M&A Hot Topics

Quarterly Update (October 17, 2018)

1. Regulatory Updates

- **Trump Signs Bill Expanding Jurisdiction of Committee on Foreign Investment in the United States:**
  - President Trump signed the Foreign Investment Risk Review Modernization Act (FIRRMA) into law on August 13, 2018, broadening the powers of the Committee on Foreign Investment in the United States (CFIUS) to review mergers and acquisitions. FIRRMA amends the definition of "covered transaction" to include: (1) an investment by a foreign person in any U.S. business involved in critical infrastructure or the production, design or testing of critical technologies, or that maintains or collects sensitive personal data that could be exploited in a manner that threatens national security; (2) any change in a foreign investor's rights that could result in foreign control of a U.S. business or an investment described in (1); (3) the purchase or lease by a foreign person of, or a concession to a foreign person with respect to, an air or maritime port, real estate in close proximity to military or other sensitive national security facilities, or real estate that could potentially expose national security activities to foreign intelligence collection or surveillance; and (4) any other transaction, transfer, agreement, or arrangement designed to circumvent or evade CFIUS review.
  - In addition to expanding the definition of a "covered transaction," FIRRMA lengthens the CFIUS review process and makes filing with CFIUS mandatory for certain covered transactions. This is a departure from past practices, where all CFIUS filings were voluntary. FIRRMA also allows CFIUS to suspend certain transactions that pose national security threats during the review process.
  - The Treasury Department also released FAQs addressing the regulatory implementation of FIRRMA and stating when certain provisions become effective. According to the FAQs, FIRRMA enables CFIUS to "conduct pilot programs to implement provisions of the legislation that are not immediately effective" and to "issue interim regulations and guidance." Read more in S&C's previously released client memo.
  - CFIUS also announced it will hire additional personnel to handle the increased caseload resulting from FIRRMA's expansion of CFIUS's review powers. FIRRMA allows up to $20 million annually to fund CFIUS and permits CFIUS to offer prioritization fees and implement filing fees for covered transactions.
  - On October 10, 2018, the Treasury Department issued interim regulations for its first pilot program, requiring mandatory filings for control and non-control transactions by foreign investors in 27 industries involving critical technology beginning on November 10, 2018.
- **DOJ Provides Guidance on Successor Liability in M&A Transactions:** The DOJ clarified its position on FCPA compliance and successor liability in M&A transactions in a speech by Matthew S. Miner on July 25, 2018. The DOJ emphasized the importance of the voluntary disclosure of misconduct by successor companies and explained how firms may earn cooperation credit in FCPA investigations through disclosure, due diligence, and the implementation of an effective compliance program. The DOJ

stated that its goal was to "incentivize companies to invest in effective compliance programs and robust control systems to prevent misconduct" and to report discovered violations. The DOJ's statement suggests that acquiring companies may avoid prosecution by complying with disclosure policies and by seeking guidance from the DOJ.

2. Delaware Developments

- **Chancery Court Permits Buyer to Terminate Merger Agreement Due to Material Adverse Effect:** In *Akorn, Inc.* v. *Fresenius Kabi AG* (October 1, 2018), the Delaware Court of Chancery held that Fresenius met the "high burden imposed by Delaware law" in proving a material adverse effect occurred that entitled it to terminate its merger agreement with Akorn. In April 2017, Fresenius agreed to acquire Akorn, but Akorn's business performance plummeted shortly after the two companies entered into a merger agreement. Fresenius also received numerous letters from anonymous whistleblowers who made "disturbing allegations" about Akorn's noncompliance with regulatory requirements and conducted its own investigation, which revealed inaccuracies in Akorn's representations about its business practices and compliance with regulations. Fresenius terminated the agreement in April 2018, alleging that Akorn's misrepresentations constituted a material adverse effect that relieved Fresenius of its obligation to consummate the deal. The court held that Fresenius was entitled to terminate the merger agreement, reasoning that the serious regulatory compliance issues resulted in a material adverse effect. As might be expected in a 246-page opinion, the *Akorn* decision provides an encyclopedic review of the legal principles implicated by an attempt to terminate a merger agreement, with expositions on a wide range of legal subjects related to materiality, burdens of proof, breach of contract claims and defenses, and interpretation of information access covenants, efforts covenants, and other customary merger agreement provisions.
- **Delaware Supreme Court Reaffirms Denial of *Corwin* Deference When Material Information Is Not Fully Disclosed:** The Supreme Court of Delaware denied dismissal of a shareholder action brought against Ray Berry, the founder and former CEO of The Fresh Market, in *Morrison* v. *Berry* (July 9, 2018). A shareholder sued Berry and The Fresh Market's board of directors, alleging that Berry cooperated with The Fresh Market's purchaser, Apollo Management, to deceptively induce the board to sell the company. The defendants claimed *Corwin* deference and sought protection under the business judgment rule, but the court held that *Corwin* deference cannot be awarded when the defendant has not fully disclosed material facts to shareholders before they vote on the future of the corporation. The court cited its recent decision in *Appel* v. *Berkman* (February 20, 2018), where it refused to award *Corwin* deference when material facts regarding meeting minutes were omitted from a recommendation statement to shareholders, and effectively reaffirmed the Chancery Court's decision in *Lavin* v. *West Corporation* (December 29, 2017), where it held that *Corwin* does not preclude shareholders from using DGCL Section 220 to inspect books and records to investigate corporate wrongdoing.
- **Delaware Chancery Court Decisions Calculate Value in Appraisal Claims as Close to Deal Price:** The Delaware Court of Chancery issued two appraisal decisions in the context of arm's-length mergers. In *Blueblade Capital Opportunities LLC* v. *Norcraft Companies, Inc.* (July 27, 2018), Fortune Brands Home & Security, Inc. acquired Norcraft, and Norcraft shareholders sued, seeking a judicial determination of the fair value of their shares at the effective date of the deal. The court considered using the deal-price-less-synergies formula to calculate the fair value of Norcraft as of the merger date, but found that calculation to be an unreliable indicator of fair value. The court reasoned that an examination of the deal process "reveal[ed] significant flaws" and instead used a DCF analysis to calculate the fair value to be about 2.5 percent above the deal price. In *In re Appraisal of Solera Holdings, Inc.* (July 30, 2018), Vista Equity Partners acquired Solera, and seven funds that held shares of Solera common stock sought appraisal.

The court did not consider the deal price to be seriously flawed and used the deal-price-less-synergies formula to calculate the fair value to be just below the deal price. The court reasoned that, "although not perfect," the deal process was sufficiently reliable. The court also commented on the reliability of the deal price in *In re Appraisal of AOL Inc.* (August 15, 2018). On reargument, Vice Chancellor Sam Glasscock III reduced AOL's post-merger appraisal value after an examination of the DCF analysis he previously used to find fair market value. Finding that he improperly calculated the accretive value of two of AOL's pending transactions in his analysis, Glasscock revised the fair value of an AOL share on the merger date from $48.07 to $47.08. He further stated that "[n]o DCF analysis, used to calculate the 'exact' value of a corporation can be sufficiently rigorous that it will not permit a good faith argument that the value should be otherwise. This, I think, substantiates the wisdom of reliance on the deal price, where appropriate."

- **Chancery Court Awards *MFW* Deference to Earthstone Energy Board of Directors in Shareholder Action:** The Delaware Court of Chancery dismissed a complaint alleging breach of fiduciary duties against the Earthstone Energy board of directors in *Olenik* v. *Lodzinski* (July 20, 2018). The breach claim arose from Earthstone's acquisition of Bold Energy III LLC. The court held that the acquisition was structured so as to invoke the business judgment rule under *Kahn* v. *M & F Worldwide Corporation (MFW)* (March 14, 2014). *MFW* in part requires the controller to condition the transaction *ab initio*—from the outset of negotiations—on the approval of both a special committee and a majority of the minority stockholders. The court found that the defendants included such conditions in an offer letter before engaging in negotiations related to the transaction, even though they had engaged in extensive preliminary discussions. The court held that, under the *ab initio* requirement, the negotiations did not begin until the buyer submitted a definitive proposal and found that Earthstone's board was therefore entitled to protection under the business judgment rule.
- **Chancery Court Holds That Anti-Reliance Clause Precludes Fraud Claim:** In *ChyronHego Corporation* v. *Wight* (July 31, 2018), the Delaware Court of Chancery held that an anti-reliance provision must "contain language that, when read together, can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract's four corners in deciding to sign the contract." In the case, which involved ChyronHego's acquisition of another company, ChyronHego argued that the sellers misrepresented the value of their company. The sellers moved to dismiss, citing the purchase agreement's clause that claimed no representations were made outside of the parties' contract. The court granted the sellers' motion and explained that, read in conjunction with the agreement's integration clause, the clause in the purchase agreement satisfied the clear language standard and amounted to an "explicit anti-reliance clause."
- **Two New Vice Chancellors Appointed to Chancery Court:** The Delaware Senate confirmed two new vice chancellors to serve on the Delaware Court of Chancery for 12-year terms on October 3, 2018. Kathaleen S. McCormick, a partner at Young Conaway Stargatt & Taylor LLP, and Morgan T. Zurn, a current Chancery Court master, were nominated by Governor John Carney after a screening process by Delaware's Judicial Nominating Commission. McCormick and Zurn will serve alongside Chancellor Andre G. Bouchard, whose term will end in 2026, and Vice Chancellors Sam Glasscock III, whose term will end in 2023, J. Travis Laster, whose term will end in 2021, Tamika Montgomery-Reeves, whose term will end in 2027, and Joseph R. Slights III, whose term will end in 2028. At the conclusion of their first terms, the judges may apply to the commission for reappointment for another 12 years.

3. Other State Legislative Developments

- **California Legislature Revises California Consumer Privacy Act:** The California State Legislature amended the California Consumer Privacy Act of 2018 (CCPA) on August 31, 2018. The CCPA, which applies to businesses that buy, collect, transfer, or sell a consumer's personal information, is scheduled to take effect on January 1, 2020. Businesses planning on mergers, acquisitions, or transactions involving consumer data should determine if and how the CCPA will impact the transaction. The CCPA requires notice be given to consumers if a third party "materially alters" how a consumer's data is used. This notice requirement could pose a challenge for businesses that do not otherwise publicly disclose their mergers, acquisitions, or transactions. Further details are available in S&C's client memo.

- **DGCL Amendments Altering Availability of Statutory Appraisal Rights and Ratification of Defective Corporate Acts Take Effect:** Several amendments to the DGCL became effective on August 1, 2018. One amendment, to Section 262, extends the application of the "market out exception" to appraisal rights for Section 251(h) intermediate-form mergers and effectively treats both long- and intermediate-form mergers consistently with respect to appraisal rights. Another amendment, to Section 204, clarifies when corporations can ratify defective corporate acts—corporate acts that are void or voidable because they have not been properly authorized. As amended, the DGCL allows companies to use Section 204 when there is no valid stock outstanding, even if ratification would have otherwise required shareholder approval. The amendment also states that notice of a shareholder vote for a ratification of a defective corporate act must be sent to all holders of valid or putative stock as of the record date for the defective corporate act. This notice can be given through documents publicly filed with the SEC or through disclosure in a proxy statement. The Delaware Court of Chancery provided further insight in *Almond* v. *Glenhill Advisors LLC* (August 17, 2018), where the court allowed the defendants to ratify certain defective corporate acts under Section 204. The case arose when Design Within Reach, Inc. executed a reverse stock split in 2010. Glenhill, its majority shareholder, then converted Design Within Reach's preferred stock into common stock in 2013, and the company was acquired through a short-form merger in 2014. Two former shareholders of Design Within Reach challenged the acquisition, stating that there were technical flaws in the reverse stock split and the merger was therefore invalid, but the company's board ratified the reverse stock split under Section 204. The court found the acts defective but validated them nonetheless.
- **Delaware LLC Act Adopts New "Divisive Merger" Provision:** The Delaware Limited Liability Company Act will now allow a Delaware LLC to implement a "divisive merger" to divide into multiple LLCs and allocate the assets, liabilities, rights, and duties of the initial LLC among the new LLCs. The provision became effective on August 1, 2018. Under the new rule, the LLC seeking division must create a plan of division containing four elements, including terms and conditions and names and addresses. The plan must be adopted in the same manner as a plan of merger. This new divisive merger provision may result in an increase in covenants in financing documents prohibiting the division of a borrower's assets.

4. U.S. Tax Reform: M&A Considerations

- **New Revenue Procedure for Debt Exchanges in Spins:** On October 3, 2018, the IRS issued Revenue Procedure 2018-53, which establishes revised standards for taxpayers seeking private letter rulings on debt exchanges in connection with tax-free spin-offs. Debt exchanges are a popular way to monetize the value of appreciated spinco stock, but in 2013 the IRS began a restrictive policy of issuing rulings only for "old and cold" parent debt. The IRS began a thaw in this policy in 2017, and the revenue procedure formalizes the new thinking. In general, the new revenue procedure relaxes what qualifies as "old and cold" debt in a move that is generally taxpayer-favorable. The revenue procedure, however, also signals new limits on "slow motion" spins and generally requires debt exchanges to be completed within 180 days of the associated spin-off.

- **Treasury Department Proposes Removing Debt-Equity Documentation Requirements:** The Treasury Department proposed eliminating or modifying documentation regulations in Section 385 of the Internal Revenue Code on September 21, 2018. The regulations, which were initially intended to discourage corporations from reducing their tax burdens by recharacterizing debt as equity and engaging in "earnings stripping," established documentation requirements for related-party debt obligations to be treated as debt for federal tax purposes. The regulations specifically aimed to reduce earnings stripping in the context of "corporate inversions," where domestic companies merge with their foreign counterparts to benefit from lower foreign tax rates. In 2017, the Treasury Department flagged the requirements as part of its implementation of President Trump's executive order instructing the Treasury Department to identify and reduce tax regulatory burdens and sought public comment on the regulations. After considering the comments, the Treasury Department stated that the requirements should be eliminated. The regulations were published in the Federal Register on September 24, 2018.

See the latest edition of the *S&C Corporate Governance Hot Topics* for more on Corporate Governance considerations.