bylaws, having the forum selection clause in the bylaws rather than in a charter provision allows the board greater flexibility with respect to the amendment than if it were in a charter provision. For these reasons, even pre-public companies may prefer to limit any forum selection provision to the bylaws rather than in a charter amendment.

3. *Assuming a company adopts a forum selection bylaw provision, when should the board invoke the provision?*

   Just because a company has a forum selection provision in its bylaws does not mean the company must invoke the provision for every lawsuit. Rather, the board typically has discretion (always subject to its fiduciary duties) as to whether or not to invoke the provision. The decision whether or not to invoke the provision should be given careful thought; in particular, if a company is sued in just one forum which is different from the

[11] *Chevron*, slip. Op. at 30

forum provided in the bylaw, the party opposing the company's effort to enforce the bylaw may accuse the company of creating the exact harm the bylaw was intended to prevent: creating multi-forum litigation by trying to start a second litigation in a different forum. Additionally, the company may be accused of forum-shopping, rather than simply trying to limit the problems caused by multi-forum litigation.

4. *What forums are available and how should a company determine the appropriate forum?*

   As with any forum selection clause, the forum selected by the company must be reasonable, have some relationship to the company and must be "unaffected by fraud, undue influence or overweening bargaining power."[12] Thus far, the forums that have generally been considered are the courts in the company's state of incorporation and the company's principal place of business. Chancellor Strine's decision in *Chevron* provides a number of thoughtful reasons why Delaware is an appropriate forum for companies incorporated in Delaware, including the benefit from having "internal affairs cases…decided in the courts whose Supreme Court has the authoritative final say as to what the governing law means".[13]

   Selecting the courts for the company's principal place of business also seems easy to defend, and the company may have many legitimate business reasons for keeping litigation in the courts where the company is located. For example, the company's officers and directors may be located close to the principal place of business, the logistics of litigation may be easier if the case is local, and many local courts also have considerable skills and experience on corporate law issues. In terms of general principles, thinking about forum selection in the bylaws raises many of the same issues as any other forum selection clause. Such clauses have become standard in many contracts these days (and in light of recent Delaware Supreme Court cases where these types of clauses are likely to become more common in business contracts in the future). Directors, well advised by management and counsel, should consider a variety of factors to determine which forums are appropriate for particular issues, much as is done now with many commercial contracts.

5. *What is the reaction of institutional investors, proxy advisory firms and shareholders to forum selection bylaws?*

   As these clauses were first being adopted by companies, there was some skepticism by institutional investors and proxy advisory firms, on the basis that plaintiffs should be allowed to choose their forum when suing the company. Following Chevron's defeat of a precatory proposal targeted against its bylaw proposal and in light of Chancellor Strine's opinion, investor hostility to these proposals seems to be declining.

   For example, ISS has recently modified its position on forum selection bylaws to view them on a case-by-case basis, although Glass Lewis and the Council of Institutional Investors continue to take a general position recommending against such bylaws. Thus any board considering whether or not to adopt this type of bylaw should consider potential shareholder reaction, including how adoption of a forum selection bylaw may affect other matters for which the board may need shareholder approval.

6. *What does the future hold?*

   Even assuming the Delaware Supreme Court affirms Chancellor Strine's thoughtful opinion and analysis, many open questions about the future of these provisions and the impact of the court's reasoning, remain open. One question is whether a decision by the Delaware Supreme Court affirming the right of Delaware corporations to adopt a forum selection bylaw will be followed by courts outside of Delaware? Under the internal affairs doctrine, the decision for companies incorporated in Delaware seems easy; even courts outside of Delaware must follow the final word of the Delaware Supreme Court on this issue. However, for companies incorporated outside of Delaware, even in states that look to Delaware corporate law for guidance, the answer is less clear.

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[12] *Chevron*, supra, slip. Op at 35-36 (citing *The Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1, 10 (1972))

[13] *Id*. at 29.

There are many other questions that may arise depending upon the reasoning of any decision by the Delaware Supreme Court. However, what is clear—and what always must be understood with this type of bylaw provision—is that there is a difference between the authority of the board to take an action (such as adopting the bylaw) and the board's use of its authority. The latter is always judged by fiduciary principles, and therefore how the bylaw is used will be determined on a case-by-case basis.

Conclusion

As has been recognized by numerous commentators, Chancellor Strine's decision in *Chevron* seems to open the way for Delaware companies to adopt forum-selection bylaws. However, even assuming that this decision is affirmed by the Delaware Supreme Court, there will still be many questions facing boards and their advisers concerning the specifics of both implementation and use of such a bylaw. Much as the Delaware Supreme Court's decision in *Moran* did not end litigation over shareholder rights plans, no one should expect the decision by the Delaware Supreme Court in *Chevron* to resolve all of the issues concerning the use of forum selection bylaws.

Checklist: Shareholder Outreach Following M&A Transaction Announcements

By Scott Winter, Managing Director, Innisfree M&A Incorporated

There has been recent increased discussion regarding shareholder outreach by the target company following the announcement of an M&A transaction—particularly in light of the high-profile going private transaction at Dell that was opposed by Carl Icahn and Southeastern Asset Management.

There is no single game plan for shareholder outreach immediately after the initial deal announcement. Circumstances vary across deals; and these different elements dictate when and how a company should best interact with its shareholders following the deal announcement. In the past when shareholder approval of transactions was virtually certain, shareholder outreach typically began after mailing the definitive proxy statement to shareholders. For uncontroversial transactions, that approach may still be appropriate.

However, when there are indications that shareholders are not overwhelmingly supportive of a deal, an earlier outreach campaign may be advisable. Below are some key factors that should be considered in deciding the timing for a shareholder outreach campaign to gain support of a deal:

– How has the deal been received by the market? If the trading price indicates that the market believes the transaction will close, aggressive shareholder outreach is likely unnecessary and could unintentionally signal company doubt regarding the level of shareholder support.

  If the trading price is trading above the deal value, it most often indicates an expectation that an increased offer could be coming either from the initial bidder or an interloper. If the trading price is significantly below the deal value, it indicates that the market believes there is a problem with the transaction, the causes of which could include high regulatory risk or fear that a required vote by the buyer's shareholders is at risk of failing. In either case, shareholder outreach may be advisable depending on the reason(s) for the trading behavior.

– Who are the shareholders? Following a deal announcement the target company's (and in some cases the buyer's) shareholder base will change as some pre-deal shareholders rotate out of the stock and merger arbitrageurs buy into the stock to "play the deal." Some deals attract relatively little interest from the arbitrage community, while other deals can see total arbitrageur involvement reach 40% or more of outstanding shares. The particular shareholder profile following a deal can impact the timing and scope of shareholder outreach.

– What form of consideration are the shareholders receiving? In deals where shareholders receive stock of another company, outreach helps shareholders understand the investment proposition of the combined company post-closing. In addition to hearing from the target company on the benefits of the deal, target company investors will be interested in speaking with the management team for the combined entity, which may include some of the buyer's executives.

– Is there shareholder opposition to the deal? Is the opposition from more than one shareholder? How many shares does the opposition own? Has the opposition gone public?

When unhappy shareholders reach out to a company, they need to be given appropriate attention so that the company can understand the concerns and try to defuse any misunderstandings. Keeping shareholder opposition to a minimum and non-public is clearly desirable. Even when the opposition remains private, it needs to be taken seriously. In recent years, disgruntled investors have learned that the voting advisory services, such as ISS, are interested in evaluating the merits of shareholder views against deals. Once shareholder opposition is public, more aggressive outreach to other shareholders will be warranted to make sure remaining shareholders understand and support the transaction. The outreach will also need to include the voting advisory firms, which typically have significant influence on the outcome of a shareholder vote.

– Has the preliminary proxy (or initial S-4) been filed with the SEC? Speaking to shareholders before the initial proxy is filed may be difficult as it will contain answers to many questions. The proxy will have detailed background on negotiations and the sales process (including whether there were other bidders), plus financial information from investment bankers, which will be useful information for the "market".
– Is there a "go shop"? In deals where there is a "go shop", there may be disclosure issues with shareholder outreach before the "go shop" period has ended.
– Is there a third party interloper trying to "jump the deal"? Even in situations where the third party is completely unexpected, shareholder outreach on the existing deal needs to be carefully coordinated to take into account any obligations under the existing contract, fiduciary duties and disclosure obligations.

Lock-Ups: When Can They Give Rise to "Affiliate" Status & Potentially Implicate Rule 13e-3?

By Jim Moloney, Partner, and Nicole Behesnilian, Associate, Gibson Dunn & Crutcher LLP

Lock-ups are quite common in business combination and similar transactions, but when can such arrangements lead to questions about whether the transaction is subject to Rule 13e-3? This is an issue that most deal practitioners do not consider until they receive comments from the SEC Staff (the "Staff") asking for their Rule 13e-3 analysis.

As many practitioners know, a "going private" transaction is, simply put, one in which a publicly-held company, or an affiliate of such company, seeks to acquire a registered class of the company's outstanding securities, thereby taking the company private and excluding public shareholders from continued equity ownership in the company. Rule 13e-3 defines a going private transaction as any one or a series of transactions (involving a securities purchase, tender offer, or specified proxy solicitation) by an issuer or an affiliate of the issuer, which has a reasonable likelihood or purpose of directly or indirectly (i) causing any registered class of equity securities to be eligible for termination of registration, or eligible for termination or suspension of reporting obligations; or (ii) causing any listed class of equity securities to cease to be listed on a national securities exchange.[1] Due to the potential for abuse and overreaching by the issuer and/or its affiliates, who may be viewed as having roles on both sides of the transaction, and the significant impact that such transactions can have on minority shareholders,[2] Rule 13e-3 imposes certain filing, dissemination, heightened disclosure, and antifraud requirements on issuers and their affiliates engaged in these types of transactions.

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[1] Exchange Act Rule 13e-3.

[2] See Exchange Act Release No. 17719 (April 13, 1981) ("Because a going private transaction is undertaken either solely by the issuer or by the issuer and one or more of its affiliates, standing on both sides of the transaction, the terms of the transaction, including the consideration received and other effects upon unaffiliated security holders, may be designed to accommodate the interests of the affiliated parties rather than determined as a result of arm's length negotiations.") (hereinafter "Release No. 17719").

A person engaging in a transaction will be viewed as an "affiliate" if such person directly or indirectly "controls, is controlled by, or is under common control with" the issuer.[3] The element of "control" is fundamental to the concept of "affiliate," and the Staff has stated that "[t]he determination of whether a person is in control of an issuer, of course, depends on all of the facts and circumstances."[4]

As noted above, it is not unusual for acquirors to purchase securities and/or enter into lock-ups (*e.g.*, voting, tender or support agreements) in order to increase the likelihood the transaction will be successful. Such agreements are often negotiated and entered into with significant shareholders at or near the time that the merger or other acquisition agreement is signed with the target company. Of course, the timing of these events and disclosures related to the parties' ultimate intentions with respect to the target company will vary from transaction to transaction.

Still, it should come as no surprise that the Staff closely scrutinizes business combination transactions, often probing into whether the facts of a particular transaction involve one or more affiliates, thereby triggering the application of Rule 13e-3.[5] Therefore, careful planning and structuring is important to limit the potential application of those heightened disclosure requirements that are better suited to a truly "affiliated" transaction. For example, where an acquiror has sought to lock-up a deal, the Staff may question whether the acquiror has in fact become an affiliate prior to or during the course of the transaction, such that Rule 13e-3 should apply to the deal.[6]

Depending on the facts, including whether shares are purchased in advance, optioned, or subject to a voting, tender, or support agreement, the specific terms of the arrangement can influence whether Rule 13e-3 is implicated. Of course, where the acquiror purchases a significant amount of target securities well before the business combination transaction, the likelihood of Staff inquiry regarding affiliate status, and risk of Rule 13e-3 applying, is at its greatest. Whereas a plain vanilla lock-up entered into at the same time as the merger or other acquisition agreement is signed, without other indicia of affiliation or control, presents less of a risk. But there are many scenarios that fall in between these two ends of the spectrum that can raise red flags for a Staff member seeking to uncover a hidden going private transaction.[7] Accordingly, acquirors will want to take steps to ensure that the terms, timing and disclosures surrounding their lock-ups and business combinations do not implicate Rule 13e-3, especially when the transaction started out as an otherwise unaffiliated arm's-length negotiated deal.

When entering into lock-ups and signing up deals, few stop to consider the legal basis for why such arrangements generally do not implicate the Rule. The key provision here is paragraph (g)(1) of Rule 13e-3 which generally excludes transactions by a person "that occur within one year of the termination of a tender offer in which such person was the bidder and became an affiliate of the issuer as a result of such tender offer," from application of the Rule so long as certain so-called "unitary transaction" requirements

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[3] Rule 13e-3(a)(1).

[4] See Exchange Act Release No. 16075 (Aug. 2, 1979). While share ownership is a factor in the "control" determination, the Staff has also stated that the ownership of any specific percentage of securities is not dispositive of whether a shareholder controls, and is therefore an affiliate of, an issuer.

[5] See Shane de Búrca, The Definition of Affiliates under the SEC's Going Private Rule, Insights, Vol. 18 No. 8, August 2004 (detailing the extent to which the Staff will sometimes go to find an affiliation with the issuer when seeking to apply Rule 13e-3).

[6] See, *e.g.*, Turbosonic Technologies Inc. Response to SEC Comment Letter (Dec. 6, 2012), available at http://www.sec.gov/Archives/edgar/data/900393/000089109212007277/filename1.htm (voting agreements with company founder and executive officers with approximately 21% addressed in Rule 13e-3 analysis); Icahn Enterprises Holdings L.P. Response to SEC Comment Letter (Jan. 6, 2011), available at http://www.sec.gov/Archives/edgar/data/1034563/000119312511002613/filename1.htm (bidder's ownership of approximately 15% prompting comments on application of Rule 13e-3); American Community Properties Trust Response to SEC Comment Letter (Nov. 27, 2009), available at http://www.sec.gov/Archives/edgar/data/1065645/000114036109027623/filename1.htm (voting agreements with shareholders holding approximately 47% triggering Staff comments regarding application of Rule 13e-3 to transaction); First Montauk Financial Corp. Response to SEC Comment Letter (Jul. 14, 2006), available at http://www.sec.gov/Archives/edgar/data/83125/000008312506000028/filename1.txt (buyer's acquisition of shares and lock-ups covering approximately 49% triggering Staff comments regarding affiliation and application of Rule 13e-3 to transaction). See also Release No. 17719, Question and Answer No. 8.

[7] Even the mere reservation of the right to purchase target company shares has given rise to Staff inquiry regarding the availability of Rule 13e-3(g)(1). SEC Comment Letter Issued to Immucor, Inc. (Jul. 26, 2011), available at http://www.sec.gov/Archives/edgar/data/736822/000000000011045311/filename1.pdf (bidder reserving right to purchase target company shares on the open market in a two-step transaction triggering Staff comment regarding availability of Rule 13e-3(g)(1)); SEC Comment Letter Issued to Pyramid Breweries Inc. (Jul. 14, 2008), available at http://www.sec.gov/Archives/edgar/data/1001917/000000000008034738/filename1.pdf (same); SEC Comment Letter Issued to Digimarc Corporation (Jul. 14, 2008), available at http://www.sec.gov/Archives/edgar/data/1089443/000000000008034743/filename1.pdf (same); SEC Comment Letter Issued to Onyx Software Corporation (Jul. 18, 2006), available at http://www.sec.gov/Archives/edgar/data/1014383/000000000006033386/filename1.txt (buyer indicating uncertainty as to whether second-step merger would be consummated giving rise to Staff comment regarding applicability of Rule 13e-3(g)(1)).

are met.[8] More specifically, the various no-action letters extrapolating paragraph (g)(1) provides that an unaffiliated acquiror that negotiates at arm's-length an acquisition transaction and locks-up a controlling block of target company shares may avoid being deemed an "affiliate" for purposes of Rule 13e-3 so long as the transaction satisfies all of the following criteria:

- **The acquiror is not an affiliate of the issuer prior to the initial acquisition of the securities by the acquiror.** The acquiror and issuer must not have an affiliate relationship prior to the initial acquisition of the securities.[9]
- **The initial and "second-step" transactions are made pursuant to an agreement for the acquisition of all of the securities at the same price.** The acquiror who locks-up a significant amount of the issuer's shares must acquire all of the issuer's securities at the same price.
- **The intention of the acquiror to engage in the second-step transaction is publicly announced at the time of the initial acquisition, including the form and effect of such transaction and the proposed terms of the transaction, if known.** The acquiror's plans for the entire transaction must be unequivocally and publicly disclosed at the *commencement* of the first-step transaction to ensure that the second-step transaction is indeed based upon arm's-length negotiations and not upon the use of any control position resulting from the completion of the first step.[10]
- **The second-step transaction is effected within one year from the expiration of the tender offer.**
- **The acquiror does not change the management or the board of directors, or otherwise seek to exercise control, of the issuer prior to the completion of the second-step transaction.** The acquiror must not subsequently exercise control over the issuer by virtue of its newfound "affiliate" status as a result of the first step, and instead must ensure the transaction proceeds on an arm's-length basis.

Unfortunately, the conditions of (g)(1) are not always squarely met, or the facts of a transaction may play out in a way that precludes reliance on the exception to the Rule. For example, there are circumstances where the acquiror purchases securities from a controlling shareholder *prior to* commencement of the tender offer (or signing of the merger agreement), and in those situations, the Staff has generally concluded that it would not be eligible to rely on the (g)(1) exception.

Similarly, where the acquiror enters into a lock-up agreement and the issuer or controlling shareholder has granted the bidder an option (which is immediately exercisable) to purchase a significant amount of securities, the Staff will generally view such acquiror as an affiliate for Rule 13e-3 purposes. The one exception to this position is where the lock-up agreement is subject to substantial conditions beyond the control of the parties (*e.g.,* a top-up option with the issuer to reach the short-form merger threshold or an option with a controlling shareholder that a majority of unaffiliated shareholders vote in favor of the transaction or tender their shares in the offer). In those situations, the agreement is unlikely to render the acquiror an affiliate.

All important considerations to take into account before rushing to lock-up that next big deal.

Conclusion

It is important to keep in mind the conditions in (g)(1) and the various Staff no-action letters[11] when structuring business combination transactions (*e.g.*, how and when lock-ups are entered into and securities acquired) as well as the related disclosures regarding any intentions of the acquiror to take the target

[8] Rule 13e-3(g)(1). See Release No. 17719, Question and Answer No. 8. The Staff has also taken a no-action position that the transactions set forth in paragraph (g)(1) do not trigger Rule 13e-3's heightened disclosure obligations when the unitary transaction conditions are present. See no-action letters re. Federal-Mogul Corp. (avail. Sep. 29, 1980) and HM Acquisition Corp. (avail. Mar. 2, 1981), where the Staff took a no-action position with respect to the applicability of Rule 13e-3 to merger transactions in which the acquiror had concurrently purchased target shares via a stock purchase agreement for the acquisition of all target shares at the same price, the merger was expected to be consummated within a relatively short time, and the acquiror would not change the management or otherwise exercise control over the target company in the interim period.

[9] See SEC Division of Corporation Finance Manual of Publicly Available Telephone Interpretations, Question No. 9, available at http://www.sec.gov/interps/telephone/cftelinterps_goingprivate.pdf. SEC Division of Corporation Finance, Compliance and Disclosure Interpretations of Going Private Transactions (Jan. 26, 2009), Question 211.02 available at http://www.sec.gov/divisions/corpfin/guidance/13e-3-interps.htm.

[10] SEC Division of Corporation Finance, Compliance and Disclosure Interpretations of Going Private Transactions (Jan. 26, 2009), Question 111.01 *available at* http://www.sec.gov/divisions/corpfin/guidance/13e-3-interps.htm.

[11] *See supra* note 8.

company private or engage in subsequent securities acquisitions. Through careful structuring of lock-ups and drafting of disclosures related to future intentions,[12] otherwise unaffiliated acquirors can avoid, or at least minimize, Staff inquiries into the potential application of the "going private" provisions of Rule 13e-3. Certainly, one clear path is to ensure the transaction satisfies the conditions of Rule 13e-3(g)(1), so that the acquisition will be viewed as a single, unitary transaction by a non-affiliate, and thus fall safely beyond the reach of Rule 13e-3.

Delaware Law: Amended to Provide for Ratification & Validation of Defective Corporate Acts

By Dean Hanley and Paul Bork, Partners, & Erica Rice, Associate, Foley Hoag LLP

As part of recent amendments to the Delaware General Corporation Law, two new sections were added to the DGCL to facilitate the ratification of so-called "defective corporate acts" that would otherwise be invalid due to improper corporate authorization. New Sections 204 and 205 of the DGCL (the Ratification Provisions), which go into effect on April 1, 2014, provide Delaware corporations the opportunity to undertake a more thorough "corporate clean-up" than is currently permitted under the DGCL.

Why Are Ratification Provisions Necessary?

The Ratification Provisions will allow a corporation to take measures to remove uncertainty surrounding its capital structure, which is particularly important when a corporation is the target of an acquisition or is in the process of conducting an initial public offering. During the course of an acquisition or IPO, a corporation—or more likely, its counsel—will typically conduct a thorough review of the corporate books and records and engage in a process to "clean up" any incorrect or incomplete records. The clean-up process often includes the adoption of resolutions by the corporation's board of directors and stockholders ratifying certain past acts of the corporation.

However, under the DGCL, certain invalid corporate actions cannot be remedied through subsequent ratification. In particular, if a corporation issued shares of capital stock in excess of the number of shares of authorized stock at the time of such issuance (the Ratification Provisions call these over-issued shares "putative stock"), the issuance is *void* and cannot be ratified. Over-issues of stock can have far-reaching effects. For example, if the Company's board of directors is elected by persons holding putative stock rather than valid stock, the board's election is also invalid. The Ratification Provisions are primarily intended to address these situations, although they are also available to ratify any other type of corporate act that is void or voidable due to a failure of proper corporate authorization.

The Ratification Provisions establish a process for ratification of defective corporate acts or putative stock by a corporation itself (under Section 204), as well as validation of defective corporate acts or putative stock by the Delaware Chancery Court (under Section 205). Upon ratification or validation by either the corporation or the Court, the defective corporate act will be deemed retroactively effective and valid as of the time of the defective corporate act.

What Is the Process Under Section 204?

In order to ratify defective corporate acts or putative stock under Section 204:

- The board of directors must adopt a resolution ratifying the defective corporate act or putative stock, and containing certain other information about the defective corporate act.
- If the defective corporate act (such as an amendment to the corporation's charter) would have required stockholder approval, the stockholders must also adopt the ratification resolution. The corporation must provide stockholders with 20 days' notice of the meeting at

[12] *See supra* note 7.

which the resolution is to be adopted. This notice must go to holders of valid stock and putative stock, whether voting or nonvoting, both current and at the time of the defective corporate act. The notice must include a statement that any challenge to the ratification of the defective corporate act must be brought within 120 days of the effective time of the ratification.

- Once approved by the board and, if applicable, the stockholders, the corporation must file a "certificate of validation" with the Delaware secretary of state. This certificate is currently being developed by the secretary of state's office—which is one reason for the delay in effectiveness of the Ratification Provisions to April of 2014.
- If stockholder approval was not required, the corporation must provide notice of the ratification to stockholders within 60 days after adoption of the ratification resolution by the board. This notice must go to holders of valid stock and putative stock, whether voting or nonvoting, both current and at the time of the defective corporate act. The notice must include a statement that any challenge to the ratification of the defective corporate act must be brought within 120 days of the effective time of the ratification.

Validation of Defective Corporate Acts by the Delaware Chancery Court Under Section 205

If a corporation is unable (due to the lack of a properly authorized board, for example) or unwilling to undertake the process contained in Section 204, certain parties may directly petition the Delaware Chancery Court to validate independently any defective corporate act or putative stock. Section 205 also gives the Court jurisdiction to hear challenges to the validity and effectiveness of any ratification undertaken by a corporation pursuant to Section 204.

The parties that can bring a claim under Section 205 include the corporation, any successor entity, any member of the board, any record or beneficial holder of valid stock or putative stock, any record or beneficial holder of valid or putative stock as of the time of a defective corporate act, or any other person claiming to be substantially and adversely affected by a ratification pursuant to Section 204. However, the timeline for a Section 204 challenge is fairly short, giving the corporation a measure of certainty. With some exceptions, any action requesting review of a Section 204 ratification must be brought within 120 days of the effective time of the certificate of validation.

A Dozen Take-Aways: In Re: Trados

By Tom Bayliss, a Partner of Abrams & Bayliss LLP

On August 16, 2013, the Delaware Court of Chancery issued a 114-page opinion in *In re Trados Incorporated Shareholder Litigation*, C.A. No. 1512-VCL. In the opinion, Vice Chancellor J. Travis Laster:

- Found that the process leading to the $60 million sale of Trados Incorporated in July 2005 failed the "fair process" prong of Delaware's entire fairness test;
- Concluded that the sales price satisfied the "fair price" prong of the entire fairness test, despite the fact that the holders of the Company's common stock received nothing in the challenged merger;
- Rejected the plaintiff's contention that the directors breached their fiduciary duties;
- Held that the fair value of the Company's common stock at the time of the merger was zero; and
- Indicated that the director defendants' litigation conduct, including their creation of "a trial record replete with contradictions and less-than-credible testimony," may support an order requiring the defendants to pay the plaintiff's attorneys' fees and expenses.

The *Trados* decision has generated extensive commentary from practitioners and academics. Highlights include the opinion's (a) extensive commentary regarding traditional principles of Delaware fiduciary law (primarily developed in the public company context), (b) application of those principles in the venture capital context, and (c) suggestion that a fair price can trump an unfair process when assessing liability under Delaware's entire fairness test.

The Take-Aways

1. The *Trados* opinion confirms that the Court of Chancery will apply traditional notions of disinterestedness, independence and fair dealing (notions largely developed in the public company context) to the venture capital space. Venture-backed companies with boards largely comprised of management directors and designees of venture funds are therefore likely to face entire fairness scrutiny (rather than business judgment protection) in financing and sales process contexts where the challenged transaction can be characterized as benefitting the holders of preferred stock at the expense of common stockholders.
2. The *Trados* opinion confirms that defendant directors can (at least in some instances) fail the "fair process" prong of the entire fairness test but avoid a determination that they breached their fiduciary duties by demonstrating that the challenged transaction resulted in a fair price. This is an important doctrinal development. In the past, Delaware courts appeared to emphasize the conjunctive nature of the entire fairness test. In other words, defendant directors needed to demonstrate both fair dealing *and* fair price to satisfy the entire fairness test and avoid a determination that they breached their fiduciary duties. *Trados* confirms that defendants can satisfy the entire fairness test and avoid liability solely by demonstrating fair price.
3. The result in *Trados* raises an interesting question—can directors avoid a determination that they breached their fiduciary duties solely by demonstrating fair process? If not, the holding in *Trados* appears to elevate the importance of the "fair price" prong above the "fair process" prong of the entire fairness test. Prior opinions have suggested that "fair price" might be the predominant inquiry. The result in Trados demonstrates the doctrinal and practical importance of that hierarchy.
4. The Court could have reached the same result even if it had determined that the entire fairness test was conjunctive. In that instance, the Court could have held that the defendant directors failed the test by failing to prove fair process and that the defendant directors had breached their fiduciary duties. The Court could have concluded that no damages resulted from the misconduct because the common stock was worthless.
5. Before *Trados*, practitioners who viewed the entire fairness test as disjunctive nevertheless debated whether the Court of Chancery would ever hold that an unfair process led to a fair transaction, or whether evidence of unfair process would necessarily infect the Court's fair price analysis and overwhelm any fact or expert testimony supporting a fair price determination. *Trados* confirms that (at least in some instances) the Court of Chancery will find that an unfair process led to a fair transaction.
6. The *Trados* opinion demonstrates that the Court of Chancery is unlikely to view preferred stockholders with significant liquidation preferences as "aligned" with common stockholders for purposes of assessing potential conflicts regarding the timing or price of an acquisition, at least where the transaction consideration is at or near the preferred stock's aggregate liquidation preference. Instead, the Court is likely to credit the argument that the preferred will favor a near-term liquidity event, while the common will prefer pursuit of a potentially riskier stand-alone plan whose upside will accrue to their benefit.
7. The procedural devices often deployed to ameliorate (or perhaps eliminate) the danger of entire fairness review (special committees, independent legal and financial advisors, fairness opinions, etc.) are often expensive, time consuming and difficult to adopt and execute even under favorable circumstances. Boards of venture-backed companies that are cash-strapped, in need of near-term financing or pressed by other events may find it impractical to deploy those procedural devices. In that circumstance, the company, its investors and its potential counterparties need to assess the risk of expensive fiduciary duty litigation that could be difficult to resolve short of trial.
8. The *Trados* Court conducts a sweeping, multi-page analysis of the economic and personal incentives of directors who are also fiduciaries of venture investors. Among other things, the Court suggests that "the cash flow rights of typical VC preferred stock cause the economic incentives of its holders

to diverge from those of the common stockholders." The Court also observes that the "VC business model reinforces the economic incentives that the preferred stock's cash flow rights create." This broadly applicable language raises questions about whether principals of venture capital firms with large holdings of preferred stock can ever be treated as independent and disinterested directors in financing or sales process contexts.

9. The *Trados* opinion helps underscore the value of contractual exit mechanisms for preferred stockholders (drag along rights, put rights etc.) that could potentially block or at least weaken litigation challenging transactions involving venture-backed companies. Footnote 32 of the opinion hints at the possibility of incorporating provisions in a venture-backed company's certificate of incorporation that would specifically address (and perhaps waive) exit-related conflicts.

10. At the beginning of its legal analysis, the Court emphasizes the distinction between the "standard of conduct" and the "standard of review" under Delaware law. According to the Court, the "standard of conduct" describes what directors are expected to do. The "standard of review" is the "test that a court applies when evaluating whether directors have met the standard of conduct." The Court emphasizes that Delaware's "standard of conduct" requires that directors "strive in good faith and on an informed basis to maximize the value of the corporation for the benefit of its residual claimants, the ultimate beneficiaries of the firm's value, not for the benefit of its contractual claimants." Interestingly, the findings in the *Trados* opinion arguably suggest that the directors failed to meet the standard of conduct—because they failed to consider the interests of the common stockholders. Yet the Court ultimately holds that the defendants satisfied the "standard of review" and therefore did not breach their fiduciary duties.

11. When assessing the materiality of the financial conflicts faced by the director defendants, the Court noted that defendants' counsel had blocked deposition questioning about the net worth and financial circumstances of the directors. According to the Court, it was "fair to infer that the payments [at issue] were material in light of defense counsel's objections and the defendants' failure to produce any countervailing evidence." This holding serves as a warning to litigators defending the deposition of director clients—questioning about the financial wherewithal of the witness is likely fair game, and blocking testimony on the subject could lead to an adverse inference.

12. The Court's suggestion that fee shifting might be warranted raises an interesting question. If the Court later orders the defendants to pay the attorneys' fees of the plaintiff's lawyers on account of the defendants' bad faith litigation conduct, will the directors qualify for indemnification under 8 *Del. C.* § 145?

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