Annual Survey of Judicial Developments Pertaining to Mergers and Acquisitions

*By the Annual Survey Working Group of the M&A Jurisprudence Subcommittee, Mergers and Acquisitions Committee, ABA Business Law Section**

The Annual Survey Working Group reports annually on judicial decisions that we believe are of the greatest significance to M&A practitioners.[1] The decisions selected for this year's Annual Survey are:

Contract Interpretation

1. *SIGA Technologies, Inc. v. PharmAthene, Inc.* (Affirming Enforceability of Agreement to Negotiate and Availability of Expectation Damages for Breaches Thereof)
2. *Sun Capital Partners III, L.P. v. New England Teamsters & Trucking Industry Pension Fund* (Potential Liability of Private Equity Investment Fund for Multi-Employer Pension Fund Withdrawal Liabilities of Bankrupt Portfolio Company)
3. *Teed v. Thomas & Betts Power Solutions, L.L.C.* (Successor Liability for Fair Labor Standards Act Claims)

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1. To be included in the *Survey*, a decision must

   1. Address a transaction involving a change of control or a sale of all or substantially all of a company's assets or of a subsidiary or division; and
   2. Interpret or apply the provisions of an acquisition agreement or an agreement preceding an acquisition agreement (e.g., letter of intent or confidentiality agreement) or a state statute that governs one of the constituent entities, rule on a successor liability issue, or decide a breach of fiduciary duty claim. Excluded are cases dealing exclusively with federal law, securities law, tax law, or antitrust law.

4. *Anvil Holding Corp. v. Iron Acquisition Co.* and *Transdigm Inc. v. Alcoa Global Fasteners, Inc.* (Seller's General Contractual Disclaimers Do Not Preclude a Buyer's Claim for Fraud Related to Seller's Extra-Contractual Misrepresentations and Omissions)
5. *Meso Scale Diagnostics, LLC v. Roche Diagnostics* GmbH (Reverse Triangular Merger Did Not Violate Contractual Prohibition on Assignments by Operation of Law)
6. *Winshall v. Viacom International Inc.* (Reviewing Obligation of Selling Stockholders to Indemnify Legal Costs Incurred Defending a Third Party Claim Despite Lack of Breach of Representation)
7. *Meda AB v. 3M Co.* (Demonstrating Court's Limited Interpretation of the Implied Covenant of Good Faith and Fair Dealing)

Fiduciary Duty

8. *Brinckerhoff v. Enbridge Energy Co.*; *Norton v. K-Sea Transportation Partners L.P.*; *Gerber v. Enterprise Products Holdings, LLC*; *Allen v. Encore Energy Partners, L.P.*; *DV Realty Advisors LLC v. Policemen's Annuity & Benefit Fund of Chicago* (Substitution of Contractual Subjective Good Faith Duties for Fiduciary Duties in Delaware Limited Partnerships)
9. *In re Trados Inc. Shareholder Litigation* (Entire Fairness Standard Satisfied Even Though Common Stock Received No Consideration in Sale of a VC-Backed Company)
10. *In re Primedia, Inc. Shareholders Litigation* (Allowing Post-Merger Direct Claim Where Target Board Failed to Value an Insider Trading Claim in the Merger)
11. *Arkansas Teacher Retirement System v. Countrywide Financial Corp.* (Certified Question from the Ninth Circuit Regarding the "Fraud Exception" to the Continuous Ownership Rule)
12. *In re Novell, Inc. Shareholder Litigation* and *In re BJ's Wholesale Club, Inc. Shareholders Litigation* (Different Outcomes on Motions to Dismiss Bad Faith Claims Against Target Directors for Seemingly Disparate Treatment of Bidders)
13. *In re Ancestry.com Inc. Shareholder Litigation* and *In re Complete Genomics, Inc. Shareholder Litigation* (Enforceability and Disclosure of "Don't Ask, Don't Waive" Standstill Provisions)
14. *In re MFW Shareholders Litigation* (Applying the Business Judgment Rule, Rather than Entire Fairness, in Going-Private Transactions with Controlling Stockholders)

Contract Interpretation

1. *SIGA Technologies, Inc. v. PharmAthene, Inc.* (Affirming Enforceability of Agreement to Negotiate and Availability of Expectation Damages for Breaches Thereof)

The Delaware Supreme Court held in *SIGA Technologies, Inc. v. PharmAthene, Inc.* that a failure to negotiate in good faith despite an express agreement to do so may lead to expectation damages reflecting the counterparty's lost profits.[2]

Background

SIGA approached PharmAthene to discuss a potential collaboration to help SIGA develop a promising drug.[3] SIGA and PharmAthene negotiated, but did not sign, a License Agreement Term Sheet (the "LATS") with respect to the drug.[4] The LATS included a footer bearing the words "Non Binding Terms."[5]

PharmAthene then suggested that the parties merge rather than enter into a licensing arrangement.[6] SIGA agreed, but requested that PharmAthene provide bridge financing during merger negotiations. PharmAthene agreed to do so, on the condition that SIGA enter into a licensing arrangement with PharmAthene if the merger negotiations failed.[7] The parties entered into a Bridge Loan Agreement governed by New York law and a Merger Agreement governed by Delaware law.[8] Each of the Bridge Loan Agreement and the Merger Agreement included an obligation to "negotiate in good faith with the intention of executing a definitive License Agreement in accordance with the terms set forth in the [LATS]."[9]

Development of the drug exceeded expectations, and SIGA began to experience what the court described as "seller's remorse."[10] SIGA and PharmAthene failed to complete the merger within the time period specified by the Merger Agreement, and SIGA terminated the Merger Agreement.[11]

PharmAthene proposed a license agreement based on the LATS.[12] SIGA countered with terms drastically more favorable to SIGA.[13] PharmAthene filed suit.[14] The chancery court found SIGA liable both for breach of its obligation

2. 67 A.3d 330 (Del. 2013).
3. *Id.* at 334.
4. *Id.* at 334–35.
5. *Id.* at 336.
6. *Id.*
7. *Id.* at 337.
8. *Id.* at 337–38.
9. *Id.*
10. *Id.* at 338.
11. *Id.* at 339.
12. *Id.*
13. *Id.*
14. *Id.*

to negotiate in good faith and under the doctrine of promissory estoppel.[15] The chancery court awarded PharmAthene an equitable payment stream for PharmAthene's "lost expectancy," including payment of 50 percent of the net profits in excess of $40 million generated by the drug for the next ten years.[16] SIGA appealed to the Delaware Supreme Court.[17]

Supreme Court Holding

Binding Obligation. The Delaware Supreme Court held that, under Delaware law, "an express contractual obligation to negotiate in good faith is binding."[18] The court further held that, although the LATS stated it was non-binding, SIGA and PharmAthene had created an enforceable obligation by agreeing in the Bridge Loan Agreement and the Merger Agreement to negotiate a license in good faith in accordance with the term sheet if the merger fell through.[19] The court also noted the chancery court's finding that the incorporation of the LATS into the Bridge Loan and Merger Agreements reflected an intent of the parties to "negotiate toward a license agreement with economic terms substantially similar to the terms of the LATS," rather than to treat the LATS as a "jumping off point," as SIGA characterized it.[20] SIGA breached this obligation by insisting on different terms in bad faith.

Expectation Damages. The court noted a split of authority as to the availability of "expectancy" or "benefit-of-the-bargain" damages. While some jurisdictions declined to award expectation damages due to the difficulty of determining the amount of such damages, others allowed such damages where the defendant had acted in bad faith and such damages were foreseeable.[21] The court then held that expectation damages can be awarded for breach of an agreement to negotiate in good faith if the plaintiff proves:

(1) that the parties would have reached an agreement but for the defendant's bad faith and

(2) the amount of such damages with "reasonable certainty."[22]

The court remanded the case for further consideration of damages.[23]

Conclusion

While reliance damages are often limited to costs related to participating in negotiations, expectation damages take into account not just actual damages in-

15. *Id.* at 340–41.
16. PharmAthene, Inc. v. SIGA Techs., Inc., No. 2627-VCP, 2011 Del. Ch. LEXIS 136 at *151 (Sept. 22, 2011).
17. *SIGA Techs.*, 67 A.3d at 340–41.
18. *Id.* at 344.
19. *Id.* at 346.
20. *Id.* at 345–46.
21. *Id.* at 349–50.
22. *Id.* at 350–51.
23. *Id.* at 353.

curred but also the benefit of what was promised and thus can be much larger. Under *SIGA Technologies*, then, the remedy for a violation of an agreement to negotiate can be substantial.

In practice, obtaining expectation damages for violation of an agreement to negotiate generally will be difficult, because it requires proof not only of breach, but also that (1) the parties would have entered into a final contract but for such breach and (2) the amount of expectation damages can be calculated with reasonable certainty.

2. *Sun Capital Partners III, L.P. v. New England Teamsters & Trucking Industry Pension Fund* (Potential Liability of Private Equity Investment Fund for Multi-Employer Pension Fund Withdrawal Liabilities of Bankrupt Portfolio Company)

In *Sun Capital Partners III, L.P. v. New England Teamsters & Trucking Industry Pension Fund*, the U.S. Court of Appeals found that Sun Capital Partners IV, L.P. ("Sun Fund IV") was a "trade or business" within the meaning of the Employee Retirement Income Security Act of 1974 ("ERISA"), as amended by the Multiemployer Pension Plan Amendment Act of 1980 (the "MPPAA"),[24] which could lead to liability for withdrawal liabilities of a portfolio company.

The "MPPAA requires employers withdrawing from a multiemployer plan to pay their proportionate share of the pension fund's vested but unfunded benefits."[25] Under regulations prescribed by the Pension Benefit Guaranty Corporation, "all employees of trades or businesses . . . under common control shall be treated as employed by a single employer and all such trades and businesses as a single employer."[26] As the opinion explains, this means that to impose liability on an organization other than the withdrawing employer, (1) the organization must be under "common control" with the withdrawing employer and (2) the organization must be a "trade or business."[27]

Background

Sun Capital Advisors, Inc. ("SCAI") is a private equity firm, and Sun Fund IV and Sun Capital Partners III, L.P. ("Sun Fund III," and, with Sun Fund IV, the "Sun Funds") are two of SCAI's private equity funds.[28] Scott Brass, Inc. ("SBI"), a portfolio company of the Sun Funds, made contributions to the New England Teamsters & Trucking Industry Pension Fund (the "Teamsters Fund") pursuant to a collective bargaining agreement.[29]

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24. 724 F.3d 129, 138 (1st Cir. 2013).
25. *Id.*
26. 29 U.S.C. § 1301(b)(1) (2012).
27. *Sun Capital Partners III, L.P.*, 724 F.3d at 138.
28. *Id.* at 133–34.
29. *Id.* at 135.

Almost two years after SBI's acquisition by the Sun Funds, SBI stopped contributions to the Teamsters Fund, resulting in withdrawal liability for SBI.[30] The Teamsters Fund demanded payment from the Sun Funds of SBI's withdrawal liability.[31]

The district court granted summary judgment for the Sun Funds, concluding that neither Sun Fund was a "trade or business" within the meaning of the statute,[32] on the basis that they had no offices or employees, did not make or sell goods or report income other than investment income on their tax returns, and were not engaged in the management activities of their general partners.[33]

Court's Reasoning and Analysis

The court of appeals reversed. The court applied a multi-factor "investment plus" test to determine whether the Sun Funds were engaged in a trade or business, concluded that Sun Fund IV is a "trade or business" for purposes of section 1301(b), and remanded the case to the district court for determinations as to whether Sun Fund III is also a trade or business and whether the common control requirement for liability was met.[34]

The "investment plus" test appears to require that, in order to be a "trade or business" under the statute, the entity involved must do more than simply invest to earn an investment return. Thus, the critical issue is what activities amount to the required "plus."

As to both Sun Funds, the court of appeals found several factors to be relevant to the "trade or business" issue.

First, the court noted that the Sun Funds invested in portfolio companies with the principal purpose of making a profit, although it noted that a mere investment to make a profit, without more, does not make an investor a trade or business.[35]

Second, the court took into account the extent to which the Sun Funds, through related entities, were involved in the management of SBI. It noted that the Sun Funds' limited partnership agreements and private placement memos explain that the Sun Funds are actively involved in the management and operation of the companies in which they invest, that the general partners of the Sun Funds are empowered to make decisions about hiring, terminating, and compensating agents and employees of the Sun Funds and their portfolio companies, and that it is the purpose of the Sun Funds to seek out potential portfolio companies in need of extensive intervention with respect to management and operations.[36] The court also considered it significant that the

30. *Id.* at 136.
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id.* at 141, 150.
35. *Id.* at 141–42.
36. *Id.* at 142.

Sun Funds were able to place SCAI employees in two of SBI's three director positions.[37]

Third, the court emphasized that Sun Fund IV received a direct economic benefit that a passive investor would not derive from its investment—namely an offset against the management fees that it otherwise would have paid its general partner for managing the investment in SBI.[38] The court did not determine whether Sun Fund III was a "trade or business" because it could not tell from the record whether that fund received a similar economic benefit from an offset against management fees.[39] This may indicate, notwithstanding the court's admonition that no factor is dispositive, that the court thought this third factor of particular importance. The opinion recognized that arrangements offsetting fees paid by portfolio companies to management companies against fees owed by funds to their general partners are common in private equity funds.[40]

Finally, the court considered the Teamsters Fund's appeal from the district court's entry of summary judgment against its claim under 29 U.S.C. § 1392(c), which provides that if a principal purpose of any transaction is to evade or avoid liability, then liability shall be determined without regard to such transaction.[41] The Teamsters Fund contended that the Sun Funds purposefully divided ownership of the holding company through which they invested in SBI 70 percent-30 percent to avoid the statute's 80 percent test for common control.[42] The court held that § 1392(c) could not serve as a basis to impose liability because application of the statutory remedy would not entitle the Teamsters Fund to any payments from the Sun Funds for withdrawal liability.[43] The court pointed out that the statute requires courts to put the parties in the same situation as if the offending transaction had never occurred, but does not permit a court to write in new terms, and that there is no way of knowing whether the acquisition would have happened anyway if Sun Fund IV were to be a 100 percent owner.[44]

Conclusion

This opinion reminds practitioners that federal statutory liabilities with respect to labor, employment, and benefits can sometimes be imposed on entities other than the direct employers, whether through control group provisions, such as in *Sun Capital Partners*, or through successor liability, as in the next case discussed in this *Survey*, and that because of judges' partiality to multi-factor tests, as Judge Posner put it, predictions as to such indirect liability can be difficult.[45]

37. *Id.* at 143.
38. *Id.*
39. *Id.*
40. *Id.* at 135.
41. *Id.* at 149.
42. *Id.*
43. *Id.*
44. *Id.*
45. See Teed v. Thomas & Betts Power Solutions, L.L.C. (discussed below in this *Survey*); and Einhorn v. M.L. Ruberton Constr. Co., 632 F.3d 89 (3d Cir. 2011) (discussed in *Annual Survey of Judicial Developments Relating to Mergers and Acquisitions*, 67 Bus. Law. 491, 527 (2012)).

This opinion is also a reminder of the importance of due diligence as to ERISA and MPPAA issues, focusing not only on whether the target in an acquisition might have direct exposure to withdrawal liability, but also on whether it might be, or have been, a member of a control group sharing such liability.

3. *Teed v. Thomas & Betts Power Solutions, L.L.C.* (Successor Liability for Fair Labor Standards Act Claims)

In *Teed v. Thomas & Betts Power Solutions, L.L.C.*,[46] an action for overtime pay under the Fair Labor Standards Act (the "FLSA"), the U.S. Court of Appeals for the Seventh Circuit applied federal common law and found successor liability.

Background

The plaintiffs were employed by JT Packard & Associates ("Packard"), all of the stock of which was acquired in 2006 by S.R. Bray Corp. ("Bray").[47] The plaintiffs filed suit under the FLSA against Packard two years later. Several months after it was filed, Bray defaulted on a $60 million loan from the Canadian Imperial Bank of Commerce (the "Bank") that Packard had guaranteed.[48] Bray's assets were placed in a receivership to be sold, and the assets of Packard were acquired by Thomas & Betts Corporation ("T & B Corp.") in an auction.[49] The transfer of assets to T & B Corp. was on the condition that T & B Corp. was not assuming any liabilities of Packard, including liabilities arising out of the FLSA litigation.[50] T & B Corp. transferred the Packard assets to its subsidiary Thomas & Betts Power Solutions, L.L.C. ("Thomas & Betts").[51]

The district court permitted the plaintiffs to substitute Thomas & Betts for the original defendants and held it liable for Packard's violations on the theory of successor liability.[52] Thomas & Betts appealed on the basis that successor liability had been incorrectly applied and that it should not have been substituted as defendant.[53]

Application of Federal Common Law in Successor Liability Cases

The court noted that, when liability is based on violation of a federal statute relating to labor relations or employment, a federal common law standard of successor liability is applied that is more favorable to plaintiffs than are most state

46. 711 F.3d 763 (7th Cir. 2013).
47. *Id.* at 765.
48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.* at 764.
53. *Id.*

law standards.[54] The opinion explains that "successor liability is appropriate in suits to enforce federal labor or employment laws—even when the successor disclaimed liability when it acquired the assets in question—unless there are good reasons to withhold such liability," such as lack of notice of the potential liability.[55] Without successor liability, the court noted, a violator of the FLSA could escape liability by selling assets and liquidating.[56]

As to the argument that successor liability could impede operation of the market in companies, the court responded that the successor is compensated for bearing the liabilities by paying less for the assets.[57]

Applicability of Federal Standard in This Case

The court then considered whether the federal standard should apply to the facts of this case. First, the court considered whether a finding of liability would enable the plaintiffs, with unsecured wage claims, to obtain a preference over a senior creditor (the Bank) with a secured claim. Thomas & Betts would have paid less at the auction had it known it would have to pay the FLSA claims, and the Bank would have received less money from the sale.[58] The court noted as a factor against applying successor liability the potential that the priorities of competing creditors would be upended after an insolvent debtor's default.[59] This factor did not figure in the appeal, however, as Thomas & Betts had not raised it.[60]

Thomas & Betts argued that to allow the plaintiffs to obtain relief would give them a windfall. Had Packard continued in business, the bank loan would have precluded their obtaining relief.[61] The court responded that to allow Thomas & Betts to acquire assets without their associated liabilities, "thus stiffing workers who have valid claims under the Fair Labor Standards Act, is equally a 'windfall.'"[62]

Finally, Thomas & Betts argued that allowing these FLSA claims in a case in which the predecessor cannot pay them could complicate the reorganization of a bankruptcy.[63] Workers might file a flurry of lawsuits, whether or not well grounded, hoping to substitute a solvent acquiror for their employer, thus scaring off prospective buyers. The court responded that there is no suggestion of such a tactic in this case, and if there were, that might be a good reason for denying successor liability.[64]

54. *Id.*
55. *Id.* at 766.
56. *Id.*
57. *Id.*
58. *Id.* at 768.
59. *Id.*
60. *Id.*
61. *Id.*
62. *Id.*
63. *Id.*
64. *Id.*

The court concluded its opinion by pointing out that Packard was a profitable company:

> Had it been sold before Bray got into trouble, imposition of successor liability would have been unexceptionable; Bray could have found a buyer . . . willing to pay a good price even if the buyer had to assume the company's FLSA liabilities. . . . [W]e have not been given an adequate reason why [Packard's] having been sold after [Bray got into trouble] should change the result.

Conclusion

The Seventh Circuit's statement that successor liability should apply unless there are good reasons to withhold liability in cases based on federal statutes relating to labor or employment represents a departure from the commonly applied multi-factor test. Practitioners should be mindful that the buyer in an asset sale may be held liable for claims against the seller based on the theory of successor liability notwithstanding the provisions of an asset purchase agreement.

4. *Anvil Holding Corp. v. Iron Acquisition Co.* and *Transdigm Inc. v. Alcoa Global Fasteners, Inc.* (Seller's General Contractual Disclaimers Do Not Preclude a Buyer's Claim for Fraud Related to Seller's Extra-Contractual Misrepresentations and Omissions)

In two separate opinions, the Delaware Court of Chancery found at the motion to dismiss stage that a seller's contractual disclaimers did not preclude a buyer's claim for fraud related to a seller's extra-contractual misrepresentations and omissions. In *Anvil Holding Corp. v. Iron Acquisition Co.*,[65] the court found that the omission of a sufficient non-reliance provision permitted the buyer to pursue its fraud claim against the sellers. In *Transdigm Inc. v. Alcoa Global Fasteners, Inc.*,[66] the court found that a non-reliance provision disclaiming the buyer's reliance on extra-contractual representations did not preclude the buyer's fraud claim based on the sellers' omissions.

Background

In *Anvil Holding Corp.*, the buyer entered into a contract to purchase all of the outstanding stock of Iron Data Solutions, LLC ("Iron Data").[67] For more than twenty years, the Social Security Administration (the "SSA") was a customer of Iron Data.[68]

Following the closing, the buyer sued the sellers for fraud, claiming that the buyer overpaid because the sellers knew that Iron Data's agreement with the

65. No. 7975-VCP, 2013 WL 2249655 (Del. Ch. May 17, 2013).
66. No. 7135-VCP, 2013 WL 2326881 (Del. Ch. May 29, 2013).
67. *Anvil*, 2013 WL 2249655, at *1.
68. *Id.* at *2.

SSA would soon convert from a firm fixed-price contract to a less profitable time and materials contract.[69] The buyer alleged, among other things, that the sellers were aware of the SSA contractual change, deliberately hid such information from the buyer, and specifically delayed entering into a revised contract with the SSA until the sale of Iron Data had closed.[70] Evidence presented indicated that, prior to closing, the buyer held two meetings with managers of Iron Data during which the buyer specifically asked whether they anticipated any changes in the SSA contract. In both instances, management failed to disclose to the buyer conversations related to the SSA contact in which the sellers understood that the SSA contract would change.[71]

In *Transdigm*, the court reviewed a similar fact pattern. In this case the buyer alleged that the sellers fraudulently concealed facts related to a key customer's intention to reduce its purchases from Linread Ltd., one of the target companies, by 50 percent and that Linread had also agreed to extend this same key customer a 5 percent discount that would take effect after the closing of the acquisition.[72]

The buyer in *Transdigm* understood that Linread's business was primarily dependent on this single key customer. Accordingly, on multiple occasions, the buyer inquired as to whether there were any disputes with the key customer or any agreements as to price reductions or the like.[73] The evidence presented indicated that in all instances the sellers denied the existence of any such discussions and deliberately concealed information that would have been responsive to the buyer's questions.[74] Internal e-mail correspondence among the sellers' management teams provided further support of the active concealment of this information.[75]

The Court's Reasoning and Analysis

In *Anvil Holding Corp.*, the court first addressed the buyer's claim that certain individual sellers (i.e., the senior management team of Iron Data) defrauded or fraudulently induced the buyer to enter into the transaction.[76] Of particular relevance was a representation by Iron Data in the purchase agreement that "no contractor . . . has notified [Iron Data] . . . in writing (or, to the Knowledge of [Iron Data], orally) of any intention to . . . materially change the terms (whether related to payment, price or otherwise) with respect to buying or supplying as the case may be, materials services or products."[77] The court found that this specific representation, although made by Iron Data and not by the individual sellers, provided a valid basis for the buyer's claim for fraud based on the

69. *Id.*
70. *Id.* at *3.
71. *Id.* at *5–6.
72. *Transdigm*, 2013 WL 2326881, at *1.
73. *Id.* at *2.
74. *Id.*
75. *Id.* at *3.
76. *Anvil*, 2013 WL 2249655, at *4.
77. *Id.* at *3 (quoting the purchase agreement between the parties).

specific language of the contract.[78] The court reasoned that the fact that senior management's knowledge was essential to the veracity of the representation gave the buyer sufficient basis to hold the individual sellers liable for fraud related to the contractual representations by Iron Data.[79] As further support for its conclusion, the court stated that the individual sellers, in their capacities as managers of Iron Data, effectively caused Iron Data to make the false representation.[80]

The court then analyzed whether the buyer had properly stated a claim for fraud outside of the contract. The court looked to language in the purchase agreement whereby the buyer agreed that the sellers were not making any representations or warranties other than those specifically set forth in the purchase agreement.[81] Nevertheless, the court found that this "no other representations" provision was distinguishable from language that specifically disclaimed the buyer's reliance on representations made outside of the contract.[82] Similarly, the court found that a standard merger or integration clause in the purchase agreement did not operate to disclaim reliance on outside representations and warranties.[83] Accordingly, in the absence of clear non-reliance language, the court determined that the buyer could proceed with its fraud claim against the sellers based on representations made outside of the purchase agreement.[84]

Also impacting the court's ruling was the fact that the *Anvil* purchase agreement specifically reserved claims based on the fraud or bad faith of the other party.[85]

In contrast to the representation contained in the purchase agreement discussed in *Anvil Holding Corp.*, the purchase agreement at issue in *Transdigm* included a durationally limited representation that ultimately barred the buyer's fraud claim. The representation stated that since December 31, 2010, no customer had "changed or indicated an intention in writing . . . to materially change the economic terms" on which it would purchase.[86] The court dismissed the buyer's claim that this representation was breached and, therefore, gave rise to recovery on the grounds that all of the discussions about the changes to the key customer's relationship took place prior to December 31, 2010.[87] Accordingly, this representation was technically correct when made and therefore it could not serve as a basis for a claim against the sellers.[88]

Additionally, unlike the purchase agreement in *Anvil Holding Corp.*, the purchase agreement in *Transdigm* did contain a disclaimer, by the buyer, of its reli-

78. *Id.* at *7.
79. *Id.*
80. *Id.*
81. *Id.* at *7–8.
82. *Id.* at *8.
83. *Id.*
84. *Id.*
85. *Id.*
86. *Transdigm*, 2013 WL 2326881, at *10 (quoting the purchase agreement between the parties).
87. *Id.* at *11.
88. *Id.* at *10–12.

ance on representations and warranties made outside of the contract.[89] The court concluded, based on the anti-reliance language, that the buyer could not have reasonably relied on the sellers' extra-contractual representations regarding the business relationship between Linread and its key customer.[90]

Nevertheless, the court agreed that the buyer had sufficiently stated a claim for fraudulent and active concealment against the sellers because the purchase agreement did not specifically disclaim any representation as to the accuracy or completeness of the information provided to the buyer, nor did the purchase agreement specifically disclaim the buyer's reliance on the sellers' omissions.[91] The court concluded that absent a disclaimer of the buyer's reliance on the sellers' omissions, it was reasonable to assume that the buyer relied on the assumption that the sellers were not hiding information that was material to the buyer's decision to proceed with the transaction.[92] Accordingly, the buyer's claim for fraud against the sellers could proceed.[93]

Conclusion

In order to disclaim claims based on fraudulent representations, warranties, and omissions outside of the four corners of the purchase agreement, a practitioner should consider, among other things, including language providing that, other than as expressly set forth in the purchase agreement:

(1) the seller is making no express or implied representations or warranties,

(2) the seller is making no representations or warranties as to the accuracy or completeness of information provided to the buyer, and

(3) the buyer is not relying on any other representations, warranties, or omissions of the seller.

5. *Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH* (Reverse Triangular Merger Did Not Violate Contractual Prohibition on Assignments by Operation of Law)

The Delaware Chancery Court, in *Meso Scale Diagnostics, LLC v. Roche Diagnostics GmbH*, held that the acquisition of a company in a reverse triangular merger did not violate a restriction in an existing agreement of the target company that prohibited assignments by operation of law.[94]

The opinion provides relief to those planning acquisitions after the court, in an earlier proceeding in the same case, had refused to find as a matter of law

89. *Id.* at *7.
90. *Id.* at *8.
91. *Id.*
92. *Id.* at *9.
93. *Id.*
94. 62 A.3d 62 (Del. Ch. 2013).

that a reverse triangular merger is not an assignment.[95] Some limits to the applicability of the holding remain, however, depending on applicable law and other factors.

Background

In 2007, Roche acquired BioVeris in a transaction structured as a reverse triangular merger, in which a newly formed subsidiary of Roche merged into BioVeris, with BioVeris surviving as a wholly owned subsidiary of Roche.[96] Roche soon shut down BioVeris' operations, leaving it with Intellectual Property ("IP") rights previously held by BioVeris.[97]

Plaintiff Meso had rights in the IP held by BioVeris and claimed that Roche's acquisition of BioVeris violated the anti-assignment provision of a Global Consent that had been entered into by Roche, Meso, BioVeris, and others in 2003, when BioVeris granted Roche a limited license to the IP.[98] The Global Consent included a provision prohibiting assignment "of the rights, interests or obligations under [the Global Consent] . . . in whole or in part, by operation of law or otherwise," but did not include language otherwise purporting to prohibit a change of control of BioVeris or to treat a change of control as an assignment.[99]

The Court's Reasoning and Ruling

The court noted that no Delaware court had addressed whether a reverse triangular merger "could ever" constitute an assignment by operation of law.[100] The court also noted that in interpreting the anti-assignment provision it would try to determine the parties' "collective intent."[101]

The court began by stating that "[g]enerally, mergers do not result in an assignment by operation of law of assets that began as property of the surviving entity and continued to be such after the merger."[102] The court noted that the Delaware General Corporation Law provides that, in a merger, the separate existence of the constituent corporations, other than the surviving corporation, ceases, and the assets and rights of the constituent corporations are vested in the surviving corporation.[103] The court also concluded, under the "objective theory" of contract interpretation, that this interpretation was consistent with the reasonable expectations of the parties.[104]

95. C.A. No. 5589 VCP-2011 Del. Ch. LEXIS 61 (Apr. 8, 2011), *discussed in Annual Survey of Judicial Developments Relating to Mergers and Acquisitions*, 67 Bus. Law. 491, 527 (2012).
96. *Meso*, 62 A.3d at 73.
97. *Id.* at 73–74.
98. *Id.* at 75.
99. *Id.* at 76.
100. *Id.* at 81.
101. *Id.* at 81–82.
102. *Id.* at 82.
103. *Id.* (citing Del. Code Ann. tit. 8, § 259).
104. *Id.* at 83.

The court declined to adopt the holding in *SQL Solutions, Inc. v. Oracle Corp.*[105] (which applied California law and federal IP principles) that a reverse triangular merger resulting in the acquisition of SQL by Sybase constituted a transfer of rights under a software license from Oracle held by SQL.[106] The court noted that following the *SQL Solutions* approach would "[upset] Delaware's well-settled law" that stock acquisitions, by themselves, do not result in an assignment by operation of law.[107]

Conclusion

Meso demonstrates that, under Delaware law, a reverse triangular merger generally does not violate anti-assignment provisions in a target company's contracts, even if the anti-assignment provision prohibits assignment by operation of law (assuming there are no prohibitions on change of control). While the opinion provides greater clarity, given the court's reasoning, practitioners may still need to consider the intent of the parties to the target company's agreements, particularly if there are ambiguities in relevant provisions of those agreements.

The court reached its conclusion after examining the effect of a merger under Delaware's merger statute and the interpretation of an anti-assignment provision under Delaware law. While Delaware law is not unusual, the effect of a merger on corporations organized in other states, and the interpretation of contracts governed by other law, should be confirmed when planning for an acquisition.

The contracts at issue in *Meso* related to BioVeris' IP rights, but the court did not discuss federal IP principles. However, other IP related cases, such as *SQL Solutions*, have noted the restrictive nature of federal IP rules. Practitioners should continue to consider federal IP rules in considering anti-assignment provisions in licenses and other IP agreements.

6. *Winshall v. Viacom International Inc.* (Reviewing Obligation of Selling Stockholders to Indemnify Legal Costs Incurred Defending a Third Party Claim Related to the Subject Matter of a Representation Despite Lack of Breach of Representation)

In *Winshall v. Viacom International Inc.*,[108] the Delaware Supreme Court affirmed decisions of the Court of Chancery[109] holding that: (1) the implied covenant of good faith and fair dealing could not be used to impose on an acquiror a duty to conduct the target company's business so as to maximize the earnout

105. No. C-91-1079 MHP, 1991 WL 626458 (N.D. Cal. Dec. 18, 1991).
106. *Meso*, 62 A.3d at 87.
107. *Id.* at 88.
108. 76 A.3d 808 (Del. 2013).
109. Winshall v. Viacom Int'l, Inc., 55 A.3d 629 (Del. Ch. 2011) (ruling on the earnout claim); Winshall v. Viacom Int'l, Inc., C.A. No. 6074-CS, 2012 Del. Ch. LEXIS 284 (Dec. 12, 2012) (ruling on the indemnification claim).

payments to the former shareholders of the target; and (2) former shareholders were not required to indemnify the acquirer for alleged breaches of representations and warranties contained in the merger agreement because (i) the merger agreement did not expressly require the payment of defense costs, and (ii) no indemnifiable breach of representations and warranties could be established where the merger agreement did not contain a clear and unambiguous representation that products in development at the time of the merger would not infringe third parties' intellectual property rights.[110]

Background

In 2006, Viacom International Inc. ("Viacom") acquired Harmonix Music Systems, Inc. ("Harmonix"), a developer of music-themed video games.[111] The merger agreement granted to Harmonix's former shareholders a contingent right to receive incremental uncapped earnout payments based on Harmonix's gross profits during 2007 and 2008.[112] The agreement, however, did not require Viacom or Harmonix to conduct its business post-merger so as to ensure or maximize the earnout payments.[113] The agreement also required Harmonix's former shareholders to "indemnify and hold harmless" Viacom and Harmonix against any losses arising out of "the breach of any representation or warranty" of Harmonix contained in the agreement.[114]

At the time that the merger closed, Harmonix was in the process of developing the video game *Rock Band*.[115] In 2007, Harmonix, at the time a subsidiary of Viacom, entered into an agreement with Electronic Arts ("EA") for the distribution of *Rock Band* through 2010.[116] The distribution fees payable to EA under the agreement constituted one of the largest single post-merger expenses of Harmonix and thus directly affected the earnout payments.[117] In 2008, following the success of *Rock Band*, Harmonix entered into an amended agreement with EA that granted to EA even broader distribution rights in exchange for, among other things, reduced distribution fees after 2008.[118] Although EA also offered to reduce the distribution fees in 2008, Harmonix rejected the offer and instead kept fees at the same level in exchange for EA's commitment to purchase advertising from certain Viacom outlets.[119]

In 2007 and 2008, third parties asserted four claims against Harmonix alleging violations of intellectual property rights related to *Rock Band*.[120] Viacom no-

110. *Winshall*, 2013 Del. LEXIS 510, at *44–45.
111. *Id.* at 811.
112. *Id.*
113. *Id.*
114. *Id.* at 820.
115. *Id.* at 811.
116. *Id.* at 811–12.
117. *Id.*
118. *Id.*
119. *Id.* at 812.
120. *Id.*

tified the shareholders' representative that it could seek indemnification for those claims.[121] All four claims were ultimately settled or dismissed.[122] Viacom, however, refused to release to the former shareholders certain funds that had been escrowed at closing for purposes of satisfaction of indemnification claims.[123]

Former shareholders filed suit in the Court of Chancery alleging (i) that Viacom and Harmonix breached the implied covenant of good faith and fair dealing by intentionally deferring the distribution fee reduction until after the expiration of the earnout period, and (ii) that Viacom was not entitled to indemnification and must be ordered to release the escrowed funds. The Court of Chancery granted defendant's motion to dismiss the earnout payment claim, and granted the shareholders' motion for summary judgment with respect to the indemnification issue, ordering the release of the funds held in escrow.[124] Both sides appealed, and the Supreme Court affirmed the Chancery Court's judgment in its entirety.

Implied Covenant of Good Faith and Fair Dealing. In dismissing the shareholders' claim for breach of the implied covenant of good faith and fair dealing, the court reasoned that the covenant could not properly be applied to give the plaintiffs contractual protections that "they [had] failed to secure for themselves at the bargaining table."[125] Since the parties could have included a specific covenant to maximize the earnout payments, but did not, the court refused to use the implied covenant as "a license to rewrite contractual language just because the [shareholders] failed to negotiate for protections that, in hindsight, would have made the contract a better deal."[126] The court further noted that, had Viacom and Harmonix agreed to increase the 2008 distribution fees beyond what they paid under the original agreement with EA, "such an agreement would arguably be a breach of the implied covenant."[127]

Indemnification. The indemnification amounts at stake consisted of Viacom's defense costs incurred in litigating the infringement claims related to *Rock Band*.[128] Viacom relied on two provisions in the merger agreement. The first clause gave Viacom the right to conduct the defense of any claim "at the expense of applicable indemnifying parties," and the second clause required the shareholders to pay "the reasonable fees and expenses of counsel retained by [Viacom]" if Viacom chose not to permit the shareholders to assume the defense of "such claims."[129] The court rejected Viacom's argument, interpreting both defense cost provisions to apply only to indemnifiable claims, and thus not triggered absent an actual breach of representations and warranties.[130] The court

121. *Id.*
122. *Id.*
123. *Id.*
124. *Id.* at 813.
125. *Id.* at 816 (quoting Aspen Advisors LLC v. United Artists Theatre Co., 861 A.2d 1251, 1260 (Del. 2004)).
126. *Id.* (quoting *Winshall*, 55 A.3d at 637).
127. *Id.* (quoting *Winshall*, 55 A.3d at 638).
128. *Winshall*, 2012 Del. Ch. LEXIS 284, at *15–16.
129. *Id.* at *16 (interpreting "such claims" to include claims for indemnification).
130. *Id.* at *17; *Winshall*, 76 A.3d at § 20.

made clear that, if the parties indeed intended to require the shareholders to pay for the defense of Viacom against *any* claim, regardless of whether a breach of representations and warranties was ultimately proven, the merger agreement would have included the language to that effect, yet it did not.[131]

Finally, the court held that Viacom could not have established any indemnifiable breach of representations and warranties because no representation in the merger agreement clearly covered *future* uses of *Rock Band*, a game under development at the time of the merger.[132] The Delaware Supreme Court further noted that a similar representation or warranty with respect to future products would be so "unusual and counter-intuitive" that "its expression in a contract would need to be clear and unambiguous."[133]

Conclusion

Delaware courts will not read into a merger agreement uncommon obligations that are not expressly spelled out in the contract. In particular:

(1) unless selling shareholders specifically negotiate and include in the merger agreement an obligation of the acquirer to act so as to maximize the selling shareholders' earnout payments, no such obligation will be implied, and

(2) buyers who want the selling shareholders to pay buyers' defense costs related to third-party claims arising out of any alleged but not established breach of representations and warranties of the selling shareholders should include an express provision to this effect.

7. *Meda AB v. 3M Co.* (Demonstrating Court's Limited Interpretation of the Implied Covenant of Good Faith and Fair Dealing)

In *Meda AB v. 3M Co.*,[134] Meda AB, after acquiring 3M Company's European pharmaceutical business, claimed that 3M breached its representations and warranties, violated the implied covenant of good faith and fair dealing, and committed fraud.

131. *Winshall*, 2012 Del. Ch. LEXIS 284, at *18 ("If the Sellers were really to be responsible for paying for arguable breach of representations and warranties, regardless of whether a breach of representation and warranties was ultimately proven, we should expect to find the relevant contractual provision stating this in as many words."); *Winshall*, 76 A.3d at 821–22 ("If the parties intended to require the Selling Shareholders to reimburse the Defendants for the costs of defending every infringement claim regardless of its merit, they could have used appropriate language to accomplish that result.").

132. *See Winshall*, 2012 Del. Ch. LEXIS 284, at *21–26; *Winshall*, 76 A.3d at 824 ("Defendants do not point to anything in the Merger Agreement clearly establishing that the Selling Shareholders intended to make legally binding representations and warranties about a future Rock Bank game that would not be completed, manufactured and sold until after Viacom acquired ownership of Harmonix.").

133. *Winchall*, 76 A.3d at 824.

134. No. 11 Civ. 412 (AJN), 2013 WL 4734811 (S.D.N.Y. Sept. 3, 2013).

Background

In 2006, Meda signed an agreement to acquire 3M's European pharmaceutical business for $854 million.[135] Following the closing, Meda sued 3M, claiming that 3M's failure to disclose during due diligence a non-public provision of a document produced by the French drug pricing authority known as "CEPS" caused Meda to overpay by over $200 million.[136] The relevant document, which was known as a "convention," established the reimbursement price for a drug in the French market. The convention contained a provision providing that, at the end of its three-year term, the price of the drug would be reduced to that of the generic equivalent.[137] 3M negotiated with CEPS in advance of the 2006 termination date, and 3M and CEPS ultimately executed a rider to the convention in which the pricing provision was struck out by hand.[138]

Analysis

Breach of Representations and Warranties

The first representation and warranty claim was for breach of the representation relating to compliance with laws. The representation, however, was limited to what were apparently upper-tier 3M entities that were defined as "sellers" in the principal acquisition agreement (as opposed to the ancillary agreement governing the transfer of the French assets), and, as a result, the French subsidiary that was the seller of the French assets was not technically included in the representation.[139] However, the court also analyzed the issue as if the French seller had been included in the representation. 3M's French law experts testified that conventions such as the one at issue were not hard and fast rules, but rather that they incorporated a degree of flexibility for improving the positions of the drug companies.[140] As a result, the court held that 3M's French subsidiary was not in violation of the law.[141]

The second representation and warranty claim was for breach of the contracts representation, based on the failure to disclose the CEPS convention. The court held, however, that the convention did not fall within the relevant definitions of contracts that were required to be scheduled.[142]

The final representation and warranty claim was for breach of a representation relating to regulatory filings. The court found that, based on the definitions in the acquisition agreement, the CEPS convention was not a regulatory filing that was required to be disclosed.[143]

135. *Id.* at *2.
136. *Id.* at *3.
137. *Id.* at *6.
138. *Id.* at *7–9.
139. *Id.* at *17.
140. *Id.* at *5.
141. *Id.* at *17–18.
142. *Id.* at *19–20.
143. *Id.* at *21.

Breach of Covenant of Good Faith and Fair Dealing

The court rejected Meda's argument that 3M had breached the implied covenant of good faith and fair dealing. First, it held that the implied covenant could protect only a mutually contemplated benefit of the bargain, and a party could not use it to create an additional benefit for which it did not bargain.[144] Second, the court found that 3M had taken no steps subsequent to the execution of the acquisition agreement to prevent Meda from enjoying the benefits for which it had bargained.[145] Third, the court found that relevant 3M executives did not act in bad faith because they believed that the business was a valuable one from which Meda could derive synergies and profits.[146] The court also noted that Meda's motivation for the acquisition was largely based on synergies and not materially affected by the CEPS convention.[147] Finally, the court held that the argument failed because it was in part premised on Meda's argument that it was a conservative and risk-averse buyer.[148] In its analysis, however, the court had observed that Meda's representatives spent little time in the electronic data room established for the transaction and reviewed none of the documents concerning drug pricing.[149]

Fraud

The court also found that 3M did not commit fraud, either by affirmative fraudulent misstatement or fraudulent omission. It noted the five elements of fraud under New York law: (1) a material misrepresentation or omission of fact; (2) made by the defendant with knowledge of its falsity; (3) and intent to defraud; (4) reasonable reliance on the part of the plaintiff; and (5) resulting damage to the plaintiff.[150] It also noted that claims for fraudulent omission require a duty to disclose.[151]

The court found that Meda failed to show that 3M knowingly or recklessly made a fraudulent misrepresentation or omission.[152] It observed the time and effort invested in preparing the confidential information memorandum, the fact that executives did not believe that the convention represented a binding agreement, but rather believed that they had the ability to negotiate for continued higher reimbursement pricing, and that they believed that the relevant pricing provision in the convention had, in fact, been eliminated in negotiations with CEPS when the rider to the convention was executed.[153]

144. *Id.* at *22.
145. *Id.*
146. *Id.* at *23.
147. *Id.* at *22.
148. *Id.*
149. *Id.* at *13.
150. *Id.* at *22.
151. *Id.* at *23.
152. *Id.*
153. *Id.*

Damages

Finally, the court held that, even if Meda had proven that 3M was liable to it based on any of its claims, Meda could not establish that it suffered any damages because the purchase of the French assets was effected by a French subsidiary of Meda, which was not a party to the action.[154] The court also found unpersuasive Meda's expert witness, who attempted to demonstrate that Meda would have paid approximately $200 million less for the business had it known about the convention, largely because the court accepted testimony from 3M's expert witnesses that an individual reasonably familiar with the French pharmaceutical industry could reasonably have concluded, based upon public information, that the price of the drug was likely to fall.[155]

Conclusion

Representations and warranties should be appropriately drafted to encompass all relevant entities, particularly in a global acquisition in which all seller entities or entities to be sold are not identified in the global acquisition agreement, but rather are parties to subsequent ancillary agreements governing the transfer of assets in various jurisdictions.

This case also demonstrates the limited extent to which a court will utilize the implied covenant of good faith and fair dealing, namely, that the covenant protects only mutually contemplated benefits, and cannot be used to create an additional benefit for which the parties did not bargain.

Finally, this case shows the difficulty of proving scienter as an element of fraud when the evidence suggests that the seller undertook reasonable efforts to make appropriate disclosures and, conversely, the purchaser's due diligence efforts were relatively limited.

Fiduciary Duty

8. *Brinckerhoff v. Enbridge Energy Co.*; *Norton v. K-Sea Transportation Partners L.P.*; *Gerber v. Enterprise Products Holdings, LLC*; *Allen v. Encore Energy Partners, L.P.*; *DV Realty Advisors LLC v. Policemen's Annuity & Benefit Fund of Chicago* (Substitution of Contractual Subjective Good Faith Duties for Fiduciary Duties in Delaware Limited Partnerships)

Many M&A transactions involve a limited partnership ("LP") or other alternative entity, and, like M&A transactions involving corporations, many of such M&A transactions are challenged on the basis that the process followed involved a violation of fiduciary duties. Five Delaware Supreme Court decisions in 2013 involving transactions by an LP with a related party address the effectiveness of contractual provisions in a limited partnership agreement ("LPA") that modify or

154. *Id.* at *26.
155. *Id.*

eliminate default fiduciary duties and substitute therefor contractual "safe harbors" to cleanse conflicted transactions.[156]

The Delaware statutes expressly allow the limitation or elimination of partner fiduciary duties in a partnership agreement, but do not allow the elimination of the implied contractual covenant of good faith and fair dealing.[157] Four of these recent decisions reaffirm the effectiveness of provisions limiting or eliminating partner fiduciary duties in a partnership agreement. The fifth decision illustrates that the implied contractual covenant of good faith and fair dealing (which parties may not contractually eliminate) can provide the basis for challenging an unfair M&A transaction.[158]

1. Substitution of Subjective Good Faith Standard for Fiduciary Duties

In *Allen v. Encore Energy Partners, L.P.*,[159] a case involving a merger of a publicly traded LP ("MLP") with its general partner's ("GP's") ultimate parent (its "controller"), a limited partner alleged that the GP, its controller, and its directors breached the contractual duties imposed by the LPA in connection with the merger.[160] The court confirmed the enforceability of clear, express, and unambiguous language in an LPA replacing default fiduciary duties with a contractual duty that would be satisfied if the transaction at issue was approved in "good faith" (as defined by the LPA) by the conflicts committee of independent directors on the GP's board.[161] The LPA in this case replaced common law fiduciary duties with a contractually adopted duty of "subjective good faith" and deemed this contractual duty to be satisfied if a committee of independent directors of the GP's board granted "Special Approval" to a transaction, so long as the independent directors themselves acted with subjective good faith.[162] The court concluded that the contractual "good faith" standard under the LPA required only a subjective belief that the determination or other action is in the best interests of the LP.[163]

156. The five decisions in order of opinion date are the following: Brinckerhoff v. Enbridge Energy Co., 67 A.3d 369 (Del. 2013); Norton v. K-Sea Transp. Partners L.P., 67 A.3d 354 (Del. 2013); Gerber v. Enter. Prods. Holdings, LLC, 67 A.3d 400 (Del. 2013); Allen v. Encore Energy Partners, L.P., 72 A.3d 93 (Del. 2013); DV Realty Advisors LLC v. Policemen's Annuity & Benefit Fund of Chi., No. 547, 2012, 2013 WL 4517001 (Del. Aug. 26, 2013).

157. DEL. CODE ANN. tit. 6, § 17-1101 (2012); *see* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979) ("every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement").

158. *Gerber*, 67 A.3d 400.

159. 72 A.3d 93.

160. *Id.* at 95.

161. *Id.* at 100–01.

162. The LPA provided:

> Except as expressly set forth in [the LPA], *neither [GP] nor any other Indemnitee [an affiliate of GP] shall have any duties or liabilities, including fiduciary duties, to the Partnership or any Limited Partner* . . . and the provisions of [the LPA], to the extent that they restrict, eliminate or otherwise modify the duties and liabilities, including fiduciary duties, of [GP] or any other Indemnitee otherwise existing at law or in equity, are agreed by the Partners to replace such other duties and liabilities of [GP] or such other Indemnitee.

Id. at 100.

163. *Id.* at 109.

Norton v. K-Sea Transportation Partners L.P.[164] involved another LP in which the LPA replaced common law fiduciary duties with a contractual process for approving related party transactions. The plaintiffs alleged that the GP obtained excessive consideration for its incentive distribution rights ("IDRs") when an unaffiliated third party purchased the LP.[165] The court held that the GP needed only to exercise its discretion in good faith, as the parties intended that term to be construed, to satisfy its duties under the LPA.[166] Noting that the GP obtained an appropriate fairness opinion, under which the LPA created a conclusive presumption that the GP made its decision in good faith, the court affirmed the chancery court's dismissal of the complaint.[167]

In rejecting plaintiff's argument that the GP is not entitled to a conclusive presumption of good faith because the fairness opinion did not specifically address the IDR payment's fairness, the court wrote that the LPA does not require the GP to evaluate the IDR payment's reasonableness separately from the remaining considerations, and explicitly states that nothing in the LPA shall be construed to require the GP to consider the interests of any person other than the LP.[168] The GP was not required to consider whether the IDR payment was fair, but only whether the merger as a whole was in the best interests of the LP (which included the GP and the LP).[169] Because of those clear provisions, the court held that plaintiff had no reasonable contractual expectation that the GP or the conflict committee's investment banker would specifically consider the IDR payment's fairness.[170]

Earlier, in *Brinckerhoff v. Enbridge Energy Co.*,[171] the court affirmed the dismissal of derivative claims brought by an LP challenging the fairness of a joint venture (the "JV") entered into between the LP and the controller.[172] The plaintiff alleged that the controller purchased its stake in the JV from the LP for substantially less than its fair value.[173] The court commented that, in order for the plaintiff to succeed, the decision to enter into the JV must have been "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."[174]

Subsequently, the Court followed *Brinckerhoff* in *DV Realty Advisors LLC v. Policemen's Annuity & Benefit Fund of Chicago*[175] and held that the removal of a GP met the contractual subjective good faith standard in the partnership agreement because the action was not "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith."[176]

164. 67 A.3d 354 (Del. 2013).
165. *Id.* at 356.
166. *Id.*
167. *Id.*
168. *Id.* at 366.
169. *Id.*
170. *Id.*
171. 67 A.3d 369 (Del. 2013).
172. *Id.* at 370.
173. *Id.*
174. *Id.*
175. No. 547, 2012, 2013 WL 4517001 (Del. Aug. 26, 2013).
176. *Id.* at *6.

2. Implied Contractual Duty of Good Faith

In *Gerber v. Enterprise Products Holdings, LLC*,[177] breach of the implied covenant of good faith and fair dealing was pled and was outcome determinative in favor of the plaintiff. *Gerber* involved allegations by an LP that the LP's purchase of interests in an entity controlled by its controller was unfair to the LP, in violation of its LPA and in breach of the duty of good faith owed to the LP.[178] Its LPA substituted a subjective good faith standard and conflicts committee process for common law fiduciary duties. The challenged transaction was, in fact, approved by the conflicts committee as in the committee's subjective belief in the best interest of the LP.[179] The plaintiff pleaded a claim for breach of the implied contractual covenant of good faith and fair dealing, alleging that the fairness opinion relied upon by the conflicts committee did not value separately the consideration the LP actually received and did not address the value of the LP's claims against the GP, the elimination of which was a disclosed purpose of the transaction.[180]

The court explained its holding on the basis of the implied contractual covenant of good faith and fair dealing in temporal conceptual terms. Adopting the reasoning in *ASB Allegiance Real Estate Fund v. Scion Breckenridge Managing Member, LLC*,[181] the court explained that the implied covenant seeks to enforce the parties' contractual bargain by implying only those terms that the parties would have agreed to during their original negotiations if they had thought to address them and that "a court confronting an implied covenant claim asks whether it is clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with respect to that matter."[182] In contrast, under a common law fiduciary duty or tort analysis, a court examines the parties as situated at the time of the wrong, determining whether the defendant owed the plaintiff a duty that was breached.[183]

The court focused on the alleged unfairness of the challenged transaction in which the LP sold the interests to the controller for only 9 percent of the LP's original purchase price and that the fairness opinion did *not* address whether holders of the LP units received fair consideration for the LP's interest (it only addressed the total consideration paid to all parties in two related transactions).[184] The court found that when plaintiff agreed in the LPA to be bound by the LPA's conclusive presumption that the GP's contractual fiduciary duty was satisfied

177. 67 A.3d 400 (Del. 2013).
178. *Id.* at 404.
179. *Id.* at 417.
180. *Id.* at 424.
181. 50 A.3d 434, 440–42 (Del. Ch. 2012), *aff'd in part & rev'd in part on other grounds*, 68 A.3d 665 (Del. 2013).
182. *Gerber*, 67 A.3d at 418.
183. *Id.*
184. *Id.* at 421.

if the GP relied upon the opinion of a qualified expert, plaintiff could hardly have anticipated that the GP would rely upon a fairness opinion that did not fulfill its basic function—evaluating the consideration the LP unitholders received for purposes of opining whether the transaction was financially fair.[185] It held this is the type of arbitrary, unreasonable conduct that the implied covenant prohibits.[186]

Applying a similar analysis, the court concluded "that the parties would certainly have agreed, at the time of contracting, that any fairness opinion contemplated by that provision would address the value of derivative claims where (as here) terminating those claims was a principal purpose of a merger."[187] In addition to clarifying that an LPA definition of good faith cannot restrict the implied contractual covenant of good faith and fair dealing, *Gerber* teaches that fairness opinions in M&A transactions involving Delaware alternative entities should (i) address the fairness of the consideration to be received in each transaction upon which it will be relied to satisfy the implied contractual covenant of good faith and fair dealing requirements under Delaware law and (ii) take into account the value of derivative claims being eliminated by a merger to which it relates.

Conclusion

The foregoing cases illustrate that:

(1) Delaware courts generally respect the statutory authority to eliminate common law fiduciary duties in an LPA if the LPA clearly does so; and

(2) The *Gerber* case notwithstanding, where they have found that parties have expressly limited fiduciary duties in LPAs, Delaware courts have been reluctant to use the implied covenant of good faith and fair dealing, viewing this duty instead as more of a gap filler where the parties had not contemplated the particular circumstance.

After *Gerber*, however, claims based on the implied covenant may be pursued more vigorously.

9. *In re Trados Inc. Shareholder Litigation* (Entire Fairness Standard Satisfied Even Though Common Stock Received No Consideration in Sale of a VC-Backed Company)

In *In re Trados Inc. Shareholder Litigation*,[188] the Delaware Chancery Court applied the entire fairness standard to claims of breach of fiduciary duty by a board in agreeing to the sale of a venture capital-backed company that had both common and preferred stock outstanding. The common stock received nothing in the merger, and the court cited numerous shortcomings in the sale process,

185. *Id.* at 422.
186. *Id.* at 423.
187. *Id.*
188. C.A. No. 1512-VCL (Aug. 16, 2013) (mem.).

but the court found that the common stock had no economic value before the transaction and therefore that it was fair for the holders of common stock to receive nothing in the merger.

Background

In July 2005, Trados Inc. was acquired by SDL plc for $60 million.[189] Trados' venture capital ("VC") investors were entitled to $57.9 million of the consideration pursuant to liquidation preferences.[190] Additionally, pursuant to a management incentive plan ("MIP") adopted by the Trados board as they were contemplating a sale process, Trados executives were entitled to the first $7.8 million of the consideration.[191] The preferred stockholders thus received only $52.2 million, and the common stockholders received nothing.[192] The board did not receive an independent financial advisor's opinion as to the fairness of the consideration to the holders of common stock.[193] The preferred stockholders, together with management, held sufficient shares to approve the merger without the vote of other holders of common stock.[194]

Analysis

The Required Standard of Conduct

The court first described the duty the Trados board owed to the common stockholders. After citing cases describing the rights of the preferred stockholders as contractual, the court stated that "generally it will be the duty of the board . . . to prefer the interests of the common stock . . . to the interests created by the special rights . . . of preferred stock."[195] The court further stated that:

> in circumstances where the interests of the common stockholders diverge from those of the preferred stockholders, it is *possible* that a director could breach her duty by improperly favoring the interests of the preferred stockholders over those of the common stockholders.[196]

The Entire Fairness Standard of Review

The court reviewed the interests of the board members who represented VC funds on the board, and it concluded that a majority were not disinterested. The court thus applied the entire fairness standard to the board's actions, stating that, to satisfy this standard of review, the defendants must establish that the transaction was the product of both (1) fair dealing and (2) fair price.[197]

189. *Id.* at 1.
190. *Id.*
191. *Id.*
192. *Id.*
193. *Id.* at 85.
194. *Id.* at 86.
195. Equity-Linked Investors, L.P. v. Adams, 705 A.2d 1040, 1042 (Del. Ch. 1997).
196. *Trados*, C.A. No. 1512-VCL, slip op. at 7.
197. *Id.* at 47.

Fair Dealing. The court commenced its analysis of fair dealing with a review of how the transaction was initiated. The court concluded that the VC directors did not make the decision to sell the company from the perspective of the common stockholders, but rather "initiated a sale process and pursued the [m]erger to take advantage of their special contractual rights," in particular their liquidation preferences.[198]

The court then turned to the transaction structure, noting that after the liquidation preference was paid in full the MIP allocated money away from the common stockholders to the management team, and therefore "the MIP converted the management team from holders of equity interests aligned with the common stock to claimants whose return profile and incentives closely resembled those of the preferred."[199] The court thus stated that the MIP was evidence that the board dealt unfairly with the common.[200]

The court then discussed director approval of the merger. The court stated that a "director's failure to understand the nature of his duties can be evidence of unfairness," and noted that the directors did not understand that their job was to maximize the value of the corporation for the benefit of the common stockholders.[201] The court pointed out that the board did not even consider forming a special committee to represent the interests of the common stockholders or obtain an independent fairness opinion.[202] In the court's words, "[t]aken as a whole, the manner in which director approval was obtained provides evidence of unfair dealing."[203]

Finally, the court pointed out that the merger was approved by the preferred stockholders who controlled a majority of the company's voting power and that the board never considered conditioning the merger on the vote of a majority of disinterested common stockholders.[204]

Having outlined these facts, the court stated that the preferred voting in their own economic interest and failure to condition approval on the vote of disinterested common stockholders are not evidence of unfairness, but taking these actions would have provided the directors with helpful affirmative defenses.[205]

Fair Price. The opinion then analyzed whether the common stock received a fair price in the merger, albeit nothing. The court discounted the company's financial advisor's valuation because it included acquisition premiums and used a comparables analysis, ultimately concluding that Trados had no comparable companies.[206] The court determined that the board minutes setting a fair market

198. *Id.* at 74.
199. *Id.* at 80.
200. *Id.*
201. *Id.* at 81.
202. *Id.* at 85.
203. *Id.* at 86.
204. *Id.*
205. *Id.* at 87.
206. *Id.* at 100.

valuation for purposes of option grants at the same time as they approved the negotiation of the merger were unreliable.[207] Finally, the court decided that the expert valuation provided by the board was the most credible because it "addressed the central question of fairness presented by this case" because it focused on the value of Trados as a stand-alone business.[208] As a result, the court stated that the board's expert "provided helpful input on the issue of fair price."[209] Under the valuation provided by the board's expert, the present value of Trados was less than the merger proceeds of $60 million.[210]

Unitary Determination of Fairness

Although the Trados directors (1) did not adopt any protective provisions, (2) failed to consider the common stockholders, and (3) sought to exit without recognizing their conflicts, "they nevertheless proved that the transaction was fair."[211] If Trados' common stock had no economic value before the merger, then the common stockholders received the substantial equivalent in value of what they had before, and the merger satisfied the test of fairness. The court stated that, under the circumstances of the case, the fact that the directors did not follow a fair process does not constitute a separate breach of duty.[212] The court held that an unfair process can infect the price, but since the directors proved that the price received by the common stockholders was fair, they demonstrated that they did not commit a fiduciary breach.[213]

Conclusion

Trados reiterates the relatively limited fiduciary duty directors owe to the holders of preferred stock and the corresponding duty of directors generally to prefer the interests of the common stock when they are in conflict with the interests of the preferred stock.

The opinion also provides a helpful analysis of a board's obligations in the context of the sale of a dual-class company where the price is insufficient to provide any consideration to the common stockholders. In addition to discussing director conflicts, the impact of a management incentive plan, and other process issues that arise under common fact patterns, the decision makes clear that, notwithstanding failures in fair dealing, proving that the common stockholders received a fair price may allow board members to prove that they had not breached their fiduciary duties.

207. *Id.* at 97.
208. *Id.* at 107.
209. *Id.*
210. *Id.* at 104.
211. *Id.*
212. *Id.* at 111.
213. *Id.*

10. *In re Primedia, Inc. Shareholders Litigation* (Allowing Post-Merger Direct Claim Where Target Board Failed to Value an Insider Trading Claim in the Merger)

In *In re Primedia, Inc. Shareholders Litigation*,[214] the Delaware Court of Chancery denied defendants' motion to dismiss, finding that pre-merger stockholders of the target company had post-merger standing to challenge directly the fairness of the transaction based on the target board's failure to value an insider trading claim in the merger, and that sufficient facts existed to suggest that the transaction was unfair.[215]

Background

In 2005 and 2006, plaintiffs filed derivative suits on behalf of Primedia, Inc., alleging that Primedia's board breached its fiduciary duties to the common stockholders by prematurely selling assets and redeeming preferred stock to benefit its 58 percent stockholder, Kohlberg Kravis Roberts & Co. L.P. ("KKR").[216] The court consolidated these actions, defendants moved to dismiss the complaint, and the court denied defendants' motion.[217]

In 2007, Primedia's board formed a special litigation committee (the "SLC") to investigate plaintiffs' redemption allegations and an additional corporate opportunity claim.[218] Plaintiffs reviewed documents generated during this investigation, and they found support that KKR traded on inside information when it purchased Primedia's preferred stock.[219] Plaintiffs informed the SLC of this finding, and sought disgorgement of those profits under *Brophy v. Cities Service Co.*[220]

In 2010, the court granted the SLC's motion to dismiss the derivative action under *Zapata Corp. v. Maldonado*,[221] holding that the SLC was independent, acted in good faith, and led a reasonable investigation (the "*Zapata* Hearing").[222] In "applying its own independent business judgment" under *Zapata*'s second prong (which requires the court to review the reasonableness of the SLC's business judgment), the court ruled that the recovery for the *Brophy* claim would be minimal.[223] The court assumed that full disgorgement of profits was unavailable for a *Brophy* claim under *Pfeiffer v. Toll*,[224] where the Court of Chancery held that

214. 67 A.3d 455 (Del. Ch. 2013).
215. *Id.* at 459–60.
216. *Id.* at 466.
217. *Id.*
218. *Id.*
219. *See id.*
220. *Id.* at 459, 466 (citing 70 A.2d 5 (Del. Ch. 1949)).
221. 430 A.2d 779 (Del. 1981).
222. *Primedia*, 67 A.3d at 468–69, 473.
223. *Id.* at 468; *see also id.* at 468 n.2, 472.
224. 989 A.2d 683 (Del. Ch. 2010), *abrogated by* Kahn v. Kolberg Kravis Roberts & Co., 23 A.3d 831 (Del. 2011); *see also Primedia*, 67 A.3d at 473.

"[a] *Brophy* claim d[id] not exist to . . . force automatic disgorgement of reciprocal insider trading gains. The purpose of a *Brophy* claim is to remedy harm to the corporation."[225] Plaintiffs appealed the dismissal of the *Brophy* claim to the Delaware Supreme Court.[226]

While the appeal was pending, Primedia approved a merger with TPG Capital ("TPG"), L.P. valued at $316 million.[227] Before closing, the board considered the value of plaintiffs' derivative action, and determined that the *Brophy* claim was of limited or no value, particularly based on the SLC's prior investigation and the court's dismissal at the *Zapata* Hearing.[228]

In 2011, the Delaware Supreme Court reversed the Court of Chancery, finding that "*Pfeiffer*'s holding—which requires a plaintiff to show that the corporation suffered actual harm before bringing a *Brophy* claim—is not a correct statement of our law."[229] The supreme court held that full disgorgement of profits was available under *Brophy*, and it remanded to determine if a "broader reading of *Brophy* would alter the balancing under the second prong of *Zapata*."[230] The SLC determined that this ruling "did not alter the conclusion . . . that it was not in the best interests of the Company to pursue the claims asserted in the derivative action."[231] Shortly thereafter, the merger closed, extinguishing plaintiffs' derivative claims.[232]

Plaintiffs filed this class action, alleging that the merger was unfair because the board failed to value the *Brophy* claim.[233] Defendants moved to dismiss.[234] The court denied defendants' motion as to the entire fairness claim, holding that plaintiffs had standing under *Parnes v. Bally Entertainment Corp.*[235] and *In re Massey Energy Co.*[236] and had alleged sufficient facts that the merger was unfair. But the court granted the motion as to plaintiffs' remaining merger agreement and aiding and abetting claims.[237]

Analysis

Standing to Challenge the Merger

The court held that, under *Parnes*, plaintiffs had standing to directly challenge the board's failure to value the *Brophy* claim.[238] *Parnes* allows direct challenges to

225. *Pfeiffer*, 989 A.2d at 699.
226. *Primedia*, 67 A.3d at 473.
227. *Id.* at 473–75.
228. *Id.* at 474.
229. *Kahn*, 23 A.3d at 837 ("To the extent *Pfeiffer v. Toll* conflicts with our current interpretation of *Brophy v. Cities Service Co.*, *Pfeiffer* cannot be Delaware law.").
230. *Primedia*, 67 A.3d at 475.
231. *Id.* (internal quotation marks omitted).
232. *Id.* at 475–76.
233. *Id.*
234. *Id.*
235. 722 A.2d 1243 (Del. 1999).
236. C.A. No. 5430-VCS, 2011 WL 2176479 (Del. Ch. May 31, 2011).
237. *Primedia*, 67 A.3d at 459–60.
238. *Id.* at 485.

a merger where a target board's failure to value assets leads to an unfair price if the following test is satisfied:

> First, the plaintiff must plead an underlying derivative claim that has survived a motion to dismiss or otherwise could state a claim on which relief could be granted.
>
> Second, the value of the derivative claim must be material in the context of the merger.
>
> Third, the complaint challenging the merger must support a pleadings-stage inference that the acquirer would not assert the underlying derivative claim and did not provide value for it.[239]

The court held the first prong satisfied, as the *Brophy* claim would survive a motion to dismiss under Rule 12(b)(6).[240] Plaintiffs likewise satisfied the second prong, as the availability of full disgorgement of profits increased the value of the *Brophy* claim to $190 million in the context of a $316 million merger.[241] Finally, plaintiffs satisfied the third prong because the company's board attributed no value to the *Brophy* claim and TPG had no incentive to assert the claim against KKR as there were no third-party losses to offset.[242] The *Brophy* claim was a "pure asset," unlike the "freestanding asset[s]" in *Massey*, which were "bound up with ongoing responsibilities the acquiror . . . [was] buying."[243]

Fairness of the Merger

The court held that plaintiffs successfully challenged the fairness of the merger because KKR received a benefit not shared with the minority stockholders.[244] When a transaction involves a sale of a controlled company to a third party, entire fairness will apply if the controlling stockholder benefits to the exclusion of the minority.[245] KKR received a benefit of reduced exposure to the *Brophy* claim not shared with the minority.[246] This benefit, combined with a lack of procedural protections, such as an "empowered committee" or a majority-of-the-minority vote, was sufficient to state a claim that the merger was not entirely fair.[247]

Defenses to the Merger Challenge

The court rejected defendants' attempt to dismiss under section 102(b)(7) of the Delaware General Corporation Law, finding it premature at this stage be-

239. *Id.* at 477 (with formatting added for clarity).
240. *Id.* at 481–82.
241. *Id.* at 482–83. The *Brophy* claim was also easy to value, unlike in *Massey*, where plaintiffs argued that their *Caremark* claim regarding a mining disaster should equal the "negative financial effect" on the company. *Id.*
242. *Id.* at 484–85.
243. *Id.* at 485.
244. *Id.* at 487–88, 490.
245. *Id.* at 486.
246. *Id.* at 487.
247. *Id.* at 487–88.

cause entire fairness applied to the merger.[248] The court similarly held that collateral estoppel did not preclude a review of issues discussed by the Delaware Supreme Court, as the issues were not identical.[249]

Change of Recommendation Provision

The court dismissed plaintiffs' claim that the merger agreement's change of recommendation provision constrained the board from updating its recommendation, as the "obligation to maintain a . . . merger recommendation terminates at the . . . stockholder vote."[250]

Aiding and Abetting Claim Against TPG and Affiliates

The court also dismissed plaintiffs' claim that TPG and its affiliates aided and abetted Primedia's board and KKR in breaching their fiduciary duties to the minority stockholders.[251] Plaintiffs' allegations that no bidder would pay for the *Brophy* claim and no acquirer would assert it were insufficient to establish that TPG "knowingly participated in the breach of duty."[252]

Conclusion

Primedia serves as a reminder that a board of directors should consider the existence and value of derivative actions when it is considering the advisability of a proposed merger, even if the merger extinguishes the ability of stockholders to pursue the derivative action as such.

11. *Arkansas Teacher Retirement System v. Countrywide Financial Corp.* (Certified Question from the Ninth Circuit Regarding the "Fraud Exception" to the Continuous Ownership Rule)

In *Arkansas Teacher Retirement System v. Countrywide Financial Corp.*,[253] the Delaware Supreme Court answered a certified question of law from the United States Court of Appeals for the Ninth Circuit, asking whether the "fraud exception" to the continuous ownership rule allows stockholder-plaintiffs to maintain post-merger derivative standing by alleging that a merger is "inseparable from" the fraud underlying their derivative claims.[254] The continuous ownership rule otherwise requires a plaintiff in a stockholder derivative suit to maintain continuous stock ownership throughout the litigation to preserve standing to pursue the

248. *Id.* at 490.
249. *Id.*
250. *Id.* at 495.
251. *Id.* at 496.
252. *Id.*
253. 75 A.3d 888 (Del. 2013) (considering question certified in *Arkansas Teacher Retirement System v. Mozilo*, 705 F.3d 973 (9th Cir. 2013)).
254. *Id.* at 890.

action, which standing would be eliminated by the closing of a merger that eliminated the plaintiff's shares.

The Delaware Supreme Court answered this question in the negative, finding that the fraud exception applies only "where the merger itself is . . . being perpetrated merely to deprive shareholders of their standing to bring the derivative action."[255]

Background

In 2007, plaintiffs, former stockholders of Countrywide Financial Corporation ("Countrywide"), filed a derivative action on behalf of Countrywide in the United States District Court for the Central District of California, alleging that Countrywide officers and directors had violated securities laws and breached their fiduciary duties to the company's stockholders.[256] While this suit was pending, Countrywide merged with a subsidiary of Bank of America Corporation.[257] Defendants moved for judgment on the pleadings, arguing that the merger extinguished plaintiffs' standing to bring derivative claims.[258] The district court agreed, granting defendants' motion in 2008.[259]

Meanwhile, a class action suit involving direct merger claims against Countrywide was pending in the Delaware Court of Chancery.[260] The Delaware plaintiffs agreed to settle their claims.[261] The district court ordered the California plaintiffs to raise any objections to the release of their direct claims in the Court of Chancery, which they did.[262] The plaintiffs argued that Countrywide's directors failed both to value and preserve plaintiffs' derivative claims in the merger.[263] The Court of Chancery found plaintiffs' claims to be "unsupported by Delaware law" and approved settlement of the claims in 2009.[264] The Court of Chancery further found the merger consideration to be fair and the target board to be motivated by "economic necessity" as opposed to a desire to eliminate plaintiffs' derivative standing.[265] Plaintiffs appealed to the Delaware Supreme Court, which affirmed the Court of Chancery in *Arkansas Teacher Retirement System v. Caiafa*.[266]

Plaintiffs then moved for reconsideration in the U.S. district court, arguing that *Caiafa* "was a new material change of law," as its dicta allegedly expanded the scope of the "fraud exception" under the continuous ownership rule "to in-

255. *Id.* at 897 (citing Lambrecht v. O'Neal, 3 A.3d 277, 288 n.36 (Del. 2010)).
256. *Id.* at 890.
257. *Id.*
258. *Id.*
259. *Id.* at 891.
260. *Id.* at 892.
261. *Id.*
262. *Id.*
263. *Id.*
264. *Id.*
265. *Id.*
266. 996 A.2d 321 (Del. 2010).

clude situations where, as here, the plaintiffs sufficiently allege fraudulent conduct that necessitated the merger."[267] The district court disagreed, finding that *Caiafa* reaffirmed existing Delaware law.[268] Plaintiffs appealed to the Ninth Circuit, and the Ninth Circuit certified the question to the Delaware Supreme Court.[269]

Analysis

The Delaware Supreme Court answered the Ninth Circuit's question in the negative, finding that the "fraud exception" to the continuous ownership rule does not allow stockholders to maintain post-merger derivative standing by alleging that a merger is "inseparable from" the fraud underlying their derivative claims.[270]

In answering this question, the court began by addressing the continuous ownership requirement in *Lewis v. Anderson*.[271] A plaintiff must continuously own her shares throughout litigation to maintain derivative standing.[272] A merger breaks such continuous ownership by depriving a stockholder of her shares, thereby extinguishing derivative standing.[273] The "fraud exception" allows a plaintiff to maintain post-merger derivative standing if "the merger itself is the subject of a claim of fraud, being perpetrated merely to deprive stockholders of their standing to bring or maintain a derivative action."[274]

In *Caifia*, the court found no facts to support the "fraud exception," holding that the merger had extinguished plaintiffs' derivative claims.[275] In dicta, however, the court discussed direct claims that plaintiffs could have brought, such as a claim for "'a single, inseparable fraud' alleging that pre-merger fraudulent conduct made the merger 'a *fait accompli*.'"[276] Plaintiffs argued that this language meant that a claim of "inseparable fraud" could preserve their post-merger derivative standing under the "fraud exception."[277] The court emphasized that plaintiffs were incorrect, as the discussion of "inseparable fraud" referred to direct, not derivative, claims.[278]

Conclusion

This decision reaffirms the limited scope of the "fraud exception" to the continuous ownership rule.

267. *Countrywide*, 75 A.3d at 893.
268. *Id.*
269. *Id.*
270. *Id.* at 890.
271. *Id.* at 894 (citing 477 A.2d 1040 (Del. 1984)).
272. *Id.*
273. *Id.*
274. *Id.*
275. *Id.*
276. *Id.* at 893 (quoting Ark. Teacher Ret. Sys. v. Caiafa, 996 A.2d 321, 323 (Del. 2010)).
277. *Id.* at 891.
278. *Id.* at 894–97.

12. *In re Novell, Inc. Shareholder Litigation* and *In re BJ's Wholesale Club, Inc. Shareholders Litigation* (Different Outcomes on Motions to Dismiss Bad Faith Claims Against Target Directors)

In two decisions, *In re Novell, Inc. Shareholder Litigation*[279] and *In re BJ's Wholesale Club, Inc. Shareholders Litigation*,[280] the Delaware Court of Chancery examined the meaning of "bad faith" in the context of stockholder claims that a board of directors failed to satisfy its *Revlon*[281] duties. The particular facts alleged in the two cases, which led the court to deny dismissal in *Novell* and grant it in *BJ's*, highlight that while it is permissible in some circumstances to treat bidders differently in connection with a sales process, it is critical that a board of directors make a record regarding—and disclose—the reasons for according any bidder different treatment.

Novell: A Preliminary Finding of Bad Faith

In March 2010 the board of directors of Novell, Inc. ("Novell"), after receiving and rejecting an unsolicited, non-binding acquisition offer, initiated a sales process in which over fifty potential buyers were contacted, thirty potential buyers signed non-disclosure agreements, and nine potential buyers submitted preliminary non-binding proposals.[282] Novell's board of directors decided to pursue discussions with five of the potential buyers that had submitted non-binding proposals, including Attachmate Corporation ("Attachmate").[283]

In May 2010, the Novel board authorized Attachmate to partner with two of Novell's principal stockholders for the purpose of submitting a preliminary proposal for Novell.[284] The Novell board never extended other potential bidders the same opportunity to work with strategic partners.[285] In August 2010, Novell asked the two remaining bidders, Attachmate and an unnamed "Party C," to submit "best and final offer[s]."[286] Attachmate offered $4.80 in cash per share while Party C bid $4.86 in cash per share.[287] Upon considering the proposals, the Novell board granted Attachmate exclusivity.[288] On October 28, 2010, Attachmate submitted a revised bid of $5.25 per share, and Party C submitted an unsolicited, non-binding proposal for $5.75 per share.[289] During the exclusivity period, a consortium of technology companies organized by Microsoft Corporation offered to purchase some of Novell's patent portfolio for $450 million, and Attach-

279. No. 6032-VCN, 2013 WL 322560 (Del. Ch. Jan. 3, 2013).
280. No. 6623-VCN, 2013 WL 396202 (Del. Ch. Jan. 31, 2013).
281. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986).
282. *Novell S'holder Litig.*, 2013 WL 322560, at *1–2.
283. *Id.* at *2.
284. *Id.*
285. *Id.*
286. *Id.*
287. *Id.*
288. *Id.*
289. *Id.* at *3.

mate, unlike any other bidder, was told of the Microsoft offer and invited to submit a revised bid.[290] Attachmate submitted a revised bid of $6.10 per share conditioned on a patent sale for no less than $450 million.[291] The Novell board accepted Attachmate's revised bid and approved a merger agreement with Attachmate.[292] On the same day, the Novell board also approved the sale of certain patents to Microsoft for $450 million.[293]

Certain Novell stockholders filed class actions challenging the acquisition and the patent sale.[294] The plaintiffs asserted, in part, that the Novell board breached its fiduciary duties by favoring Attachmate over other bidders.[295] The Novell director defendants denied that any breach of fiduciary duty occurred and argued that, even if the directors breached their fiduciary duties, at most those breaches amounted to breaches of the duty of care, which would be exculpated under Novell's section 102(b)(7) charter provision.[296] Plaintiffs maintained that the Novell board's actions amounted to bad faith conduct, which deprived them of the benefit of the charter provision.[297]

Analysis

The court acknowledged that a board "is not absolutely required to treat all bidders equally,"[298] but found that the complaint stated "a reasonably conceivable claim that the Novell [board] treated a serious bidder in a materially different way and that approach might have deprived shareholders of the best offer reasonably attainable."[299] Because there was "no apparent answer in the record before the [c]ourt"[300] to the question of why the Novell board treated Party C in a way that was both adverse and materially different from the way it treated Attachmate,[301] the court found that the plaintiffs had satisfied their burden of pleading that the Novell board's actions "were 'so far beyond the bounds of reasonable judgment that it seems inexplicable on any ground other than bad faith.'"[302] Accordingly, the court held that plaintiffs had sufficiently pled a

290. *Id.*
291. *Id.*
292. *Id.*
293. *Id.*
294. *Id.* at *5.
295. *Id.* at *7 ("The Plaintiffs . . . claim that the Novell Defendants breached their fiduciary duties in bad faith by guiding the outcome of the process toward a favored bidder at the expense of Novell's shareholders.").
296. *Id.*
297. *Id.*
298. *Id.* at *9 (citing *In re* Fort Howard Corp. S'holder Litig., No. 9991, 1988 WL 83147, at *14 (Del. Ch. Aug. 8, 1988)).
299. *Id.*
300. *Id.* at *10.
301. *Id.* at *9 ("Party C could not team with any other interested bidder and, more importantly, was not informed of the Patent Sale which would have provided a substantial amount of cash at closing. The availability of additional funds might have allowed (or incentivized) Party C to increase its offer.").
302. *Id.* at *10 (quoting *In re* Alloy, Inc. S'holder Litig., No. 5626-VCP, 2011 WL 4863716, at *12 (Del. Ch. Oct. 13, 2011)).

claim that exculpation under the section 102(b)(7) charter provision was not available, and the court denied the defendants' motion to dismiss the plaintiffs' bad faith claims.[303]

BJ's: Novell Distinguished

On July 1, 2010, Leonard Green Partners ("LGP") disclosed a 9.5 percent beneficial ownership stake in BJ's Wholesale Club, Inc. ("BJ's") and indicated its interest in a buyout of BJ's.[304] BJ's engaged a financial advisor to assist the company in exploring strategic alternatives and formed a special committee of the BJ's board of directors for that purpose.[305] On February 3, 2011, BJ's publicly announced that it would "explore strategic alternatives" based on the recommendation of the special committee.[306] Shortly thereafter, "Party A," one of BJ's two direct channel competitors, expressed an interest in acquiring BJ's.[307] Party A "had no prior history of acquiring domestic companies," and BJ's, with the advice of its financial advisor, was dismissive of Party A's interest.[308] Because of this and because the BJ's board of directors was "not comfortable sharing material, non-public information with a direct competitor," Party A was rebuffed.[309] In contrast, the BJ's board provided a confidential offering memorandum to twenty-three private equity firms.[310] In April 2011, Party A submitted a conditional proposal to acquire BJ's in an all-cash transaction at a purchase price in the range of $55 to $60 per share.[311] After two subsequent meetings with Party A over the next ten days, the special committee "determined that it would not be in the best interest of [BJ's] to pursue the expression of interest by Party A."[312] No other negotiations with Party A occurred.[313] Ultimately, after negotiation, the board accepted LGP's $51.25 per share offer.[314]

Certain BJ's stockholders filed suit against the BJ's board alleging, among other things, that the BJ's board had breached, in bad faith, its fiduciary duties and failed to maximize shareholder wealth by "shun[ing] Party A (in favor of a deal with LGP) despite its superior offer of $55 to $60 per share."[315] To support this claim of bad faith, the plaintiffs pointed to the fact that the BJ's board "(1) did not share non-public information with Party A, as it did with the private equity suitors, and (2) dismissed Party A's proposal in a mere ten days."[316]

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303. *Id.*
304. *In re* BJ's Wholesale Club, Inc. S'holder Litig., No. 6623-VCN, 2013 WL 396202, at *2 (Del. Ch. Jan. 31, 2013).
305. *Id.*
306. *Id.*
307. *Id.*
308. *Id.*
309. *Id.*
310. *Id.*
311. *Id.*
312. *Id.*
313. *Id.*
314. *Id.* at *3.
315. *Id.* at *4.
316. *Id.*

Analysis

The court ruled that the plaintiffs' attempts to infer bad faith on the part of the BJ's board were not reasonable considering the rational explanations for the board's conduct in favoring one bidder over another.[317] Specifically, the court determined that it was reasonable for the BJ's board to consider Party A's interest as "something to shrug off" given that Party A had no history of acquiring domestic companies and potential regulatory obstacles.[318] The court explained that, "[a]t the very least, any judgment that the BJ's [b]oard . . . [made] that Party A was not a serious bidder was not 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith.'"[319] Similarly, the court held that the BJ's board's decision not to share confidential information with Party A did not raise an inference of bad faith given the BJ's board's reasonable concerns about sharing such information with a direct competitor, "especially where, as here, the seriousness of Party A's interest was in doubt."[320] Because the plaintiffs failed to rebut the presumption that the BJ's board acted in good faith, the plaintiff's bad faith claims were dismissed.[321]

In its analysis of the plaintiffs' bad faith claims, the court highlighted the differences between the facts presented in *BJ's* and *Novell*, emphasizing that, based on the pleaded facts, the Novell board's disparate treatment of Party C "was explicable only as bad faith," while the BJ's board's disparate treatment of Party A was "explained by facts . . . that tend[ed] to show that the [BJ's] [b]oard's actions were reasonable under the circumstances."[322]

Moreover, the court indicated that, "[p]erhaps the crucial difference" between the two cases is that the Novell board adversely and unjustifiably ignored a third-party bidder after it had already determined that the bidder was a serious participant in the process. In contrast, the BJ's board used its business judgment in making an initial assessment at the outset that pursuing Party A's interest was not in the best interest of the company and could raise regulatory issues.[323]

Conclusion

Together, *Novell* and *BJ's* illustrate that there is no rule that requires directors to treat all bidders equally in all circumstances. If directors do determine to treat bidders differently, however, it is important for the board and its advisors to evaluate the reasons for doing so, to make a determination that there is a reasonable basis for doing so that is tied to the best interests of the corporation and its stockholders, and to make a record of the reasons for treating bidders differently and disclose those reasons to stockholders.

317. *Id.* at *8.
318. *Id.*
319. *Id.* (quoting *In re* Alloy, Inc. S'holder Litig., No. 5626-VCP, 2011 WL 4863716, at *12 (Del. Ch. Oct. 13, 2011)).
320. *Id.*
321. *Id.*
322. *Id.* at *8 & n.75.
323. *Id.*

13. *In re Ancestry.com Inc. Shareholder Litigation* and *In re Complete Genomics, Inc. Shareholder Litigation* (Enforceability and Disclosure of "Don't Ask, Don't Waive" Standstill Provision)

In *In re Complete Genomics, Inc. Shareholder Litigation*, Vice Chancellor Laster enjoined Complete Genomics, Inc. ("Genomics") from enforcing a "Don't Ask, Don't Waive" ("DADW") provision with a bidder in connection with a merger.[324] In contrast, in *In re Ancestry.com Inc. Shareholder Litigation*, Chancellor Strine required disclosure to shareholders of the prior effectiveness of Ancestry.com Inc.'s ("Ancestry's") DADW provision, but declined to find a per se rule prohibiting DADW provisions.[325]

Background

In May 2012, Genomics engaged a financial advisor to explore strategic alternatives, and in June publicly announced that it was exploring strategic alternatives.[326] Nine parties signed confidentiality agreements; four of those agreements contained standstill provisions with DADW provisions.[327] That September, Genomics entered into a merger agreement with BGI-Shenzhen.[328]

Plaintiffs sought to enjoin the merger, and sought preliminary relief barring Genomics from enforcing DADW provisions with four potentially interested parties.[329] Plaintiffs claimed that the DADW provisions had been an unreasonable impediment on potential competing bids for Genomics, thereby adversely affecting the ultimate shareholder value to be gained in a potential transaction.[330]

In *Ancestry* the court addressed a similar fact pattern. In early 2012, Ancestry began an auction process.[331] Several bidders entered into non-disclosure agreements containing DADW standstill provisions.[332] Permira Advisors LLC ("Permira") ultimately prevailed and entered into a merger agreement with Ancestry. Permira, the court noted, neither requested nor received an assignment of the DADW provisions.[333]

Plaintiffs claimed that the DADW provisions violated Delaware law by preventing directors from providing an informed recommendation to shareholders.[334] Plaintiffs further claimed that Ancestry's proxy statement was misleading because it did not disclose the DADW provisions.[335] Following initiation of the

324. Transcript, *In re* Complete Genomics, Inc. S'holder Litig., C.A. No. 7888-VCL (Del. Ch. Nov. 27, 2012) [hereinafter *Genomics*].
325. Transcript at 22, *In re* Ancestry.com Inc. S'holder Litig., C.A. No. 7988-CS (Del. Ch. Dec. 17, 2012) [hereinafter *Ancestry*].
326. *Genomics*, *supra* note 324, at 7.
327. *Id.* at 8.
328. *Id.* at 9.
329. *Id.* at 11.
330. *Id.* at 8.
331. *See Ancestry, supra* note 325, at 29.
332. *Id.*
333. *Id.*
334. *Id.* at 29.
335. *Id.* at 19.

litigation, Ancestry notified each of the bidders that it was waiving the DADW provision, thus permitting the bidders to request waivers of the standstill provisions so that they could make alternative proposals to Ancestry pursuant to the other provisions of the merger agreement.[336] However, no bidder made any further bid.[337]

The Courts' Reasoning and Analysis

In *Genomics*, Vice Chancellor Laster analogized DADW provisions to no-talk clauses, which had been found to violate a board's fiduciary duties because they "not only prevent[] a party from soliciting superior offers or providing information to third parties, but also from talking to or holding discussions with third parties."[338] Vice Chancellor Laster enjoined Genomics, pending trial, from enforcing the terms of the DADW provision.[339]

The court explained that a board has an ongoing duty to give meaningful, current recommendations to shareholders regarding a merger, including whether a merger has become unadvisable as a result of subsequent developments.[340] Agreements that "create problems for the decision to negotiate," such as DADW or no-talk provisions, interfere with a target company's ability to assess whether to change its merger recommendation because they preclude the flow of information to the board.[341] The court reasoned that, by agreeing to the provision, the Genomics board impermissibly limited its ongoing fiduciary and statutory obligations to evaluate properly competing offers, disclose material information, and make a meaningful merger recommendation.[342]

In contrast, in *Ancestry*, Chancellor Strine declined to find a per se prohibition of DADW standstills. He commented that such provisions could be used "for value-maximizing purposes," noting that a well-motivated seller could use a DADW standstill as a "gavel" to encourage bidders to place their highest offers in an auction process with the knowledge that each bidder's offer would be final.[343] He cautioned, however, that directors must use such provisions "consistently with their fiduciary duties."[344]

Chancellor Strine noted that, in this case, until Ancestry waived the DADW provisions, the plaintiffs would have had a "reasonable probability of success . . . on the substance of the thing."[345] Chancellor Strine reasoned that, in order to have value as an "auction gavel," the directors must understand and use the provisions as such.[346] Here, however, the directors did not seem to have been aware

336. *Id.* at 31–32.
337. *See id.* at 32.
338. *Genomics*, *supra* note 324, at 15.
339. *Id.* at 13.
340. *Id.* at 17.
341. *Id.*
342. *Id.*
343. *Ancestry*, *supra* note 325, at 23.
344. *Id.* at 22.
345. *Id.* at 20.
346. *Id.* at 25.

of the provisions, and did not take appropriate steps, such as waiving the provisions when Permira did not demand an assignment of them, which "probabilistically is a violation of the duty of care."[347] Overall, however, Chancellor Strine found that Ancestry's auction "had a lot of vibrancy and integrity to it" and that Ancestry's board of directors did in good faith attempt to maximize price and create a competitive dynamic among the bidders.[348]

Chancellor Strine required Ancestry to disclose to its stockholders the existence and subsequent waiver of the DADW provisions, so that they would not vote under the "false impression that . . . folks who signed the standstill could have made a superior proposal."[349] He noted that the stockholders should understand that the directors had "made the cost/benefit trade-off" of trying to "draw the highest bid from those people while they were in the process," even though there was still the possibility of another party making a topping bid.[350]

Conclusion

Parties should use care when employing DADW standstill provisions. As explained in *Ancestry*, directors must at least understand the provisions and use them in their pursuit of maximum shareholder value. Boards also should understand and consider other appropriate measures, such as providing fall-away provisions or waivers. Directors should also recognize that other recent decisions, such as *Complete Genomics*, have cast the validity of the provisions in an ambiguous light, at least in a *Revlon* setting.

Furthermore, shareholders should be informed of the presence of a DADW provision, even if the provision is subsequently waived, particularly where shareholders might otherwise be left with the impression that the other bidders were free to make topping bids.

14. *In re MFW Shareholders Litigation* (Applying the Business Judgment Rule, Rather than Entire Fairness, in Going-Private Transaction with Controlling Stockholders)

In *In re MFW Shareholders Litigation*,[351] the Delaware Court of Chancery addressed the standard of judicial review applicable in connection with a going-private merger with a controlling stockholder when the merger is conditioned from the outset on (1) the approval of a fully empowered committee of independent directors and (2) the fully informed, uncoerced approval of the holders of a majority of the stock held by minority stockholders (a "majority of the minority").

347. *Id.*
348. *Id.* at 29.
349. *Id.* at 25.
350. *Id.* at 28.
351. 67 A.3d 496 (Del. Ch. 2013).

Analysis

MacAndrews & Forbes ("MacAndrews"), a holding company, owned approximately 43 percent of M & F Worldwide ("MFW") and controlled it.[352] MacAndrews offered to purchase MFW's remaining equity.[353] In its initial letter of intent, MacAndrews insisted that the merger would require the approval of both a committee of independent MFW directors and holders of a majority of the stock held by MFW's unaffiliated stockholders.[354] MFW formed a special committee of independent directors and empowered it with the authority to hire its own independent advisors and to turn down any transaction (i.e., say "no").[355] MacAndrews promised not to pursue a tender offer if the special committee decided not to enter into a transaction with MacAndrews.[356] Ultimately, the special committee and 65 percent of the unaffiliated MFW stockholders approved the MacAndrews merger.[357]

Certain stockholders of MFW filed suit challenging the fairness of the merger.[358] Defendants moved for summary judgment.[359] The primary issue before the court was whether the business judgment rule was the appropriate standard of judicial review.[360]

A Fully Empowered Committee of Independent Directors and Approval by a Fully Informed, Uncoerced Majority of the Minority Stockholders

First, the court noted that the special committee hired independent legal and financial advisors, was fully empowered to negotiate with the controlling stockholder, and could preclude MFW from entering into any transaction with the controlling stockholder.[361] The court emphasized MacAndrews' promise not to proceed with a unilateral offer without the special committee's support, which allowed the special committee to bargain hard without worrying that MacAndrews would turn hostile.[362] The court explained that a special committee under the circumstances should have more than just the power to "evaluate" an offer, and instead should be empowered to negotiate fully with the controlling stockholder.[363] The court stated that "[w]hen a committee is structurally independent, has a sufficient mandate and cannot be bypassed, and fulfills its duty of care, it should be given standard-shifting effect."[364] The court did not find it nec-

352. *Id.* at 499.
353. *Id.* at 505.
354. *Id.* at 506.
355. *Id.* at 506–08.
356. *Id.* at 508.
357. *Id.* at 499.
358. *Id.*
359. *Id.*
360. *Id.* at 500.
361. *Id.* at 507–08.
362. *Id.* at 508.
363. *Id.* at 507–08.
364. *Id.* at 518.

essary to assess whether the special committee was "effective in the sense of being substantively good at its appointed task," because "[f]or a court to determine whether a special committee was effective in obtaining a good economic outcome involves the sort of second-guessing that the business judgment rule precludes."[365]

The court also held that plaintiffs' failure to allege any disclosure violations or act of coercion meant it was undisputed that the approval of the merger by a majority of the minority stockholders was fully informed and uncoerced.[366]

Business Judgment Rule Applies

The court next noted that the Delaware Supreme Court had never definitively addressed whether the entire fairness standard of judicial review always applied to going-private transactions with controlling stockholders.[367] While inviting the Delaware Supreme Court to resolve the issue,[368] the court held that a court may apply the business judgment rule to a going-private merger with a controlling stockholder that is conditioned from the outset on both:

> (1) a fully empowered committee of independent directors with the power to definitively say "no"; and
>
> (2) the fully informed, uncoerced approval of holders of a majority of the stock owned by unaffiliated stockholders.[369]

The court stated that there would now exist a meaningful incentive to use both procedural protections, which, when used together, would replicate arm's-length bargaining.[370] The court also noted a lack of evidence that the application of the entire fairness standard in cases where both procedural protections were utilized added any real value for minority stockholders.[371] Accordingly, the court held that the business judgment standard of review would apply and granted defendants' motion for summary judgment.[372]

Conclusion

At the time of this summary, the court's decision has been appealed to the Delaware Supreme Court. If the decision is affirmed, controlling stockholders and boards of directors of corporations with controlling stockholders will have a clear pathway to ensuring that a going-private transaction with the controlling stockholder will be subject to the business judgment rule standard of review,

365. *Id.*
366. *Id.* at 517.
367. *Id.* at 520–21.
368. *Id.* at 536.
369. *Id.* at 535.
370. *Id.* at 528–36.
371. *Id.* at 534–36.
372. *Id.* at 536.

rather than the stringent entire fairness standard and the uncertainty that always accompanies application of that standard, provided the controlling stockholder is willing to subject the transaction to the independent approval of both a special committee of independent directors and the majority of the minority stockholders.