Corporate Governance Forum

Lillian Brown

Stephanie C. Evans

Piers Fennell

Justin L. Ochs

WILMER CUTLER PICKERING HALE AND DORR LLP ®

October 15, 2019

Agenda

- Data Privacy and Cybersecurity
- Environmental, Social and Corporate Governance (ESG)
- Hot Topics for Boards of Directors
- Corporate Culture Issues and Oversight
- Updates in M&A

Data Privacy and Cybersecurity

GDPR

- GDPR is a sweeping new data privacy law, effective May 25, 2018, designed to "harmonize" data privacy laws across Europe as well as give greater protection and rights to individuals
- Initial observations suggest that compliance with “harmonized” laws may not result as intended given the number of permissible derogations that each EU member country has adopted, increasing the complexity of compliance
- Regulatory risk and financial penalties stemming from noncompliance with GDPR and other similar data privacy laws can be severe
  - Fines for more severe GDPR violations can range up to €20 million, or 4% of the company’s worldwide annual revenue from the preceding financial year, whichever amount is higher

California Consumer Privacy Act

- Effective January 1, 2020, but enforcement not expected to begin until July 1, 2020
- Applies to businesses that do business in California and that satisfy any of the following thresholds
  - — Generates annual revenues over $25 million
  - — Receives or shares any personal information on at least 50,000 California residents
  - — Derives 50% or more of its annual revenues from selling consumers' personal information
- Among other things, establishes a duty to implement and maintain reasonable security procedures and practices appropriate to the nature of the information to be protected

California Consumer Privacy Act

- Broader than GDPR in some respects, e.g., defining "personal information" as that which "identifies, relates to, describes, is capable of being associated with, or could reasonably be linked, directly or indirectly, with a particular consumer or household"
- California Attorney General primarily responsible for enforcement
- Includes limited private right of action for certain data breaches resulting from a business' duty to "implement and maintain reasonable security procedures and practices"
- Fines for violations can also be significant, ranging up to $7,500 per violation

Data Privacy – Practice Tips

- Board or committee oversight:
  - Manage like other regulatory compliance risks with potentially significant financial penalties
  - Engage with internal auditors and others from management re compliance efforts and estimated risk exposure
  - Review financial reporting disclosures for alignment with reports received from management and internal audit
- Public Company considerations:
  - For public companies, do not provide hypothetical risk factor disclosure about GDPR or other data privacy law compliance if facts exist to suggest events are not hypothetical
  - Ensure disclosure controls and procedures are in place to capture data privacy violations that could result in disclosure obligations (e.g., contingent liabilities, risk factors, entry into material settlement agreements, etc.)

Cybersecurity – Commission Guidance

- Commission issued Commission Statement and Guidance on Public Company Cybersecurity Disclosures, Release No. 33-10459, in February 2018
  - Reiterated and expanded Corporation Finance 2011 CF Disclosure Guidance: Topic No. 2, Cybersecurity
  - Discussed the application of disclosure controls and procedures, insider trading prohibitions, and Regulation FD selective disclosure prohibitions
  - Raised the possibility that companies may need to update cybersecurity disclosures, but acknowledged that this may not be required under the federal securities laws
- Chair Clayton has noted that cybersecurity disclosure will be “carefully monitored” as part of the SEC staff’s selective filing reviews

Cybersecurity – Yahoo! Settlement

- SEC settled enforcement proceeding in April 2018 with Altaba Inc. (f/k/a Yahoo! Inc.) for $35 million civil penalty in first action the SEC has brought based on a disclosure theory regarding a cyber incident
- **Practice Tips**:
  - Evaluate disclosure controls and procedures to ensure cyber events are identified and appropriately evaluated for potential and timely disclosure of material events
  - Carefully review risk factor disclosure (i.e., describing "potential breaches" is misleading when actual breaches have occurred)
  - SEC may find disclosure violation under Section 21(a) based on inaccurate representations in agreements filed as exhibits to SEC filings

Cybersecurity – Investigative Report

- SEC released Section 21(a) investigative report in October 2018, describing investigation into whether nine public companies that suffered cyber-related frauds violated federal securities laws by failing to have sufficient system of internal accounting controls
  - Ultimately, no enforcement action was brought
- **Practice Tips**:
  - Evaluate internal accounting controls and determine whether such controls factor in cyber threats and human vulnerabilities.
  - Possible remedial measures to consider evaluating/adopting include:
    - Clarifying and enhancing payment authorization procedures
    - Adopting verification requirements for vendor information changes
    - Enhancing account reconciliation and payment verification procedures with vendors to help more quickly identify any fraudulent activity
    - Providing additional training to employees about cybersecurity threats and how to avoid common cyber frauds

Cybersecurity – Practice Tips

- Tailor oversight to risks facing the company
- Implement an oversight structure appropriate for the company and board structure
  - — Establish mechanisms to quickly identify and escalate red flags
- Include cybersecurity oversight as a routine board agenda item
- Develop tools to enable the board to measure cybersecurity risks
- Seek expert advice, if needed, for the board to meaningfully engage on cybersecurity issues
- Ensure protocols are in place to address a potential incident quickly
- Ensure management is properly attuned to cybersecurity risks

Environmental, Social and Corporate Governance (ESG)

ESG Generally

- Discussion of environmental, social and governance (ESG) matters has risen significantly in the past few year, garnering ever increasing shareholder focus
- Environmental, social and governance (ESG) topics constitute a majority of all filed shareholder proposals, with environmental and social (E&S) topics particularly hot over the past season
  - E&S proponents tend to be open to negotiation – early reports suggest 48% of E&S proposals were ultimately withdrawn
- E&S proponents are expanding, with traditional corporate gadflies broadening their focus to include E&S proposals, particularly political spending proposals
- SEC staff has granted no-action relief in regards to certain E&S proposals under the micromanagement prong of Rule 14a-8(i)(7)
  - The staff is drawing some fine lines in this space

ESG – Trends Among Public Companies

- Institutional shareholders are continuing to pay attention, with some revising their proxy voting guidelines to account for E&S matters
  - For 2019, BlackRock updated its proxy voting guidelines and expects certain company boards to have "demonstrable fluency" in how climate risk affects the business and management's response thereto, particularly for companies in industries significantly exposed to climate-related risk
- Some notable governance proposals garnering majority support at Fortune 250 companies include:
  - Board declassification (Anthem and Kellogg)
  - Shareholder right to act by written consent (Cigna)
  - Simple majority voting (Dean Foods, FirstEnergy, L Brands, Leidos, Norfolk Southern, Xerox)
  - Special meeting – reduce the share ownership threshold to 15% (Citigroup and Occidental Petroleum)
- Some notable governance proposals declining compared to 2018 include:
  - Proxy access – 21 proposals in 2019, compared to 55 in 2018
    - 579 companies have implemented proxy access (including 70% of S&P 500 companies) and "fix-it" proxy access proposals averaged only 28% support in 2017 and 2018
  - Special meetings – less than 20 in 2019, compared to 84 in 2018
    - Proponents have shifted to other proposal topics this year, such as independent chair, written consent, simple majority voting and more lenient proxy access provisions

Sources: Proxy Monitor data as of July 8, 2019; Alliance Advisors 2019 Proxy Season Preview (data as of March 31, 2019)

ESG – ERISA Considerations

- Department of Labor issued guidance in 2018 on the extent to which ERISA fiduciaries can consider ESG in making plan investments (Field Assistance Bulletin 2018-01 (the “FAB”))
- Generally, fiduciaries cannot accept lower investment returns or higher risks in exchange for ESG goals
  - Fiduciaries may use ESG considerations to “break ties” between otherwise equivalent alternatives
- Although the recent FAB acknowledges that ESG factors can be a tie-breaker, it cautioned against use of ESG factors as economic considerations
- Fiduciaries should not conclude ESG factors “promote positive general market trends or industry growth” or “too readily treat ESG factors as economically relevant”

ESG – Board Oversight Considerations

- Does the company have a sustainability reporting strategy that is supported by suitable policies? Has this strategy been reviewed and approved by the board?
- Do we understand the company's sustainability reporting and disclosure process and underlying drivers, including the consideration of risks and opportunities related to increased transparency?
- Has sustainability reporting been aligned with the overall business reporting process?
- Do we receive adequate educational and briefing information from senior management regarding sustainability issues facing the organization and related disclosure considerations?
- Do we have an appropriate governance structure in place to effectively oversee the management of sustainability reporting and disclosure issues?
  - Consider SASB framework and areas that SASB has identified as potentially financially material and decision-useful to investors for your industry

MANAGING CONFLICTS OF INTEREST
BOARD DIVERSITY
TECHNOLOGY LITERACY
ACCOUNTABILITY
OVERBOARDING
CORPORATE BOOKS AND RECORDS DEMANDS
BOARD OBSERVERS

Hot Topics for Boards of Directors

Managing Conflicts of Interest

- Challenges to director independence under Delaware law can affect:
  - Standard of review applied to a transaction (business judgment rule, enhanced scrutiny, entire fairness)
  - Assessments of special committee that was formed to review the challenged transaction
  - Whether stockholders are entitled to pursue derivative litigation on behalf of directors against the corporation
  - Whether courts will accept a recommendation of a special litigation committee to dismiss litigation brought on behalf of the company
- Independence under Delaware law is not the same as other standards, such as Sarbanes-Oxley, stock exchange listing rules, and proxy advisory firm voting guidelines

Managing Conflicts of Interest

- Delaware courts consider personal relationships
  - *Marchand v. Barnhill et al.*, 212 A.3d 805 (Del. 2019) (holding at the pleading stage that close personal ties between a director and the company CEO and his family, including giving the director his first entry-level job, seeing the director through his career to a top management position and naming a community building after the director, were sufficient to question the director's independence)
  - *Sandys v. Pincus*, 152 A.3d 124 (Del. 2016) (holding that owning an airplane with an interested party "is suggestive of the type of very close personal relationship, that, like family ties, one would expect to heavily influence a human's ability to exercise impartial judgment")

Managing Conflicts of Interest – Practice Tips

- Refresh director and officer questionnaires as needed to update for developments in any public company reporting requirements and to consider personal and other relationships that might bear on independence
- Periodically remind directors and officers of their obligation to disclose conflicts of interest
- Maintain a list of disclosed conflicts of interest and evaluate potential conflicts of interest in advance of significant transactions

Board Diversity

- Continues to be a key focus for many institutional investors, with gender receiving the greatest focus so far
  - Vanguard expects boards to focus on gender diversity and will examine a board's demonstration of "meaningful progress over time" to inform its engagement and voting
  - BlackRock expects at least two women directors on every board
- Proxy advisory firms also monitoring closely
  - For 2020, ISS will generally recommend voting against the nominating committee chair of a board that has no female members absent mitigating factors, such as a firm commitment stated in the proxy to appoint at least one female director in the near term, the presence of a female director at the preceding annual meeting, or other relevant factors
  - For 2019, Glass Lewis began recommending voting against the nominating committee chair of a board that has no female members, absent sufficient rationale for lack of female board members or a disclosed plan to address the lack of diversity

Board Diversity

- Over 20 board diversity shareholder proposals were submitted in 2019, down from approximately 30 in 2018
  - Disclose diversity characteristics in a director skills and qualifications matrix, with a particular focus on gender diversity, though some shareholders are beginning to focus more on skills diversity
- Approximately 27% of S&P 500 and 19% of Russell 3000 board seats are held by female directors
- New directors have skills in the following areas at a percentage rate that is higher than that for tenured directors: technology (10% higher), sales (8% higher), international experience (8% higher), and strategic planning (6% higher)

Sources: ISS Analytics U.S. Board Diversity Trends in 2019, June 18, 2019; Alliance Advisors 2019 Proxy Season Preview (data as of March 31, 2019)

Board Diversity – Practice Tips

- Consider preparing a matrix to assess board diversity (race, gender, age, geography, technical skills, etc.)
- Incorporate board diversity characteristics into director succession planning discussions and consider such characteristics when opportunities arise to add new members to the board
- Monitor for state laws requiring certain board diversity characteristics
  - California, for instance, requires any public company with executive offices in California to have at least one woman on its board by the close of 2019, which ratchets up to two by December 31, 2021, if the corporation has five directors, and to three if the corporation has six or more directors

Technology Literacy

- Consider seeking technical advisors, rather than dedicated board members and consider cultural fit of candidates
- While technological awareness is important, some studies have suggested that it is more impactful to recruit directors who have led or participated in a transformation of a traditional business, rather than those with a deep bench of experience from technologically advanced companies
- Ability for board members to contribute to all governance matters is a critical competency for board appointments
- **Practice Tips**:
  - Consider board talents and whether subject-specific advisory councils for certain technology topics, or other technical areas, would be more appropriate
  - Involve the CTO, if applicable, when assessing the areas of technological experience that would be most relevant to the company

Accountability

- For public companies, the SEC’s Division of Enforcement continues to charge senior-level officers and directors where possible, particularly in financial reporting and disclosure cases, with the number of individuals charged in SEC actions remaining steady in the first half of 2019
- In late 2018, the U.S. Department of Justice signaled that it was placing individual accountability as a top priority in its corporate investigations
  - Indicated that for cooperation credit in civil investigations, companies must identify wrongdoing by senior officials, including directors and officers
- **Practice Tips**:
  - Remind directors and officers to remain vigilant for instances of potential bad behavior
  - Periodically assess communication lines to ensure appropriate risk-related information is timely communicated to directors and officers

Overboarding

- Directors are considered "overboarded" if the number of boards on which they serve could result in excessive time commitments and an inability to fulfill their duties
- Glass Lewis and ISS generally issue negative voting recommendations for:
  - Directors who sit on more than five public boards or
  - CEOs (executive officers for GL) of public companies who sit on more than two public boards (excluding their own for ISS; including their own for GL)
- Effective April 1, 2019, Vanguard will take a more restrictive approach by recommending votes against any NEO who sits on more than one outside public board, in addition to directors who sit on more than five public boards
  - Georgeson estimates this new policy will affect 230 NEOs and another 142 non-executive directors
- Glass Lewis, ISS and Vanguard generally will not vote against overboarded directors at the companies where they serve as an executive

DGCL § 220 Demands for Corporate Books and Records

- ***DGCL § 220*** – enables stockholders and directors of public or private Delaware corporations to demand access to a corporation's books and records where a proper purpose can be demonstrated
  - Stockholders' requests must be "necessary and essential" to their stated purpose
  - Directors have "virtually unfettered access" to books and records if they can demonstrate a proper purpose
- Recent cases have clarified:
  - Emails and text messages from personal accounts and devices of directors and officers may be subject to a books and records demand if the company has insufficient formal documentation and used such informal communication to conduct corporate business (*KT4 Partners LLC v. Palantir Techs. Inc.*, 203 A.3d 738 (Del. 2019); *Schnatter v. Papa John's Int'l, Inc.*, No. CV 2018-0542-AGB, 2019 WL 194634 (Del. Ch. Jan. 15, 2019))
  - There is no presumption of confidentiality in productions under DGCL § 220 governing a stockholder's inspection of books and records (*Tiger v. Boast Apparel, Inc.*, No. 23,2019, 2019 WL 3683525 (Del. Aug. 7, 2019))

Housekeeping Reminder re Record-Keeping Practices

- Consistently document board actions in formal meeting minutes and written consents
- Ensure formal documentation of board action is sufficiently robust to eliminate gaps that could be used as a basis for directors or stockholders to seek less formal communications (e.g., ensure formal documentation adequately captures corporate actions taken via informal communication methods)
- Maintain an organized repository of documented board actions and materials sent to the board for review and discussion
- Discard or otherwise exclude informal communications and notes from formal documentation of corporate action where such informal documentation is not intended to form a part of the corporation’s books and records (in accordance with any applicable document preservation requirements in place)
- Educate directors and officers about the risks of using informal communications and personal accounts or devices such as email or text messages to take corporate action and keep those communications to a minimum

Board Observers

- Legal status, rights and obligations of board observers remain unsettled
- In a recent Third Circuit decision (*Obasi Investment LTD v. Tibet Pharmaceuticals, Inc*, 2019 WL 3294888 (3d Cir. 2019)), the Court distinguished observers from directors in three key areas in determining that observers did not have liability for misrepresentations under Section 11 of the Securities Act:
  - Observers did not have the right to vote which is the primary way directors exercise management functions
  - Shareholders did not have the ability to vote observers out of office since observer rights are contractually provided
  - Absence of a duty of loyalty to the company’s shareholders
- Observer relationship is mostly defined by the contractual agreement providing the observer right, with limited statutory or common law guidance

Board Observers – Practice Tips

- Good practice to contractually address specific areas of legal ambiguity:
  - Fiduciary duties and litigation exposure
    - Predominant view is observers are not subject to the same fiduciary duties as directors, but consider expressly defining duties to avoid determination that observer is a “de facto director”
  - Indemnification and insurance
    - Observers may be named as a defendant in litigation and would not have the benefit of indemnification provided to directors by statute nor would they likely have the benefit of D&O insurance, unless included as an additional insured
  - Confidentiality
    - Absent a specific confidentiality agreement, companies should consider excluding observers from participation in sensitive or competitive discussions because they do not have fiduciary duties
  - Conflicts and trading restrictions
    - Observers may not be subject to “off-the-shelf” conflict of interest or trading black-out policies of the board, which typically should be tailored to include observers

Corporate Culture Issues and Oversight

Corporate Culture

- Large investors, including BlackRock, Vanguard, and State Street Global Advisors, are asking for board oversight of both culture and human capital management
- An increasing number of boards are focusing on corporate culture as a key component of corporate strategy
- Boards or board committees may want to ask management to develop a dashboard of the most meaningful data and analytics linked to the company's culture and business strategy
- Some useful dashboard metrics to assess corporate culture include social media and employer rating websites and whistleblower/hotline reports
- Assessments of culture should also consider the "mood in the middle," which has been at issue in some recent public failings involving weaknesses in corporate culture

Corporate Culture – Practice Tips

- Evaluate allocation of culture oversight responsibilities at board and committee levels
- Assess alignment between management and the board re the desired culture
- Ensure that the board has access to employee hotline or engagement data
- Consider facilitating site visits for the board to assess, in informal interactions, the corporation's culture
- Ensure a crisis management plan is in place to deal with culture-related crises (e.g., #metoo)
- Consider including questions related to board culture in the board's self-evaluations

Risk Oversight – Default Rule

- Delaware's seminal *Caremark* decision made clear that directors could be liable for failures in their duties to monitor the company and its functions (i.e., oversight)
- Directors fail their duty of oversight if they:
  - — completely fail to implement any reporting or information system or controls, or
  - — having implemented such a system or controls, consciously fail to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention
- Proving a violation of the *Caremark* standard is "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment"

Risk Oversight – Recent Development

- ***Marchand v. Barnhill et al.*, 212 A.3d 805 (Del. 2019)**
  - Plaintiffs successfully pleaded a *Caremark* claim for director oversight liability related to a 2015 listeria outbreak involving ice cream produced by Blue Bell Creameries
  - Directors, as part of the duty of loyalty, "must make a good faith effort to implement an oversight system and then monitor it"
  - Some key areas of focus leading to the holding included the lack of the following at Blue Bell Creameries:
    - Committee addressing food safety
    - Protocols requiring management to keep board apprised of food safety practices, risks or reports
    - Schedule for the board to consider key food safety risks on a regular basis
    - Any evidence in the minutes that food safety red flags received by management were disclosed to the board

Risk Oversight – Recent Development

- ***In re Clovis Oncology, Inc. Derivative Litigation*, C.A. No. 2017-0222-JRS, 2019 WL 4850188 (Del. Ch. Oct. 1, 2019)**
  - Plaintiffs successfully pleaded, at the motion to dismiss phase, a *Caremark* claim for director oversight liability related to allegations that directors ignored red flags that the company was not adhering to internal clinical trial protocols and associated FDA regulations
    - The Delaware Chancery Court relied heavily on *Marchand*
  - Alleged red flags related to one of three developmental drugs that could have generated large profits for the company, which was solely reliant on invested capital and had no revenues
    - For example, the board received reports that (a) the company was publicly reporting an inflated, unconfirmed objective response rate (ORR), a success-defining metric, for one developmental drug, rather than confirmed ORR to be used in the FDA's approval process and (b) the drug had serious, undisclosed side effects
  - Unlike in *Marchand*, the Clovis board's Nominating and Corporate Governance Committee provided compliance oversight and received detailed clinical trial information
  - Further discovery and hearings will bring light to defendants' arguments about reporting metrics agreed with the FDA to color whether the board truly ignored red flags

Risk Oversight – Practice Tips

- Counsel should advise directors to:
  - Demonstrate proactiveness in discharging risk oversight responsibilities
  - Demonstrate that periodic monitoring of risks has taken place
  - Consider tasking a board committee with oversight of specific market or industry risks may be appropriate to help demonstrate the board's due care in monitoring such risks
    - A separate committee is not required if oversight is handled by the full board
- Counsel should evaluate internal risk management programs and trainings to determine whether updates are merited in light of changes in the company's regulatory and risk environments and the company's risk tolerance
- Counsel should ensure proper recordkeeping:
  - Detailed references to relevant risk-related discussions can be helpful in defending against challenges to director oversight
  - Both good and bad risk-related reports should be included
  - Attaching or referencing presentations and other risk-related materials that are provided to directors to further strengthen the evidentiary record is suggested

MATERIAL ADVERSE EFFECT
PRIVILEGE IN THE M&A CONTEXT
CONFLICT OF INTEREST
CONTROLLING SHAREHOLDER
APPRAISAL TRENDS

Updates in M&A

Material Adverse Effect

- ***Akorn, Inc. v. Fresenius Kabi AG*, C.A. No. 2018-0300-JTL, 2018 WL 4719347 (Del. Ch. Oct. 1, 2018)**
  - First decision of a Delaware court allowing a buyer to terminate a merger agreement due to the occurrence of a material adverse effect
  - German healthcare company Fresenius Kabi AG entered agreement to acquire generic drug maker Akorn, Inc. in April 2017. Shortly thereafter, Akorn's business performance severely declined and Fresenius received a series of whistleblower letters questioning Akorn's compliance with FDA regulations.
  - Fresenius gave notice it was terminating the merger agreement because of (i) breach of regulatory representations that could reasonably be expected to have an MAE and (ii) its right not to close after the outside date because Akorn suffered an MAE (the general MAE condition)

Material Adverse Effect

- The Court of Chancery upheld the termination, finding two separate material adverse effects:
  1. Akorn's breach of the regulatory compliance representation constituted a material adverse effect
     - Investigation by Fresenius of Akorn's practices showed fundamental flaws in Akorn's data management procedures such that the FDA would have grounds to challenge the accuracy of Akorn's representations
     - Court found "overwhelming evidence of widespread regulatory violations and pervasive compliance problems at Akorn"
     - Regulatory issues were expected to take at least three to four years to remedy and cost approximately 20% of Akorn's equity value

Material Adverse Effect

2. 55% drop-off in annual EBITDA constituted a material adverse effect
    - Court focused on the long-term nature of the decline, noting the decline over five straight quarters was "durationally significant" with no sign of ameliorating, and could not be attributed to general industry decline
    - Akorn's poor performance resulted from company-specific problems, rather than industry-wide conditions

— Court cautioned that it was not making any bright-line rule based on specific profitability or liability metrics

— Court was careful to honor express contractual language and noted that the parties may allocate risks by contract

- For example, the material adverse effect definition could have (but did not) exclude specific matters that the seller believed were likely to occur during the pre-closing period or matters disclosed in due diligence

Privilege in the M&A Context

- After a merger, under DGCL § 259, “all property, rights, privileges, powers and franchises, and all and every other interest shall be thereafter as effectually the property of the surviving or resulting corporation ...,” which has been interpreted to include legal privilege
- Delaware courts have allowed parties to contractually exclude from assets passing to an acquiring company, privileged communications between counsel and the target entity
  - *Great Hill Equity Partners IV LP v. SIG Growth Equity Fund I LLLP*, 80 A.3d 155 (Del. Ch. 2013)

Privilege in the M&A Context

- ***Shareholder Representative Servs. LLC v. RSI Holdco, LLC*, C.A. No. 2018-0517-KSJM, 2019 WL 2290916 (Del. Ch. May 29, 2019)**
  - Court of Chancery relied on *Great Hill Equity Partners* and upheld merger agreement provision preventing the buyer from using seller's pre-merger privileged communications in a post-closing dispute
  - Rejected buyer's argument that privilege was waived because sellers took no action to segregate, excise or demand the return of privileged communications
    - As an example, the sellers did not affirmatively seek to retain the computers on which the privileged communications were stored
- **Practice Tip**: Sellers should "take the steps necessary" to preserve privilege in their M&A agreements, and buyers should be mindful of privileged communications it may not benefit from in a transaction

Conflict of Interest

- The board of directors has a critical role in the governance of a company and any sale process and is expected to exert proper control over management and advisors in a sale process and to address conflicts that arise
- Sufficient stockholder disclosures in connection with a sale process remain critically important
- Business judgment protection may not apply if stockholder disclosures are insufficient
- Third party advisors to a board can be liable for aiding and abetting

Conflict of Interest

- ***Chester County Employees' Retirement Fund v. KCG Holdings, Inc., et al.*, C.A. No. 2017-0421-KSJM, 2019 WL 2564093 (Del. Ch. June 21, 2019)**
  - Prior to the merger for the sale of KCG to Virtu Financial, KCG's financial advisor and largest stockholder, Jefferies, allegedly met with Virtu to discuss a potential acquisition of KCG without informing KCG or its board
  - Jefferies shared confidential information relating to KCG's standalone bond trading platform and later acted as Virtu's financial advisor in its sale of the bond trading platform following the merger
  - Stockholders brought a claim for breach of fiduciary duty by KCG's directors
  - In motion to dismiss, Delaware Court of Chancery declined to apply Corwin business judgement protection after determining that pleadings supported the claim that proxy disclosures relating to the merger were inadequate

Conflict of Interest

- Majority stockholder approval of the merger did not cleanse deficient disclosures to stockholders
- Deficient disclosures included failures to disclose the following in the proxy:
  - KCG's largest shareholder and financial advisor Jefferies approached Virtu about acquiring KCG without informing KCG or its board
  - KCG's CEO initially thought the $20-per-share offer was too low but reversed after negotiating a compensation pool provided by Virtu
  - KCG lowered its internal financial projections prior to accepting the offer so it would fit in the valuation projection

Controlling Shareholder

- Under Delaware law, controlling shareholders owe fiduciary duties to the company and minority shareholders
- Control may exist generally or with respect to a particular transaction
- While majority shareholders are automatically controlling shareholders, minority shareholders are generally not controllers.
  - — However, courts have found minority stockholders to have exercised “de facto” control
- Minority shareholders should consider whether they have sufficient influence over the board or the process with respect to a particular transaction such that they may be deemed *de facto* controlling shareholders

Controlling Shareholder

- ***Tornetta v. Musk, et al.*, C.A. No. 2018-0408-JRS, 2019 WL 4566943 (Del. Ch. Sept. 20, 2019)**
  - Entire fairness standard is appropriate at the motion to dismiss phase, where a plaintiff adequately alleges that an equity award was unfair, thus asserting a valid claim for the breach of a fiduciary duty
  - Applied 2013 holding from *In re MFW Shareholders Litigation,* 67 A.3d 496 (Del. Ch. 2013), which held that transactions involving conflicted controller are subject to the more deferential business judgment review, if, <u>before "substantive economic negotiations" take place</u>, the transaction is conditioned <u>upfront</u> on the approval of:
    - An independent, fully functioning special committee of the board; and
    - An uncoerced and informed vote by majority of the minority shareholders
  - Suggests that Delaware courts will review conflicted compensation decisions under the entire fairness standard
  - <u>**Practice Tip**</u>: boards should consult with counsel before making grants in a controlling shareholder context

Controlling Shareholder

- ***FrontFour Capital Group LLC v. Taube*, C.A. No. 2019-0100-KSJM, 2019 WL 1313408 (Del. Ch. March 22, 2019)**
  - Delaware law imposes fiduciary duties on stockholders who effectively control a corporation. Control may exist generally or with respect to a particular transaction
  - In connection with a merger of two affiliated entities, Delaware Court of Chancery found that controlling stockholders and special committee members breached fiduciary duties to stockholders
  - Despite holding only a 15% ownership stake of Medley Capital, the Taube brothers were found to be controlling stockholders in the context of the transaction
  - Taube brothers exercised *de facto* control and dominated the process by:
    - Setting the deal structure
    - Controlling the flow of information
    - Withholding details about the existence of offers from third-parties
    - Locking out ‘interlopers’ through standstill agreements, deal protections, and an aggressive timeline

Appraisal Trends

- There is no “one size fits all” approach in the appraisal context
- Deal price is typically the most reliable indicator of value
- Robustness of deal process increases likelihood of reliance on deal price
- Plaintiffs risk potentially unfavorable appraisal values and the incidence of appraisal litigation has declined

Appraisal Trends – One Size Does Not Fit All

- ***Verition Partners Master Fund Ltd. v. Aruba Networks*, Inc., 210 A.3d 128 (Del. 2019) (Per Curiam)**
  - Overturned the Chancery Court's use of thirty-day average market price prior to announcement of the deal to determine fair value
    - Chancery Court's approach double counted agency costs and injected due process and fairness problems by preventing rigorous discovery around potential valuation approaches
    - Use of unaffected market price failed to account for significant nonpublic information
  - Proper appraisal valuation was equal to the deal price minus any synergies resulting from the deal
  - Reiterated that one size does not fit all by clarifying that market price of a stock is not necessarily the best estimate of the stock's so-called fundamental value at any particular time
    - Cautioned against over-reliance on recent cases *DFC Global Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346 (Del. 2017) and *Dell, Inc. v. Magnetar Global Event Driven Master Fund Ltd*, 177 A.3d 1 (Del. 2017), suggesting market value should not be an automatic default approach and encouraging a full analysis of the facts and circumstances

Appraisal Trends – One Size Does Not Fit All

- ***In re Appraisal of Stillwater Mining Company*, Consol. C.A. No. 2017-0385-JTL, 2019 WL 3943851 (Del. Ch. Aug. 21, 2019)**
  - In determining fair value court assessed three principal metrics: (1) the deal price, (2) the adjusted trading price of Stillwater's stock, and (3) the parties' respective discounted cash flow analyses
  - The best indicator of fair value was the original deal price of $18 per share
  - Court considered the following factors in relying on deal price:
    - The merger was an arms-length transaction with a third party
    - A majority of the board was disinterested and independent
    - The acquirer undertook due diligence, including accessing confidential information
    - The negotiations involved multiple price increases
    - No bidders emerged during the post-signing phase
  - Court rejected the shareholders' valuation based on a discounted cash flow analysis, noting that a market-tested indicator was available in the form of the deal price

Speaker Biographies

Lillian Brown is a partner in the Transactional and Securities Departments and a member of the Corporate Practice Group. Ms. Brown advises clients, including public companies and their boards, on federal securities law compliance and corporate governance matters. She has extensive experience in SEC reporting and disclosure requirements, shareholder proposal and proxy matters, the federal securities laws relevant to control-related transactions, proxy access and shareholder activism and engagement. Ms. Brown regularly counsels public company clients on new and evolving disclosure and governance requirements and practices, including under the Dodd-Frank and JOBS Acts. Ms. Brown works with a diverse range of companies, from Fortune 500 to private companies, spanning multiple industries including financial services, technology, entertainment, consumer products, security, biotechnology and retail

Lillian Brown
Lillian.Brown@wilmerhale.com

Stephanie Evans advises domestic and international clients on a wide range of corporate transactions, with a particular focus on mergers and acquisitions, joint ventures, strategic alliances and financings. She regularly advises boards and special committees in connection with transactions and provides advice on governance and commercial transactions. Her clients include private and public companies in a variety of industries, including financial services, defense and technology. She is active with emerging growth companies throughout their development cycle (see more on Ms. Evans' emerging growth company practice on WilmerHaleLaunch.com). She was previously Vice Chair of the Corporate Practice Group. Ms. Evans also worked as an associate in the Global Investment Banking Group of Deutsche Banc.

Stephanie Evans
Stephanie.Evans@wilmerhale.com

Piers Fennell is a VP, Associate General Counsel for E*TRADE Securities Corporation where he is head of Corporate Legal. In this role, Mr. Fennell advises on Corporate Governance, Securities and SEC Reporting, Mergers & Acquisitions, Contracts and other general corporate law matters as well as executive compensation. Mr. Fennell also serves as Assistant Secretary for the Company. Prior to joining E*TRADE, Mr. Fennell worked at Skadden, Arps, Slate, Meagher and Flom LLP and Latham & Watkins, LLP.

Piers Fennell
piers.fennell@etrade.com

Justin Ochs represents both public and private companies on a variety of corporate finance and other matters. Borrowers, private equity sponsors and financial institutions rely on Mr. Ochs' experience and strategic business advice and turn to him for counsel on a wide range of debt financing transactions. Mr. Ochs successfully represents his clients in matters involving secured and unsecured financings, leveraged buyouts and acquisition financings, bridge loans, first- and second-lien, mezzanine and other subordinated debt, working capital facilities, commercial paper programs and letters of credit. He is also a trusted advisor to clients on mergers and acquisitions and other general corporate and securities matters. Mr. Ochs is a member of the American Bar Association (Business Law Section), the DC Bar Association and the New York State Bar Association. He also serves on the Advisory Board of the Georgetown Law Corporate Counsel Institute.

Justin Ochs
Justin.Ochs@wilmerhale.com