Fourth Quarter 2015

The Ropes Recap

Mergers & Acquisition Law News

A quarterly recap of mergers and acquisition law news from the M&A team at Ropes & Gray LLP.

Contents

News from the Courts 2

The Demise of Disclosure-Only Settlements? The Court of Chancery Outlines a New Regime. 2

Delaware Supreme Court Upholds Court of Chancery Rulings in the Rural/Metro Case.......... 3

Court of Chancery Reverses Finding of Financial Advisor Aiding and Abetting Liability for Lack of an Underlying Breach 5

Hostile Bid Prevented by Confidentiality Agreement 6

Delaware Court of Chancery Invalidates Charter & Bylaw Provisions Allowing Only "For Cause" Director Removal Where Board Is Unclassified 8

Oregon Supreme Court Enforces Delaware Exclusive Forum Selection Bylaw 9

Delaware Supreme Court Upholds Award of Expectation Damages in Breach of Contract Claim 10

Delaware Court of Chancery Opinion Provides Guidance on the Interpretation of Contractual Provisions Relating to Fraud-Based Claims 11

Delaware Supreme Court Draws Inference that Controller's Long-Term Friend Is Not Independent 13

Delaware Court of Chancery Binds Investor to Contractually Mandated Fair Value Assessment Determination 13

Contributors 15

News from the Courts

The Demise of Disclosure-Only Settlements? The Court of Chancery Outlines a New Regime.

In a recent opinion, Chancellor Bouchard of the Delaware Court of Chancery reiterated the Court of Chancery's belief that settlements of M&A litigation where the target company agrees to issue supplemental public disclosures in exchange for a global release of all claims relating to the transaction "rarely yield genuine benefits for stockholders and threaten the loss of potentially valuable claims that have not been investigated with rigor" and that, going forward, the Court will be "vigilant in scrutinizing the 'give' and the 'get' of such settlements to ensure they are genuinely fair and reasonable."

It is well-recognized that, for many years, nearly all public company M&A transactions precipitated litigation. Many of those actions were settled when the target company agreed to supplement its public disclosures concerning the transaction to add technical information that could potentially be helpful to stockholders in determining how to vote on the transaction. In exchange for issuing those supplemental disclosures, the stockholder plaintiffs would grant the defendants broad releases of all claims that were *or could have been* filed in connection with the transaction – including claims unrelated to the adequacy of the disclosures at issue in the case. The plaintiffs' counsel would then seek a fee for having conferred a benefit to the company's stockholders. Academics, practitioners, and even certain courts denounced these "merger tax" lawsuits.

However, in recent decisions, the Court of Chancery has expressed reluctance to approve disclosure settlements in transactional litigation. Here, Chancellor Bouchard went further and rejected a proposed disclosure-only settlement of stockholder litigation challenging the acquisition of Trulia, Inc. by Zillow, Inc. In so doing, Chancellor Bouchard held that the proposed settlement terms, which involved immaterial supplemental disclosures concerning the work performed by Trulia's financial advisor, did not provide Trulia's stockholders with adequate consideration for the released claims. Chancellor Bouchard also held that, going forward, disclosure claims should be raised either in a preliminary injunction motion or through a mootness application for attorneys' fees if a company voluntarily moots a stockholder plaintiff's disclosure claim by disclosing the relevant information, each of which procedural vehicles would result in the parties to litigation advocating in an adversarial context the true value of the supplemental discloses.

This opinion, particularly following the Court's prior rulings concerning disclosure settlements, likely signals the end of "disclosure only" settlements, which may have a material impact on the number of stockholder lawsuits filed in connection with normal course M&A transactions. Indeed, it has been publicly reported that in the fourth quarter of 2015 after the Court of Chancery has become increasingly hostile to unremarkable disclosure-only settlements,

stockholder lawsuits were filed in connection with only 21.4% of public company transactions – far lower than the 90% and more that had become the norm.

(*In re Trulia, Inc. Stockholder Litigation*, C.A. No. 10020-CB (Del. Ch. Jan. 22, 2016))

Delaware Supreme Court Upholds Court of Chancery Rulings in the Rural/Metro Case

The *Ropes Recap* for the First Quarter of 2014 reported on the Delaware Court of Chancery's March 2014 opinion in *In Re Rural Metro Corporation Stockholders Litigation*, in which the Court of Chancery held that Rural/Metro's financial adviser, RBC, was liable to a class of Rural/Metro stockholders for aiding and abetting a breach of fiduciary duty by Rural/Metro board of directors in connection with the acquisition of Rural/Metro by Warburg Pincus. Additionally, the *Ropes Recap* for the Third Quarter of 2014 reported that the Court of Chancery had awarded $75.8 million in damages to the class. RBC appealed these rulings to the Delaware Supreme Court and, on November 30, 2015, the Supreme Court issued its ruling upholding the Court of Chancery's decisions.

The Supreme Court found that the Court of Chancery's factual findings were adequately supported by the trial record. Specifically, the Court of Chancery had found that Rural/Metro had commenced a sales process without authorization from the full board of directors and that the sales process was shaped by RBC in a manner designed to benefit RBC by creating potential opportunities for RBC both to participate in the financing of a contemporaneous acquisition of EMS, a Rural/Metro competitor, and to provide financing to Warburg Pincus, the ultimate acquirer of Rural/Metro.

The Supreme Court also upheld several key legal rulings made by the Court of Chancery:

- *Application of Revlon scrutiny.* RBC argued that the Court of Chancery erred in applying *Revlon*'s enhanced scrutiny test to the entire Rural/Metro sale process (including the unauthorized commencement of the sale process). RBC argued such scrutiny should apply only to the board's decision to select Warburg Pincus as the winning bidder. The Supreme Court rejected this argument, finding that a Special Committee had initiated an active bidding process to sell the Company months before the final board approval, and the board subsequently ratified the Special Committee's actions. Moreover, the Supreme Court noted that delaying the application of *Revlon* to the endpoint of a sale process – when the final decision was made to sell the company -- would potentially incentivize boards to avoid active engagement in a transaction until the end of a sale process. Finally, the Supreme Court noted that the key flaws in the sale process occurred during the period between the initiation of that process by the Special Committee and board approval of the transaction, and to find that *Revlon* was not applicable during this period would undermine the *Revlon* inquiry, which required the court to "examine whether a board's overall course of action was reasonable."

- *Reasonableness of Board Conduct*. Applying the *Revlon* standard, the Supreme Court affirmed the Court of Chancery's finding that the board's conduct fell outside of the range of reasonableness required by *Revlon* in the context of a sale of the company. The Supreme Court found that RBC had a conflict of interest arising from designing the sale process to enable it to seek to finance the acquisition of EMS and then, later, Warburg Pincus, the ultimate acquirer of Rural/Metro, which the Court of Chancery found were not fully disclosed to the board. The Supreme Court noted that, although a board can consent to such conflicts, "directors need to be active and reasonably informed when overseeing the sale process, including identifying and responding to actual or potential conflicts of interest". The failure of the board to manage such conflicts, combined with their failure to be adequately informed as to the Company's value (having received a valuation report from RBC less than two hours before the meeting at which the transaction was approved) led the Supreme Court to affirm the Court of Chancery's finding that the board breached its fiduciary duties.
- *Disclosure Failures.* The Supreme Court also upheld the Court of Chancery's findings that the Rural/Metro board failed to satisfy its duty of disclosure to the Company's stockholders. Of particular note was the Court's finding that the proxy statement failed to fully disclose how RBC intended to use the Rural/Metro sale process to obtain fees for financing activities (both in connection with a contemporaneous transaction involving a competitor of the Company, and by providing financing to Warburg Pincus). The Court dismissed as inadequate a generic disclosure in the proxy statement that RBC had the right to offer staple financing in light of, among other things, RBC's efforts to obtain a financing role for Warburg Pincus, especially towards the end of the sale process.
- *Aider and abettor liability*. The Supreme Court also affirmed the Court of Chancery's holding that RBC was liable as an aider and abettor of the board's fiduciary breaches, emphasizing in particular RBC's role in *intentionally* misleading the board and in creating an "informational vacuum" that caused the board to breach its fiduciary duties. In so finding, the Court rejected arguments that attaching aider and abettor liability to a board's unintentional breach of duty would create an imbalance of responsibilities to the detriment of the non-fiduciary, noting that aider and abettor liability requires *scienter* of the aider and abettor, which makes such liability difficult to prove.

Importantly for financial advisors, the Supreme Court rejected the Court of Chancery's view that financial advisors function as "gatekeepers" in M&A transactions. Instead, the Supreme Court noted that the services provided by a financial advisor are primarily contractual in nature and can vary from one transaction to another, and that it is for a board to determine, in negotiation with the financial advisor, the scope and terms of the financial advisor's engagement. According to the Supreme Court, "[t]he banker is under an obligation not to act in a manner that is contrary to the interests of the board of directors, thereby undermining the very advice that it knows the directors will be relying upon in their decision making processes." As a result, it is not the case

that any failure by a financial advisor to prevent directors from breaching their duty of care gives rise to an aiding and abetting claim against the advisor.

(*RBC Capital Markets, LLC v. Joanna Jervis*, No. 140, 2015 (Del. 2015))

Court of Chancery Reverses Finding of Financial Advisor Aiding and Abetting Liability for Lack of an Underlying Breach

On October 1, 2015, in *In re Zale Corporation Stockholders Litigation*, the Delaware Court of Chancery refused to dismiss a claim against Zale Corporation's financial advisor asserting that the advisor had aided and abetted an alleged breach of the duty of care by Zale board. However, following the Delaware Supreme Court's decision in *Corwin v. KKR Financial Holdings, Inc.*, which we discussed in the third quarter of 2015, and which held that a transaction approved by uncoerced and fully-informed shareholder results in business judgment rule review, the Court reversed its earlier decision and dismissed the claim against the advisor, concluding that the Court had incorrectly applied the *Revlon* enhanced scrutiny standard of review in the initial decision, rather than the business judgment rule standard of review mandated by the *KKR Financial* decision.

The plaintiffs' complaint alleged that Zale's directors breached their duty of care by retaining the advisor in connection with Zale's sale to Signet Jewelers without conducting an adequate investigation into its potential conflicts, and further alleged that the advisor had aided and abetted those breaches. The Zale board had engaged the advisor after the advisor had represented that it had no conflicts and a limited relationship with Signet. However, the advisor had received $2 million in fees from Signet in the prior two years and a managing partner on the Zale engagement had made a presentation to Signet concerning a possible acquisition of Zale—including a maximum price that Signet should be willing to pay in such a transaction—shortly before being engaged by Zale. The Zale board did not learn about that presentation until after the merger agreement was signed.

The Court of Chancery initially determined that *Revlon* was the appropriate standard of review under which to evaluate the plaintiffs' claims against Zale's directors. Under a *Revlon* analysis, the Court found it reasonably conceivable that the Zale directors' reliance on the advisor's representations about its relationship with Signet without further investigation "could constitute a breach of their duty of care in this *Revlon* context." The Court stated that board members have a duty to detect a preexisting conflict when engaging a financial advisor, which it could satisfy by asking probing questions about prior relationships and negotiating for representations and warranties in the engagement letter. The Court further determined that it was reasonably conceivable that the advisor's alleged failure to disclose its presentation to Signet, where it proposed making a bid to acquire Zale for a purchase price in the range of $17-$21 per Zale share, adversely impacted the advisor's and, consequently, the Board's ability to seek a higher per share price.

The Court ultimately determined that the exculpatory provision in Zale's certificate of incorporation shielded its directors from monetary liability for any breach of their duty of care; however, the Court held that the plaintiffs had adequately stated a claim against the advisor for aiding and abetting those breaches.

Immediately following the Delaware Supreme Court's ruling in *KKR Financial*, the advisor moved for reconsideration of the Court of Chancery's decision, claiming that, consistent with *KKR Financial*, the Court should have applied the business judgment standard of review rather than *Revlon* enhanced scrutiny when determining whether the Zale directors had breached their duty of care.

On reconsideration, the Court determined that, in light of *KKR Financial*, the business judgment rule was the appropriate standard of review because a majority of Zale's disinterested stockholders had approved the merger in a fully informed vote.

The Court concluded that "when reviewing a board of directors' actions during a merger process after the merger has been approved by a majority of disinterested stockholders in a fully informed vote, the standard for finding a breach of the duty of care under [the business judgment rule] is gross negligence." The Court then applied the gross negligence standard to the allegations presented in the complaint and determined that it was not reasonably conceivable that the Zale directors breached their duty of care by acting in a grossly negligent manner with respect to their engagement of advisor. With "no basis for a predicate fiduciary duty breach," the court held that the plaintiffs had not adequately pled that the advisor had any breach by the Zale directors.

(*In re Zale Corporation Stockholders Litigation*, C.A. No. 9388-VCP (Del. Ch. Oct. 29, 2015)).

Hostile Bid Prevented by Confidentiality Agreement

On November 18, the Superior Court of California in *Depomed Inc., v. Horizon Pharma*, *PLC*, issued a preliminary injunction prohibiting Horizon Pharma, PLC from pursing its hostile bid to acquire Depomed, Inc.

By way of background, Horizon and Depomed had both participated in an auction process during 2014-2015 to acquire the rights to a pain relief drug called Nucynta, which was at the time owned by Janssen (a subsidiary of Johnson & Johnson). Depomed emerged from the bidding as the winner and acquired the rights to Nucynta from Janssen in April 2015. Prior to such auction process, Horizon and Janssen had entered into a mutual confidentiality agreement regarding "a contemplated co-promotion of products", with Janssen to promote Horizon's drug Duexis and Horizon to promote Nucynta. The confidentiality agreement protected confidential information regarding "a potential commercial business arrangement, specifically a co-promotion

arrangement whereby HORIZON would co-promote JANSSEN's NUCYNTA® drug product in the United States." Janssen ultimately elected not to pursue that co-promotion and notified Horizon of such decision in early 2014. In connection with the auction process, Horizon and Janssen did not enter into a new confidentiality agreement. Although Horizon suggested to Janssen that the terms of the confidentiality agreement be amended to specifically address the new auction process, no amendment was ever formally made and the parties did not enter into a separate confidentiality agreement. However, Depomed submitted evidence that subsequent correspondence between Horizon and Janssen indicated that the two intended that the confidentiality agreement would nonetheless apply to the auction process.

In July 2015, Horizon launched a hostile bid to acquire Depomed. Depomed sought injunctive relief and claimed that Horizon was improperly using confidential information it obtained from Janssen when it participated in the auction for Nucynta. Although Horizon claimed that (i) Horizon's obligations of confidentiality were limited to discussions related to the potential co-promotion transaction, (ii) it never breached the agreement in its pursuit of the hostile bid, and (iii) Depomed lacked standing because it had never acquired Janssen's rights under the confidentiality agreement since the confidentiality was not specifically identified as a transferred asset under the purchase agreement, the Court found Depomed's claims were likely to prevail and it granted the preliminary injunction. Horizon withdrew its $1 billion hostile bid following the ruling.

This decision bears great resemblance to the 2012 *Martin Marietta* decision (*Martin Marietta Inc. v. Vulcan Materials Co*., 56 A.3d 1072 (Del Ch. 2012)) where the Delaware Court of Chancery blocked a hostile bid because of a violation of a confidentiality agreement, and provides a couple of important reminders for a prospective acquiror of a business:

- It is important for a company to carefully monitor the confidentiality agreements that it enters into in the course of its business, especially those relating to the evaluation of potential acquisitions and other business ventures. In particular, a company should keep track of the counterparties to which it owes obligations regarding confidentiality, as well as the use restrictions for which it may use the confidential information it receives.

- In anticipation of the potential need to assign rights under confidentiality agreements to a future acquiror of all or a part of its business, a potential seller should consider including in the ordinary course a provision in its confidentiality agreements expressly providing for the assignability, in whole or in part, of such seller's rights under the confidentiality agreement to the purchaser of the assets to which such agreement relates, without the need for obtaining the consent of the other party to the confidentiality agreement. In doing so, consider the scope of information to be disclosed as part of the sale process and whether any such

information relates in whole or in part to retained assets to ensure that rights are not inadvertently assigned with respect to any retained assets in a sale of only a portion of the seller's business.

(*Depomed Inc., v. Horizon Pharma*, *PLC*, No. 1:15-cv-283834 (Cal. Super. Ct. Nov. 18, 2015)).

Delaware Court of Chancery Invalidates Charter & Bylaw Provisions Allowing Only "For Cause" Director Removal Where Board Is Unclassified

In December 2015, the Delaware Court of Chancery invalidated provisions of VAALCO Energy, Inc.'s corporate charter and bylaws that purported to limit the removal of VAALCO directors to "for cause" removals even though the VAALCO board was not classified (*i.e.*, the VAALCO directors are elected on an annual basis). Vice Chancellor Laster held that those provisions violated Section 141(k) of the Delaware General Corporation Law, which requires that any director may be removed "with or without cause" by a majority vote of the corporation's stockholders, except where the board is classified or the directors are elected by cumulative voting.

Here, the "for cause" removal provisions in VAALCO's corporate charter and bylaws were adopted at a time when its board was classified. When stockholders voted to de-classify the board in 2009, there was no corresponding amendment to the company's organizational documents. Stockholders ultimately challenged the validity of those provisions. VAALCO and its directors moved to dismiss those claims, arguing that "numerous" (at least 175) other corporations had similar provisions. Vice Chancellor Laster rejected that argument, noting that those corporations constituted less than 5 percent of public companies, and stating that an "all the other kids are doing it" argument did not survive judicial scrutiny. The Court also rejected VAALCO's argument that Section 141(d) of the DGCL, which states that a board may "be divided into 1, 2 or 3 classes," creates the concept of a single-class classified board. The Court therefore rejected VAALCO's arguments, and entered a declaratory judgment holding the provisions of the corporation's charter and bylaws which permit only "for cause" removals to be invalid.

This ruling shows that the directors of Delaware corporations that have declassified their boards should not rely on any "for cause only" restrictions to the removal of directors as part of its defensive profile, as the Delaware Courts will not respect such restriction.

(*In re VAALCO Energy, Inc. Stockholder Litigation*, C.A. No. 11775-VCL (Del. Ch. Dec. 21, 2015))

Oregon Supreme Court Enforces Delaware Exclusive Forum Selection Bylaw

In recent years, many courts across the country—including courts in California, Illinois, Louisiana, New York, and Texas—have followed the lead of the Delaware Court of Chancery and held that exclusive forum selection bylaws are valid and enforceable. One notable exception to that trend was an August 2014 opinion from an Oregon trial court (which was reported on in the third quarter 2014 edition of the *Ropes Recap*), which refused to enforce a Delaware exclusive forum selection bylaw that would have barred an Oregon litigation challenging a merger between TriQuint Semiconductor, Inc. and RF Micro Devices, Inc. In a recent opinion, the Oregon Supreme Court reversed that trial court ruling, holding that TriQuint's exclusive forum selection bylaw was valid and enforceable, and compelled stockholders challenging that transaction to pursue their claims in Delaware.

In reversing the trial court's ruling, the Oregon Supreme Court held that the TriQuint exclusive forum selection bylaw was valid under both Delaware and Oregon law. The Court first held that, as stated by the Delaware Court of Chancery in its opinions in *Chevron* and *First Citizens*, Delaware corporations are generally permitted to adopt exclusive forum selection bylaws (as further memorialized in DGCL 115). The court proceeded to hold that the forum selection bylaw adopted by TriQuint was enforceable, even though it was adopted two days prior to the public announcement of the TriQuint/RF merger and the plaintiffs had claimed that it was enacted for an improper purpose. In so holding, the Supreme Court rejected the trial court's conclusion that the bylaw was invalid because the TriQuint stockholders did not have an adequate opportunity to reverse the bylaw by vote. The court also rejected the trial court's reliance on the 1971 Delaware Supreme Court decision in *Schnell v. Chris-Craft Industries, Inc.*, holding that the TriQuint bylaw did not prevent TriQuint's stockholders from challenging the merger, but only dictated the forum in which they could do so. Here, the Supreme Court noted that exclusive forum selection bylaws benefit corporations and their stockholders by eliminating the costs incurred by "a multiplicity of suits in various states," and that the plaintiffs would not be harmed by litigating their claims in Delaware.

The Supreme Court also held that TriQuint's forum selection bylaw was valid under Oregon law, stating that comity and respect for Delaware corporate law mandated deference to Delaware law absent a compelling public policy to the contrary. There, the Court went on to state that it could "discern no public policy sufficient to overcome" comity-driven deference to the "internal relationship" between TriQuint and its stockholders and their concern of subjecting a Delaware corporation to "inconsistent regulation in different forums."

This opinion warrants mention because it overturned one of the few cases upon which stockholder plaintiffs challenging exclusive forum selection bylaws could rely, and provides yet another case permitting the adoption and enforcement of such bylaws. The opinion also validated an exclusive forum selection bylaw adopted a mere two days prior to the public announcement of

a change in control transaction, providing support for the argument that such bylaws do not need to be enacted on a "clear day" in order to be enforceable.

(*Roberts v. TriQuint Semiconductor, Inc.*, 358 Or. 413 (Or. 2015))

Delaware Supreme Court Upholds Award of Expectation Damages in Breach of Contract Claim

In *SIGA Technologies, Inc. v. PharmAthene, Inc.,* the Delaware Supreme Court upheld a $113 million judgment against SIGA Technologies Inc. over a failed merger and licensing agreement, in an opinion that provides useful guidance to practitioners as to the recovery of expectation damages.

This decision was the second time the Supreme Court reviewed the case, having previously remanded the case back to the Court of Chancery for further review of the appropriate damages. The case arose from the failed 2006 merger between SIGA Technologies and PharmAthene. The merger agreement provided that if the merger failed to close, the parties would negotiate in good faith a license agreement consistent with a non-binding term sheet previously agreed upon by the parties for the licensing of ST-246, a drug owned by SIGA Technologies for the treatment of smallpox. PharmAthene was unable to negotiate a license agreement with SIGA and sued SIGA for breaching its obligation to negotiate the license agreement in good faith consistent with the term sheet. The Court of Chancery initially determined that SIGA did not negotiate in good faith and breached its agreement to do so, but it was unable to award expectation damages because such an amount was "speculative and too uncertain, contingent, and conjectural" and it awarded PharmAthene an equitable payment stream based on SIGA's future profits. On review the Supreme Court looked to New York law for guidance and determined that the agreement at issue was a "Type II" agreement (i.e. "preliminary agreements [where the parties] 'agree on certain major terms, but leave other terms open for further negotiation'") which entitled PharmAthene to recover expectation damages. The Supreme Court remanded the case back to the Court of Chancery for "reconsideration of the damages." On remand the Court of Chancery determined that PharmAthene was entitled to $113 million in expectation damages, and SIGA appealed the decision.

The Supreme Court upheld the Court of Chancery's determination of the damages and held that the Court of Chancery's *de novo* review of damages was done in accordance with the Supreme Court's instructions from its earlier decision. The Court relied heavily on the fact that SIGA had, by its breach of the agreement, caused much of the uncertainty as to proper amount of damages. The Court stated that the standard for evaluating expectation damages is based upon "the reasonable expectations of the parties *ex ante*" and is measured by "the amount of money that would put the promisee in the same position as if the promisor had performed the contract." Although the injured party must prove that it was actually damaged with reasonable certainty, the amount of damages can be estimated. The Court stated that "the injured party need

not establish the amount of damages with precise certainty 'where the wrong has been proven and injury established.'" According to the Second Restatement of Contracts (quoted in the Court's opinion), "where the existence of damages is certain, and the only uncertainty relates to the amount … the burden of uncertainty as to the amount of damages falls upon the wrongdoer." The Supreme Court noted that the Court of Chancery was correct in resolving uncertainties about costs against SIGA when the uncertainties would have been avoided if SIGA had negotiated the license agreement in good faith. The willfulness of the breaching party "is a relevant factor in deciding the quantum of proof required to establish the damages amount" and the Court of Chancery's use of willfulness in deciding to require a lesser degree of certainty was appropriate. A court may consider post-breach evidence to confirm its conclusions as to the parties' reasonable expectations at the time of breach.

It should be noted that the Supreme Court's decision was a rare non-unanimous decision, and Justice Karen L. Valihura authored a lengthy dissent in which she disagreed with many of the majority's conclusions and pointed out that the majority's decision would move Delaware out of alignment with other major commercial jurisdictions such as California and New York by eroding the requirement that damages be proved with reasonable certainty.

(*Siga Technologies, Inc. v. PharmAthene, Inc.*, Del. Supr., No. 20, 2015 (December 28, 2015)).

Delaware Court of Chancery Opinion Provides Guidance on the Interpretation of Contractual Provisions Relating to Fraud-Based Claims

On November 24, 2015, Vice Chancellor Laster issued an informative opinion on a motion to dismiss allegations of fraud under Delaware law in *Prairie Capital vs. Incline Equity Partners*. The case involved a sponsor to sponsor sale of Prairie Capital's portfolio company Double E Company to Incline Equity Partners. Incline alleged that the CEO and CFO of the company (with Prairie Capital's knowledge and approval) committed fraud by fabricating sales to achieve certain financial targets that Incline required to close the acquisition. Incline also made an indemnification claim and sought to recover $500,000 held in escrow for indemnification obligations. Although Vice Chancellor Laster's opinion was only made on a motion to dismiss, the opinion provides useful guidance for drafting and negotiating fraud provisions and serves as an important reminder of the importance for buyers and sellers to clearly define the scope of potential fraud-based claims.

The key takeaways from the opinion are as follows:

- ***Extra-contractual Representations.*** *There are no magic words when it comes to clearly establishing non-reliance.* The purchase agreement had an exclusive representations and warranties clause (stating that the buyer disclaimed any representations and warranties outside of the agreement) and an integration clause, but did not have a non-reliance clause (i.e. that the buyer has not relied on any representations outside of the

agreement). Vice Chancellor Laster found the combination of the exclusivity and integration clauses created a "clear anti-reliance clause" (even in the absence of a non-reliance clause) and he noted that "[t]ransaction planners can limit their risk by using tested formulations, but they do not need to employ magic words." As a result of determining that an anti-reliance clause existed, Vice Chancellor Laster dismissed any extra-contractual claims based on fraudulent misrepresentations.

- ***Extra-contractual Omissions.*** *Exclusive representation provisions could bar claims for fraudulent omissions or concealments beyond the four corners of the contract.* Incline argued that the exclusive representation provision should not bar claims for fraudulent omissions or concealments outside of the contract. Vice Chancellor Laster, however, noting how a misrepresentation claim can easily be flipped into an omission claim, held that a valid disclaimer of extra-contractual representations will also bar claims of extra-contractual omissions. Vice Chancellor Laster noted that this holding may be in disagreement with *TransDigm Inc. v. Alcoa Global Fasteners, Inc*. (Del. Ch. May 29, 2013) "[t]o the extent that *Transdigm* suggests that an agreement must use a magic word like 'omissions'." Given that this may not be settled law, practitioners should consider still using the word "omissions" or other language that clearly indicates that the seller is not making "any representation as to the accuracy or completeness" of the information provided.

- ***Exclusive Remedies.*** *Courts will likely read provisions relating to fraud taken as a whole.* Incline also argued that the exclusion of fraud in the indemnification provisions exclusive remedies provision should permit it to make an extra-contractual fraud claim. However, Vice Chancellor Laster determined that the exclusion of fraud meant only that the indemnification provisions are not the exclusive remedy in respect of fraud, but did not expand the universe of claims for fraud that can be made – in other words, he found that fraud claims were preserved, but could only be based on the representations and warranties in the agreement, because Incline had waived reliance (an essential element of a fraud claim) on anything outside the agreement.

- ***Claims Against Non-Parties (Directors, Officers & Controlling Sponsor).*** *D&O and secondary liability claims with a basis in fraud are possible.* Prairie and the officers of the company argued that they should not be liable because the representations in the agreement were made by the company and not by the officers or Prairie, but at the motion to dismiss stage Vice Chancellor Laster rejected this argument and permitted Incline to continue to pursue (i) the fraud claims against the officers of the company based upon the company's representations and warranties because an "officer actively participating in the fraud cannot escape personal liability on the ground that the officer was acting for the corporation" and (ii) the secondary liability claims (e.g. aiding and abetting) against

Prairie due to Prairie's involvement in the sale process and knowledge of the fraudulent behavior.

As a result of the foregoing, the claims for fraud based on representations and warranties in the agreement itself and certain contractual claims for indemnification were permitted to proceed past the motion to dismiss stage of litigation.

(*Prairie Capital III, L.P. v. Double E Holding Corp.*, C.A. No. 10127-VCL (Del. Ch. Nov. 24, 2015)).

Delaware Supreme Court Draws Inference that Controller's Long-Term Friend Is Not Independent

In a recent Delaware Supreme Court case, the Court found that, for purposes of demand excusal in a derivative action, there is a reasonable doubt about the independence of a director who has been a close personal friend and confidant of the chairman of the board for over 50 years, and whose job and other sources of income were linked to this friendship. The Supreme Court, in reversing the Court of Chancery, differentiated this long-standing bond, along with strong circumstantial evidence that the director's economic position was based on the friendship, from the "thin social-circle friendship" found in certain other Delaware cases where directors merely move in some of the same circles and where courts found that there was no reasonable doubt about directors' independence.

This decision shows that the Delaware Courts will continue to contextually analyze independence – while the fact that a director is an acquaintance of the controller is unlikely to support an inference that the director is conflicted, a close personal friendship could rebut the presumption of independence.

(*Delaware County Employees Retirement Fund v. Sanchez,* C.A. No. 9132-VCG (Del. Ch. Oct. 2, 2015)).

Delaware Court of Chancery Binds Investor to Contractually Mandated Fair Value Assessment Determination

In a recent opinion, Chancellor Bouchard of the Delaware Court of Chancery held that investors in an LLC were bound to a valuation made in good faith by a third party that the investors and the LLC had agreed would determine the value of the investors' shares.

In this case, two investors acquired shares in PECO Logistics, LLC. The investors acquired those units subject to an LLC agreement that gave them the right to "put" their shares to PECO after three years of ownership. The agreement further provided that if the investors exercised that put right, PECO would retain a nationally recognized valuation firm to assess the fair market value

of the investors' shares, and then repurchase those shares at that determined value. The LLC agreement also provided that PECO and the investors would be bound by the valuation firm's determination. The investors exercised their put right, and PECO retained Duff & Phelps to value the investors' shares, with no objection from the investors' board designee. Applying the valuation methodologies specified in the LLC agreement, Duff & Phelps assessed the total equity value of the shares to be approximately $93 million. The investors rejected that valuation as too low, and refused to put their shares back to PECO at that value. PECO then initiated a declaratory judgment action to force the investors to put their shares at that value.

The investors complained that the Duff & Phelps valuation was conducted improperly. The court rejected that argument, holding that the court should "defer to the judgment calls Duff & Phelps had to make to apply the valuation formula in a sensible manner" because the parties had already agreed that the firm's determination would be binding without any mechanism for review. In the absence of a contractual mechanism for review, the court could only focus on whether the valuation somehow breached the implied covenant of good faith and fair dealing inherent in every contract governed by Delaware law or was inconsistent with any prescribed valuation mechanisms and procedures under the agreement. Since Duff & Phelps' independence was not in question, and their other complaints with the valuation were critiques of reasonable judgment calls not inconsistent with the agreement, the Court found that the valuation did not violate the covenant of good faith and fair dealing.

Ultimately, the court's opinion underscores the deference that Delaware courts will give to valuation assessments and other private determinations of this kind where sophisticated parties have agreed that such determinations will be final and binding on all parties. Absent some evidence of manipulation or bad faith, the courts will likely hold the parties to the benefit of their bargain.

(*PECO Logistics, LLC v. Walnut Investment Partners, L.P.*, C.A. NO. 9978-CB (Del. Ch. Dec. 30, 2015))

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