Litigation Lookout

PE Industry Guide to Legal Developments

ROPES & GRAY

As spring approaches, we wanted to take the opportunity to review some of the past year's notable court decisions and litigation developments with particular relevance to our private equity clients. We hope that this will serve not only as a refresher on several notable developments but also as a guide to the issues that may materialize in the coming months. Look for additional updates from your Ropes & Gray litigation team in the coming months.

In This Issue

Developments in Delaware Law 1

Developments in Federal Securities Law 12

Developments in Restructuring 15

Developments in General Business Guidance 16

Looking Ahead... 18

Developments in Delaware Law

Caremark Claims Gain Strength under Delaware Law

The Background: Two decisions issued by the Delaware Court of Chancery this year highlight the continuing trend of stockholders successfully pursuing *Caremark* "failure of oversight" fiduciary duty claims against corporate directors and officers. Such claims have historically not survived pleading-stage motion practice and were rightfully considered among the most difficult to plead and prove. But the Court of Chancery has allowed a series of cases to survive dismissal motions and proceed to discovery. Two recent decisions highlight the risks associated with this trend. First, on May 10, Vice Chancellor Laster denied a motion to dismiss a stockholder derivative suit against Meta's directors and officers concerning their alleged failure to properly oversee the company's data privacy practices. The plaintiffs alleged that the directors' failures of supervision cost the company hundreds of millions in fines and penalties. In short, the Vice Chancellor held that the plaintiffs had adequately pleaded that Meta's directors had ignored a "string of red flags" regarding issues concerning user privacy.

> These rulings will further incentivize the stockholder plaintiffs' bar to pursue these claims in hopes of extracting meaningful settlement value.

Similarly, Vice Chancellor Laster denied a motion to dismiss filed by Walmart's directors and officers in a *Caremark* action concerning Walmart's alleged role in the opioid crisis. The plaintiffs alleged that the directors ignored "red flags of misconduct" because they knew or should have known that Walmart's pharmacy division was failing to ensure that opioids were not wrongfully administered to customers, and that this caused Walmart to incur billions in fines and settlements. The Vice Chancellor credited that allegation, as well as the plaintiffs' "information system" claims that Walmart "utterly failed to implement any reporting or information system or controls to address a central compliance risk." The Vice Chancellor also faulted Walmart and its directors for preparing board and committee meeting materials that did not provide sufficient information about what the directors considered or did to address the company's role in the opioid crisis.

The Takeaway: The claimed damages in these cases are significant and discovery is likely to be extensive. So, these rulings – combined with the Court of Chancery's prior decision in *McDonald's* holding that officers are also subject to *Caremark* failure of oversight liability – will further incentivize the stockholder plaintiffs' bar to pursue these claims in hopes of extracting meaningful settlement value. These decisions underscore the advantages that stockholders can gain from pursuing pre-suit discovery through Section 220 books and records demands, which allow plaintiffs to review and then spin board-level materials to bolster their claims. They also show the clear need to proactively document the processes a board undertakes to monitor and address core regulatory risk, as those board-level documents will be vital to any attempt to dismiss Caremark claims prior to discovery.

Identity-Based Voting Provision Survives Challenge

The Background: In a recent decision, the Delaware Court of Chancery rejected a stockholder plaintiff's challenge to Bumble Inc.'s governance structure, which offered certain Bumble insiders the combined benefits of an Up-C structure (i.e., pass-through tax treatment) and a dual class voting structure (i.e., insider control). Bumble's charter stated that each share of common stock would carry one vote, unless that share is owned by a "Principal Stockholder," which was defined to include the company's founder and its financial sponsor. This provision allowed the two "Principal Stockholders" to exercise 92% of the company's outstanding voting power despite owning a minority of the company's common stock.

> This decision gives companies reasonable confidence that they can adopt "identity-based" voting provisions in corporate charters.

The Plaintiff challenged these charter provisions, arguing that (1) this "identity-based" voting violated Delaware General Corporation Law ("DGCL") 212(a) by creating a mechanism in which shares of the same class have different share-based voting power depending on who holds them; and (2) the formula Bumble used to exchange Class B and Class A shares violated DGCL 151(a) because it did not create the same outcome for each share in the class, resulting in de facto subclasses. The Court ultimately rejected these arguments and found that the challenged provisions complied with the DGCL, as Bumble's charter set out a formula that applied to all the shares of the company's common stock and that specified how voting power is calculated. The Court further noted that having the level of voting power in shares turn on the identity of the owner was permissible.

The Takeaway: This decision gives companies reasonable confidence that they can adopt "identity-based" voting provisions in corporate charters, which grant founders and other pre-IPO stockholders flexibility in maintaining their voting power after the company accesses the public markets. However, such provisions can still be enticing targets for the plaintiffs' bar, as the Court of Chancery's decision rejecting the stockholder's challenge to Bumble's charter provision gave plaintiffs a potential alternate avenue for challenging similar provisions. While the Court held that the provisions did not facially violate the DGCL, the decision also stated that stockholders can still challenge similar provisions to determine whether they are equitable or have been applied improperly. So the door remains open for plaintiffs to argue that an "identity-based" voting structure was implemented or executed improperly, which requires practitioners to account for such potential challenges when adopting similar voting provisions. We expect further developments in this area as plaintiffs refine their challenges to similar provisions.

Recent Challenges to Stockholder Agreements Granting Consent Rights to Sponsors

The Background: Plaintiffs' firms have recently started to pursue litigation challenging stockholder agreements granting sponsors and other large stockholders consent rights over a corporation's management, arguing that directors of Delaware corporations breach their statutory obligation, under DGCL Section 141(a), to manage corporate affairs when they "contract those rights away." These suits represent a challenge to consent and other rights that sponsors have historically relied on to protect their investments in publicly traded portfolio companies.

The plaintiffs' bar has filed many complaints asserting this theory, and a test case has emerged. In that litigation, plaintiffs are challenging the consent rights of Ken Moelis, the CEO of global investment bank Moelis & Co., over the corporation's ability to take certain actions, including (1) deciding the composition of the majority of the company's board of directors; and (2) hiring or firing the company's CEO. Mr. Moelis also has the right to (1) partly dictate Board committee composition; and (2) control the issuance of preferred stock and entry into mergers.' These rights were all disclosed when the company went public in 2014.

The Court of Chancery heard argument on the parties' cross-motions for summary judgment in October 2023. The defendants argued, among other things, that the plaintiffs' claims are barred by the statute of limitations, and not ripe because they identified no practical harm caused by Mr. Moelis's rights under the stockholders' agreement. The defendants also argued that stockholder agreements including similar rights are both commonplace and that a board's decision to negotiate those rights with the company's founder is no different than a company entering into restrictive covenants in a credit agreement or other generally accepted commercial contract.

> These suits represent a challenge to consent and other rights that sponsors have historically relied on to protect their investments in publicly traded portfolio companies.

The Court rejected those arguments in two recent decisions. In a decision issued on February 12, 2024, the Court found that the plaintiffs' claims are ripe and not barred by the statute of limitations, but reserved judgment on the parties' merits arguments. The Court addressed those remaining issues in a decision issued on February 23, 2024, in which the Court concluded that the combination of the rights afforded to Mr. Moelis under the stockholder agreement—including many of his rights over the composition of the company's board and his right to hire or terminate the company's CEO—violated Section 141(a).

The Court of Chancery is unlikely to be the last word on this issue, as the decisions will likely be appealed to the Delaware Supreme Court.

The Takeaway: The *Moelis* decisions raise questions about the viability of rights for which sponsors have historically negotiated with their portfolio companies, with obvious consequences for their ability to exercise control over certain aspects of those companies' affairs. However, there may be ways to address this issue going forward, including charter amendments granting sponsors the same rights that have been reflected more typically in stockholder agreements. In addition, while the Moelis litigation has proceeded, plaintiffs' firms have sent letters to companies with stockholder agreements granting sponsors certain of the rights challenged in the Moelis case, demanding that those companies amend the agreement to remove offending provisions or face litigation. We advise proactive engagement with counsel to discuss how best to address such challenges.

Recent Challenges to Advance Notice Bylaw Provisions

The Background: Stockholder plaintiffs' firms have also recently started to challenge advance notice bylaws requiring stockholders nominating board candidates to disclose any coordination with other stockholders. Such acting in concert advance notice provisions were originally designed to address efforts by stockholders to work collectively without disclosing their coordination. These challenges, which at times commence with Section 220 books and records demands, assert that such provisions (including related "daisy chain" provisions extending the definition of a person acting in concert to third parties coordinating with a person deemed to be acting in concert with the nominating party) are an unreasonable infringement on the stockholder franchise, are facially unreasonable, and that a board breaches its duty of loyalty by enacting or failing to repeal such bylaws. Given the common use of similar bylaws, this type of litigation appears likely to become more common. In what appear to be test cases for their theories, stockholder plaintiffs' firms recently asserted similar claims against the directors of ContextLogic, Inc and Peloton Interactive, Inc. Those cases commenced only recently, but will be closely watched for guidance as to how the Court of Chancery, and ultimately the Delaware Supreme Court, view these claims.

> Plaintiffs' firms have also recently started to challenge advance notice bylaws requiring stockholders nominating board candidates to disclose any coordination with other stockholders.

The Takeaway: This flavor of challenge to advance notice bylaws is relatively new, but we expect stockholder plaintiffs to continue to pursue litigation and serve 220 demands challenging these provisions while the ContextLogic and Peloton litigations proceed. In the interim, we recommend advance coordination with counsel to discuss how to best address such challenges and proactively develop a response strategy, including a clear record of any decision by the board in response to such demands.

The Court of Chancery Provides Guidance on the Availability of Lost Merger Premium Damages

The Background: In a recent decision, the Delaware Court of Chancery ruled that the "Con-Ed" lost-premium damages provision in the merger agreement executed in connection with Elon Musk's acquisition of Twitter was unenforceable. This decision is the first to consider this issue under Delaware law, and it seems likely to upend the way in which practitioners negotiate such provisions in future merger agreements.

This decision arose in an unusual procedural context. During Elon Musk's failed attempt to abandon his acquisition of Twitter, and in parallel to Twitter's suit to specifically enforce that sale, a Twitter stockholder brought suit against Musk for breaching the merger agreement. After the transaction closed, that stockholder sought a mootness fee for his purported role in forcing Musk to close the transaction. The defendants opposed that application, which required the Court to consider whether the plaintiff's claim was "meritorious when filed." To assess that issue, the Court considered whether the Twitter/Musk merger agreement granted Twitter stockholders third-party beneficiary status to seek lost merger premium damages. In its analysis, the Court focused on two key provisions in that merger agreement. The first expressly disclaimed, in relevant part, any third-party beneficiaries. The second was a traditional "Con-Ed" lost premium damages provision through which the parties

A lost premium provision could be enforceable if it expressly made the target stockholders third-party beneficiaries.

had agreed that Twitter could pursue lost merger premium damages as a remedy for any intentional breach by Musk of the merger agreement.

In considering the "Con Ed" provision, the decision discussed how such provisions arose following the Second Circuit's 2005 decision in *Consolidated Edison, Inc. v. Northeast Utilities*, which applied New York law and held that the acquiror in that transaction was not liable for lost premium damages. In response to that decision, M&A practitioners began to negotiate for provisions in merger agreements granting sellers the right to pursue lost merger premium damages, which disincentivized acquirors from abandoning transactions while also minimizing stockholder litigation risk by vesting sellers with the sole right to recover such damages. The Court of Chancery in *Twitter, Inc. v. Musk* concluded that the stockholder lacked third-party beneficiary status when he filed his complaint, which meant that his suit was not "meritorious when filed" and his counsel was therefore not entitled to a fee. The decision held that the plaintiff (i) had no third-party beneficiary rights at all; or (ii) had third-party beneficiary rights that had not yet vested because Twitter was still suing for specific performance of the merger agreement when the plaintiff filed suit.

Most importantly, the decision addressed for the first time the impact of a typical lost premium provision under Delaware law, holding that the provision was not enforceable because (i) in the context of a breach of a purchase agreement, Delaware law only permits expectation damages that make the non-breaching party whole; and (ii) Twitter itself was never entitled to receive the merger premium. The Court held that a lost premium provision could be enforceable if it expressly made the target stockholders (the parties to which a merger premium is actually owed) third-party beneficiaries for purposes of that provision. In any event, the Court held that even if stockholders are third-party beneficiaries for purposes of such a provision, they are precluded from pursuing a claim for lost-premium damages while the target seeks specific performance (the typical vehicle by which sellers seek to enforce buyers' closing obligations under merger agreements), because during the pendency of specific performance action, damages have not yet accrued.

The Takeaway: The Court's decision disrupts a market-standard practice aimed to address (i) the evaporated premium in broken deals following *Con Ed*; and (ii) more practically, the "option problem" that results when a buyer is not adequately incentivized to close a deal. If specific performance or an adequately sized reverse termination fee are not available, buyers may have limited economic incentives to close a deal that sours post-signing. Practitioners are still adapting to this decision and will have to negotiate enforceable provisions that properly address the "option problem" while avoiding a situation in which the seller does not control any eventual money damages litigation if the transaction does not close.

Shareholders' Covenant Not to Sue for Breach of Fiduciary Duty Is Not Facially Invalid under Delaware Law

The Background: The Delaware Chancery Court upheld a contractual covenant in which stockholders agreed not to sue for breach of fiduciary duty in connection with a drag-along sale. The plaintiffs in *New Enterprise Associates 14, L.P. v. Rich* were investment funds managed by sophisticated venture capital firms, each of which held an interest in a portfolio company called Fugue, Inc. Following an unsuccessful sale attempt, Fugue needed

The Delaware Chancery Court upheld a contractual covenant in which stockholders agreed not to sue for breach of fiduciary duty in connection with a drag-along sale. The Court declined, however, to dismiss the plaintiffs' claims based on intentional wrongdoing, holding that as a matter of public policy, contractual covenants cannot exempt a party from intentional tort liability.

capital and concluded that a recapitalization led by investor George Rich was its only viable option. Rich conditioned his investment on the plaintiffs entering into a voting agreement that included a covenant not to sue for a breach of fiduciary duty arising from a drag-along transaction (in which the company's board and a majority of its preferred stockholders could "drag along" other stockholders in a sale of the company).

Following the recapitalization, the board agreed to sell the company in a transaction that met the requirements of a drag-along sale under the voting agreement. The plaintiffs refused to vote in favor of the merger and sued the directors for breach of fiduciary duty. The directors moved to dismiss on the grounds that the covenant not to sue prohibited the plaintiffs' claims; the plaintiffs argued that the covenant was facially invalid because it conflicted with the DGCL, which permits only limited fiduciary tailoring.

The Court concluded that stockholders' contractual agreements not to sue for breach of fiduciary duty are not facially invalid under the DGCL. Citing the Delaware Supreme Court's recent opinion in *Manti Holdings, LLC v. Authentix Acquisition Co.* (holding that stockholders may waive statutory appraisal rights by contract), the Court proposed a two-part test to determine the validity of covenants such as the one at issue. First, the provision must be narrowly tailored to address a specific transaction. The Court suggested that the level of specificity must "compare favorably with what would pass muster for advance authorization in a trust or agency agreement, advance renunciation of a corporate opportunity under [DGCL] Section 122(17), or advance ratification of an interested transaction like self-interested director compensation." Here, the covenant was narrowly tailored, as it applied only to certain sale transactions meeting contractually specified criteria.

Second, the provision must be reasonable under the circumstances, based on factors such as (1) the existence of a written contract formed through actual consent, (2) the clarity of the provision, (3) the sophistication of the parties and whether they understood the provision's implications, (4) the covenanting party's ability to reject the provision, and (5) the presence of bargained-for consideration. The Court found that the covenant at issue was a clear, express provision agreed to by sophisticated parties that could have rejected the covenant.

The Court declined, however, to dismiss the plaintiffs' claims based on intentional wrongdoing, holding that as a matter of public policy, contractual covenants cannot exempt a party from intentional tort liability.

The Takeaway: While the Court's decision allows for some greater degree of fiduciary tailoring, including through advance waivers of claims for breach of fiduciary duties, the effect of this ruling is circumscribed by the factual circumstances of the case and by the public-policy carveout for intentional wrongdoing. The Court noted that *NEA* presented "optimal" circumstances for enforcement because the covenant in question was both clear and specifically bargained for by sophisticated parties. Under less ideal circumstances, the provision would likely not be enforceable. Moreover, the Court held that such a covenant may not be enforced when the breach of fiduciary duty is intentional or in bad faith.

Delaware Court of Chancery Declines to Enforce Noncompete Provisions

The Background: In *Centurion Service Group, LLC v. Wilensky*, a company sued to enforce a noncompete provision that forbade a former employee from engaging in competitive business for two years anywhere in the United States. The provision prohibited any employment competitive not only with the company's current business, but also with business the company was "planning to design, develop, sell or provide." The defendant former employee argued that this provision was unenforceable because of its nationwide scope and two-year duration, and because it was vague and failed to advance a legitimate business interest. The Delaware Chancery Court agreed, concluding that the geographic breadth, coupled with the two-year duration, "casts a limitless net over [the former employee] in both geography and scope of conduct." The Court rejected the company's argument that the former employee's involvement in deal-making and relationship-building, and his access to the company's confidential information (such as the identities of buyers, sellers, and vendors), justified the scope of the non-compete. The Court characterized these as "vague and everyday concerns."

> While the fate of the FTC rule remains unresolved, the proverbial writing on the wall in Delaware is clear: Parties should ensure that restrictive covenants in the employment context are tailored to protect the parties' legitimate interests, since Delaware courts will scrutinize the provisions for overbreadth.

The Court confronted similar circumstances, and reached a similar holding, in *Sunder Energy, LLC v. Jackson*, another case in which a company sued to enforce a noncompete provision. In this case, the Court declined to enforce—or blue-pencil—restrictive covenants that lawyers embedded in the company's LLC Agreement, including a non-compete clause and a restriction on soliciting employees. The covenants at issue, which applied not only to the defendant former employee but also his "Affiliates" (broadly defined in the LLC Agreement to include his spouse, parents, siblings, and descendants), were to remain in force while the former employee held "incentive units" in the company (a form of

incentive compensation) and for two years afterwards. In effect, the duration was potentially perpetual, inasmuch as a holder of incentive units has no ability to transfer or redeem them, and the company can opt not to repurchase them. The covenants prohibited the former employee from any employment in the entire door-to-door sales industry (regardless of whether the plaintiff company marketed similar products), and the restriction applied to any state in which the company "reasonably anticipates conducting its business." The Court found such restrictions overbroad and therefore unreasonable.

The Takeaway: These cases are the latest instances of the Delaware Court of Chancery declining to enforce or blue-pencil contractual noncompete provisions, and they come at an inflection point in the debate over legal restrictions on non-competes. In December, New York Governor Kathy Hochul vetoed a bill that would have banned non-competes in the state. Meanwhile, the Federal Trade Commission continues to consider a proposed rule, introduced in January 2023, that would broadly ban noncompete clauses in employment contracts nationwide. During the FTC's public comment period, many employers expressed concern that the rule would put their intellectual property at risk and suppress innovation. Labor groups and staffing agencies, by contrast, argued that the rule would both allow for a free flow of talent and benefit employees (particularly low-wage workers who often sign employment contracts without the advantage of legal advice). The FTC is expected to vote on the proposed rule in 2024, and if the rule passes, it will likely face legal challenges. While the fate of the FTC rule remains unresolved, the proverbial writing on the wall in Delaware is clear: Parties should ensure that restrictive covenants in the employment context are tailored to protect the parties' legitimate interests, since Delaware courts will scrutinize the provisions for overbreadth.

Delaware Court of Chancery Rejects Politically Motivated 220 Demand

The Background: In *Simeone v. The Walt Disney Company*, a "longtime" stockholder of the Walt Disney Company ("Disney") was solicited by an activist plaintiff's attorney to serve a books and records demand on Disney pursuant to Section 220 of the DGCL seeking information regarding Disney's opposition to Florida House Bill 1557, which "limits instruction on sexual orientation or gender identity in Florida classrooms."

On February 24, 2022, the Florida House of Representatives passed HB 1557, which became a political lightning rod. In response, many of in the state's (and the nation's) culture wars. In response, many of Disney's employees and partners called on Disney to denounce the legislation. On March 28, 2022, HB 1557 was signed into law. That same day, Disney issued a public statement opposing the bill, stating that HB 1557 "should never have passed and should never have been signed into law." In response, the

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state legislature voted to dissolve a special tax district surrounding Walt Disney World Resort.

The plaintiff's 220 demand asserted that Disney's directors and officers may have breached their fiduciary duties in opposing HB 1557 by either "put[ting] their own beliefs ahead of their obligations to stockholders or flout[ing] the risk of losing rights associated with the special district." In response, Disney asserted that the stockholder lacked grounds to make the demand but nevertheless produced certain documents, including board minutes and corporate policies. The plaintiff then filed suit alleging that he was entitled to additional information under Section 220.

On June 27, 2023, the Delaware Court of Chancery issued a post-trial opinion denying the stockholder's request after applying the familiar standards governing Section 220 demands. In particular, the Court held that (1) "the purposes described in the demand are not the plaintiff's own purposes"; (2) "the plaintiff has not provided a credible basis from which to infer possible wrongdoing"; and (3) "the defendant has provided the plaintiff with all necessary and essential documents." First, the Court concluded that the demand was driven by plaintiff's counsel, rather than the plaintiff himself, referencing testimony from the plaintiff that he did not independently consider making a demand or pursuing litigation until after he was contacted by counsel affiliated with a public interest law firm. Second, the Court held that the plaintiff's demand was merely "critiquing a business decision" to make a public statement on HB 1557 rather than describing any potential wrongdoing. Finally, the Court held that

the plaintiff failed to meet his burden that the additional records he sought were "essential" to the purpose of his demand, concluding that the board materials and corporate policies provided by Disney contained all of the necessary and essential information.

The Takeaway: The Disney decision is notable because it is one of the rare decisions in recent years denying a demand by a stockholder under DGCL Section 220. While future plaintiffs (and plaintiffs' counsel) may seek to utilize Section 220 to further their own ideological agendas, the *Simeone* decision makes clear that the Court of Chancery will apply the well-established standards governing Section 220 demands to such maneuverings. Where plaintiffs are unable to prove that the demand is motivated by a proper purpose entitling the stockholder to an inspection of every item sought or that each category of books and records sought is essential to accomplish the stockholder's articulated purpose for inspection, the Delaware courts will likely continue to deny such requests.

Delaware Court of Chancery Denies Motion to Dismiss Fiduciary Duty Claims Challenging De-SPAC Transaction

The Background: On January 4, 2023, Vice Chancellor Will of the Delaware Court of Chancery, denied a motion to dismiss breach of fiduciary duty claims filed in connection with a de-SPAC transaction through which GigCapital3, Inc. ("Gig3"), a SPAC sponsored by GigAcquisitions3, LLC (the "Sponsor") and formed by serial SPAC founder Avi Katz, acquired Lightning eMotors Inc. ("Lightning") in December 2020.

As is typical, the Sponsor was differently situated from the SPAC's common stockholders given its founder shares, which it had received for a nominal sum and which vested only if a de-SPAC transaction occurred. After the de-SPAC closed, those founder shares were worth more than $39 million.

Denying the defendants' motion to dismiss and relying on the guidance set forth in *In re MultiPlan Corp. Stockholders Litigation*—the Court of Chancery's first-ever decision addressing fiduciary duty claims in the de-SPAC context—the Court held that entire fairness was the applicable standard of review for such claims, and that exculpation under Section 102(b)(7) of the Delaware General Corporation Law was not available to any of Gig3's directors, given (i) the Sponsor's incentives to prioritize any deal (including the allegedly value-destructive transaction challenged in this action) over liquidation for fear that its founder shares would otherwise be worthless; and (ii) the directors' close ties to Katz (who beneficially owned and controlled the Sponsor), including their prior service on the boards of other Katz-affiliated SPACs.

> The Gig3 decision gives former SPAC stockholders the green light to pursue fiduciary duty claims based on an omission that may be notionally present in almost all de-SPAC transactions.

Finally, the Court held that the defendants disloyally (i) failed to disclose the "net cash per share" that Gig3 would invest in the combined company; and (ii) disclosed inflated Lightning projections that did not account for the fact that Lightning's business model was allegedly difficult to scale. As for the "net cash per share" disclosure, the Court observed that the proxy statement's disclosure that Gig3's shares were worth $10 each did not properly account for "dilution and dissipation of cash," and that after accounting for sources of such dilution and dissipation of cash (e.g., underwriting, advisory, and other transaction fees, the market value of the warrants issued in connection with Gig3's IPO), Gig3's net cash per share was only $5.25. With respect to allegedly inflated projections, the Court observed that the proxy "was silent as to Lightning's true prospects," which were concealed by optimistic management projections based on the assumption that Lightning could scale its production capacity dramatically over a period of five years. Because "Lightning's lofty projections were not counterbalanced by impartial information," such as the fact that "Lightning's business would be difficult to scale because it built highly customized vehicles in small batches," the proxy did not accurately portray Lightning's financial prospects, and "public stockholders could not fairly decide whether it was preferable to redeem for $10 plus interest or to invest in a risky venture."

The Takeaway: The *Gig3* decision confirmed that entire fairness will become the default standard of review for fiduciary duty claims filed against SPAC sponsors and directors regarding de-SPAC transactions, given the court's views regarding the alleged structural conflicts of interest that inhere to such transactions. The *Gig3* decision also gives former SPAC stockholders the green light to pursue fiduciary duty claims based on an omission that may be notionally present in almost all de-SPAC transactions (the failure to disclose net cash per share). The *Gig3* and *Multiplan* decisions have precipitated an abundance of stockholder challenges to de-SPAC transactions following those plaintiffs' playbook; sure enough, multiple decisions following *Gig3* have held at the pleadings stage that the failure to disclose net cash per share constitutes a disclosure violation.

Court Permits Challenge to Tax Receivable Agreement Payments Made to Sponsor

The Background: In August 2023, the Delaware Court of Chancery allowed a stockholder plaintiff to pursue derivative claims concerning payments made to GoDaddy Inc.'s founders and former financial sponsors pursuant to a tax receivable agreement, or TRA. The suit focuses on an $850 million payment made by the company to its pre-IPO stockholders to resolve the company's remaining obligations under a TRA that had been implemented prior to the company's 2015 IPO. The TRAs gave those pre-IPO stockholders the right to collect payments on realized tax savings that would accrue after the company became profitable.

Following an unsuccessful special committee process, the GoDaddy Board of Directors approved the TRA buyout. Plaintiff sued for breach of fiduciary duty and corporate waste, claiming that the company overpaid in the transaction, including because at that time, GoDaddy had not generated taxable income, never realized any tax savings, and had never made any payments under the TRAs. In denying the defendants' motions to dismiss, the Court concluded that the complaint supported a reasonable inference that the GoDaddy directors had acted in bad faith in approving the transactions and that the entire fairness standard of review therefore governed the plaintiffs' claims. The Court identified several factors that, taken together, support that conclusion. First, an "extreme disparity in valuation" between the $850 million payment and the roughly $175 million value that the company had attributed to its obligation under the TRA in its audited financial statements: "The contrast between those figures is so glaring as to support a claim of waste and hence an inference of bad faith on that basis alone." Second, the GoDaddy CFO made conflicting representations to various directors regarding the value of the company's obligations under the TRA. Third, the CFO's projections and analysis excluded consideration of the impact of GoDaddy's M&A-based business model on its ability to use certain tax assets. Finally, the Court noted that the circumstances surrounding the formation of the special committee, its meetings, and its decision to disband and transfer authority over the transaction to the full Board, all contributed to the inference of bad faith under a "holistic analysis" of the allegations in the complaint. The decision ultimately held that the plaintiffs had pleaded a reasonable inference that the Board "wanted to approve a deal that would make the [pre-IPO investors] happy."

The Takeaway: *GoDaddy* is the first major Chancery decision to address the transactional conflicts posed by tax receivable agreements. TRAs are very common in publicly traded portfolio companies, as they compensate pre-IPO stockholders for the tax value they typically lose when the portfolio company goes public. When a then-public portfolio company sells, the TRA typically terminates on

> "The contrast between [the TRA payment and the company's internal valuation of its TRA obligations] is so glaring as to support a claim of waste and hence an inference of bad faith on that basis alone."

the change of control, allowing pre-IPO stockholders (typically sponsors and founders) to receive a one-time payment that can be alleged to be a conflict in the deal. In *GoDaddy*, as with many transactions that utilize TRAs, the pre-IPO stockholders who would "receive the bulk of the consideration" from the TRA buyout "carried considerable influence" at GoDaddy, given their prior controlling stake in the company. That influence "would not have vanished overnight" post-IPO, considering the "transaction process began only ten months after those [pre-IPO stockholders] completed their sales, at a point when [three compromised directors] were still on the Board." *GoDaddy* is also a reminder of the importance of executing on the basics of a committee-led process: Ensure the committee is properly empowered and able to fulfill its mandate. Appropriately document the efforts made by the committee to negotiate the transaction. And recognize any potential issues (e.g., the valuation discrepancy identified in the Court's decision) and address them proactively.

Acquirors May Be Liable for Misleading Sell-Side Proxy Disclosures and for "Nominal Damages" Associated with Those Disclosures

The Background: In two recent post-trial decisions, the Delaware Court of Chancery held acquirors liable for false and misleading transactional disclosures made by target companies. Those decisions held that the acquirors aided and abetted the target directors' breaches of their duty of disclosure by failing to correct the misleading disclosures. In both decisions, the Delaware Court of Chancery awarded the plaintiffs significant per-share "nominal damages"—traditionally thought of as purely symbolic damages awarded where a plaintiff fails to prove economic damages—to remedy the disclosure violations proven at trial.

The first decision concerned the 2019 sale of Mindbody, Inc. to Vista Equity Partners for roughly $1.9 billion. Mindbody stockholders filed suit in the Delaware Court of Chancery in connection with that transaction, claiming that Mindbody's CEO (i) hijacked the sale process and steered the company to a deal with Vista to further his own goal of achieving

near-term liquidity; and (ii) caused the company to issue a materially misleading merger proxy. The plaintiffs alleged that Mindbody's CEO favored Vista in the sale process and intentionally obscured the extent of his backchannel, unauthorized contacts with Vista in the merger proxy.

In a post-trial decision, Chancellor McCormick ultimately found for the plaintiffs and held that (i) the Mindbody CEO breached his fiduciary duties in connection with (a) the sale process, and (b) the merger proxy; and (ii) Vista aided and abetted the Mindbody CEO's disclosure violations. Notably, the Court observed that the merger agreement gave Vista the right to "review and comment upon" the merger proxy. It also held that Vista knew of the disclosure violations because the relevant omissions involved contacts between the CEO and Vista. As such, the Court held that Vista's failure to correct inaccuracies in the merger proxy constituted aiding and abetting. Also of note, the Court held that the Mindbody CEO and Vista were jointly liable for "nominal damages" of $1 per share (approximately $45 million) for causing (in the CEO's case) and aiding and abetting (in Vista's case) the issuance of misleading proxy disclosures regarding the CEO's contacts with Vista during the sales process.

> Acquirors with a contractual right to review merger proxies are obligated, under Delaware law, to correct material omissions of which they are aware.

The second decision concerned the 2016 sale of Columbia Pipeline Group, Inc. to TC Energy Corp. for roughly $13 billion. Columbia Pipeline stockholders claimed that Columbia Pipeline's CEO and CFO (i) led a sales process designed to achieve a deal that would trigger their lucrative retirement and change-in-control benefits; and (ii) caused Columbia Pipeline to issue a materially misleading merger proxy, which failed to disclose certain of their interactions with TransCanada during the deal process. The plaintiffs also claimed that TransCanada aided and abetted, among other things, the CEO's and the CFO's disclosure violations.

In a post-trial decision, Vice Chancellor Laster ultimately found for the plaintiffs and held that (i) the Columbia Pipeline CEO and CFO breached their fiduciary duties in connection with (a) the sale process, and (b) the merger proxy; and (ii) TransCanada aided and abetted those breaches. As in *Mindbody*, the Court observed that TransCanada "had the right under the merger agreement to review the [merger proxy] and an obligation to inform Columbia [Pipeline] of any material omissions." It held that TransCanada's failure to correct the material omissions regarding its contact with the officers during the sale process constituted aiding and abetting. Again like *Mindbody*, the Court also held that the Columbia Pipeline's CEO and CFO and TransCanada were jointly liable for "nominal damages" of $0.50 per share (roughly $200 million) for causing (in the CEO's and CFO's case) and aiding and abetting (in TransCanada's case) the issuance of misleading proxy disclosures regarding the CEO's and CFO's contacts with TransCanada during the deal process. It observed that although it is difficult to calculate the economic harm associated with the stockholders being deprived of an informed vote on the transaction, a court can still "award damages equal to a small percentage of the equity value of each share."

The Takeaway: Acquirors with a contractual right to review merger proxies are obligated, under Delaware law, to correct material omissions of which they are aware. If they fail to do so, they will expose themselves to aiding and abetting liability and joint responsibility for any eventual damages (including significant per-share "nominal damages"). To minimize this risk, the acquiror should keep an accurate, factual log of substantive interactions with the target (particularly the target's senior management and directors), review the merger proxy carefully, correct any substantive misstatements or omissions, and make a record of that review. Furthermore, the *Mindbody* and *Columbia Pipeline* courts' decision to award "nominal damages" on a per-share basis is a significant new development in Delaware. Previously, "nominal damages" were awarded in the form of $1 for a plaintiff's entire claim and not on a per-share basis. While *Columbia Pipeline* and the precedent on which the Court in *Mindbody* relied could well be read to tether the "nominal damages" to an attempted quantification of the plaintiff's actual injury, plaintiffs' counsel will push the envelope on claiming "nominal damages" in future cases.

California Court Declines to Enforce Delaware Forum Selection Clause

The Background: Citing the state's public policy, a California appellate court refused to enforce a forum selection clause in a company's corporate constitutive documents. In *EpicentRX v. Superior Court*, the plaintiff, a minority shareholder in EpicentRX, brought suit against the company in the Superior Court of San Diego County and demanded a jury trial, alleging fraudulent concealment, breach of contract, breach of fiduciary duty, and other California state-law claims, which carry a right to a jury trial under California law. The defendant, a Delaware biotech company headquartered in California, sought dismissal based on provisions in its certificate of incorporation and bylaws designating the Delaware Court of Chancery as the exclusive forum to resolve shareholder disputes. The trial court found that enforcement of the forum selection clause would deprive the plaintiff of its "inviolate

right to a jury trial." (The Delaware Court of Chancery is a court of equity and, as such, does not conduct jury trials.) Because this right is unwaivable under California law, the burden shifted to the defendants to show that litigating in the Delaware Court of Chancery would not substantially diminish the rights of the California-resident plaintiff. On appeal, the defendants argued that the forum selection clauses were not intended to impinge upon

> Under California law, there is no right to a jury trial for shareholder derivative actions or equitable actions, so California courts will likely continue to enforce a Delaware Court of Chancery forum selection clause in such cases, provided they do not also involve claims carrying a right to a jury trial.

shareholders' jury-trial rights, but the appellate court was unpersuaded, finding that the provision—whatever the intention—would operate as an impermissible implied waiver of the plaintiff's right to a jury trial. As a result, the Court affirmed the trial court's decision, holding that enforcing the forum selection clauses would violate the state's public policy, which deems the right to a jury trial "an inviolate, fundamental, and constitutionally-protected right." The Supreme Court of California has agreed to hear EpicentRX's appeal.

The Takeaway: Under California law, there is no right to a jury trial for shareholder derivative actions or equitable actions, so California courts will likely continue to enforce a Delaware Court of Chancery forum selection clause in such cases, provided they do not also involve claims carrying a right to a jury trial. Moreover, the immediate effect of the appellate court decision is limited, since appellate courts in other districts or divisions are not bound by it. That may change, of course, depending on the outcome of the case in the California Supreme Court. Most other states currently enforce Delaware forum selection clauses, even though nearly all state constitutions recognize a litigant's right to a jury trial. Though if the EpicentRX decision stands, shareholder plaintiffs may attempt to persuade other state courts to follow California's approach. To do so, the plaintiffs would need to plead state-specific causes of action for which there is a right to a jury trial.

Controllers Held Subject to Enhanced Scrutiny When Exercising Voting Authority

The Background: In a January 24, 2024 decision, Vice Chancellor Laster of the Delaware Court of Chancery held that the controlling stockholder of Sears Hometown and Outlet Stores had fiduciary duties when he exercised his rights as a stockholder. The decision breaks new ground by holding plainly that, separate and apart from any fiduciary duties they may owe as directors or officers, controllers have fiduciary duties of care and loyalty "when exercising stockholder-level voting power." The Court also held that when a controlling stockholder acts in their controller capacity in a way that changes the corporation's status quo, they are subject to an "enhanced scrutiny analysis to determine whether the[y] acted in good faith, after a reasonable investigation, to achieve a legitimate objective."

The decision concerns a series of proposed transactions involving Sears Hometown and its controller, Eddie Lampert. The company had two businesses, Hometown Stores and Outlet Stores. Hometown Stores experienced financial difficulties, and the company formed a special committee to explore possible transactions with Lampert. The committee's mandate later expanded to include consideration of other potential transactions. Management and the special committee concluded that a Hometown liquidation was the best strategic option. But Lampert believed (sincerely in the Court's view) that liquidation would destroy value for all stockholders. When liquidation looked imminent, Lampert acted by written consent to (i) remove the two special committee members who had most forcefully supported the proposed liquidation; and (ii) amend the company's bylaws so that a liquidation would require 90% approval by the board in two votes held at least 30 business days apart. The remaining committee member determined that no liquidation was possible given these new conditions, so proceeded to negotiate a sale of the Company with Lampert, who agreed to buy the Company, minus the Outlet Stores business, for $2.25 per share. The Outlet Stores business sold separately for $0.96 per shares, with the all-in value of those sales providing stockholders with a 76% premium over the Company's unaffected trading price.

The plaintiffs' claims against Lampert proceeded to trial. In its decision, the Court held that Lampert's exercise of his rights as a stockholder was subject to "enhanced scrutiny" review as to whether he had violated his fiduciary duties as a controller because he had taken steps to disrupt the status quo by amending the company's bylaws and removing two directors. The Court held that Lampert had not breached his duties by so doing because he had not acted in bad faith or with gross negligence. However, the Court separately concluded that the sale to Lampert was subject to entire fairness review and that both the transactional process and the resulting sale price were unfair. As such, the Court awarded damages of $1.78 per share, which amounted to roughly $18 million in damages.

The Takeaway: In considering the controller's actions as a stockholder, the Vice Chancellor arguably broke new ground in holding explicitly that controllers owe fiduciary duties when they decide to use their voting power to change the status quo at the company. The decision also held that in taking such actions, a controller "cannot harm the corporation knowingly or through grossly negligent action." In addition, the decision held that if a controller breaches its duty of care, it cannot be protected from a monetary damages award simply because the corporation has a Section 102(b)(7) exculpation provision in its charter, as such provisions only apply to directors and officers. Lastly, the Vice Chancellor held that such conduct would be subject to "enhanced scrutiny" in litigation, with an attendant focus on whether controllers "sought to pursue a legitimate end and selected an appropriate means of achieving it." These holdings raise novel questions that could impact how courts evaluate actions by controlling stockholders going forward, including their decisions to vote their shares in favor of corporate transactions or to otherwise exercise influence over corporate boards.

Elon Musk's Pay Package Is Invalidated

The Background: On January 30, 2024, Chancellor McCormick of the Delaware Court of Chancery invalidated a roughly $55 billion equity award that Tesla had previously granted to Elon Musk. The decision, which capped years of litigation, held that Musk was Tesla's controlling stockholder. The Court therefore considered the challenged equity award under the rigorous entire fairness standard, and held that the award had not been issued following a "fair process" and was not issued at a "fair price." The award was therefore not "entirely fair," and the Court ordered that it should be rescinded.

The 200-page decision discusses at length the Court's views regarding the flaws in the process by which Tesla's compensation committee negotiated the equity award, along with the Court's findings regarding the adequacy of the company's public disclosures regarding that process. In short, the Court determined that the compensation committee members were not independent of Musk given their personal relationships with him and the fact that most of them had obtained generational wealth from their Tesla board service that rendered them beholden to Musk as Tesla's controlling stockholder.

The Court also held that the compensation committee allowed Musk to drive the negotiations surrounding his equity award and had in fact not negotiated with Musk at all regarding the amount or terms of his compensation. Indeed, the ultimate equity award mirrored Musk's original proposal. The Court considered these perceived failings and concluded that the award was not granted pursuant to a fair process. The Court also concluded that the defendants failed to prove that the award was issued at a fair price. Despite touting the award as aligning Musk's interests with those of the Tesla stockholders, the Court concluded that the defendants had failed to offer any explanation as to why Musk's existing equity stake did not already achieve this aim, or that the award was similar to comparable compensation packages.

Lastly, the Court concluded that the proxy disclosures surrounding this process were inadequate because they characterized the compensation committee members as independent fiduciaries who engaged in arm's-length bargaining with Musk.

The Takeaway: Despite its celebrity defendant, the size of the rescinded equity award, and the associated publicity, in some ways this decision is fairly straightforward. The Court held that outside directors were beholden to an assertive controlling stockholder and therefore did not engage in arm's-length bargaining when negotiating a transaction that uniquely benefited the controller. That said, two aspects of the decision warrant a close review.

First, the Court held that Musk was Tesla's controlling stockholder even though he owns only 21.9% of Tesla's outstanding stock. Calling him a "Superstar CEO," the Court concluded that Musk operated at Tesla with virtually no board oversight. In addition, the Chancellor held that Musk's equity stake gave him substantial sway over stockholder votes, and that he had exercised this power in the past to defeat proposals requiring supermajority approval. The Court's willingness to consider a roughly 20% blockholder to be a controlling stockholder will be important to future disputes regarding who can properly be considered a controller under Delaware law, although alleged controllers will likely argue that Tesla's relationship with Musk is sui generis and cannot support a broader rule regarding the power of minority blockholders.

Second, the decision reinforces the need for special committees to create a defensible and well-drafted record of actual negotiations with a controller. The decision does not bar directors from granting outsized pay packages to "Superstar CEOs" or from otherwise contracting with controlling stockholders. But the burden in such transactions will clearly be on the directors to document the associated negotiation and ensure a proper public disclosure.

Delaware Corporations Can Reincorporate Elsewhere, but at a Price

The Background: In a February 20, 2024 decision, Vice Chancellor Laster of the Delaware Court of Chancery allowed plaintiffs to pursue breach of fiduciary duty claims premised on the directors of TripAdvisor approving

the company's reincorporation in Nevada. The decision rejected the plaintiffs' request for an injunction barring that reincorporation, but will permit plaintiffs to pursue a claim for the monetary damages they claim the company's stockholders incurred as a result of this reincorporation.

While the Court appeared to have been focused on avoiding the perception that Delaware could be "Hotel California," the decision largely focused on the alleged benefit of the reincorporation to TripAdvisor's controlling stockholder, Greg Maffei. The decision credited the plaintiffs' allegation that reincorporating in Nevada would lower the litigation risk faced by Maffei and other TripAdvisor fiduciaries, thereby devaluing the "right to sue" that TripAdvisor stockholders acquired when purchasing their shares. Given the alleged benefit to Maffei and other insiders, and the fact that TripAdvisor board did not form a special committee to consider the reincorporation or otherwise make that determination subject to a vote of the company's minority stockholders, the Court applied the onerous entire fairness standard of review in considering the defendants' motion. The Vice Chancellor then focused on the "give and the get" in the transaction, holding that the Board had given the controller a benefit through the reincorporation without extracting anything from the controller to benefit the minority stockholders.

The Court appeared to be reluctant to grant the extreme remedy of an injunction indefinitely barring the reincorporation. So the decision denied the plaintiffs' injunction request while allowing them to pursue money damages, which the Court suggested could potentially be calculated by measuring any decline in the company's stock price caused by the announcement of the move to Nevada. Lastly, the decision noted that an injunction barring reincorporation could be appropriate when "warranted" by the equities, so the Court of Chancery has reserved its right to deploy that remedy as needed.

The Takeaway: The decision crystallizes two core principles of Delaware law. First, that non-economic rights associated with stock ownership have value. And second, that Delaware courts will be skeptical of transactions in which the controlling stockholder is alleged to have extracted a benefit. The decision confirms that the "right to sue" is a core right for stockholders of Delaware corporations, and that courts will apply strict judicial review to transactions that allegedly impair that right for the benefit of fiduciaries. The decision also provides a roadmap for Delaware corporations looking to reincorporate, observing that absent a controlling stockholder a corporation could reincorporate without serious litigation risk if they (i) "fully disclosed the consequences of the change of legal regimes;" and (ii) the reincorporation was then approved by a fully informed stockholder vote. For corporations with controllers, the Court held that the reincorporation would have to be made subject to approval by a fully empowered and independent special committee and a fully informed and uncoerced vote of the company's minority stockholders if the board and controller expect something like business judgment deference from the Court.

Developments in Federal Securities Law

The Supreme Court Bolsters Defenses to Some Securities Claims Related to Registration Statements

The Background: The U.S. Supreme Court's unanimous decision in *Slack Technologies, LLC v. Pirani* offers a strong defense to claims involving direct listings brought under § 11 of the Securities Act of 1933 (the "Securities Act"). The Court held that § 11 requires a plaintiff to plead and prove that he or she purchased shares traceable to an allegedly defective registration statement. The Court's decision on § 11 should give companies proceeding with a direct listing added protection from investor suits under § 11. However, the decision potentially makes direct listings less attractive for investors who now face greater exposure.

> The Supreme Court's decision offers companies another incentive to choose a direct listing over a traditional IPO, but risks alienating potential investors in direct listings by making it difficult, if not impossible, to bring § 11 claims.

The case arose after Slack conducted a direct listing on the NYSE in 2019. The plaintiff, Fiyyaz Pirani, bought Slack shares on the day the company went public and subsequently filed a class action lawsuit against the company when its stock price dropped. Mr. Pirani claimed that Slack had violated both §§ 11 and 12 of the Securities Act by filing a materially misleading registration statement and prospectus. Section 11 addresses registration statements and makes issuers strictly liable for any untrue statement of material fact or omission; any person acquiring "such security" under § 11 may sue the issuer. Section 12(a)(2), by contrast, deals with the prospectus or oral communications accompanying an offer or sale of securities and similarly creates liability for material misstatements or omissions.

Mr. Pirani argued that § 11 permits claims related not only to securities traceable to a defective registration statement, but also "other securities that bear some sort of minimal relationship to a defective registration statement." Traceability issues often arise in direct listings because, unlike a traditional IPO, they involve the sale of commingled securities that are both registered and unregistered. There is no "lockup period" in a direct listing, which in a traditional IPO bifurcates the sale of unregistered and registered securities. Thus, in a direct listing, it is difficult for investors to know whether they are purchasing shares issued pursuant to a registration statement. Given the lack of transparency in the direct listing process, Pirani argued for a liberal interpretation of traceability under § 11 that would encompass the shares he bought in Slack's direct listing. In his view, Slack could be liable under § 11 simply because its unregistered shares would not have been eligible for sale to the public if it had not issued a registration statement.

The Ninth Circuit agreed with Mr. Pirani and affirmed the district court's ruling denying Slack's motion to dismiss the complaint. The Supreme Court then reversed the Ninth Circuit, siding with Slack and finding that the use of the term "such security" in § 11 requires plaintiffs to show that the securities they hold are traceable to an allegedly false or misleading registration statement.

The Takeaway: The Supreme Court's decision provides some clarity to the relatively new direct listing process and avoids a broad interpretation of § 11 that may have complicated future direct listings. It also offers companies another incentive to choose a direct listing over a traditional IPO in order to limit potential § 11 claims. However, the decision risks alienating potential investors in direct listings by making it difficult, if not impossible, to bring § 11 claims. Following the Supreme Court's ruling in *Slack*, the lower courts will need to determine what facts a plaintiff must plead and prove to establish traceability and prevail on a § 11 claim. It also remains to be seen how the Ninth Circuit will approach Mr. Pirani's claim under § 12(a)(2)'s different standard.

The Second Circuit Revisits Whether Debt Instruments Are Securities

The Background: In *Kirschner v. J.P. Morgan*, the Second Circuit affirmed a district court's dismissal of state law securities claims on the ground that syndicated term loans are not "securities" under the federal securities laws. The case arose out of the defendants' issuance of a $1.775 billion syndicated term loan on behalf of a medical testing company, Millennium Laboratories LLC ("Millennium"). Before it could repay the notes, Millennium resolved an investigation brought by the Department of Justice for $256 million and subsequently filed for bankruptcy. The plaintiff then sued, claiming Millennium failed to disclose the existence of the DOJ investigation in the notes' prospectus. The district court dismissed the case after determining that the notes were not securities.

On appeal, the Second Circuit applied a four-factor test outlined by the U.S. Supreme Court in *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946), to whether an investment product is a security. That test considers (1) the motivations of the buyer and seller in the transaction, (2) the distribution of the instrument, (3) the reasonable expectations of the investing public, and (4) whether the instrument is governed by another regulatory scheme. The Second Circuit determined that, on balance, the factors weighed against treating the notes as securities because the notes were not widely available to the public, the parties to the transaction were sophisticated investors who understood that the notes were distinct from securities, and the existing regulatory scheme overseen by the Office of the Comptroller of the Currency, the Federal Reserve, and the Federal Deposit Insurance Corporation was sufficient.

The Second Circuit, however, left open the possibility that the result could be different depending on the facts, explaining that in a different scenario, the investing public could perceive an instrument labeled as a "syndicated term loan" to be a security.

The Second Circuit's decision may be most notable for the conspicuous absence of the SEC's involvement. Before ruling, the Second Circuit panel invited the SEC to weigh in on the topic, thereby giving the SEC the opportunity to take the position – consistent with its prior stance with respect to a similar debt instrument – that the term loans at issue should be treated as securities. To the surprise of many, after multiple delays, the SEC informed the Second Circuit that it would not be providing any position on whether the syndicated term loans at issue in the case were securities subject to the SEC's jurisdiction.

The Takeaway: The Second Circuit's holding that syndicated term loans are not securities is in many respects a faithful application of Supreme Court and Second Circuit precedents that broke no new ground. The SEC's apparent inability to take a formal position on that question stands out, however, as it is in direct contravention of its previous position regarding a similar debt instrument. Although it is risky to read too much into the SEC's silence, one possibility is that the SEC's

> The SEC's Commissioners may have diverging opinions as to whether syndicated term loans are "securities."

Commissioners had diverging opinions as to whether syndicated term loans are "securities." What remains to be seen is whether that lack of consensus will have any impact on the subject matter or scope of potential investigations undertaken by SEC staff. The safe bet, for now, is "no."

Supreme Court to Decide Case with Potentially Wide-Ranging Impacts on Regulatory Authority

The Background: The U.S. Supreme Court recently heard oral argument in *Securities and Exchange Commission v. Jarkesy*. The case stems from an enforcement action brought by the SEC against George Jarkesy and an investment adviser he controlled ("Jarkesy"). In 2011, the SEC opened an investigation into two hedge funds managed by Jarkesy and eventually brought an in-house action alleging that Jarkesy committed various forms of securities fraud. An SEC administrative law judge and the SEC Commissioners found him liable.

Jarkesy appealed to the Fifth Circuit, challenging, among other things, the constitutionality of the SEC's administrative courts. The Fifth Circuit held that the enforcement proceedings suffered from three constitutional defects. First, the Fifth Circuit found that the SEC's administrative court system violated the Seventh Amendment right to a jury trial because it involved the delegation of traditional legal claims to an administrative tribunal with no jury trial option. Second, the court held that the system involved an unconstitutional delegation of legislative power to the SEC because it failed to provide a "guiding intelligible principle," such as statutory language dictating which types of actions should or should not be heard by an SEC tribunal as opposed to an Article III court. Lastly, the Fifth Circuit found that the process for potential removal of SEC administrative law judges was too onerous and therefore interfered with the Constitutional requirement that the President must "take care that the laws be faithfully executed."

> *Jarkesy* follows a line of recent cases challenging the constitutionality of regulatory action, and the Court has shown an increased willingness to limit the regulatory authority of executive agencies based on separation of powers principles.

The Supreme Court agreed to hear the case and held oral argument on November 29. The justices focused their questioning on the first prong of the Fifth Circuit's holding – i.e., potential interference with defendants' jury trial rights. At least three justices appeared skeptical of the SEC's arguments on this score, whereas three others appeared sympathetic. The remaining three justices – Roberts, Kavanaugh, and Barrett – will thus likely determine the outcome.

The Takeaway: *Jarkesy* follows a line of recent cases challenging the constitutionality of regulatory action, and the Court has shown an increased willingness to limit the regulatory authority of executive agencies based on separation of powers principles. A Supreme Court decision affirming the Fifth Circuit on any of the three bases outlined in its opinion would limit the authority of regulatory agencies. But a decision based on the first or second bases could also have wide-ranging impacts on regulatory enforcement actions and agency authority more broadly by significantly limiting agencies' authority to regulate under existing statutes. The potential impact of the Court's decision will thus depend on the basis and scope of the Court's decision. We can expect an opinion from the Court towards the end of its term in late spring 2024.

Supreme Court Considers When Omissions Suffice as Securities Fraud

The Background: A half-truth is a whole lie, or so the adage goes. But if all a plaintiff can plead is silence, can it still prove a lie? That is the question posed by *MacQuarie Infrastructure Corp. v. Moab Partners, L.P.*, a putative securities class action currently pending before the Supreme Court.

The legal issue in *MacQuarie* is fairly technical, though its implications for securities class actions are potentially broad. The case concerns Item 303 of SEC Regulation S-K, which requires management of a public company to disclose "known trends or uncertainties that have had or that are reasonably likely to have a material favorable or unfavorable impact" on the company's financial performance going forward. In *MacQuarie*, the company experienced a stock drop after lowering its earnings guidance, in part due to reduced demand at one of its storage facilities as a result of a new United Nations regulation. The inevitable securities class actions followed. Among the theories plaintiffs alleged were that the company had failed to affirmatively disclose, as allegedly required by Item 303, that a material portion of its business would be impacted were the UN regulation to become effective. But rather than point to particular statements that partially addressed that topic and were thereby rendered misleading by the absence of full disclosure, plaintiffs instead simply alleged a total omission of *any* disclosure about the regulation or its

purported impact, arguing that the failure to comply with Item 303's disclosure obligations could alone be the basis for securities fraud.

The approach taken by the *MacQuarie* plaintiffs is increasingly common in stock drop suits. Federal securities law generally provides that omissions only give rise to an actionable fraud claim if the plaintiff can allege a preexisting duty to disclose. In most securities class actions, plaintiffs' firms try to address this requirement by asserting that a company was required to make additional disclosures in order to make something else it said—the proverbial "half-truth"—not misleading. Over time, the plaintiffs' bar has increasingly pointed to Item 303 as imposing a separate duty of disclosure that might not necessarily require a half-truth. Under that logic, and given Item 303's disclosure requirements, silence may be sufficient to state a claim. The viability of such a pleading in the face of a motion to dismiss has, however, varied by circuit, with the Second Circuit—where *MacQuarie* arose—among the more favorable, holding that failure to disclose a matter purportedly required by Item 303 can serve as the basis for a securities fraud claim. The Supreme Court granted certiorari given the circuit split.

The Supreme Court heard oral argument on January 16, 2024. Several members of the Court were openly skeptical of the plaintiffs' position, with some hinting that regardless of Item 303, an alleged omission alone—with no asserted "half-truth"—should be insufficient to state a securities fraud claim. Others raised questions about the extent to which Item 303 should be a basis for private plaintiff Exchange Act liability at all. A ruling is expected by June.

The Takeaway: All indications are that a Supreme Court ruling should be helpful to securities class action defendants. The question is to what extent. At least some members of the Court seem inclined to rein in the plaintiffs' bar's strategy of pursuing litigation – and exacting large settlements to boot – based on theories of what public companies did not say, but arguably should have, rather than for affirmative misstatements. On the other hand, the Court may simply narrow the circumstances in which private plaintiffs can sue based on purported violations of Item 303. Time will tell.

Developments in Restructuring

The Second Circuit Upholds Bankruptcy Courts' Authority to Approve Nonconsensual Third-Party Releases, but a U.S. Supreme Court Ruling on the Matter Is Expected This Term

The Background: In 2019, Purdue filed for bankruptcy to resolve thousands of claims related to the opioid epidemic arising from Purdue's role in developing, marketing, and selling OxyContin. Many of these lawsuits personally named members of the Sackler family, Purdue's owners, as defendants, but the Sacklers themselves did not file for bankruptcy. Generally, debtors are released from liability in bankruptcy, whereas non-debtor owners are not. In *In re Purdue Pharma L.P.*, the Second Circuit ruled that the Purdue Bankruptcy Court had the authority to approve third-party releases of the Sackler family as part of Purdue's plan of reorganization.

Tellingly, when agreeing to take up the *Purdue* matter, the Supreme Court framed the question for review as whether bankruptcy courts may approve releases that "extinguish[] claims held by nondebtors against nondebtor third parties, without the claimants' consent."

In its opinion, the Second Circuit held that whether to grant a third-party release is a fact-intensive question and laid out a new, seven-factor test, each factor of which courts must consider. The factors are (1) the identity of interests between the debtor and released parties, (2) whether the claims against the debtor and non-debtor are factually intertwined, (3) the scope of the third-party release, (4) how necessary the release is to the plan of reorganization, (5) whether the released parties contributed assets to the plan, (6) the number of creditors who approved the plan, and (7) whether the plan provides for the fair payment of enjoined claims.

The Supreme Court took up the case and heard oral argument on December 4. Tellingly, when agreeing to take up the matter, the Court framed the question for review as whether bankruptcy courts may approve releases that "extinguish[] claims held by nondebtors against nondebtor third parties, without the claimants' consent." Questions from at least some of the justices at oral argument reflect a similar skepticism about the legitimacy of such nonconsensual third-party releases, though it remains to be seen whether the Court might leave open the door for such releases in some (perhaps narrower) circumstances than those found in Purdue. A decision is expected by June 2024.

The Takeaway: The Second Circuit's ruling, if allowed to stand, would be a win for the bankruptcy system and underscore its value as a platform for global resolution of mass tort liability and other bankruptcy-adjacent litigation. The Supreme Court's decision to hear the matter creates significant uncertainty as to whether the ruling will stand, at least in full. Stay tuned.

Courts Offer Guidance on Unique Liability Management Transactions

The Background: Liability management transactions have become increasingly popular tools for companies facing financial stress, liquidity issues or upcoming debt maturity dates. Some of these transactions, which take a variety of forms, including a so-called “uptier” or “drop-down,” have been met with challenges from lenders excluded from newly-created credit facilities that give new debt priority over existing debt.

In a typical uptier transaction, a borrower partners with a majority of existing lenders to cause the reordering of payment priority, lien priority, or both, in favor of just the debt held by the majority lenders. In such cases, the majority lenders may agree to concessions in favor of the borrower, such as extending their debt maturities or providing additional capital. As a result of the transaction, the debt held by the minority lenders who did not participate in the transaction is subordinated. In a drop-down transaction, by contrast, the borrower sells, contributes, or transfers assets to a newly formed unrestricted subsidiary in accordance with the covenant baskets in the existing credit agreement, which has the effect of releasing the existing lenders’ liens on those assets. The unrestricted subsidiary then uses those assets to secure new indebtedness that is senior to the debt in the original agreement.

The caselaw with respect to liability management transactions is evolving, though two notable trends stand out. First, disputes over the permissibility of such transactions under the applicable credit documents often focus on a few key provisions addressing the quantum of lender approval that is necessary for potential modifications or amendments to the intra-creditor relationship. These provisions often use terms well-known to finance lawyers, such as “open market purchase,” that are less familiar to a judiciary not steeped in market finance terms-of-art. Minority lender claims have, in some instances, been permitted to progress into discovery over concern that such terms are ambiguous and capable of multiple interpretations. Second, the implied covenant of good faith and fair dealing is alive and well, and has been invoked in complaints filed by minority lenders in several of the actions. As a result, even transactions that strictly comply with credit agreement terms may, in some instances, still be subject to challenge apparently out of fear that such transactions may comply with the letter but not the spirit of the intra-creditor relationship. Although such claims may not ultimately survive, the costs associated with discovery in such cases counsels in favor of close attention both to the language of the credit agreement as well as the overall narrative that may come into play in litigation.

Disputes over the permissibility of such liability management transactions under the applicable credit documents often focus on a few key provisions addressing the quantum of lender approval that is necessary for potential modifications or amendments to the intra-creditor relationship. These provisions often use terms well-known to finance lawyers that are less familiar to a judiciary not steeped in market finance terms-of-art.

The Takeaway: Liability management transactions may well be contested, but recent decisions have shown that carefully crafted, unambiguous agreements can and do survive judicial scrutiny. In reviewing challenges to liability management transactions, courts have carefully compared the facts of the case to the terms of the relevant credit agreement. Thus far, cases challenging uptier transactions in bankruptcy court have resulted in favorable outcomes for the majority lenders and debtors, while courts in other forums have been more inclined to allow discovery out of concern for minority lender rights. As these cases and others involving liability management transactions continue to be litigated, stay tuned for more decisions likely to impact the calculus of borrowers and creditors when entering into credit facilities or weighing unique financing options.

Developments in General Business Guidance

Recently Enacted New York Law Has Potential Implications for Recordkeeping Practices

The Background: On September 14, 2023, New York Governor Kathy Hochul signed into law a bill (A836) that prohibits employers, in certain circumstances, from requesting or requiring access to employee personal accounts such as email, text and mobile apps like WhatsApp through electronic devices. A836 also prohibits employers from discharging, disciplining, or failing to hire individuals who refuse to provide such access.

The law, which goes into effect on March 12, 2024, has led some to speculate that it may impede private equity firms and other registered investment advisers from archiving

Sponsors should, however, continue to carefully evaluate the scope of their capture programs to ensure compliance, including, for example, by ensuring that employees receive notice regarding the potential need for access to personal accounts that are also used for business purposes.

communications consistent with Rule 204-2(a)(7) of the Advisers Act (the "Recordkeeping Rule"). These concerns have been heightened by the SEC's ongoing electronic communications sweep, in which the SEC has imposed over $1.5 billion in fines on over 40 registrants for their failure to retain business communications made through text messages and other electronic messaging applications, often conducted using personal devices. The sweep has caused some advisers to enhance their policies and deploy technological solutions aimed at capturing various forms of electronic communications, including on personally owned devices. However, A836 is limited in scope and provides important exceptions that together provide a pathway for advisers to meet the requirements of the Recordkeeping Rule without running afoul of the New York law.

In all cases, the restriction only applies to access to personal accounts, which exclude accounts utilized for business purposes. A836 does not restrict the collection of communications made using business applications, even if they are installed on personal devices. Likewise, A836 does not apply to mixed use accounts used by an employee for both business and personal communications. "Personal account" is expressly defined as an account or profile "used by an employee or an applicant *exclusively for personal purposes*" (emphasis added). A836 also contains language making clear that it does not apply to employer-provisioned accounts used for business purposes if the employee was informed of the employer's right to require access, which should ensure that an employer's ability to access and monitor corporate email accounts remains undisturbed. In this regard, the law critically notes that employers may continue to comply with any preexisting duty to "monitor or retain employee communications [] established under federal law or by a self regulatory organization."

The Takeaway: While A836 may impose certain hurdles to archiving, which merit careful consideration in designing and deploying capture solutions, private equity sponsors and other registered advisers can still comply with the Recordkeeping Rule without running afoul of the New York law. Sponsors should, however, continue to carefully evaluate the scope of their capture programs to ensure compliance, including, for example, by ensuring that employees receive notice regarding the potential need for access to personal accounts that are also used for business purposes.

The U.S. Supreme Court Rules Pennsylvania Consent Jurisdiction Statute Does Not Violate the 14th Amendment

The Background: As part of its business registration statute, Pennsylvania requires out-of-state corporations registering to do business within the state to submit to the jurisdiction of its courts for all matters—even if they are incorporated or headquartered in other jurisdictions. Recently, in *Mallory v. Norfolk Southern Railway* a plurality of the U.S. Supreme Court decided that the Pennsylvania statute does not violate due process.

A Virginia-based former employee of Norfolk Southern Railway Co., a corporation that was incorporated and headquartered in Virginia, sued the corporation in Pennsylvania for injuries that occurred in Ohio and Virginia. The corporation argued that the courts of Pennsylvania—plaintiff's chosen forum—lacked personal jurisdiction over the defendant company. However, the plaintiff asserted that jurisdiction was proper because Norfolk had consented to jurisdiction in Pennsylvania by registering to do business in that state. The Commonwealth of Pennsylvania requires all foreign corporations (i.e., companies that are incorporated and/or headquartered in another state) to "register" with the Pennsylvania Department of State in order to do business within that state. One of the requirements of such registration is that the foreign corporation agree to be subject to the jurisdiction of courts in Pennsylvania. On the basis of *Daimler AG v. Bauman* and *International Shoe*, the Pennsylvania Supreme Court agreed with the trial court that the statute violated Norfolk's due process rights.

Corporations should be aware where they are registered to do business and the statutes of those states. Several states interpret their registration statutes to confer general jurisdiction over registered entities who may not otherwise be domiciled in that jurisdiction.

In a 4-1-4 decision, in *Mallory v. Norfolk Southern Railway*, U.S. Supreme Court disagreed. In answering the narrow question of whether the Due Process Clause of the 14th Amendment prohibits a state from requiring an out-of-state corporation to consent to personal jurisdiction when registering to do business there, the Supreme Court reversed and remanded the decision. According to the plurality decision, *International Shoe's* minimum contacts test expanded rather than contracted the modes of obtaining personal jurisdiction. The Court held that the nearly identical case of *Pennsylvania Fire*—a pre-*International Shoe* decision—controlled the issue of consent to jurisdiction through business registration. As a result, the plurality ruled in the former employee's favor, and upheld the Pennsylvania law requiring foreign corporations to consent to the jurisdiction of Pennsylvania courts when registering to do business in that state. However, other members of the Court disagreed with the rationale, and Justice Alito issued a particularly notable concurring opinion—in which he suggested that Pennsylvania's coercive business registration statute may unreasonably restrict interstate business and violate the dormant commerce clause.

The Takeaway: Corporations should be aware of where they are registered to do business and the statutes of those states. Several states interpret their registration statutes to confer general jurisdiction over registered entities who may not otherwise be domiciled in that jurisdiction. However, as suggested by Justice Alito's concurrence, the Court may not be inclined to broadly construe similar statutes in other states and may have opened the door to a challenge to such statutes based on the interstate commerce clause.

Looking Ahead

2024 promises to be an eventful year for private equity litigation. Antitrust regulators and class action lawyers alike have set their sights on private equity practices ranging from acquisition strategy to board membership and information sharing. And the Delaware Court of Chancery is set to rule on a number of issues with potentially far-reaching consequences for sponsors, including the validity of common provisions of stockholder agreements and the applicability of MFW to certain controller transactions.

For more information on any of these developments, or if you would like to speak with someone with particular expertise in any of these areas, please contact your regular Ropes & Gray advisor or any member of the Ropes & Gray litigation department.

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