Second Half 2016

The Ropes Recap

Mergers & Acquisitions Law News

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

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NEWS FROM THE COURTS

Delaware Court of Chancery Once Again Rejects Transaction Price as the Best Measure of Fair Value in DFC Global Litigation

On July 8, 2016, the Delaware Court of Chancery released its post-trial opinion in an appraisal action that arose from the sale of DFC Global Corporation, an international non-bank provider of alternative financial services, to a private equity buyer, Lone Star Fund VIII (U.S.), L.P. Despite acknowledging that the parties arrived at the sale price after a lengthy process involving multiple interested parties, and despite acknowledging that the Delaware Court of Chancery "frequently defers to a transaction process that was the product of an arm's-length process and a robust bidding environment," Chancellor Bouchard found that the transaction price is "reliable only when the market conditions leading to the transaction are conducive to achieving a fair price."

After rejecting sale price as an equivalent of fair value, the Court employed a three-pronged valuation model to come to its determination as to the appropriate per share value of the Company. First, taking into account elements of both parties' positions with respect to the inputs to the discounted cash flow model, the Court used a discounted cash flow analysis to derive a value of $13.07 per share at the time of DFC's sale. Second, the Court focused on a multiples-based comparable company analysis proposed by DFC's expert, which looked to a peer group of similar companies and resulted in a valuation of $8.07 per share. Third, the Court considered the transaction price of $9.50 per share. Weighing each prong equally, Chancellor Bouchard arrived at a valuation of $10.21 per share at the time of the transaction, an approximately 7.5% premium over the deal price. Because only four stockholders, holding approximately 4.6 million shares, sought appraisal, this resulted in an increase to the transaction consideration of only $3.3 million in the aggregate.

The *DFC* opinion built on Vice Chancellor Laster's May 2016 appraisal rights decision in *Dell*, which found that the deal price is not necessarily determinative for ascertaining fair value in certain situations where there was a robust bidding process. However, rather than concluding that these decisions are indicative of a sea change in Delaware's recent tendency to defer to the transaction price resulting from an arm's-length process in an appraisal action, it is likely that these decisions were the result of the specific facts and circumstances surrounding the relevant transactions.

In *Dell*, the market's "myopic" valuation of Dell and management's long-term assessment of the company raised concerns that the transaction price was artificially low and resulted from asymmetric information. Mr. Dell's role in the buyout also raised concerns about conflicts of interest and fairness. In *DFC*, the Court found that transaction price is informative of fair value only when it is the product of not only a fair sale process, but also of a well-functioning market. The *DFC* Court found that, while transaction price could fairly be used as one measure of value because the transaction did not involve potential conflicts of interest inherent to a management buyout or negotiations to retain existing management, it could not be relied upon as the only measure because significant company turmoil and regulatory uncertainty around the time of the transaction raised doubts about the fairness of the arm's-length transaction price as well as concerns regarding the financial projections provided by DFC's management. (*In re: Appraisal of DFC Global Corp.*, C.A. No. 10107-CB (Del. Ch. July 8, 2016)).

In an Appraisal Proceeding, Chancery Court More Likely to Equate Deal Price with Fair Value Where Transaction Is the Result of an Appropriate Sales Process

Another Delaware appraisal decision issued during the fourth quarter of 2016 reinforces that Delaware courts are more likely to give substantial evidentiary weight to the deal price as an indicator of fair value where the transaction was the product of an appropriate arm's-length sales process between two independent parties.

In *Dunmire v. Farmers & Merchants Bancorp of Western Pennsylvania, Inc.* ("*Dunmire*"), Chancellor Andre Bouchard considered an appraisal petition arising from an October 2014 merger between two community banks in western Pennsylvania – NexTier, Inc. ("NexTier") and Farmers & Merchants Bancorp of Western Pennsylvania, Inc. ("Farmers") – whereby NexTier acquired Farmers in a stock-for-stock transaction at an exchange ratio that impliedly valued Farmers at $83 per share. A group of Farmers shareholders brought an appraisal petition, arguing that the merger price of $83 per share was too low.

Each party's expert offered significantly differing estimates of the appropriate value of Farmers' share price. The Farmers shareholders' expert estimated the value of Farmers at $137.97 per share, while the NexTier's expert estimated the value of Farmers at $76.45 per share. Similar to prior appraisal cases, Chancellor Bouchard was not impressed with either valuation, stating: "This Court has remarked before on the tendency of litigants to submit wildly divergent valuations of the same company even when using similar methodologies. This case is no different."

Chancellor Bouchard was particularly critical of NexTier's assertion that the actual merger price ($83 per share) should be considered as an indicator of fair value, noting that: (1) there was no true auction because no other bids were solicited or received; (2) the Special Committee was not truly independent; and (3) the transaction was not conditioned on the approval of a majority of Farmers' minority shareholders. The Snyder family owned a majority of the stock of both banks involved in the merger and stood on both sides of the transaction. While the Farmers board created a Special Committee to assess the transaction and engaged a financial advisor, the Court determined that the Special Committee members were closely connected to the Snyders, giving the Snyders considerable behind-the-scenes influence.

Chancellor Bouchard also noted that the use of comparable transactions by the Famers shareholders' expert to arrive at a value of $137.97 per share was inflated because it failed to account for synergies that were potentially incorporated in the merger prices in those transactions. After undertaking a "fair value" assessment itself, using a discounted net income analysis, the Court arrived at a valuation of $91.90 per share as the fair value of Farmers' stock, which was 11% higher than the merger price.

The *Dunmire* case is a reminder that the Delaware Chancery Court is likely to give substantial weight to the deal price in determining the fair value of a company if the deal price is the product of a robust arm's-length sales process. *See also Merion Capital L.P. v. Lender Processing Services, Inc.*, C.A. No. 9320-VCL (Del. Ch. Dec. 16, 2016). A sales process that is less than robust or in which the negotiations are not arm's-length will impair price discovery and would produce a deal price that the Court would not likely consider to be a reliable indicator of fair value. In addition, sellers should carefully evaluate the independence of the members of any Special Committee that is formed to consider a sale transaction to ensure that they are truly independent. Both sides in an appraisal proceeding have the burden of proving their respective valuation positions by a preponderance of evidence, and parties to appraisal proceedings should therefore take notice that the Court will readily challenge experts' valuations when performing its own independent valuation of the fair value of a company. (*Dunmire v. Farmers & Merch. Bancorp of Western Pennsylvania, Inc.*, C.A. No. 10589-CB (Del. Ch. Nov. 10, 2016).)

Some Non-Delaware Courts Reject "Disclosure-Only" Settlements and Endorse Trulia Standard, but a New York Court Adopts a Different Approach

In *In re Trulia, Inc. Stockholder Litigation* (which we previously discussed in the First Quarter 2016 issue of the Ropes Recap), Chancellor Bouchard had rejected a proposed disclosure-only settlement of stockholder litigation challenging the acquisition of Trulia, Inc. by Zillow, Inc. and 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 indicated that disclosure-only settlements will be met with disfavor unless they involve supplemental disclosures that address a "plainly material misrepresentation or omission" and include a "narrowly circumscribed" release of claims. In his opinion, Chancellor Bouchard also expressed his hope and trust that "sister courts" in other jurisdictions would adopt a similar approach to disclosure-only settlements. This decision has effected a dramatic change in stockholder litigation in Delaware. Two cases, one from the Seventh Circuit Court of Appeals and the other from the New Jersey Superior Court of Union County, may signal growing support for *Trulia* in courts outside of Delaware. More recently, however, the Appellate Division for the First Department of New York reversed a lower court's rejection of a disclosure-only settlement.

In *In re: Walgreen Co. Stockholder Litigation*, the Seventh Circuit rejected a "disclosure-only" settlement involving stockholder litigation concerning Walgreen Co.'s 2014 purchase of Alliance Boots GmbH, and cited the Delaware Court *Trulia* decision with approval.

Judge Posner, writing the majority decision for the Seventh Circuit in a 2-to-1 decision, noted that that the district court judge had approved the disclosure-only settlement "with misgivings," and was ultimately persuaded that the supplemental disclosures "may have mattered to a reasonable investor." Judge Posner concluded, however, that the supplemental disclosures agreed to in the settlement represented only a trivial addition to the extensive disclosures already made in the proxy statement, and their value was "nil." He further explained that the "question the [district court] judge had to answer was not whether the disclosures may have mattered, but whether they *would* be *likely* to matter to a reasonable investor." Judge Posner called these types of disclosure-only settlements a "racket" that "must end" and further stated that such settlements "that seek only worthless benefits for the class should be dismissed out of hand."

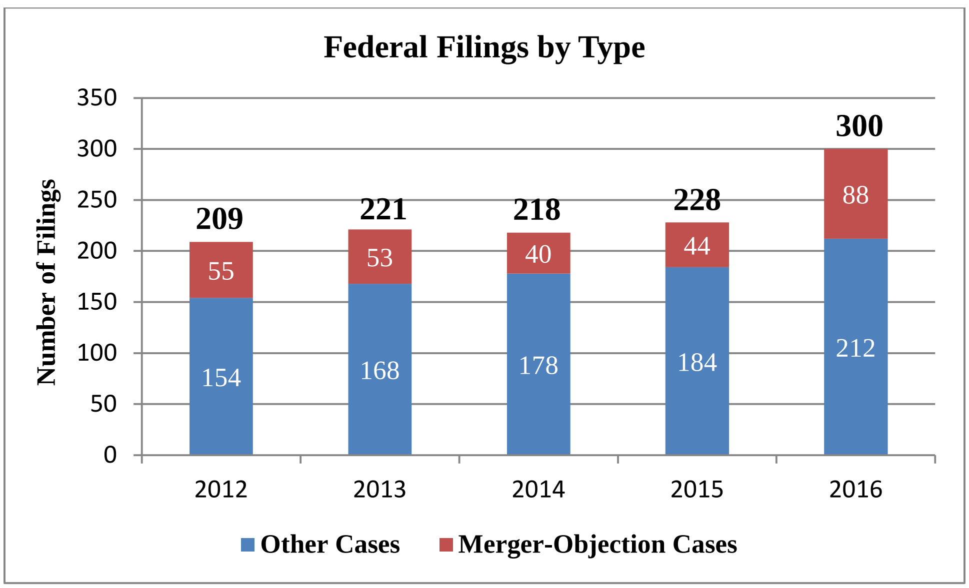
Unlike *Trulia*, where the plaintiffs had brought actions in state court asserting statutory breach of duty claims, the plaintiffs in Walgreen brought their actions in federal court and filed their complaints against Walgreen Co. (an Illinois corporation) in the U.S. District Court for the Northern District of Illinois, alleging violations of Section 14(a) and Section 20(a) of the Securities Exchange Act of 1934 and breaches of the board's fiduciary duty of disclosure under Illinois state law.

In *Vergiev v. Aguero*, a New Jersey Superior Court also rejected a disclosure-only settlement involving stockholder litigation concerning the 2015 merger of Metalico, Inc. with Total Merchant Limited. In applying *Trulia*, the trial judge concluded that he could not approve the settlement in light of the immateriality of the supplemental disclosures that were provided in exchange for a broad release of claims relating to the transaction.

In contrast, in *Gordon v. Verizon Communications, Inc.*, the Appellate Division for the First Department in New York found that, in applying New York law, the five factors articulated in *In re Colt Industry Shareholders Litigation*, 76 N.Y.2d 704 (N.Y. 1990) ("*Colt*"), weighed in favor of approving the proposed disclosure-only settlement of litigation arising from Verizon's acquisition of Vodafone's 45% stake in Verizon Wireless for approximately $130 billion in cash and Verizon common stock. Under *Colt*, the Appellate Division evaluated: (i) the likelihood of success on the merits, (ii) the extent of support from the parties for the proposed settlement, (iii) the judgment of counsel, (iv) the presence of bargaining in good faith, and (v) the nature of the issues of law and fact. After observing that the *Colt* five-factor test had not been revisited in 25 years and determining that it should be revisited, the Appellate Division then proceeded to introduce two additional factors: (a) "whether the proposed settlement is in the best interest of the putative settlement class as a whole," and (b) "whether the settlement is in the best interest of the corporation." Although the lower court had concluded that the supplemental disclosures that were negotiated as part of the proposed settlement failed to "materially enhance" the shareholders' knowledge about the merger and that they provided "no legally cognizable benefit to the shareholder class," the Appellate Division found that, in applying its first additional factor, the supplemental disclosures were "of some benefit to the shareholders." Furthermore, the Appellate Division found that the "most beneficial aspect" of the proposed settlement to be the inclusion of a corporate governance requirement that obligated Verizon to obtain a fairness opinion in the event that it sought to sell or spin off a certain amount of assets over the next three years. With respect to the second additional factor, the Appellate Division concluded that the proposed settlement was in the best interest of the corporation because Verizon had "direct input" into the supplemental disclosures and the corporate governance requirement and enabled it to avoid additional litigation expense.

While other New York courts have rejected disclosure-only settlements, the Appellate Division distinguished those cases on the basis that they had relied on Delaware law and/or did not involve an application of the *Colt* five-factor test. The *Gordon* decision is being heralded as New York's break with Delaware's rejection of disclosure-only settlements, but it remains unclear whether the enhanced *Colt* standard set forth in *Gordon* will be adopted by other judicial departments and/or the New York Court of Appeals.

In 2016, in response to the change effected by the Delaware Court of Chancery's increasing rejection of disclosure-only settlements, there was a significant decrease in the volume of M&A-related lawsuits filed in Delaware and a dramatic increase in the number of M&A-related lawsuits filed in federal court. While it is too early to tell how these cases will be treated, Judge Posner's sharp rebuke of disclosure-only settlements in *Walgreen*, in addition to the *Trulia* decision, may persuade judges in other jurisdictions to review disclosure-only settlements with greater skepticism. Irrespective of whether more non-Delaware courts decide to follow *Trulia*, given the *Gordon* opinion, Delaware corporations that have not adopted Delaware-only forum selection bylaws should consider the benefits of doing so. (*In re: Walgreen Co. Stockholder Litigation*, No. 15-3799 (7th Cir. Aug. 10, 2016); *Vergiev v. Aguero*, No. L-2276-15, order (N.J. Super. June 6, 2016); and *Gordon v. Verizon Communications, Inc.*, No. 653084/13 (N.Y. App. Div. Feb. 2, 2017)).



Source: NERA Economic Consulting

- Three hundred securities class actions were filed in U.S. federal courts in 2016, representing a 32% increase over 2015. This increase was largely driven by merger-objection cases, with 88 such filings in 2016 as compared to 44 filings in 2015.

Narayanan v. Sutherland Global Holdings: The Importance of Unifying D&O Indemnification and Expense Advancement Standards Across Corporate Documentation

On July 5, 2016, Vice Chancellor Montgomery-Reeves of the Delaware Court of Chancery issued an opinion holding that, where a corporation provides its officers or directors with advancement of legal expenses via multiple instruments, such as corporate bylaws and separate indemnification agreements, each such instrument is an independent source of such advancement rights and must be read separately, absent an express provision to the contrary.

In *Narayanan v. Sutherland Global Holdings*, the plaintiff, Muthu Narayanan, served as a director and officer of certain foreign subsidiaries of the defendant-corporation, Sutherland Global Holdings, Inc. After failing to persuade Sutherland to allow him to exercise his stock options, Narayanan sued Sutherland for breach of contract and unjust enrichment. In its response, Sutherland alleged that Narayanan breached his fiduciary duties to Sutherland in connection with certain transactions involving those of Sutherland's foreign subsidiaries of which Narayanan was a director. Moreover, Sutherland counter-claimed that Narayanan failed to cooperate with Sutherland in its efforts to collect missing funds in connection with the same transactions. Narayanan sought advancement to fund his defense to Sutherland's claims and, after Sutherland refused, brought suit to enforce his advancement rights.

The analysis of whether Narayanan was entitled to advancement of legal expenses turned on three documents. First, Sutherland's certificate of incorporation, which authorized Sutherland, to the fullest extent permitted by applicable law, "to provide indemnification of (and advancement of expenses to) [Narayanan] … through bylaw provisions, agreements … or otherwise" subject to certain limitations under the Delaware General Corporation Law or other state laws, "with respect to actions for breach of duty to a company, its stockholders and others." Second, Sutherland's bylaws conferred such rights, including indemnification and mandatory advancement of expenses. Third, Sutherland and Narayanan entered into an indemnification agreement, which provided for, among other things, mandatory advancement of expenses, subject to prior notice of any claim for which advancement was sought and cooperation from Narayanan as Sutherland may reasonably have required. Notably, the bylaws did not contain such a cooperation condition, and both the bylaws and the indemnification agreement contained a non-exclusivity provision, which provided that the rights conferred through the bylaws and the indemnification agreement were in addition to—or not exclusive of—rights conferred in other agreements.

Sutherland argued that Narayanan was not entitled to advancement because of his failure to cooperate under his indemnification agreement. Conceding that the bylaws did not contain a cooperation requirement, Sutherland nonetheless argued that, because Sutherland adopted the bylaws and the parties entered into the indemnification agreement on the same day, they intended them to be read in conjunction with one another and the Court should enforce the cooperation obligation as a condition precedent to Narayanan's right to receive advancement under either the bylaws or the indemnification agreement. Narayanan, on the other hand, argued that the bylaws and the indemnification agreement should be read separately. He posited that, because the bylaws did not contain a cooperation requirement, he was entitled to advancement of his legal expenses. In finding that Narayanan was entitled to advancement of legal expenses, the Court relied on the non-exclusivity provision in each instrument, noting that "the non-exclusivity provision in each manifests the parties' express intent for each instrument to provide rights and obligations independent of the other… [h]ad the parties intended the instruments to operate conjunctively, they only needed to replace the non-exclusivity provisions with language to that effect." (*Narayanan v. Sutherland Global Holdings, Inc.*, C.A. No. 11757-VCMR (Del. Ch. July 5, 2016)).

Three Court of Chancery Decisions Consider the Effect of Stockholder Approval on Challenged Transactions

Three members of Delaware's Court of Chancery rendered decisions over three consecutive days this August, all considering the impact of stockholder votes on challenged corporate transactions. All three cases involved post-transaction claims that board members breached their fiduciary duties during the deal process, notwithstanding the fact that the transactions at issue received stockholder approval.

In *City of Miami General Employees' and Sanitation Employees' Retirement Trust v. Comstock* ("*C&J*"), a former stockholder of C&J Energy Services, Inc. filed suit seeking damages for breaches of fiduciary duty against C&J's directors following C&J's merger with a subsidiary of Nabors Industries Ltd. The defendant directors were alleged to have been improperly influenced by the prospect of continued employment and/or significant compensation and thereby breached their duty of loyalty in approving the transaction. The plaintiff also alleged that C&J made inadequate disclosures about the proposed transaction and asserted claims against Nabors and the financial advisor to C&J's special committee for aiding and abetting the breach of fiduciary duty.

After rejecting the plaintiff's disclosure claims on the basis that the disclosures were accurate and the alleged omissions immaterial, Chancellor Bouchard then considered the impact of the C&J stockholder vote on the breach of fiduciary duty claim in light of the Delaware Supreme Court's decision last year in *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304 (Del. 2015). *Corwin* held that "the business judgment rule is invoked as the appropriate standard of review for a post-closing damages action when a merger that is not subject to the entire fairness standard of review has been approved by a fully informed, uncoerced majority of the disinterested stockholders." *Id.* at 305-06. Rather than finding that stockholder approval necessarily cleansed the C&J merger, however, Chancellor Bouchard considered whether the plaintiff adequately "rebut[ted] the business judgment presumption that the board acted loyally." The Court ultimately rejected the plaintiff's attempt to trigger entire fairness review, concluding that the prospect of future board membership was "wholly insufficient" to establish that the Board was interested, and that the plaintiff had not adequately alleged that C&J's CEO had intentionally deceived the board to further his own self-interest. The Delaware Supreme Court later affirmed *C&J* on appeal in a two-page order without addressing Chancellor Bouchard's application of *Corwin*.

Vice Chancellor Slights' decision one day later in *Larkin v. Shah* ("*Auspex*") took a broader view of *Corwin*. *Auspex* involved a challenge by former shareholders to the 2015 all-cash sale of Auspex Pharmaceuticals, Inc. to Teva Pharmaceuticals Industries, Inc. for $3.5 billion. The plaintiffs alleged that two venture capital firms that collectively controlled 23.1% of Auspex's stock and three of nine board seats acted as a controlling shareholder block, and that a majority of directors who approved the deal had disabling conflicts of interest, including affiliation with the venture capital firms and the enticement of post-merger employment offers. The Court dispensed with the plaintiffs' controlling shareholder allegation, holding that they failed to adequately allege that the venture capital board designees exercised any form of actual control over the rest of the board. The Court then turned to the impact of stockholder approval on the breach of duty claims.

Applying *Corwin* to those claims, Vice Chancellor Slights concluded that, absent a controlling stockholder that extracted personal benefits from the transaction, "the effect of disinterested stockholder approval of the merger is review under the irrebuttable business judgment rule, even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts faced by individual directors." Stockholder approval, then, "extinguishes all challenges to the merger except those predicated on waste." As a result, unlike *C&J*, the Court in *Auspex* concluded that it did not need to reach the plaintiffs' allegations about disabling board conflicts because stockholder approval triggered the "irrebuttable" business judgment rule and extinguished the plaintiffs' duty of loyalty claim.

A third decision from the Court of Chancery just one day after *Auspex* was issued also considered a similar issue but reached yet another result. In *Basho Technologies Holdco B, LLC, et al. v. Georgetown Basho Investors, LLC, et al.*, the former Chairman of Basho Technologies, Inc., along with several Basho investors, brought suit against certain directors and officers of the company for alleged breach of fiduciary duty related to a 2014 preferred stock financing transaction, which had received Board and stockholder approval. The plaintiffs claimed that the financing transaction was precipitated by a cash crisis created by minority stockholder Georgetown Basho Investors, LLC ("GBI"), by GBI's intentionally withholding payments in violation of its obligations under a convertible promissory note and effectively preventing Basho's board from considering other funding options.

Ruling from the bench, Vice Chancellor Laster explained that "[t]he complaint has a problem . . . the plaintiff, both as a director and as the managing member of the four stockholder entities, voted in favor of the transaction." Given that the plaintiff himself approved the transaction, the Court's analysis focused on the twin doctrines of waiver and acquiescence as possible defenses. V.C. Laster observed that while "ordinarily that's a great defense . . . this could be the case that is the exception that proves the rule." Because the complaint contained "specific detail about aggressive, self-interested, prolonged, abusive fiduciary misconduct . . . where the company is days from insolvency and has absolutely no alternatives to accepting the punitive financing," the Court denied the defendants' motion to dismiss. In doing so, the Court did not conclude that the transaction was subject to entire fairness review or even address the application of *Corwin*. However, the plaintiffs had alleged that the stockholder vote was infected by coercive conduct by GBI—specifically, that the independent stockholders had provided an irrevocable proxy to vote their shares "under extreme duress" due to Basho's liquidity crisis—which would ostensibly remove it from *Corwin*'s reach, and which highlights a limitation of this doctrine.

These three decisions offer important insights into the Court of Chancery's evolving view of the impact of stockholder approval on post-closing breach of fiduciary duty claims for money damages. At least one judge, Chancellor Bouchard, held that such approval does not have a complete "cleansing" effect, and Vice Chancellor Laster's ruling in *Basho* confirms that *Corwin* will not even enter the discussion where there are well-pleaded allegations of coercion. In addition, given the apparent tension between *C&J* and *Auspex,* it may be only a matter of time until the Delaware Supreme Court weighs in to clarify the applicable standard. (*City of Miami General Employees' and Sanitation Employees' Retirement Trust v. Comstock* ("*C&J*"), C.A. No. 9980-CB (Del. Ch. Aug. 24, 2016), *aff'd*, No. 482, 2016 (Del. Mar. 23, 2017); *Larkin v. Shah*, C.A. No. 10918-VCS (Del. Ch. Aug. 25, 2016); and *Basho Technologies Holdco B, LLC, et al. v. Georgetown Basho Investors, LLC, et al.*, C.A. No. 11802-VCL (Aug. 26, 2016)).

Chancery Court Dismisses Suit by Former Shareholders Against Board Members of OM Group, Inc., Applying the Corwin Standard and Making the Sale at Issue Subject to the Business Judgment Rule

On October 12, 2016, the Delaware Court of Chancery, in another application of *Corwin* (see discussion above), granted the defendant board members' motion to dismiss an action by former shareholders of OM Group, Inc. seeking post-closing damages following the closing of the sale of OM Group to Apollo Global Management for $1 billion. Vice Chancellor Slights, following his decision in *Auspex* (described above), held that because an overwhelming majority of disinterested stockholders voted to approve the merger, the business judgment rule applies, rather than enhanced scrutiny as argued by the plaintiffs, and the plaintiffs failed to allege that the transaction amounted to waste.

Under *Corwin*, the business judgment rule applies if the approval of a majority of disinterested stockholders is the product of a fully informed, uncoerced vote. However, the business judgment rule would not apply if facts were not disclosed that would have been material to a voting stockholder. Plaintiffs argued that the proxy materials were misleading in three material respects: (1) they omitted information regarding a competing bid, (2) they omitted information about a director's alleged conflicts of interest, and (3) they omitted information about the timing of the board's discovery of certain purported conflicts of one of its financial advisors and also the evolution of that financial advisor's fee structure. Vice Chancellor Slights analyzed each item in turn and found that none were materially misleading to stockholders and the plaintiffs had failed to present facts that undermined the validity of the stockholder vote. Because the plaintiffs had not alleged or argued that the merger amounted to waste, the presumption of the business judgment rule resulted in the dismissal of the complaint. (*In re OM Group, Inc. Stockholders Litig.*, C.A. No. 11216-VCS (Oct. 12, 2016))

Chancery Court Dismisses Disclosure Claims Relating to AOL's Acquisition of Millennial Media, Noting the Higher Standard for Asserting Post-Closing Claims for Damages

On September 28, 2016, in an action challenging the disclosures issued by Millennial Media in connection with its 2015 acquisition by AOL, Vice Chancellor Glasscock of the Delaware Court of Chancery granted a motion to dismiss in favor of the directors of Millennial Media, finding that a claim alleging insufficiency of disclosures and whether they are misleading or incomplete in a way that is material to the stockholders should be pursued pre-closing (and not post-closing) and that there is a higher burden on the plaintiff to sustain a post-closing disclosure claim for damages against directors than there is to sustain a pre-closing disclosure claim heard in a pre-closing injunction proceeding.

In *Nguyen v. Barrett*, following denial of preliminary injunctive relief based on the disclosure claims, the merger closed and, following the closing, the plaintiff amended his complaint, seeking damages for two alleged disclosure violations that included a claim that the Court had previously rejected and another that the plaintiff had not previously asserted. In rejecting these claims, Vice Chancellor Glasscock highlighted the contrast between disclosure claims heard on a motion for preliminary injunctive relief brought prior to closing and claims for damages against directors bought post-close. The Court noted that a pre-closing claim concerns a stockholder's right to a fully informed vote and the plaintiff must demonstrate "a reasonable likelihood of proving that the alleged omission or misrepresentation is material." However, with respect to a disclosure claim for damages against directors post-closing, a "plaintiff must allege facts making it reasonably conceivable that there has been *a non-exculpated breach* of fiduciary duty by the board in failing to make a material disclosure." Thus, the standard for sustaining a disclosure claim in a post-closing action for damages is that it is reasonably conceivable both that the alleged nondisclosure was material and that it constituted a breach of the duty of loyalty. The Vice Chancellor granted the defendant's motion to dismiss on the grounds that the plaintiff had not satisfied the higher burden of the post-closing claim for damages against the directors with respect to the alleged disclosures.

The decision thus reaffirms the position regarding disclosure claims and the timing of when those should be sought and the differing standards that apply based on the stage at which such claims are brought. (*Nguyen* v. *Barrett*, C.A. No. 11511-VCG (Del. Ch. Sept. 28, 2016)).

Delaware Court of Chancery Applies Entire Fairness Standard to Find Interested Directors May Not Extinguish Breach of Fiduciary Duty Claims through Merger

On July 28, 2016, the Delaware Court of Chancery released an opinion allowing fiduciary duty claims of unfair dealing to survive a motion to dismiss where the board of Riverstone National Inc. approved a merger that extinguished a potential derivative shareholder suit against a majority of the directors, highlighting that directors will be subject to entire fairness review where transactions involve alleged self-interested motives and unfair benefits.

In 2014, two stockholders approached Riverstone alleging certain officers and directors breached their fiduciary duties by privately investing in what became a $7.5 billion property management business that the stockholders claimed was a corporate opportunity belonging to Riverstone. The stockholders filed a Section 220 action seeking to compel Riverstone to provide its books and records for inspection. However, that same day, Riverstone's board approved a merger with Greystar Real Estate Partners that extinguished the potential derivative stockholder claim and pursuant to which Greystar agreed not to otherwise pursue the corporate opportunity claim. In response, the stockholders filed a direct claim against the interested Riverstone directors alleging that the directors subject to the derivative suit breached their fiduciary duties in approving the merger, which resulted in an unfair price to the stockholders.

Vice Chancellor Glasscock found that the affected directors could not benefit from the protection of the business judgment rule and that the entire fairness standard would apply as the complaint alleged that they derived a material personal financial benefit from the merger not shared with all stockholders – the extinguishment of potentially material derivative claims, which in turn could have brought additional value to Riverstone and therefore its stockholders in the merger. However, the Vice Chancellor was clear that "[e]ven in the merger context…the stockholders must plead facts that, if true, rebut business judgment and demonstrate a non-exculpated breach of duty," warning that the Court should be wary of "conclusory allegations" without particularized facts such as those presented in the instant case. Specifically, the Vice Chancellor noted that the stockholders had pleaded such particularized facts, showing (i) the existence of a viable claim, (ii) the directors were aware of the potential claim at the time of the merger, (iii) the claim as material to the directors and (iv) the directors were able to negotiate a transaction that extinguished the claim.

In addition, the Court reinforced that, even where entire fairness review applies, to survive a motion to dismiss a plaintiff must initially state a claim that alleges some facts suggesting the transaction in question was unfair – either in process or price – an allegation which, once sufficiently pleaded, must be rebutted by the defendant directors. In the case of the Riverstone stockholders, Vice Chancellor Glasscock determined that the stockholders sufficiently alleged the price of the merger could be found to be unfair given the expected value of the derivative claim viewed against the total merger consideration paid to the stockholders.

Consistent with other Delaware precedent, the decision confirms that the extinguishment of claims against directors may be viewed as a material benefit to directors in the transaction context. (*In re Riverstone National Inc. Stockholder Litigation*, Consol. C.A. No. 9796-VCG (Del. Ch. July 28, 2016)).

Chancery Court Confirms Continued Applicability of "MFW" Standard in Dismissing Challenge to Controller Buyout

On October 10, 2016, the Delaware Court of Chancery applied the standard established in *In re MFW Shareholders Litigation* and *Kahn v. M & F Worldwide Corporation* ("*MFW*") in rejecting a challenge to a controlling stockholder's buyout of the remaining shares of Books-A-Million, Inc. ("BAM") from minority stockholders. In the decision, Vice Chancellor Laster confirmed the framework to be followed by Delaware companies and controlling stockholders that seek to avoid the "entire fairness" standard of review.

BAM's controlling stockholder sent an unsolicited proposal to the Board of Directors of BAM, offering to acquire the outstanding BAM shares that it did not already own for a price of $2.75 per share. Consistent with the *MFW* standard, the proposal expressly stated that the transaction would be conditioned on approval by a special committee of independent directors with its own financial and legal advisors and a non-waivable majority-of-the-minority vote. The board formed a special committee comprised of the directors not affiliated with the controlling stockholder to consider the proposal, and the committee solicited alternative proposals from three third parties that had previously expressed an interest in acquiring BAM. One of the parties ultimately submitted a proposal to acquire all of the shares of BAM for $4.21 per share, but as the controlling stockholder was not interested in selling its shares, the special committee decided that a whole-company transaction was not viable. The special committee negotiated an increase in price to $3.25 per share with the controlling stockholder, and the transaction was then approved by a majority of the shares held by the minority stockholders who were fully informed of the higher potential alternative offer in the proxy statement that was provided to the stockholders.

Certain minority stockholders then challenged the transaction, alleging that the *MFW* standard was not met because the special committee was not independent and did not satisfy its duty of care, and the transaction should be subject to entire fairness review, rather than to the deferential business judgment standard. The plaintiffs argued that the special committee acted irrationally and in bad faith in recommending the transaction to the board, primarily because it did not proceed with the third party that had indicated an interest in acquiring all of the shares of BAM at a higher price. Vice Chancellor Laster dismissed these arguments, stating that while independent directors supporting a controller transaction at a "grossly inadequate" price could potentially constitute bad faith, it was within the rights of a controller to decide not to sell its shares, and that the controlling stockholder in this transaction "did not breach any duty to the corporation or its minority, nor did it overreach or threaten exploitation, by proposing a going-private transaction at a substantial premium to the market price," even though that price was lower than the price offered by a third party. The Court recognized that a comparison between offers from a controller and a third party could be relevant because if the amount of the minority discount was not "within a rational range of discounts," then "one might infer that the independent directors sought to serve the interests of the controller, confident that stockholders focused on short-term gains would approve any transaction at a premium to market," but the Court determined that this transaction was not such a case and that, if stockholders felt the minority discount was egregious, their appraisal rights provided an appropriate remedy. This decision confirms that *MFW* remains the appropriate standard in assessing controller buyouts, and extends its applicability to situations where higher potential alternative offers are also on the table. The decision was also notable because the Court dismissed the case based on *MFW*, even though the Supreme Court in *MFW* stated in a footnote that the *MFW* complaint would have survived a motion to dismiss. (*In re Books-A-Million, Inc. Stockholders Litig.*, C.A. No. 11343-VCL (Del. Ch. Oct. 10, 2016).)

Additional Delaware Guidance on Avoiding Extra-Contractual Fraud Claims in a Sale Transaction

On November 30, 2016, Vice Chancellor Bouchard of the Delaware Court of Chancery issued an opinion that provides additional guidance on how inclusion of certain key provisions in a purchase agreement can protect a seller against an extra-contractual fraud claim asserted by a buyer in connection with an acquisition transaction. To minimize a seller's exposure to a potential extra-contractual fraud claim, a purchase agreement should contain the following provisions: (1) a buyer's disclaimer of reliance on extra-contractual representations, (2) a buyer's acknowledgment that seller has not made any such representations, and (3) a release of seller from any liability arising out of misstatements made during due diligence.

In the suit, the plaintiff, IAC Search, asserted that ValueClick fraudulently induced IAC Search to overpay for one of ValueClick's subsidiaries by providing false information concerning such subsidiary's ad sales in documents placed in an electronic data room and in statements ValueClick made in response to information requests in a "diligence tracker." Importantly, while the ultimate purchase agreement contained representations concerning certain financial results and performance metrics of the subsidiary in question, the parties chose not to incorporate the allegedly fraudulent information into an express contractual representation.

Chancellor Bouchard's decision to grant ValueClick's motion to dismiss IAC Search's fraud claim hinged on three key provisions of the purchase agreement. First, the agreement contained an express disclaimer by ValueClick of any extra-contractual representations and warranties. Second, IAC Search acknowledged that ValueClick was not making any representations concerning information provided during due diligence unless such information was included in an express representation and warranty in the purchase agreement. Chancellor Bouchard found this provision to be "critical" because it defined in precise terms *from IAC Search's perspective* the universe of information on which IAC Search relied and did not rely when it entered into the purchase agreement. Third, the purchase agreement contained a standard integration clause defining the universe of documents that made up the parties' understanding of the terms of the transaction. In conclusion, Chancellor Bouchard found that the integration clause and the buyer acknowledgment clause added up to a "clear anti-reliance clause to bar fraud claims based on extra-contractual statements made during due diligence." Notably, the purchase agreement did not include a release of seller from liability for misstatements made during the due diligence process, and the opinion noted that the absence of such a release made this a "closer call" than if such a release had been included.

Although the Court of Chancery has noted in the past that there are "no magic words," this case provides helpful drafting guidance on how to minimize the risk of extra-contractual fraud claims in the context of a sale transaction. (*IAC Search, LLC v. Conversant LLC (f/k/a ValueClick, Inc.)*, C.A. No. 11774-CB (Del. Ch. Nov. 30, 2016).)

Delaware Supreme Court Revives Fiduciary Duty Claim and Provides New Guidance on Director Independence

In *Sandys v. Pincus*, the Delaware Supreme Court reversed a decision by the Delaware Court of Chancery that had dismissed a shareholder derivative complaint for failure to adequately plead demand futility under Court of Chancery Rule 23.1. Writing for a majority of the Court, Chief Justice Strine concluded that the complaint pled sufficient facts to raise a reasonable doubt about whether a majority of the Board of Zynga, Inc. ("Zynga") could impartially consider a pre-suit demand.

The complaint alleged a breach of fiduciary duty centering on allegations of insider trading by certain officers and directors of Zynga just prior to an earnings announcement that caused the company's stock price to plummet. The Court of Chancery concluded that two of Zynga's nine directors were interested, but that at least five directors were disinterested and independent for purposes of Rule 23.1. Accordingly, the Court dismissed the complaint for failure to make a pre-suit demand on the board.

On appeal, the Delaware Supreme Court reversed, holding that the plaintiff had raised enough doubt about the independence of three additional directors—Ellen Siminoff, William Gordon, and John Doerr—to survive dismissal under the demand futility test set forth in *Rales v. Blasband*, 634 A.2d 927 (Del. 1993). With respect to Ms. Siminoff, the Court found that her family's co-ownership of a private plane with an interested party, controlling stockholder Mark Pincus, called into question her ability to be impartial, because it "involves a partnership in a personal asset that is not only very expensive, but that also requires close cooperation in use, which is suggestive of detailed planning indicative of a continuing, close personal friendship." The opinion concluded that the plaintiff had raised sufficient doubt regarding Messrs. Gordon and Doer's ability to be impartial, based in part on the fact that they were partners of a venture capital firm that controlled 9.2% of Zynga's equity, and both were deemed by the Board not to qualify as independent under the NASDAQ Listing Rules. Justice Valihura dissented from the majority opinion on the grounds that there was no proof that the private plane was anything more than a business venture, that the plaintiff pleaded no facts about the materiality of the venture capital firm, and that independence under the NASDAQ Rules is not dispositive.

Although Justice Strine's opinion does not purport to modify the *Rales* demand futility test, it represents a more rigorous application of that standard than in prior decisions by the Delaware Supreme Court and the Court of Chancery. *Sandys* suggests that any business ventures or co-ownership of assets with interested parties will be subject to exacting scrutiny in the demand futility context and may expose directors to allegations that they cannot impartially consider a pre-suit demand. Boards should also recognize that plaintiffs will seize on NASDAQ and NYSE independence requirements (and the failure of certain directors to meet those requirements) as evidence of their inability to be impartial. Notwithstanding Justice Valihura's admonition that this factor is not dispositive to the demand futility analysis, it will likely be a focal point for plaintiffs given the weight afforded to it by the *Sandys* court. (*Sandys v. Pincus, C.A. No. 9512-CB* (Del. Dec. 5, 2016))

Court of Chancery Addresses Standing to Bring Fiduciary Duty Claims Following a Freeze-Out Merger

In *I.A.T.S.E. Local No. One Pension Fund v. General Electric Company*, the Delaware Court of Chancery provided new guidance on a stockholder's standing to bring fiduciary duty claims following a freeze-out merger that forced the stockholder to sell his shares. The case involved a complex series of transactions in which General Electric Company ("GE") merged with a subsidiary, General Electric Capital Corporation ("GECC"). As a result of the merger, holders of GECC preferred stock, including the plaintiff, received new shares of GE preferred stock, which were allegedly worth less due to lower dividend rates. GE subsequently allowed the preferred stockholders to swap their stock for other assets in exchange for a release of their claims, but the plaintiff was not afforded this opportunity because it sold its stock shortly after the merger, prompting this lawsuit.

The defendants (GE and related entities, along with certain GE officers and directors) moved to dismiss on the ground that the plaintiff lacked standing to pursue its breach of fiduciary duty claim because it no longer held GECC stock. The defendants' argument relied on the Court of Chancery's 2015 decision in *In re Activision Blizzard, Inc. Stockholder Litigation*, 124 A.3d 1025 (Del. Ch. 2015), which held that a stockholder selling his stock abandons all but direct claims that are personal in nature, such as a claim that the stockholder was defrauded by the company. Direct claims that are non-personal in nature—that is, claims arising from the relationship between the stockholder and the company—adhere to the stock and may not be brought by former stockholders. In *I.A.T.S.E.*, the Court held that when a stockholder is forced to sell his stock in a freeze-out merger representing an alleged breach of fiduciary duty, the transaction "necessarily severs the relationship between the stockholder and the entity." Vice Chancellor Glasscock explained that "the breach of duty claim arose simultaneously with the sundering of the relationship between the plaintiff/stockholder and GECC, and cannot have adhered to the GECC stock."

In rejecting the defendants' arguments and permitting the pension fund to proceed with its claim, the *I.A.T.S.E.* decision provides important guidance on the limits of *Activision*, which was distinguishable on the ground that the stock held by the plaintiff in that case (and which the plaintiff in that case elected to sell) remained intact (though diluted) following the transaction, and was never "eliminated, converted, exchanged, or otherwise transmogrified." *I.A.T.S.E.* makes clear that a transaction that causes a stockholder to involuntarily release its stock will not foreclose an action by that former stockholder for breach of fiduciary duty. (*I.A.T.S.E. Local No. One Pension Fund v. General Electric Company*, C.A. 11893-VCG (Dec. 6, 2016))

Court of Chancery Invalidates Fee-Shifting Bylaw

In *Solak v. Paylocity Holding Corporation*, Chancellor Bouchard of the Delaware Court of Chancery determined that a corporation's fee-shifting bylaw was invalid because it violated Section 109(b) of the Delaware General Corporation Law (the "DGCL"), explaining that the statute "unambiguously prohibits the inclusion of 'any provision' in a corporation's bylaws that would shift to a stockholder the attorneys' fees or expenses incurred by the corporation 'in connection with an internal corporate claim,' irrespective of where such a claim is filed." This decision thus confirms that any fee-shifting bylaw adopted by a stock corporation and relating to internal corporate claims is invalid.

In 2015, the Delaware legislature amended the DGCL to permit exclusive forum bylaws (Section 115) and prohibit fee-shifting bylaws (Section 109(b)). In February 2016, about six months after these amendments took effect, Paylocity Holding Corporation ("Paylocity") adopted two new bylaw provisions. The first bylaw provision was an exclusive forum bylaw that required internal corporate claims to be filed in a state or federal court located in Delaware. The second bylaw provision was a fee-shifting bylaw that purported to shift, absent a written waiver from Paylocity, Paylocity's litigation expenses to a stockholder litigant for an action that was brought in a forum outside of Delaware and for which the stockholder litigant failed to obtain a judgment on the merits that substantially achieved the full remedy sought.

Paylocity raised several arguments in defense of its fee-shifting bylaw. Paylocity argued that the Delaware legislature's recent amendment to Section 109(b) should be read in conjunction with its simultaneous adoption of Section 115, such that Section 109(b) was not intended to prohibit fee-shifting for internal corporate claims filed outside of Delaware when a corporation adopts an exclusive forum bylaw requiring that such claims be filed in Delaware, which complies with Section 115. The Court rejected this argument, noting that Section 109(b) "makes no distinction between internal corporate claims filed inside or outside of Delaware." While he acknowledged that the Delaware legislature had adopted both provisions at the same time, Chancellor Bouchard saw nothing in the plain text of those provisions to indicate that the legislature intended to create an exception to Section 109(b).

Paylocity also argued that the plaintiff failed to state a claim for relief because Paylocity's fee-shifting bylaw contained a savings clause that made it "enforceable only '[t]o the fullest extent permitted by law,'" and thus "carve[d] out all interpretations inconsistent with Delaware law." The Court rejected this argument, holding that a savings clause could not negate a facial challenge to the validity of a bylaw where the bylaw has been found entirely invalid.

Finally, the Court dismissed the plaintiff's claim that the Paylocity board breached its fiduciary duties in adopting it, in light of the Section 102(b)(7) exculpation provision in Paylocity's certificate of incorporation and the lack of any factual allegations in the complaint raising a reasonably conceivable inference that Paylocity's board adopted the bylaw in bad faith. The Court also noted that, although the savings clause could not salvage Paylocity's fee-shifting bylaw from being rendered invalid, its presence "negate[d] the notion that the directors knew that they would be violating the law by approving the provision." (*Solak v. Paylocity Holding Corporation*, C.A. No. 12299-CB (Del. Ch. Dec. 27, 2016))

GOVERNANCE UPDATE

State Street Calls upon Corporate Boards to Protect the Interests of Long-Term Shareholders in Responding to Activists

On October 10, 2016, State Street Global Advisors (SSGA) issued a press release calling on corporate boards to adopt principles for engaging with activist investors "to promote long-term value creation and sustainable economic growth." Citing research from Lazard, SSGA noted that "as of August 2016, 49 companies had conceded 104 board seats to activists [in 2016], almost on par with the 106 seats conceded by 54 companies in all of 2015." SSGA called particular attention to the fact that settlements have become an increasingly popular way to deal with activist investors, with less than 10% of board seats conceded in an activist campaign in 2015 and 2016 having resulted from a proxy contest, as compared to 34% in 2014. In response, SSGA called on corporate boards to adopt approaches towards settlement agreements that would do more to take into account the interests of long-term investors when faced with the prospect of activist investor strategies that may focus on the short term.

SSGA expressed its view that although negotiated settlements can help companies avoid the time, expense and reputational risk of a proxy fight, rushing into negotiated settlements often precludes long-term shareholders from having the opportunity to engage in a public discussion of important corporate strategies concerning items such as compensation, share buybacks and other financial engineering mechanisms. In order to balance the interests of long-term shareholders, SSGA advised that corporate boards should increase the duration of settlement agreements, institute holding period requirements for activist investors after receiving board seats, require minimum ownership thresholds for board representation, and evaluate the practices of activists that pledge their shares in margin accounts and develop robust mechanisms to oversee and mitigate the risk from these pledge positions to the stock price.

SSGA's press release makes clear that the increasing prevalence of settlements with activist investors has not gone unnoticed by institutional investors who increasingly feel that their interests are not being adequately considered in the negotiation of such settlement agreements. (State Street Global Advisors, *State Street Global Advisors Calls on Corporations to Protect Long-Term Shareholder Interests In Activist Engagements*, (Oct. 10, 2016), http://newsroom.statestreet.com/press-release/corporate/state-street-global-advisors-calls-corporations-protect-long-term-shareholde.)

SEC UPDATE

RBC Fined $2.5 Million for Misleading Proxy Disclosure in Rural/Metro Sale

In August 2016, RBC Capital Markets, LLC agreed to a $2.5 million settlement with the Securities and Exchange Commission for causing materially false and misleading disclosures about the valuation analysis underlying its fairness opinion in the proxy statement related to the sale of Rural/Metro Corporation to Warburg Pincus in 2011. The SEC settlement is the first occurrence of a financial advisor being held responsible by the SEC for a client's proxy disclosure.

As reported in the *Ropes Recap* for the First Quarter of 2014, in March 2014, the Delaware Court of Chancery held in *In re Rural Metro Corporation Stockholders Litigation* that RBC, Rural/Metro's financial advisor, was liable to a class of Rural/Metro stockholders for aiding and abetting a breach of fiduciary duty by Rural/Metro's board of directors in connection with the 2011 transaction. In subsequent issues, we reported that the Court of Chancery awarded $75.8 million in damages to the class, and that the Delaware Supreme Court upheld those decisions, affirming, among other things, the Court of Chancery's holding that RBC was liable as an aider and abettor of the board's fiduciary breaches.

Following these decisions, the SEC alleged that Rural/Metro's proxy statement included a summary of RBC's valuation analysis that falsely stated that RBC used "Wall Street research analyst consensus projections" for 2010 "consensus" adjusted EBITDA when the figures used did not actually reflect certain adjustments to EBITDA reflected in the associated analyst reports. According to the SEC, RBC had caused the proxy statement to include false and misleading disclosures because RBC provided the summary of its valuation analyses to the company for inclusion in the proxy statement and RBC investment bankers reviewed the preliminary and definitive proxy statements before they were filed, without making changes to the false and misleading disclosures. The SEC also stated that the final proxy disclosure was misleading because it described a "comparable companies" analysis under the heading "other factors" when the bank did not rely on this analysis for purposes of its opinion. This settlement serves as an important reminder that financial advisors need to have robust procedures in place for reviewing and approving analyses underlying fairness opinions, for ensuring that any changes to such analysis requested by an internal fairness committee are properly documented and for preparing and reviewing disclosures relating to such analyses in any SEC filings related to the transaction. In particular, where a bank provides a board with supplemental analyses that are not relied upon as part of reaching a conclusion as to fairness, any associated disclosure must be drafted to distinguish between those analyses that were part of the fairness conclusion and those that were presented on a supplemental basis. (*In the Matter of RBC Capital Mkts., LLC*, Administrative Proceeding File No. 3-17520, Release No. 78735 (August 31, 2016)).

New C&DIs Relating to Tender Offer Rules

In November 2016, the SEC's Division of Corporation Finance issued two compliance and disclosure interpretations (C&DIs) relating to the required scope of disclosure regarding financial advisor fees. The staff: (i) indicated that a financial advisor engaged by an issuer's board or independent committee for the exclusive purpose of providing financial advice ***is*** considered a person "directly or indirectly employed, retained, or to be compensated" to assist the issuer to make its Schedule 14D-9 solicitation or recommendation, even if the financial advisor's opinion expressly includes a disclaimer that the financial advisor is not making a solicitation or recommendation to any of the target company shareholders, and (ii) clarified that generic disclosure such as "customary compensation" will ordinarily be insufficient disclosure because it lacks the specificity needed to assist security holders in evaluating the merits of the solicitation or recommendation and the objectivity of the financial advisors' analyses or conclusions used to support such solicitation or recommendation. The staff noted that although quantifying the amount of compensation payable to a financial advisor may not necessarily be required in all instances, disclosure of the summary of the material terms of the financial advisors' compensatory arrangements would generally need to include:

- the types of fees payable to the financial advisors (e.g., independence fees, sale transaction or "success" fees, periodic advisory fees, or discretionary fees);
- if multiple types of fees are payable to the financial advisors and there is no quantification of these fees, then sufficiently-detailed narrative disclosure to allow security holders to identify the fees that will provide the primary financial incentives for the financial advisors;
- any contingencies, milestones, or triggers relating to the payment of the financial advisors' compensation (e.g., the payment of a fee upon the consummation of a transaction, including with a bidder in an unsolicited tender or exchange offer); and
- any other information about the compensatory arrangement that would be material to security holders' assessment of the financial advisors' analyses or conclusions, including any material incentives or conflicts that should be considered as part of this assessment.

(U.S. Securities and Exchange Commission, Division of Corporation Finance, *Compliance and Disclosure Interpretations – Tender Offers and Schedules*, Questions 159.01 and 159.02)

TAX UPDATE

New Related-Party Debt Rules Target Earnings Stripping

On October 13, 2016, the Treasury Department and Internal Revenue Service released Final and Temporary regulations under section 385 (the "Regulations") that broadly impact the tax treatment of certain related-party debt issued by U.S. corporate borrowers. When applicable, the Regulations reclassify a related-party debt instrument issued after April 4, 2016 as equity for tax purposes, including if the U.S. borrower fails to properly document the loan or substantiate its ability to make timely interest and principal payments.

The Regulations curb a range of transactions that use related-party debt to reduce a U.S. corporation's future taxable income. Although the Treasury Department had announced plans to prevent "earnings stripping" by "inverted" companies, these Regulations generally apply to borrowings of a U.S. corporate subsidiary from its non-U.S. corporate parent (or affiliate) regardless of whether the anti-inversion rules apply. The Regulations also apply to a limited range of U.S. company borrowings from related U.S. companies (including related tax-exempts) where similar earnings stripping concerns arise. For a detailed description of the Regulations, see our November 15, 2016 Client Alert.

General Summary. The Regulations target related-party debt issuances that both facilitate "earnings stripping" and arguably have limited non-tax significance by reclassifying that related-party debt as equity to eliminate U.S. tax deductions on interest payments and to impose dividend withholding. The Regulations target debt issued by a domestic corporation to a highly related member of that corporation's "expanded group" (very generally, a group of corporations with a common corporate parent connected to each other by direct or indirect ownership of at least 80% of stock by vote or value), such as a foreign corporate parent. In addition to many other exceptions, the rules do not apply to loans among members of a U.S. consolidated group or issued by foreign corporations, or to debt issued by or owed to most private investment partnerships. Additionally, the rules include exceptions for aggregate related party debt issuances not in excess of $50 million and for debt issuances out of accumulated earnings and profits.

The Regulations target situations where a U.S. corporation's net equity is reduced or replaced through a related-party debt issuance in an effective "reshuffling" of the capital of the corporation (as compared to simple increases in leverage to expand operations). When applicable, the rules reclassify debt based on a single factor: whether the issuance of the note decreases the net equity capital of the issuer (including in the 36-month period leading up to and following the debt issuance). In this regard, the rules upset well-settled common law that has weighed a broad set of factors and scrutinized whether the parties' actions reflect an intention to create a debtor-creditor relationship. However, a related-party debt issuance still must satisfy the traditional common law standards to be respected.

Documentation. Beginning in 2018, certain issuers of related-party debt, including all publicly listed U.S. corporations, must adhere to significant documentation rules. When applicable, a borrower must (i) enter into a written loan agreement that records certain compulsory debt terms, (ii) substantiate the borrower's expected ability to pay interest and re-pay principal, and (iii) maintain records demonstrating compliance with the terms of the loan. Even if an instrument otherwise would be regarded unequivocally as debt for tax purposes, debt will be automatically reclassified as equity if the issuer fails to satisfy the documentation requirements before its U.S. federal income tax filings are due. Prudent taxpayers borrowing prior to January 1, 2018 should meet the documentation requirements for non-ordinary course borrowings.

Key Observations. Despite these new limits on increasing debt within the U.S. group beyond annual earnings and profits, some planning opportunities remain.

> Acquisitions of a U.S. corporation by a foreign parent (whether pre-existing or newly formed). A foreign corporation acquiring U.S. target stock or assets (to be held in a U.S. corporation) for cash (including cash borrowed by the foreign acquirer) should consider funding a U.S. acquisition vehicle to fund the acquisition. In this regard, funds loaned to a U.S. corporation to acquire U.S. assets or operating companies should not result in equity reclassification under the new rules. It is important, however, to ensure that the loan is not reclassified either as a result of distributions or acquisitions in the 36-month period preceding or following the intercompany loan. The Regulations eliminate a common strategy used by

foreign acquirers to increase or inject related-party debt in connection with a taxable acquisition of a U.S. target. Specifically, a newly formed U.S. acquisition vehicle would acquire shares of its U.S. parent in exchange for debt of the acquisition vehicle, which debt would ultimately be serviced by the U.S. target. A similar technique was used to acquire parent shares delivered in a tax-free reorganization, although in that case withholding tax could arise with respect to the related-party debt issuance.

Debt "push-down." Buyers of non-U.S. parented targets will often push down a portion of debt borrowed to acquire foreign parent shares to U.S. operating subsidiaries by distributing debt issued by the U.S. operating subsidiary to its non-U.S. parent. Intercompany loans may thus be used to repatriate funds from the U.S. to both secure and pay down acquisition financing, as well as to tax-efficiently allocate interest expense deductions. Because the new rules can prevent traditional strategies for inserting related-party debt within a U.S. corporate group, acquirers will need to consider alternative strategies. For example, the non-U.S. parent could on-loan externally borrowed funds to the U.S. group to repay existing indebtedness. Alternatively, the U.S. group could separately borrow and distribute the proceeds to its foreign parent, which can use the funds to repay short-term acquisition financing. The withholding tax consequences and income tax consequences to the foreign parent would need to be evaluated.

Dividend recapitalizations. Private equity funds often finance shareholder distributions with third-party borrowing. For non-U.S. parented groups, the inability to borrow at the parent level and push down a portion of the debt in the U.S. will encourage U.S. operating subsidiaries to borrow from third-party lenders directly to finance distributions by the parent. Although such third-party borrowing by a U.S. subsidiary to fund a dividend to its non-U.S. parent does not involve a related-party borrowing, such subsidiary must consider the impact of the distribution on any related-party borrowings that were made in the prior 36-month period (but not before April 4, 2016) or anticipated in the subsequent 36 months (for example, with an anticipated U.S. add-on).

Refinancing. Although a pure refinancing of a related-party debt instrument would not be treated as a distribution, and thus not, on its own, run afoul of the new rules, it would be treated as a new funding. Therefore, taxpayers will need to be mindful of prior or anticipated distributions or related-party stock acquisitions occurring in the 36-month period (but not before April 4, 2016) or the subsequent 36-month period that, combined with the refinancing, cause the loan to be reclassified as equity. Modification of the duration of the term of the debt instrument that is not significant, thus causing a deemed reissuance under section 1001, can permit flexibility for planning during a particular period of time.

The Regulations are exceedingly complex, contain many material exceptions and can apply in a broad range of cases (not described above). Even taxpayers who don't plan to issue related-party debt, but who wish to maintain flexibility to do so in the future, should seek guidance soon, as actions today can impact future planning, even where related-party debt issuances are not tax-motivated.

ASIA UPDATE

Mounting Uncertainties for Chinese Outbound Investments in the U.S.

2016 appears to have been another record year for Chinese outbound investments both in the world and in the U.S. According to the data released by the Ministry of Commerce of China ("MOFCOM"), Chinese companies' overseas purchases have surpassed 2015's full-year record of $121 billion for non-financial outbound investments, reaching $146 billion in the first ten months of 2016. In particular, the amount of Chinese outbound investments in the U.S. in the first ten months of 2016 increased by 173.9% when compared to the same period of 2015.[1]

However, political and legal uncertainties appear to be on the rise for Chinese outbound investments in the U.S. from both the China and U.S. sides. The following reflects our observation of the most recent developments on China's tightened scrutiny and uncertainties associated with the U.S. presidential transition for Chinese outbound investments in the U.S.

China Tightens Controls on Outbound Investments

As the Chinese Renminbi ("RMB") has come under downward market pressures and Chinese investors have sought to make investments abroad, Beijing has reacted by taking measures to clamp down on capital movement into foreign currencies. Recently, it has been widely reported that China is implementing new rules to enhance the scrutiny of certain types of overseas deals.[2] These reports were largely based on certain "allegedly leaked" provisions of a draft document circulated by the State Council, China's cabinet, which requires government agencies to sign off on certain types of foreign acquisitions by Chinese companies.

Based on our review of the "allegedly leaked" draft document, the new measure seems to target the following outbound acquisitions, including pending deals that already have National Development and Reform Commission of China ("NDRC") clearance:

- Deals over $10 billion;
- Real estate deals over $1 billion made by state-owned enterprises ("SOEs");
- Non-real estate deals over $1 billion that are unrelated to the Chinese buyer's core business;
- Overseas direct investments made by limited partnerships;
- Less than 10% investments in overseas-listed companies;

[1] See http://hzs.mofcom.gov.cn/article/aa/201611/20161101961499.shtml.
[2] See the *Wall Street Journal* report: http://www.wsj.com/articles/china-issuing-strict-controls-on-overseas-investment-1480071529.

- Investments in delisting of overseas-listed Chinese companies; and

- Investments in overseas companies with high debt-to-assets ratio and low rate of return on net assets.

Industry-wise, Chinese officials have named real estate, hotel, movie theater, entertainment and sports clubs as examples of "irrational" outbound investments made by Chinese companies on which the officials said they have been keeping their eyes, according to a joint press release issued by NDRC, MOFCOM, the State Administration of Foreign Exchange of China ("SAFE") and The People's Bank of China ("PBOC") on December 6, 2016.

Regardless of whether the draft document will be officially promulgated or not, it is clear that the scrutiny of Chinese outbound investments by NDRC, MOFCOM and SAFE has significantly increased recently. In practice, the Chinese government does not need to promulgate any new regulations in order to exercise more controls on Chinese outbound investments. Each of NDRC, MOFCOM and SAFE has broad discretion and they could choose to simply apply existing regulations more strictly to achieve the same effect. One piece of evidence that this is happening is another document, apparently from SAFE, that has "leaked" in recent weeks indicating that SAFE is now exercising closer scrutiny of any transaction involving outbound investment in excess of $5 million. Any prolonged process from NDRC, MOFCOM or SAFE review would increase deal uncertainty and likely deter foreign targets and sellers from executing deals with Chinese buyers.

It was stated in the "allegedly leaked" draft document that it would be a temporary measure that would expire at the end of September 2017. Whatever the duration, the effect of these measures would appear to make it more difficult to execute very large transactions, while apparently leaving the lane open for middle-market deals, especially acquisitions of technologies and capabilities that are consistent with the overall Central Government strategy of transitioning the economy from its base in low-cost manufacturing, infrastructure and construction towards increased domestic consumption and higher value-added sectors. Arguably, the common theme of extra scrutiny on real estate, hospitality, entertainment and sports sector investments, take privates of Chinese companies with foreign listings, highly leveraged deals, deals with low return on assets and deals where Chinese buyers would be limited partners or own less than 10% is that Beijing would prefer to prioritize deals that more clearly enhance Chinese industry, technology and competitiveness over deals that are perceived as being primarily financial or non-strategic in nature.

In another recent development, PBOC promulgated a new regulation on December 30, 2016, pursuant to which, beginning July 1, 2017, financial institutions in China will be obligated to report to PBOC, (i) any domestic or cross-border cash receipt or payment of RMB 50,000 or $10,000 by any individual or entity client, (ii) any domestic or cross-border transfer of RMB 2 million or $200,000 by any entity client, or (iii) any cross-border transfer of RMB 200,000 or $10,000 by any individual client, in each case in a single day either through a single transaction or a series of transactions.

Immediately following that announcement by the PBOC, SAFE issued a press release on December 31, 2016, to clarify that, although the total annual foreign exchange limit of $50,000 for each individual remains unchanged for legitimate uses, each individual is now obligated to undertake to the financial institutions when they apply for foreign exchange that they will not use such funds for overseas property purchases or to invest in overseas securities, among other restrictions.

Most recently, it is being reported that banks in Shanghai must now "import" an equivalent amount of RMB as they allow clients to remit overseas, a significant tightening of prior policy that allowed banks to remit RMB 160 overseas for every RMB 100 brought back into China. Banks in Beijing are reportedly now subject to an even tighter policy, allowing them to remit overseas only RMB 80 for every RMB 100 they import.

CFIUS Review under the Trump Administration

The Committee on Foreign Investment in the U.S. ("CFIUS") had not been perceived to have been "soft" on national security review under former President Barack Obama's administration. In the latest significant development, President Obama issued an order on December 2, 2016, prohibiting the acquisition of the U.S. business of Aixtron SE ("Aixtron") by Chinese-owned Grand Chip Investment GmbH and certain of its direct and indirect shareholders (together, the "Purchasers"). The order directed the Purchasers and Aixtron to take all steps necessary to fully and permanently abandon the proposed acquisition of Aixtron's U.S. business not later than 30 days after the date of the order. The order is only the second formal presidential action taken by the Obama Administration, but many other transactions were abandoned at earlier stages of the CFIUS review process in the face of regulatory concerns.

Although it is still too early to draw any firm conclusion as to whether the Trump Administration will seek to change foreign investment policy, the CFIUS process or the CFIUS statute, certain transactions – particularly those involving investment in industries that have been the focus of trade-related concerns with China – may receive greater political and regulatory scrutiny.

In light of President Trump's rhetoric about China before and after the election, the Trump Administration, working with a Republican-controlled Congress, could seek to amend the CFIUS statute to extend its scope and raise the bar for foreign acquirers, particularly Chinese buyers. While it is too early to predict what, if anything, will change, there are several possible CFIUS amendments that seem set to be debated in Washington. One possibility would be to expand the scope of CFIUS review beyond purely national security concerns, which would give regulators wider discretion to block deals based on broader social or economic factors. Some proposals being discussed in Washington are more clearly directed at China, including a possible "negative presumption" against Chinese buyers, a "reciprocity" criteria under which CFIUS would be required to take into account the investing country's openness to reciprocal investments by U.S. buyers[3] (and under which China would score poorly), and even an outright ban on Chinese SOEs making U.S. acquisitions.

Major Revisions to China Foreign Investment Regulatory Regime

On January 19, 2015, MOFCOM released for public comments a draft new law governing foreign investments into China (the "Draft Foreign Investment Law"). Among other things, the Draft Foreign Investment Law proposes to unify China's foreign investment regulatory regime, which currently consists of various laws, regulations and industry-specific policies, and to provide "national treatment" for foreign investors except for investments into certain industrial sectors listed on a "negative list" (the "Negative List").[4]

Although the Draft Foreign Investment Law has yet to be promulgated, through pilot programs in free trade zones in Shanghai, Guangdong, Tianjin and Fujian, China has taken steps to shift its approval system, which has been in place for over 30 years since China's reform and opening-up in late 1970s, to a more investor-friendly "record-filing" system for certain foreign investments in the free trade zones.

Following the successful trials in the free trade zones, on September 3, 2016, the Standing Committee of the National People's Congress ("NPC") adopted significant revisions to China's Wholly Foreign-owned Enterprises ("WFOE") Law (the "WFOE Law"), the Sino-foreign Equity Joint Ventures Law (the "EJV Law") and the Sino-foreign Cooperative Joint Venture Enterprises Law (together with the WFOE Law and the EJV Law, the "FIE Laws") to replace existing approval requirements with record-filing requirements for all foreign-invested enterprises ("FIEs") that are not subject to national market access restrictions. On October 8, 2016, MOFCOM promulgated new regulations ("New MOFCOM Regulations") to implement the proposed record-filing system.

The key changes contemplated by the revisions to the FIE Laws and the New MOFCOM Regulations include, among others, the following:

- Other than foreign investments in industrial sectors falling into (i) the restricted category (covering 38 industrial sectors), (ii) the prohibited category (covering 35 industrial sectors), or (iii) the encouraged category with restrictions on foreign investors' shareholding percentage or management team in the FIEs (covering 35 industrial sectors) (collectively, the "Restricted Sectors") as specified in the current Industrial Guidance Catalogue for Foreign Investment (2015) (the "FIE Catalogue"),[5] all establishments of

[3] See, e.g., Covington, "*CFIUS and Foreign Direct Investment under President Donald Trump*" (November 23, 2016).
[4] For a detailed introduction on the Draft Foreign Investment Law, see article "*China to Overhaul its Foreign Investment Regulatory Regime*" on "Ropes Recap - Mergers & Acquisitions Law News" Q4 2014, published on January 29, 2015.
[5] For a detailed introduction on the FIE Catalogue, see article "*China Continues Foreign Investment Reforms by Revising Foreign Investment Catalogue*" on "Ropes Recap – Mergers & Acquisitions Law News" Q1, 2015, published on April 9, 2015.

FIEs (including foreign-invested investment companies and foreign-invested venture capital enterprises) or changes in certain key matters of FIEs only need to be filed with the provincial MOFCOM through an online filing system. Record-filing for establishment of an FIE or a change of a key matter of an FIE must be made either before or within 30 days of the issuance of the business license, for the former, or within 30 days of the occurrence of such change, for the latter. If filing is confirmed by the provincial MOFCOM to be outside the Restricted Sectors, and information required to be submitted is complete, the provincial MOFCOM must issue a notification of completion of filing within 3 working days of such submission. However, unlike the old FIE Laws under which MOFCOM's approval is a condition to the issuance of a business license by State Administration for Industry and Commerce ("SAIC") upon which the establishment or change of an FIE become effective, the effectiveness of the establishment or the change of an FIE under the revised FIE Laws is not conditioned upon completion of the record-filing.

- Key changes of FIEs that are subject to the record-filing requirements include (but are not limited to): (i) basic information regarding the FIE (e.g., name, address, nature and scope of business, registered capital, total investment, organizational structure, legal representative, etc.) and its investors (e.g., name, nationality, term, amount and form of investment, etc.); (ii) any change in equity interest of the FIE; (iii) merger, division and termination; and (iv) pledge and transfer of economic interest in the WFOE.

- The New MOFCOM Regulations require more extensive information disclosure than the former foreign investment approval regime. For example, applicants need to disclose the "ultimate effective controlling person(s)" of an FIE in order to complete the record-filing. Such term is broadly defined to include not only a person who holds 50% or more of the ownership interests but also a person who has a "material influence" on operational decisions of such FIE. In contrast, under the old FIE Laws, only information on the immediate shareholder(s) of an FIE is required to be disclosed.

- While a nationwide Negative List was supposed to have been promulgated on October 1 to replace the FIE Catalogue, the release of such a Negative List was postponed, and as an alternative, the NDRC and MOFCOM issued a joint notice on October 8, 2016 to specify that the FIE Catalogue remains effective and applicable to the revised FIE Laws.

The New MOFCOM Regulations do not apply to the following foreign investments (which are still subject to approval(s) from MOFCOM and/or other relevant authorities):

- Any foreign investment in Restricted Sectors.

- Any foreign investment in existing companies in China by way of mergers & acquisitions.

- Any strategic investment by foreign investors in companies listed in China's stock exchanges.

- Any foreign investment that may involve China's national security review.

The revised FIE Laws will have a significant impact on China's entire legal regime for FIEs. In addition to the New MOFCOM Regulations, many other national and local laws and regulations issued by authorities such as NDRC, SAIC and SAFE will need to be updated to be consistent with the revised FIE Laws.

An ongoing uncertainty remains whether and when the Draft Foreign Investment Law will be promulgated. Some commentators suggest that the NPC's decision to revise the FIE Laws separately signals a likely delay in implementing the much more extensive changes contemplated in the Draft Foreign Investment Law. Time will tell.

UK UPDATE

Are Contractual Warranties Also Representations for Purposes of the Misrepresentation Act?

In a recent decision, the High Court for England and Wales considered whether a set of warranties provided by a seller to the buyer in a share purchase agreement were also actionable representations that would permit the buyer to bring a claim for misrepresentation under the Misrepresentation Act 1967.

In *Idemitsu Kosan Ltd v Sumitomo Corporation*, Idemitsu Kosan filed suit against defendant Sumitomo Corporation and its wholly owned subsidiary alleging breaches of warranties by Sumitomo under a 2009 share purchase agreement whereby Sumitomo sold the entire issued share capital of Petro Summit Investment UK Limited to Idemitsu. The claimant paid approximately $575 million for the company.

The purchase agreement provided for a number of standard limitations on the defendant's liability under the warranties, including a time limit within which claims for breach of warranty should be brought and a financial cap on the seller's liability.

The claimant's allegation was that certain matters that had been warranted under the purchase agreement were not actually the case on the date of the purchase agreement. The claimant's contention accepted that it had not notified the defendant within the requisite contractual time frame and that it was, therefore, unable to bring a claim for breach of warranty. The buyer's claim was that the warranties provided in the purchase agreement were not just a set of contractual warranties but were also a series of representations by that seller that could be actionable as misrepresentations under the Misrepresentation Act 1967 and also that they were pre-contractual representations made by the defendant to the claimant by providing the execution copy of the purchase agreement prior to signature. The defendant rejected these arguments and brought an action for summary judgment to dismiss the claim without a full trial.

The question of whether contractual warranties could also be considered to be actionable representations has real commercial significance in terms of the measure of damages available. Obviously, in the case in point, it was accepted that a claim for breach of warranty was no longer possible due to the expiry of the limitation period. However, the judge commented that, at its highest, the damages claim for breach of warranty would have been about £6 million (the measure of damages, in broad terms, being designed to put the buyer in the position it would have been in had the warranty been true). Conversely, at its highest, an award of damages for a claim for misrepresentation could be equivalent to or exceed the consideration paid (the measure of damages, again, in broad terms, being designed to put the buyer in the position that it would have been in had it not entered into the contract). In the case in question, the claimant estimated the damages sought at $109.5 million.

The Court granted summary judgement in favour of the defendant, concluding that the warranties provided in the purchase agreement did not, in and of themselves, have a dual quality as both warranties and representations. In support of this view, he drew on a number of points of construction of the contract as a whole. In this regard, he pointed out that:

- there is a clear distinction between representations and warranties under English law, that would have been appreciated by the draftsman of the purchase agreement, and that under the terms of the purchase agreement and associated documentation, the warranties are clearly, and at all times, described as warranties, and are nowhere described as representations;

- the purchase agreement includes standard provisions to limit the seller's liability in respect of the sale. The relevant clauses form a significant part of the overall structure of liability that was agreed between the parties, and expressly limit the seller's liability in respect of a breach of warranty both as to the period and quantum of liability. On a strict reading of the purchase agreement, these limitation of liability provisions would not apply to limit the seller's liability in respect of a claim for misrepresentation, were the contractual warranties also to be considered to be actionable misrepresentations. The judge noted that, in this eventuality, the defendant would be deprived of the benefit of the raft of protections that they had agreed with the claimant, which could never have been what the parties intended; and

- there is a conceptual problem in characterising provisions in the contract as being representations relied on in entering into that same contract. Typically, the normal case in misrepresentation involves the making of a representation, and as a result the conclusion of the contract. The judge concluded that this does not work where the only representation is said to be in the contract itself.

The judge also dismissed the argument that the defendant had made an actionable pre-contractual representation to the claimant by virtue of providing an execution draft of the purchase agreement to the claimant prior to execution that contained the warranties. The Court also noted, in any event, that the purchase agreement contained an entire agreement clause that limited the buyer's right to claim in respect of any pre-contractual representations.

The decision provides welcome clarity in this area and confirms the sensible approach taken in *Sycamore Bidco Ltd v (1) Sean Breslin, (2) Andrew Dawson* [2012] EWHC 3443 (Ch). It removes some of the residual ambiguity in this area of law, and reasserts the importance of ensuring that a careful and consistent approach is taken to contractual drafting, so as to avoid any unintended consequences. (*Idemitsu Kosan Ltd v Sumitomo Corporation* [2016] EWHC 1909 (Comm)).

The PSC Regime: Update

We reported previously that from April 6, 2016, all UK companies (with some limited exceptions) and all UK limited liability partnerships are now required to take reasonable steps to identify individuals who have significant control over the entity in question, and to maintain a register of these individuals. Entities that maintain a PSC register will need to update their PSC register when any changes occur and are also required to update the central public register at Companies House annually.

As we have noted previously, the introduction of the new PSC regime is one of a number of important reforms of UK company law that are designed to increase the accountability of companies registered in the UK. The reforms are part of a global initiative designed to tackle the criminal misuse of companies by means of enhanced corporate transparency. The requirements of the European Fourth Money Laundering Directive ("4MLD"), which requires member states to establish a central register to hold information on beneficial ownership for corporate and other legal entities incorporated within their territory, provides the overarching framework for European Union member states. The UK is ahead of the curve, since it has already implemented the vast majority of its obligations as regards corporate transparency and beneficial ownership under the 4MLD by virtue of the introduction of the PSC regime. Other European countries will follow suit as they transpose the provisions of the European Union Fourth Money Laundering Directive into their own domestic law.

There are two further important developments to the UK regime that are likely to arise over the coming year in order to bring the PSC regime into line with the broader requirements of 4MLD. First, it is likely that in the near future (at a time that has not yet been finally confirmed, but no later than the end of June 2017) companies and limited liability partnerships that maintain a PSC register will be required to update their PSC information at Companies House within 6 months of a change occurring, as opposed to on an annual basis, as the 4MLD requires that information on the central register of beneficial ownership should be current. Second, the PSC regime is likely to be extended to apply to other legal entities (including Scottish partnerships and Scottish limited partnerships and OEICs).

Recent Case Law on Restrictive Covenants

Karen Denise Millen v (1) Karen Millen Fashions Limited and (2) Mosaic Fashions US Limited [2016] EWHC 2104 (Ch)

Summary of facts: In this recent decision, Karen Millen, who sold her fashion retail business, sought to establish that her proposed new ventures would not infringe the restrictive covenants provided in the 2004 share sale agreement. This was one of a number of hearings on related matters between the parties both in the UK and overseas. A key issue was whether the seller would infringe the restrictive covenants in the 2004 sale agreement, if she were to sell any products (including women's fashion) under the name 'Karen' and home wares under the name 'Karen Millen' in the U.S. and China.

Points of interest: The decision is of particular interest because, the seller of a business was seeking to identify the scope and extent of her restrictive covenants in order to provide a form of 'pre-clearance' for her new business, as opposed to the typical scenario, where an aggrieved buyer seeks to assert that a seller has already acted in breach of these covenants. The decision also provides useful commentary on standard boilerplate provisions, including further assurances, assignment and third-party rights provisions.

Decision: The judge failed to provide Millen with the 'preclearance' declaration that she sought. Interestingly, the judge concluded that the protections in the sale agreement applied to the goodwill of the business as at the date that the declaration was sought and not as at the date that Millen had sold the business, notwithstanding that the business had evolved considerably in the U.S. and China in the intervening period (with the effect that the restriction was broader than it would otherwise have been). Whilst this provides interesting commentary on how the concept of goodwill will be interpreted, it also underlines the point that careful thought should be applied to the drafting of restrictive covenants so as to ensure that they apply in the way that is desired.

In addition, the defendants also relied on the provisions of a 'further assurances clause' in the original sale agreement to compel the seller to register trademarks in these jurisdictions in their names. The judge provided interesting commentary on what level of obligations might be required in order to comply with a further assurances clause; and the takeaway point in this respect is that such a clause represents a significant level of obligation that goes beyond signature of the specific deal documentation. Interestingly, the judge also confirmed that the defendants (who were respectively an assignee of the original purchaser and a third party with rights conferred by the original agreement) were restricted from bringing proceedings in relation to the sale agreement in other jurisdictions by virtue of the exclusive jurisdiction clause in the agreement. The defendants had tried to maintain that they were not bound by the exclusive jurisdiction clause on the grounds that they were not original parties to the agreement. The judge found that the exclusive jurisdiction clause applied to them irrespective of this.

Rush Hair Limited v Hayley Gibson-Forbes and S.J. Forbes Limited [2016] EWHC 2589 (QB).

In this decision, the High Court considered the scope and extent of a number of typical restrictive covenants in a share purchase agreement and assessed whether they were enforceable.

Summary of facts: Rush Hair Ltd ("RHL") entered into a franchise agreement in 2008 with a company owned by Hayley Gibson-Forbes to operate a Rush Hair hairdressing salon in Windsor. In March 2015, Gibson-Forbes agreed to sell the shares in the Windsor salon to RHL. Gibson-Forbes agreed that she would not, for a period of two years following completion of the sale: (i) canvas, solicit, entice or employ certain named key employees, and/or (ii) directly or indirectly be engaged, concerned, employed or interested in any competing 'Rush business' within a two-mile radius of the Windsor salon. In July 2016, Gibson-Forbes opened a salon within a two-mile radius of the Windsor salon, using a newly formed limited company jointly owned with her husband. The new salon then engaged one of the key employees named in the employee covenant in the sale agreement to provide services as a consultant hairdresser. RHL alleged that Gibson-Forbes was in breach of both covenants, notwithstanding that the new salon was operated by a separate company and that there was no definition of Rush business in the sale agreement.

Points of interest: The decision is interesting because it provides a useful summary of the current status of various aspects of the law on restrictive covenants and their interplay with other key legal doctrines and principles of contractual construction.

As a preliminary, the Court summarized the correct approach to be taken in assessing the reasonableness of the restrictive covenants in question: (i) what does each covenant mean when properly construed; (ii) has RHL shown on the evidence that it has a legitimate business interest that requires protection; and (iii) if a legitimate protectable interest has been established, can it be shown that the covenant is no wider than is reasonably necessary for the protection of those interests? To this end, the factual matrix in question required the Court to consider the principle of contractual construction that provides that where a provision is ambiguous it is permissible to choose a 'commercially sensible' meaning over one that leads to apparent absurdity, but only in circumstances where the language of the provision is truly ambiguous. In addition, the Court had to consider whether the situation required them to pierce the corporate veil: or, as more specifically applied to the facts, whether a person who covenants not to do something is in breach of the covenant, if the prohibited act is done not by him but by a company with which he is concerned.

The decision also provided some very useful commentary on the legal principles that underpin the enforceability of restrictive covenants in the context of share sale agreements (as distinct from employment contracts) and the recognition that there is more freedom of contract between a buyer and seller than between an employer and employee, because it is in the public interest that a seller should be able to achieve a high price for what he has to sell.

Decision: The Court concluded that the seller, Gibson-Forbes, was in breach of both covenants. The Court held that there was no need to pierce the corporate veil to reach this conclusion (which reinforces the general reluctance of the Courts to pierce the corporate veil where the correct decision can be reached on separate legal principles). The judge concluded that the non-employment covenant should be construed in a commercially sensible manner, as prohibiting Gibson-Forbes from 'canvassing, soliciting, enticing or employing' any of the named individuals, whether on her own behalf or as agent for another, on the basis that a contrary interpretation would result in a 'toothless restrictive covenant'. As regards the non-complete covenant, the judge was not persuaded by Gibson-Forbes' argument that "RUSH business" should be narrowly construed, in the absence of a clear definition in the sale agreement. The judge concluded that it was fairly obvious that "RUSH business" means Rush's hairdressing business. Additionally, he concluded that the non-complete covenant was sound both in its geographical reach and duration.

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