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SEC/CORPORATE

Delaware Court of Chancery Rules That a Major Debt Holder and 48 Percent Stockholder Is a Controlling Stockholder and Owes Fiduciary Duties to Minority Stockholders

In *Hamilton Partners, L.P. v. Highland Capital Management, L.P.*, the Delaware Court of Chancery denied a motion to dismiss breach of fiduciary duty claims brought by former stockholders of American Home Patient, Inc. (AHP) against Highland Capital Management, L.P in connection with a going-private transaction.

Following a failed attempt to acquire AHP in 2006, Highland acquired large positions in AHP's common stock and secured debt in the public markets. By 2007, Highland held 82 percent of AHP's secured debt and owned 48 percent of AHP's common stock. Due to its ownership of 48 percent of AHP's common stock, Highland became an "interested stockholder" for purposes of Section 203 of the Delaware General Corporation Law and was prohibited from effecting a business combination with AHP until 2010. In 2009, AHP and Highland entered into a series of forbearance agreements relating to AHP's senior debt, which was in default. The forbearance agreements expired in May 2010 shortly after the expiration of the statutory three-year moratorium on Highland's ability to enter into a business combination with AHP. Prior to the expiration of the statutory moratorium and during the forbearance period, Highland proposed to acquire all of the shares of common stock of AHP not owned by it pursuant to a restructuring and subsequent cash tender offer. Highland also indicated that, if the proposed transaction were not approved, it would not extend the forbearance agreement. In response to Highland's proposal, AHP formed a special committee of independent directors, which engaged its own counsel and financial advisor. After the expiration of the forbearance period, the special committee approved the transaction without conducting a market check or sale auction.

AHP's stockholders brought suit alleging that Highland was AHP's controlling stockholder, despite holding less than a majority of AHP's common stock and having no representatives on the board of directors of AHP and that, as AHP's controlling stockholder, Highland breached its fiduciary duties by exercising control over AHP to facilitate a transaction on unfair terms. Highland moved to dismiss the stockholders' claims, asserting that Highland was not AHP's controlling stockholder and, therefore, did not owe any fiduciary duties to AHP or its minority stockholders.

The court denied Highland's motion to dismiss. While the court acknowledged that creditors do not owe fiduciary duties to a borrower or its stockholders, the court reasoned that, when the parties agreed to the going-private transaction, the combination of Highland's ownership of AHP's common stock and AHP's defaulted senior debt was sufficient to support an inference of control and, accordingly, that Highland owed fiduciary duties to the minority stockholders of AHP. The court further noted that Highland's alleged willingness to enter into multiple forbearance agreements with AHP only until after the expiration of the three-year business combination moratorium required by Section 203 of the Delaware General Corporation Law supported the plaintiff's assertion that Highland controlled AHP.

Click here to read the opinion.

Delaware Court of Chancery Applies Entire Fairness Standard to Going-Private Transaction with a Controlling Stockholder Negotiated by Special Committee and Approved by a Majority of the Minority Stockholders

In *In re Orchard Enterprises, Inc. Stockholder Litigation*, the Delaware Court of Chancery held that the entire fairness standard of review applied to a going-private transaction with a controlling stockholder, even though the transaction was negotiated by a special committee of independent directors and approved by a majority of the minority stockholders.

Dimensional Associates, LLC, which held 42 percent of the common stock of Orchard Enterprises, Inc. and 99 percent of Orchard's senior convertible preferred stock, proposed to acquire all of the outstanding shares of Orchard's capital stock held by the minority stockholders for $2.05 per share. Orchard's board of directors formed a special committee of independent directors to evaluate the proposal. The special committee had the exclusive power and authority to negotiate with Dimensional, terminate consideration of Dimensional's proposal, solicit interest from third parties and retain independent advisors. After several rounds of negotiations, Dimensional and the special committee agreed that the transaction would be subject to a non-waivable condition that the majority of the minority stockholders approve the transaction.

The court held that, even though the transaction was subject to the approval of Orchard's special committee and a majority of the minority stockholders, the transaction would be subject to review under the entire fairness standard rather than the business judgment rule. In distinguishing the court's decision in *In re MFW Shareholders Litigation* (as summarized in the *Corporate & Financial Weekly Digest* edition of June 7, 2013) and the Delaware Supreme Court's decision in *Kahn v. M&F Worldwide Corp.* (as summarized in the *Corporate & Financial Weekly Digest* edition of March 21, 2014), which affirmed the court's decision in *In re MFW Shareholders Litigation*, the court explained that, in order to avoid entire fairness review, a controlling stockholder must agree "up front, before any negotiations begin" that the transaction will be subject to (i) the affirmative recommendation of a special committee composed of independent and disinterested directors that is empowered to freely select its own advisors and to say no definitively and (ii) the affirmative vote of an informed majority of the minority stockholders. If none or only one of the protections is agreed to up front, the transaction will be subject to entire fairness review. If the controlling stockholder can show that at least one of the protections was in place, the controlling stockholder can shift the burden of proof to the plaintiffs to show that the transaction was unfair, even if such protections are not agreed to up front. If the controlling stockholder is unable to shift the burden of proof such that the plaintiff challenging the transaction must prove unfairness, the controlling stockholder will bear the burden at trial of proving that the transaction was the product of a fair process and that the price paid was fair.

Click here to read the opinion.

BROKER DEALER

FINRA Proposes to Amend Rule 2360

The Financial Industry Regulatory Authority, Inc. is proposing to amend FINRA Rule 2360(b)(23) to harmonize the expiration date of standardized equity options with the rules of The Options Clearing Corporation (OCC) and the options exchanges. Specifically, the proposed rule amendment will change the expiration date for most standardized options contracts from the Saturday following the third Friday of the expiration month to the third Friday of the expiration month. The revised expiration date will apply to (i) special procedures for the exercise of standardized equity options, (ii) to the exercise cut-off time and (iii) in the event that the OCC or national options exchange provides advance notice modifying the time for the close of trading in standardized equity options.

More information on the proposed rule change to FINRA Rule 2360 is available here.

DERIVATIVES

SEC to Hold Open Meeting on Cross-Border Security-Based Swap Definitions

On June 18, the Securities and Exchange Commission announced that it will hold an open meeting on June 25 to consider whether to adopt rules that would apply the definitions of “security-based swap dealer” and “major security-based swap participant” to cross-border security-based swap activities. The proposed rules would be issued pursuant to the SEC’s authority under the Securities Exchange Act of 1934 and Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

For more information, click here.

CFTC

JAC Issues Guidance on FCM Financial Information Disclosure Requirements

The Joint Audit Committee (JAC) has issued a regulatory alert reminding futures commission merchants (FCMs) of their obligation to make certain financial information available on their websites effective July 12 in accordance with Commodity Futures Trading Commission Regulation 1.55(o)(1). The JAC alert reminds FCMs that the requirement to post information for the most current 12-month period is a retroactive rolling requirement and provides the following additional guidance:

- An FCM must include its daily customer segregated, secured amount and cleared swaps statements for the period of July 11, 2013 through July 10, 2014. The use of summary schedules will not be permitted.

- A dually registered FCM/broker dealer will be required to include its month-end summary schedule of tentative net capital, net capital and excess net capital for the period of June 30, 2013 through May 31, 2014. An FCM-only firm will be required to include its month-end summary schedule of adjusted net capital, net capital and excess net capital for the same period.

- An FCM must include its year-end certified statement of financial condition, customer segregated, secured amount and cleared swaps statements and all related footnotes to the above schedules that are part of the FCM’s most recent certified annual report. The FCM is not required to include any other financial statements that are part of its annual report.

- An FCM must include its customer segregated, secured amount and cleared swaps statements that are part of its monthly unaudited Form 1-FR-FCM or FOCUS report for the period of June 30, 2013 through May 31, 2014, but is not required to include any other financial statements that are part of its monthly unaudited Form 1-FR-FCM or FOCUS reports.

The JAC regulatory alert can be accessed here.

INVESTMENT COMPANIES AND INVESTMENT ADVISERS

SEC Releases Guidance on Affiliated Transactions of Series Investment Companies

On June 6, the Securities and Exchange Commission’s Division of Investment Management released a Guidance Update clarifying that separate series of a series investment company are each considered an individual company for the purposes of determining whether such series have entered into affiliated transactions. A mutual fund typically operates as a “series company,” in which multiple investment portfolios are offered to investors as separate series, but the company has a single set of organizational documents and board of directors and is permitted to use a single registration statement. Each series, however, has its own investment objectives and set of shareholders and is considered a separate investment company under the Investment Company Act of 1940 (1940 Act).

The SEC and the staff have applied the 1940 Act to separate series as separate investment companies in virtually all cases. The Guidance Update was issued to remind mutual funds and series investment companies to ensure that their compliance policies and procedures are reasonably designed to prevent violations of federal securities laws on a series-by-series basis. Mutual funds should devote particular attention in their compliance policies and procedures to transactions with "affiliated persons" that are prohibited by Section 17(a) of the 1940 Act. More specifically, Section 17(a) of the 1940 Act prohibits an "affiliated person" of a mutual fund or an affiliate of such affiliated person from selling any security or property to the mutual fund. Section 2(a)(3) of the 1940 Act defines an affiliated person as one who owns five percent or more of the outstanding voting securities of an entity. In a series investment company, a person who owns five percent or more of the shares of stock of a single series also would be considered an affiliated person. Compliance policies and procedures should not only provide for the identification of affiliated persons of the series investment company, but also for the identification of affiliated persons of each series separately, in light of the particular circumstances of the mutual fund.

To read the full text of the Guidance Update, click here.

LITIGATION

Delaware Court of Chancery Finds Contract Rate Applies to Post-Judgment Interest

The Delaware Court of Chancery recently held that, in a case alleging breach of a loan agreement for more than $100,000, post-judgment interest accrues at the rate set forth in the agreement and not at the lower statutory rate.

FE Partners, LLC made a loan to Sequoia Presidential Yacht Group LLC with an 8.75 percent interest rate per annum. Sequoia later commenced an action to prevent FE Partners from utilizing an option to purchase the collateral for the loan, and FE Partners counterclaimed for breach of the loan agreement. Although the dispute ultimately settled, with Sequoia consenting to entry of a default judgment on FE Partners' counterclaim, the parties disagreed over the rate for the post-judgment interest.

In considering which rate should apply, the court looked to the state's usury law, Section 2301 of Title 6 of the Delaware Code. Section 2301(a) caps the interest rate on loans at five percent over the Federal Reserve discount rate including any surcharge thereon (the legal rate), and provides that "except as otherwise provided," post-judgment interest shall be the legal rate or the contract rate, whichever is less.

Sequoia argued that Section 2301(a) governed its loan and therefore interest was limited to the lower legal rate. The court, however, held that Section 2301(c), not Section 2301(a), governed the agreement. Section 2301(c) imposes no limit on the interest charged for loans in excess of $100,000 and not secured by a mortgage against the borrower's principal residence.

Despite Section 2301(c)'s silence on the issue of post-judgment interest, the court looked to the statutory scheme laid out in Section 2301(a), which permits lawful contract rates to govern post-judgment. As such, the court determined that post-judgment interest would accrue at the parties' agreed-upon contract rate of 8.75 percent.

Sequoia Presidential Yacht Group LLC v. FE Partners, LLC, Civil Action No. 8270-VCG.

SEC Obtains Settlement for Investment Adviser's Real Estate Investment Fraud

The Securities and Exchange Commission recently announced a settlement with an investment adviser based on alleged fraud in a real estate investment offering.

From April to September 2011, Robert C. Acri was the controlling manager of Kenilworth Asset Management LLC, a registered investment adviser. The SEC contended that Acri defrauded Kenilworth's clients in the offer and sale of $240,000 in promissory note securities of Prairie Common Holdings LLC by informing clients that their investment would help develop retail property in Indiana, and would be secured.

According to the SEC, Acri misappropriated $41,250 of Kenilworth clients' funds and never secured their investment as promised. In addition, Acri allegedly failed to disclose material information, such as a conflict of interest stemming from his motivation to secure investments to help other Kenilworth clients recover on a delinquent loan of $500,000 to an entity related to Prairie. The SEC also contended that Acri failed to inform clients of the property's distressed financial condition, as well as the five percent commission ($13,750) Kenilworth would receive for the sale of the securities.

The SEC found that Acri violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5, and Sections 206(1) and (2) of the Investment Advisers Act of 1940. As part of the settlement, which did not require factual admissions, Acri agreed to a permanent industry bar, disgorgement of $55,000, prejudgment interest of $4,478.96 and a civil monetary penalty of $55,000.

In the Matter of Robert C. Acri, A.P. File No. 3-15926 (June 11, 2014).

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