ROPES & GRAY

MERGERS & ACQUISITIONS LAW NEWS

2016 QUARTERLY RECAP FROM THE M&A TEAM

# The Ropes Recap

## Mergers & Acquisitions Law News

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

**Contents**


News from the Courts ........ 1

*Delaware Court of Chancery Rejects Transaction Price as the Best Measure of Fair Value in Dell Appraisal Litigation* ........ 1

*Delaware Court Rejects Claim of Bad Faith Where Board Instructed Financial Advisor to Ignore Management's Optimistic Financial Projections* ........ 2

*Chancery Court Equates Tender of Shares to a Stockholder Vote in Determining the Standard of Judicial Scrutiny for Board of Directors Who Approved Volcano Corp. Merger* ........ 3

*New York Court of Appeals Adopts Delaware Law, Affirming Business Judgment Deference for Kenneth Cole's Controlling Stockholder Transactions Structured with Minority Protections* ........ 3

*Delaware Supreme Court Holds that Sale of Zale Approved by Uncoerced, Disinterested, and Informed Stockholders are Properly Reviewed Under a Corporate Waste Standard* ........ 4

*Chancery Court Offers Guidance on "Commercially Reasonable Efforts" Standard in Williams Cos. v. Energy Transfer Equity Litigation* ........ 6

*New York Court of Appeals Rules that Communications between Merger Parties Countrywide and Bank of America Are Not Protected by the Common Interest Exception to the Waiver of Attorney-Client Privilege* ........ 7

*Sun Capital Partners on Remand: District Court Rules that Related Funds May be Held Liable for Pension Fund Withdrawal Liabilities* ........ 8

*Continued Focus on the "Investment-Only" Exemption of the HSR Act: DOJ Files Suit against ValueAct* ........ 9

*Court of Chancery Applies Enhanced Judicial Scrutiny to Actions Taken by Cogentix Medical Board in Connection with Proxy Fight* ........ 11

*Chancery Court Addresses Potential Limitations to a Claim for Advancement of Expenses by Employees Serving in Company Management* ... 12

*Delaware Court of Chancery Allows Delaware Corporation, CytRx Corp., to Waive Forum Selection Bylaw* ... 12

*Court of Chancery Grants Advancement to Directors Hyatt and Gore in Merger Agreement Indemnification Dispute with Al Jazeera America* ... 13

Delaware Legislative Update ... 14

Tax Update ... 17

*Treasury Issues Regulations Intended to Deter "Inversion" Transactions and Prevent Earnings Stripping from U.S. Subsidiaries* ... 17

SEC Update ... 19

UK Update ... 21

Contributors ... 23

## NEWS FROM THE COURTS

***Delaware Court of Chancery Rejects Transaction Price as the Best Measure of Fair Value in Dell Appraisal Litigation***

On May 31, 2016, the Delaware Court of Chancery released its post-trial opinion in the closely-watched appraisal action that arose from the buyout of Dell Inc. by Michael Dell, its founder, and a private equity backer. Despite finding that the transaction resulted from a disinterested, fair, and robust process that would have "sailed through" a traditional fiduciary duty review, Vice Chancellor Travis Laster nonetheless held, after a four-day trial featuring 1,200 exhibits and extensive witness testimony, including from five experts, that the $13.75 per share transaction price did not provide Dell stockholders with fair value for their shares.

The *Dell* opinion is notable in that, contrary to the recent trend in Delaware, the court did not accept the transaction's market price as presumptively representative of fair value. Vice Chancellor Laster refused to view the market price as determinative for a number of reasons, including the fact that the transaction was a management buy-out, evidence showing a gap between Dell's intrinsic value and its share price, and certain limitations in the transaction process, including the lack of meaningful pre-signing price competition and the limitations of the go-shop provision.

The Court instead employed a discounted cash flow (DCF) analysis to render an independent conclusion. Interestingly, the Court rejected the company's internal projections as overly optimistic, and instead focused on projections prepared by the special committee's financial advisor, the Boston Consulting Group, Inc., in connection with the transaction, as well as projections provided to the buyout group's lenders. The Court also rejected many of the conclusions offered by the parties' experts concerning the proper DCF inputs, seeing them as litigation-driven. Ultimately, the Court selected different inputs from each of the experts, and valued Dell at $17.62 per share, an approximate $6 billion increase from the total consideration paid. However, because so few stockholders participated in the appraisal action, Dell likely will pay former stockholders only $35 million as a result.

The *Dell* opinion reminds merger parties that although deal price may be the best indicator of fair value in most instances, it is not determinative. The Delaware Court of Chancery will scrutinize the transaction process to evaluate whether it is a reliable measuring stick for assessing fair value. And even if that process would pass muster under a traditional fiduciary duty analysis, it may not be deemed the best measure of value. Here, the contrast between the market's "myopic" valuation of Dell and management's long-view 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. While some may view this opinion as breathing life into Delaware appraisal actions, the facts and circumstances surrounding the Dell transaction suggest that it may be an anomaly confined to its unusual facts. In a merger presenting none of these concerns, the Court of Chancery might very well follow its

recent practice of giving substantial (often determinative) weight to a transaction price fairly and rigorously set. (*In re: Appraisal of Dell, Inc.*, C.A. No. 9322-VCL (Del. Ch. May 31, 2016)).

***Delaware Court Rejects Claim of Bad Faith Where Board Instructed Financial Advisor to Ignore Management's Optimistic Financial Projections***

On May 20, 2016, Vice Chancellor Glasscock of the Delaware Court of Chancery issued a ruling in *In Re Chelsea Therapeutics International Ltd. Stockholders Litigation* granting dismissal of breach of fiduciary duty claims brought against the directors of Chelsea Therapeutics arising from a tender offer and intermediate merger under Section 251(h) of the Delaware General Corporation Law. The plaintiffs contended that the directors acted in bad faith by knowingly selling the company for an amount substantially below its standalone value, including by instructing the company's financial advisors to ignore a more optimistic internal financial model in favor of projections prepared by a consulting firm when conducting their fairness analysis.

The plaintiffs, however, failed to allege that the directors were interested in the transaction or otherwise lacked independence. Because the Chelsea directors were not alleged to have lacked independence in connection with the transaction, and because Chelsea's governing documents included a Section 102(b)(7) exculpatory provision, the Court focused its ruling on the narrow question of whether the plaintiffs had sufficiently alleged a non-exculpated claim that the directors had breached their duty of care. The Court noted that the plaintiffs were required to show an extreme set of facts to establish either that "disinterested directors were intentionally disregarding their duties" or that the Board's decision was "so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any ground other than bad faith." Scrutinizing the plaintiffs' allegations against that high bar, Vice Chancellor Glasscock dismissed the complaint because it was well within the bounds of reason for directors to decline to use optimistic projections of speculative value as indicators of the company's value.

In reaching its decision, the Court expressly declined to decide whether the holding of *Corwin v. KKR Financial Holdings LLC*—which held that the business judgment rule protects the conduct of directors in connection with transactions approved by a vote of fully informed, uncoerced, and disinterested stockholders—would apply to a transaction effected pursuant to Section 251(h). In declining to do so, the Court noted that it is unclear under *Corwin* whether a stockholder vote cleanses a board action in bad faith, even if the act is disclosed to stockholders before the vote. Second, the rule in *Corwin* applied to one-step mergers, not tender offers where there is no formal vote. (Note that the Chancery Court's subsequent decision in the *Volcano* case summarized below did apply the rule in *Corwin* to tender offers.) Given the particular difficulty of alleging a non-exculpated breach of fiduciary duties, this opinion highlights the deference Delaware courts will continue to extend to disinterested and independent directors not otherwise shown to be intentionally disregarding their duties in the conduct of a sale process. (*In Re Chelsea Therapeutics Int'l Ltd. S'holders Litig.*, Consol. C.A. No. 9640-VCG (Del. Ch. May 20, 2016)).

***Chancery Court Equates Tender of Shares to a Stockholder Vote in Determining the Standard of Judicial Scrutiny for Board of Directors Who Approved Volcano Corp. Merger***

In a recent case, the Delaware Chancery Court held that business judgment review irrebuttably applies to board decisions in mergers where a majority of holders of a company's outstanding stock express their consent to a merger by tendering their shares in a "two-step" merger pursuant to Section 251(h) of the Delaware General Corporation Law (DGCL). Although such tenders offers are not formal stockholder votes, the Court held that the acceptance of a tender offer by a majority of the stockholders will have the same cleansing effect on board decisions under Delaware law as the approval of a merger by a vote of the majority of the stockholders.

The case arose from the acquisition of Volcano Corporation by Phillips Holding USA through a two-step merger pursuant to Section 251(h) of the DGCL. Certain shareholders of Volcano filed suit alleging that (among other things) the board breached its duties of care and loyalty because (1) the board members were motivated by certain benefits that they received in the transaction and (2) the board relied on the "flawed advice" of its conflicted financial advisor, Goldman, Sachs & Co., who had previously entered into a series of hedging transactions with Volcano in 2012. In its analysis of the standard applicable to the board's decision, the Chancery Court reviewed the recent Delaware Supreme Court decisions in *Gantler v. Stevens* and *Corwin v. KKR Financial Holdings LLC* and determined that business judgment review applies to mergers when a majority of a corporation's fully informed, un-coerced, and disinterested stockholders approve the merger though a statutorily-required vote. The Court went on to hold that, although there was no formal stockholder vote in this case, a tender offer commenced and consummated pursuant to Section 251(h) had a similar "cleansing effect" as a statutorily required stockholder vote. Citing the policy rationales for applying business judgment review to mergers that are approved by a statutory vote of the stockholders, the *Volcano* court held that there was no basis for distinguishing a statutory stockholder vote and a tender offer accepted by the majority of the stockholders pursuant to Section 251(h).

The Court's decision in Volcano makes clear that, if properly executed, the tender offer that comprises the first step of a two-step merger pursuant to Section 251(h) will be viewed in the same manner as a statutorily-required stockholder vote with respect to the standard of review for board decisions regarding such a transaction. Thus, so long as a majority of disinterested and fully informed stockholders have accepted such a tender offer, Delaware courts will apply business judgment review in examining the board decision relating to the tender offer. (*In re Volcano Corp. Stockholder Litig*., C.A. No. 10485-VCMR (Del. Ch. June 30, 2016)).

***New York Court of Appeals Adopts Delaware Law, Affirming Business Judgment Deference for Kenneth Cole's Controlling Stockholder Transactions Structured with Minority Protections***

On May 5, 2016, New York's highest court confirmed that, under New York law, business judgment deference—rather than the more searching "entire fairness" review—applies to

controlling stockholder transactions that are approved by a duly empowered special committee of independent directors and that receive a "majority of the minority" vote from stockholders not affiliated with the controlling party. In *In the Matter of Kenneth Cole Productions Inc. Shareholder Litigation*, a case in which plaintiffs challenged the take-private of a New York corporation by its controlling stockholder, the New York Court of Appeals affirmed the trial court's dismissal of the case and adopted the Delaware Supreme Court's 2014 holding in *Kahn v. M&F Worldwide Corp.* (*MFW*). In adopting the *MFW* framework, the Court of Appeals aligned New York law with Delaware law, making the *MFW* mechanism available to New York corporations and offering a path for New York corporations to reduce litigation risk in connection with controlling party transactions.

The *Kenneth Cole Productions* litigation arose in 2012 after Mr. Kenneth Cole, the controlling stockholder of the prominent fashion retailer bearing his name, offered to purchase all of the outstanding Kenneth Cole stock that he did not already own. He also made clear that he would not sell his shares to another potential acquiror. In response, the company formed a special committee of independent directors to negotiate with Mr. Cole. The special committee engaged in successful negotiations to increase Mr. Cole's offer, and a deal was ultimately approved by the special committee and a majority of the non-controlling stockholders. Nonetheless, several stockholders sued in New York State court, challenging the transaction as unfair. In view of the protections afforded the non-controlling stockholders—an independent special committee and a majority of the minority vote—the trial court applied business judgment review and dismissed the consolidated action. After the intermediate Appellate Division affirmed and endorsed business judgment review, the plaintiff appealed to the State's highest court, the Court of Appeals, which similarly affirmed the trial court's determination.

The decision makes business judgment review available to controlling-party transactions involving New York corporations where the transaction at the outset is conditioned on its approval by both (1) a special committee comprised of independent, duly empowered directors and (2) a majority of the minority stockholders in a fully informed vote. To avoid application of business judgment review at the motion to dismiss stage, the burden is now on the plaintiff challenging such a transaction to "sufficiently and specifically allege" that the protections afforded the minority were not adhered to. Absent such allegations (or sufficient allegations of fraud or bad faith), New York law requires business judgment review for challenges to going-private transactions between a company and its controlling stockholder that are structured with the requisite minority protections, and transaction planners for New York corporations can now be confident that New York is aligned with Delaware in deferentially reviewing these types of transactions. (*In the Matter of Kenneth Cole Productions, Inc., Shareholder Litigation*, No. 54 (N.Y. May 5, 2016)).

***Delaware Supreme Court Holds that Sale of Zale Approved by Uncoerced, Disinterested, and Informed Stockholders are Properly Reviewed Under a Corporate Waste Standard***

On May 6, 2016, the Delaware Supreme Court confirmed that the conduct of sell-side directors in connection with the sale of Zale to Signet would be subject to the business judgment rule, as a

result of having been approved by a vote of uncoerced, disinterested, and informed stockholders, and on that basis determined that such conduct should be reviewed under the deferential corporate waste standard. In so holding, the Court expanded upon its prior ruling in *Corwin v. KKR Financial* that the business judgment rule will apply under such circumstances, and resolved a divide in authority within the Court of Chancery as to whether, in the context of such stockholder approval, the business judgment rule requires the directors' conduct to be reviewed under a corporate waste or a gross negligence standard. Confirming that a waste standard should govern, the Court held that "dismissal is typically the result" of claims asserted under those circumstances.

Prior to the ruling, the Court of Chancery had dismissed the plaintiffs' claim because the stockholder plaintiffs had failed to properly allege that the Zale directors had breached their fiduciary duty. In so holding, the Court of Chancery applied *Corwin* and reviewed the directors' conduct pursuant to the business judgment rule. However, it did so under a gross negligence standard, conducting a thorough inquiry of the directors' actions.

The Supreme Court affirmed the Court of Chancery's application of the business judgment rule to the Zale directors' conduct. However, the Court also concluded that the Court of Chancery erred in conducting a thorough post-closing analysis of whether the directors' conduct satisfied a gross negligence standard, holding such analysis was inappropriate because the Zale stockholders were uncoerced, disinterested, and informed when they approved the Signet transaction. The Court instead concluded that the plaintiffs' claims should be evaluated under a corporate waste standard. Waste is found only when "no person of ordinary or sound business judgment" could have found the transaction to be fair, making dismissal the typical result for such claims.

As part of the Supreme Court's decision, it also affirmed the lower court's dismissal of an aiding and abetting claim against Merrill Lynch, which had advised the board of directors of Zale in connection with its sale to Signet. In its opinion on the defendants' motion to dismiss, the Court of Chancery concluded that the plaintiffs adequately alleged that (1) the Zale directors breached their duty of care by failing to adequately inform themselves about Merrill Lynch's conflict of interest, which was premised upon a prior pitch presentation Merrill Lynch had made to Signet concerning a potential acquisition of Zale and (2) Merrill Lynch knowingly aided and abetted that breach by failing to inform the directors of that conflict in a timely manner. However, the Court of Chancery ultimately dismissed the aiding and abetting claim after concluding that the directors had not committed a predicate breach of fiduciary duty. The Supreme Court affirmed the dismissal and "distanced" itself from the Court of Chancery's earlier opinion that held that Merrill Lynch had knowingly aided and abetted a breach of duty by the Zale directors through "the late disclosure of a business pitch that was then considered by the board, determined to be immaterial, and fully disclosed in the proxy." The Supreme Court was "skeptical" that such conduct could support an aiding and abetting claim against a financial advisor, and sought to contrast the allegations asserted against Merrill Lynch with the post-trial findings by the Court of Chancery in *RBC Capital Markets, LLC v. Jervis*, where RBC was found to have committed a fraud on the directors whom it had been hired to advise.

Ultimately, the Court's opinion here provides more certainty that sell-side directors' conduct in connection with change of control transactions that are approved by a vote of uncoerced, disinterested, and informed stockholders will be subject to a deferential standard of review. The opinion also provides helpful guidance to the Court of Chancery concerning aiding and abetting claims asserted against financial advisors – reminding the lower court that while such claims can be maintained against truly bad actors, Delaware law utilizes a "defendant-friendly" standard for aiding and abetting liability and weak claims like those asserted here should be viewed skeptically. (*Singh v. Attenborough*, No. 645 (Del. May 6, 2016)).

***Chancery Court Offers Guidance on "Commercially Reasonable Efforts" Standard in Williams Cos. v. Energy Transfer Equity Litigation***

In a recent decision, the Delaware Court of Chancery provided additional guidance on the meaning of the "commercially reasonable efforts" required of parties to an acquisition agreement to ensure that the closing conditions are satisfied. The case arose from the proposed acquisition of Williams Cos., a publicly traded energy company, by another publicly traded energy company, Energy Transfer Equity, LP (ETE), for approximately $38 billion based on the valuation at signing. The transaction involved a heavily negotiated and highly complex tax structure, stemming from Williams' desire for its stockholders to remain holders of publicly traded common stock (as opposed to partnership units) and to receive a significant cash payment. Because there were many potentially negative tax ramifications to the merger, the parties included a condition to closing that ETE's tax attorneys, Latham & Watkins LLP, issue an opinion that the transaction "should" be treated by the tax authorities as a tax-free exchange under Section 721(a) of the Internal Revenue Code, and also included a covenant that required ETE to use "commercially reasonable efforts" to cause its tax attorneys to issue the 721 tax opinion.

Following the execution of the merger agreement in September 2015, however, the energy markets deteriorated, resulting in a sharp decline in the value of the parties' assets that threatened ETE's ability to finance the $6 billion cash portion of the merger. These circumstances left ETE with what Vice Chancellor Glasscock described as "a bitter case of buyer's remorse" and according to court testimony, ETE preferred to terminate rather than restructure the agreement. During this period, ETE's tax director reassessed several aspects of the merger structure and raised concerns that the IRS might not consider the transaction a tax-free exchange. After sharing those concerns with ETE's tax counsel at Latham, Latham reviewed the transaction and concluded that because of the decline in value of ETE's partnership units, the firm would be unable to deliver the necessary opinion before the closing of the merger, frustrating a closing condition and allowing ETE to terminate the agreement without penalty. While Williams' attorneys proposed two potential restructuring solutions, Latham concluded that neither proposal would enable it to deliver the opinion.

Williams then brought suit against ETE claiming that ETE failed to use its "commercially reasonable efforts" to obtain the tax opinion and should be enjoined from terminating the merger agreement. Following a two-day expedited trial, the Court held that ETE could terminate the

merger agreement, even after assessing the matter with a "skeptical eye" in light of ETE's non-tax-related motivation to walk away. The Court found no evidence that ETE's tax attorneys had been unduly pressured into changing their analysis or had otherwise acted in bad faith, and reasoned that the reputational damage Latham was likely to incur far outweighed any benefits of "unethical deferring" to the interests of this particular client. The Court then analyzed the meaning of the term "commercially reasonable efforts," which was not defined in the merger agreement. Based on the Delaware Supreme Court's 2008 decision in *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, the Court determined that "commercially reasonable efforts" required ETE to "to do those things objectively reasonable to produce the desired 721 Opinion, in the context of the agreement between the parties." Because Williams was unable to provide the Court with any commercially reasonable efforts that ETE could have taken to cause Latham to issue the opinion, the court could not conclude that ETE breached the agreement.

This decision highlights the risks associated with using undefined terms such as "commercially reasonable efforts" in acquisition agreements. Parties will often use some form of an "efforts" requirement in acquisition agreements and as this case illustrates, there may not be a meeting of the minds on what efforts are required, or a clear answer as to what actions satisfy a particular "efforts" standard used in the agreement. The case also illustrates the dangers of tying a closing condition to the actions of a single third party. (*Williams Cos. v. Energy Transfer Equity, LP*, C.A. No. 12337-VCG (Del. Ch. June 24, 2016)).

***New York Court of Appeals Rules that Communications between Merger Parties Countrywide and Bank of America Are Not Protected by the Common Interest Exception to the Waiver of Attorney-Client Privilege***

On June 9, 2016, New York's highest court issued a decision in *Ambac Assurance Corp. v. Countrywide Home Loans, Inc*. that narrowly interprets the scope of the common interest exception to the attorney-client privilege. Under the common interest exception, sharing privileged communications with a third-party will not serve to waive the privilege insofar as there is a common legal interest between parties. Holding that the common interest exception only shields the waiver of attorney-client privilege in the context of current or reasonably anticipated litigation, the New York Court of Appeals overturned a prior intermediate appellate court decision and cleared the way for discovery of over 400 communications between Bank of America and Countrywide Home Loans.

Bank of America was not initially a party to the case and the case initially arose from Ambac Assurance Corporation's guarantees of payments on residential mortgage-backed securities issued by Countrywide. When the mortgage-backed securities that Ambac insured failed during the 2007 financial crisis, Ambac sued Countrywide, alleging that Countrywide "fraudulently misrepresented the quality of the loans and fraudulently induced Ambac to guaranty them." In 2008, Countrywide sold substantially all of its assets to, and merged into, a wholly-owned subsidiary of Bank of America. After the merger, Ambac added Bank of America as a defendant and in 2012, sought discovery of certain communications between Bank of America and Countrywide exchanged after the merger agreement was signed but prior to closing. Bank of

America resisted disclosure, arguing that the information was protected by attorney-client privilege and the common interest doctrine defeated any claim of waiver.

Going against the decisions of several federal circuits and both Delaware and other state courts, the New York Court of Appeals held that the common interest exception is only available under New York law where communications between separately-represented parties relate to “pending or reasonably anticipated litigation,” and not when parties only share a common legal interest in consummating a commercial transaction. In rejecting Bank of America’s argument that its denial of protection to the merger parties in Ambac would chill M&A activity in New York, the court responded that: “[put] simply, when businesses share a common interest in closing a complex transaction, their shared interest… is already an adequate incentive for exchanging information ….” Finding it likely that Bank of America and Countrywide would have shared the information even if both knew it would be discoverable at a later date, the court dismissed fears that its decision might lead to a “corporate crisis” or discourage M&A activity in the state. While *Ambac* was a split decision, and the majority opinion leaves room for legislative action to expand the common interest exception, following *Ambac*, parties to in M&A transactions subject to New York law must take care to understand in which situations courts will consider litigation to be “pending or reasonably anticipated,” to avoid inadvertent waivers of privilege when sharing communications with the other parties to the transaction. Ambac could also have further ramifications beyond agreements that stipulate that New York law will govern: it can be hard to fully predict which evidentiary rules will be applied, and so parties should approach with care their decision-making around sharing privileged communications during all phases of a M&A transaction. (*Ambac Assurance Corp. v. Countrywide Home Loans, Inc.,* No. 80, 2016 N.Y. Lexis 1649 (N.Y. June 9, 2016)).

***Sun Capital Partners on Remand: District Court Rules that Related Funds May be Held Liable for Pension Fund Withdrawal Liabilities***

On March 28, 2016, the U.S. District Court for the District of Massachusetts concluded that two private equity funds with the same sponsor, investing together in a distressed portfolio company, can be held liable for pension liabilities incurred by the company under the Employee Retirement Income Security Act of 1974 (ERISA) even where the ownership interest in the company of each of the funds, viewed separately, would have been insufficient to reach that result. The District Court’s decision rests on a finding that the two funds, based on their coordinated actions in making and managing the investment, entered into a “partnership-in-fact” or deemed partnership and that this deemed partnership was part of a controlled group with the company.

Under ERISA, “trades or businesses” under “common control” are jointly and severally liable for multiemployer pension plan withdrawal liabilities incurred by other members of the controlled group. Generally, entities are under “common control” if, among other tests, they are linked by an 80% ownership interest. Here, the two funds managed by Sun Capital held 70% and 30%, respectively, of the limited liability company through which the portfolio company was acquired, so neither fund’s stake was individually sufficient to meet this test. However, the Court held that the two funds in fact had formed a partnership (or joint venture) to hold their investment,

notwithstanding the funds' express disavowal of intent to form such a partnership, and the court treated the deemed partnership (without explicit analysis) as a general partnership, notwithstanding the funds' decision to form a limited liability vehicle. In reaching its conclusion with respect to "common control," the Court looked to the "smooth coordination" in fund investments, control of the funds by the same general partners, and similarities in fund governing instruments and fund operations. These factors were found to indicate a lack of "actual independence" in the funds' investment decisions. The Court's conclusion that a separate deemed partnership sat between the limited liability company and the funds, coupled with its determination that the deemed partnership was itself engaged in a trade or business, enabled the Court to pierce the limited liability shield and hold the funds liable for the deemed partnership's liabilities, specifically its controlled-group liability for the pension obligations of the portfolio company.

While the reach of the decision has yet to be seen, private equity sponsors should consider reviewing their fund structures and investing practices with counsel to determine the extent to which they may share features that this decision found indicative of a partnership-in-fact or of being engaged in a common trade or business with a portfolio company. Sun Capital filed a notice of appeal in the First Circuit on April 4, 2016. (*Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund*, No. 10-10921-DPW (D. Mass. Mar. 28, 2016)).

***Continued Focus on the "Investment-Only" Exemption of the HSR Act: DOJ Files Suit against ValueAct***

The lawsuit by the U.S. Department of Justice (DOJ) against ValueAct powerfully reminds investors to proceed with caution when relying on the investment-only exemption of the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended (HSR Act). In April 2016, the DOJ sued investment firm ValueAct Capital and two of its affiliated funds, for violations, alleging improper reliance on the investment-only exemption. According to the complaint, ValueAct failed to obtain HSR clearance – in three different acquisitions between 2014 and 2015 – prior to acquiring voting securities of Baker Hughes Incorporated and Halliburton Company in excess of the then-applicable thresholds of the HSR Act. The DOJ asserted that ValueAct erroneously relied on the investment-only exemption while taking action deemed to be inconsistent with passive investment, and sought, at a minimum, a $19 million fine. On July 12, 2016, the DOJ announced that ValueAct agreed to pay a record $11 million penalty to settle the allegations.

HSR reporting is required for an acquisition if an investor will hold voting securities in excess of the "size of transaction" threshold of the HSR Act, currently $78.2 million. Under the investment-only exemption, however, acquisitions that result in holding ten percent or less of an issuer's issued and outstanding voting securities – regardless of dollar value – are exempt so long as the investor acquires the shares with passive investment intent (i.e., without the intention of participating in management or influencing the basic business decisions of the issuer).

The acquisitions challenged by the DOJ occurred after Baker Hughes and Halliburton, two competitors in the oilfield products and services market, announced their potential merger (a transaction that has since been abandoned). Shortly following the announcement, the ValueAct funds acquired securities through several open market purchases resulting in holdings exceeding the notification threshold but representing less than ten percent of each of the issuer's shares. ValueAct relied on the investment-only exemption in each of the acquisitions. The DOJ, however, contends that at the time of its acquisitions, ValueAct engaged in actions that foreclosed the availability of the exemption. Specifically, ValueAct's alleged conduct included:

- Contacting and meeting with senior management at both companies in order to influence management and merger discussions;
- Offering to apply pressure to certain members of management teams in an effort to push the merger through; and
- Making statements regarding planned discussions and proposed changes with management on public filings, including in a Schedule 13D filed with the Securities and Exchange Commission.

The ValueAct suit also provides a warning to investors to proceed with caution if relying on the investment-only exemption when investing in a competitor. The recent shift in guidance from the Premerger Notification Office of the Federal Trade Commission (FTC) on the applicability of the exemption with respect to holding stakes in competitors suggests that there may not be a safe harbor for such stakes, meaning stakes positions below 10% may no longer qualify for the exemption even if the investor is "truly" passive.

Moreover, the complaint reinforces the notion that the investor's subjective intent with respect to an issuer determines the availability of the exemption. Investors must exercise caution with respect to statements regarding intent, even with boilerplate language, and investors should not automatically assume that the reporting of holdings on a Schedule 13G as a passive investor will be sufficient to avoid liability under the HSR Act. The DOJ cited as evidence of non-passive conduct ValueAct's website, which explained that it "pursues a strategy of 'active, constructive involvement' in the management of the companies in which it invests," and a draft investor memorandum in which ValueAct highlighted its active role as an additional reason to invest in both companies.

The DOJ's action against ValueAct reflects the antitrust authorities' increased focus on the use of the investment-only exemption and follows on the heels of two other settlement agreements. Last year in one such case, investment adviser Third Point LLC and three of its funds also settled with the FTC and the DOJ for improperly relying on the investment-only exemption despite taking actions that the FTC deemed to be non-passive, including contacting third parties to gauge their interest in joining the board of directors or becoming CEO of the issuer and discussing a possible launch of a proxy battle for directors of the issuer. (*United States v. VA Partners I, LLC*, No. 4:2016-cv-01672 (D. N.D. Cal.) (Complaint))

***Court of Chancery Applies Enhanced Judicial Scrutiny to Actions Taken by Cogentix Medical Board in Connection with Proxy Fight***

On May 19, 2016, Vice Chancellor Laster of the Delaware Court of Chancery applied enhanced judicial scrutiny in granting a motion to preliminarily enjoin the directors of Cogentix Medical from reducing the size of the board prior to an annual stockholder meeting. This opinion follows another recent decision in which the Court applied *Unocal* enhanced scrutiny to a defensive bylaw enacted by a board in response to an activist stockholder (See *In re Ebix, Inc. Stockholder Litigation*, C.A. No. 8526-VCN (Del. Ch. Jan. 15, 2016)). The Court's decision reinforces two central tenets of Delaware law: first, that there is a strong suspicion of board conduct that threatens to disenfranchise stockholders; and second, that such suspicion is further heighted when any such conduct occurs in the context of a proxy contest or other fight for corporate control.

Cogentix was formed in March of 2015 when two medical device companies, Uroplasty and Vision-Sciences, merged. Cogentix had an eight-member staggered board, comprised of Robert C. Kill, the former CEO, President and Chairman of the Board of Uroplasty, four legacy directors of Uroplasty, Lewis C. Pell, the co-founder and Chairman of the Board of Vision-Sciences, and two former directors of Vision-Sciences, creating a five-to-three majority in favor of those aligned with Kill. Three members were up for re-election at the company's annual meeting, one of whom was a legacy Uroplasty director. Pell had filed a Schedule 13D airing grievances with the Company and previewing his intention to run a proxy contest to elect himself and two of his allies to the Board. While the directors other than Pell and Kill attempted to negotiate a solution, another legacy Uroplasty director resigned, leaving open the possibility for Pell to achieve a four-to-three majority in his favor. In an effort to thwart Pell's efforts, the Uroplasty-controlled Board approved a plan to reduce the size of the Board from eight to five and reduce the number of directors up for re-election at the annual meeting to one, ensuring that, regardless of how the stockholders voted at the annual meeting, the legacy Uroplasty directors would maintain at least a three-to-two majority.

In reviewing the Board's action, the Court applied the three-prong test for enhanced scrutiny, whereby the defendant directors must prove that their conduct (1) was for a proper (and not selfish) purpose, (2) did not disenfranchise stockholders or force stockholders to vote a certain way and (3) had a compelling justification. Although the Court was willing to assume the Board's reduction in the number of directors before the annual meeting was well-intentioned, the actions of the incumbent directors pre-determined the outcome of the stockholder vote because if the Board's plan were put in place, it would ensure that the Uroplasty directors maintained control.

The Court relied heavily on email correspondence among the incumbent directors indicating that the Board reduction plan was meant to avoid a proxy fight and prevent Pell from controlling the Board and attached almost no weight to non-adversarial affidavits submitted as testimony. Vice Chancellor Laster noted that if the Board had taken the same action "on a clear day" (not immediately prior to a contested election) the outcome of the analysis may have been different

and the justifications given for having a smaller board may have been sufficient to survive enhanced scrutiny.

The Court's decision is a reminder that courts will closely scrutinize any conduct by a board affecting stockholders' right to vote and that the context of a board's actions, particularly when they are in the midst of an ongoing fight for control will strongly influence the outcome of a court's analysis. (*Pell v. Kill*, C.A. No. 12251-VCL (Del Ch. May 19, 2016)).

***Chancery Court Addresses Potential Limitations to a Claim for Advancement of Expenses by Employees Serving in Company Management***

In a recent transcript ruling, the Delaware Court of Chancery rejected a claim by a plaintiff employee for advancement of expenses from Computer Sciences Corp., a Nevada corporation, on the grounds that the plaintiff was not a covered person entitled to indemnification or advancement under the bylaws of the corporation since he had not been formally appointed by the board of directors as an officer as was required in the corporation's bylaws. The Court reached this conclusion despite the fact that the plaintiff held the title of Vice President and Computer Sciences' marketing material, such as its website, listed him on its "Management" page and identified him as a member of its "Executive Leadership."

The Court, applying Nevada law, which requires that an officer be appointed in accordance with the bylaws of the corporation, observed that the defendant's bylaws required that officers be appointed by the board of directors and held that the plaintiff had not been formally appointed by the board and thus was not an officer entitled to advancement of expenses or indemnification under the defendant's bylaws. *(Eric Pulier v. Computer Sciences Corp., et al., C.A. No. 12005-CB, hearing (Del. Ch. May 12, 2016)).*

***Delaware Court of Chancery Allows Delaware Corporation, CytRx Corp., to Waive Forum Selection Bylaw***

In a transcript ruling, the Delaware Court of Chancery allowed a Delaware corporation to waive its exclusive forum selection bylaw. Although the Court has previously approved the use of forum selection bylaws, this decision clarifies that the Delaware courts acknowledge that Delaware corporations may, in certain circumstances, waive such bylaw provisions and consent to litigation in another jurisdiction.

CytRx Corp. adopted an exclusive forum selection bylaw that, unless waived by the company, made Delaware the sole and exclusive forum for derivative and breach of fiduciary duty actions. CytRx faced multiple lawsuits, including a derivative suit against its officers and directors filed in the U.S. District Court for the Central District of California, as well as various demands for books and records under Section 220 of the Delaware General Corporation Law brought forth by two stockholders in Delaware. The Central District of California dismissed the California plaintiff's derivative suit, citing CytRx's exclusive Delaware forum selection bylaw. The plaintiffs appealed and subsequently reached a non-monetary settlement with CytRx. To

effectuate the settlement, CytRx waived its forum selection bylaw and consented to jurisdiction in California.

During this same period, Section 220 stockholder claimants in Delaware asserted a derivative claim identical to the derivative action in California. CytRx, which had originally used its forum selection bylaws to successfully defend against the derivative action in California, now moved to stay the Delaware action by noting that they had already waived its forum selection bylaw to effectuate a derivative settlement in California. The California derivative settlement would release the Delaware plaintiff's claims. Accordingly, the Delaware plaintiffs opposed the stay and sought an order from the Delaware Court of Chancery to halt the California federal court's settlement proceedings. In addition, they amended their complaint to challenge CytRx's bylaw waiver as an additional breach of fiduciary duty on the part of the directors, whom they accused of forum shopping.

The Delaware Court stayed the Delaware case and declined to intervene in the California proceeding. The Court noted that while it stands ready to address allegations of misconduct by corporations abusing forum selection bylaws, the facts in this case supported no such allegation. Furthermore, as the Section 220 claimants derivative claims were identical to those in the pre-existing California derivative action, the Court concluded that practicality and efficiency of judicial and litigants' resources weighed in favor of allowing the California court to address those objections. (*Niedermayer v. Kriegsman*, C.A.No.11800-VCMR (Del.Ch.May 2, 2016)).

***Court of Chancery Grants Advancement to Directors Hyatt and Gore in Merger Agreement Indemnification Dispute with Al Jazeera America***

Vice Chancellor Glasscock of the Delaware Court of Chancery recently held that former directors and officers of an acquired target company, one of whom served as sellers' representative under the merger agreement, were entitled to advancement of fees and expenses in defending themselves against certain claims by the buyer for indemnification for breaches of representations regarding the target company's business.

In this case, Joel Hyatt and Albert Gore, former directors (one of whom was also a former officer) of Current Media, LLC, asserted rights to advancement of expenses under the company's operating agreement in connection with litigation arising out of the completed merger. Al Jazeera International (USA) acquired Current Media. In the merger agreement, Al Jazeera had assumed the obligations of advancement to the extent that Current Media would have been so obligated. When Hyatt and Gore sued Al Jazeera to invalidate certain indemnification claims made by Al Jazeera and to collect money that was placed in escrow after the transaction, Al Jazeera counterclaimed, arguing that Hyatt and Gore breached the merger agreement by rejecting Al Jazeera's indemnification claims. In response to Hyatt and Gore's argument that they were entitled to advancement of their fees and expenses, Al Jazeera argued that advancement was not applicable because its counterclaims did not relate to actions taken by Hyatt or Gore in their capacity as former directors and officers. Hyatt and Gore argued that the counterclaims required them to defend their actions as former directors and officers.

The Court engaged in a detailed analysis of the applicable provisions of the merger agreement and Current Media's LLC operating agreement. The Court held that the indemnification provision in the merger agreement did not supersede the right to advancement arising from another section of the merger agreement, noting that "[a]lthough indemnification and advancement rights are closely related, each are 'distinct types of legal rights,' and the 'right to advancement is not ordinarily dependent upon a determination that the party in question will ultimately be entitled to be indemnified.'" The Court concluded that Hyatt and Gore were entitled to advancement to the extent they would have been so entitled under Current Media's LLC operating agreement.

Noting that advancement rights "do not attach 'when the parties are litigating a specific and personal contractual obligation that does not involve the exercise of judgment, discretion, or decision-making authority on behalf of the corporation,'" the Court went on to examine and ultimately concluded that nearly all of Al Jazeera's counterclaims possessed a sufficient nexus to Hyatt's and Gore's "corporate powers" (i.e., that the defense of the claims implicated defense of actions taken by Hyatt and Gore in their capacity as former directors and officers of Current Media) such that advancement of fees and expenses was appropriate. Although the facts of this case were unique, the case serves as a reminder that parties to a transaction should carefully review the scenarios in which officers and directors that are also selling stockholders are entitled to advancement. Buyers in particular should consider whether the provisions of any existing agreements could require them to fund both sides of litigation. (*Hyatt v. Al Jazeera America Holdings II, LLC*, C.A. No. 11465-VCG (Del. Ch. Mar. 31, 2016)).

**DELAWARE LEGISLATIVE UPDATE**

On June 16, 2016, Delaware Governor Jack Markell signed into law House Bill 371, which amends the Delaware General Corporation Law with respect to, among other things, appraisal proceedings and "intermediate-form" mergers.

Specifically, the bill amends Section 262 of the DGCL to limit *de minimis* appraisal claims and to provide surviving corporations with the right to pay stockholders exercising appraisal rights prior to the time the Delaware Court of Chancery makes a final value determination, thereby limiting the amount of interest that would accrue on an appraisal award.

The legislation also clarifies the requirements and procedures relating to "intermediate-form" mergers under Section 251(h) of the DGCL, particularly those involving rollover of target equity.

The amendments became effective on August 1, 2016. The amendments to Section 262 affecting appraisal proceedings will be effective only with respect to appraisal proceedings arising out of transactions consummated pursuant to agreements entered into on or after August 1, 2016 (or, in the case of mergers pursuant to Section 253 of the DGCL, resolutions adopted by a board of directors on or after August 1, 2016 or, in the case of mergers pursuant to Section 267 of the DGCL, authorizations provided on or after August 1, 2016). The amendments to Section 251(h)

regarding intermediate-form mergers will be effective only with respect to merger agreements entered into on or after August 1, 2016.

Appraisal Actions

Under Section 262 of the DGCL, stockholders of any corporation that is acquired in certain merger or consolidation transactions may exercise appraisal rights, subject to certain exceptions and to compliance with specified procedural requirements. The new legislation amends Section 262(g) to institute a *de minimis* exception whereby the Court of Chancery must dismiss an appraisal proceeding as to all stockholders who assert appraisal rights unless (a) the total number of shares entitled to appraisal exceeds 1% of the outstanding shares of the class or series eligible for appraisal, or (b) the value of the consideration provided in the merger or consolidation for such total number of shares seeking appraisal exceeds $1 million, or (c) the merger was approved pursuant to Section 253 or Section 267 of the DGCL. These provisions thus prevent stockholders from demanding appraisal in cases where the number of their shares or the value of those shares is minimal. This *de minimis* exception applies only to shares that were listed on a national securities exchange immediately before the merger or consolidation.

Section 262(h) of the DGCL provides that, unless the Court of Chancery determines otherwise for good cause, interest on an appraisal award always accrues from the effective date of the merger through the date of payment of the appraisal award at a rate of 5% over the Federal Reserve discount rate, compounded quarterly. Of course, surviving corporations already have the ability to propose agreements with appraisal petitioners to release all or a portion of the merger consideration and thereby to eliminate the running of statutory interest as to the amount released. Previously, however, surviving corporations could not *require* appraisal petitioners to accept such payments. The legislation now amends Section 262(h) to give the surviving corporation the right to make a voluntary cash payment to stockholders seeking appraisal prior to the Court of Chancery's final judgment regarding fair value, thereby reducing the amount of interest that accrues during the appraisal process. If the surviving corporation makes a prepayment, interest will accrue only on the sum of (i) the difference, if any, between the amount paid and the fair value of the shares as determined by the Court of Chancery and (ii) interest accrued before the prepayment, unless paid at the time of such prepayment. The amount of any prepayment is in the sole discretion of the surviving corporation, and there is no inference that the amount paid by the surviving corporation is equal to, greater than, or less than the fair value of the shares to be appraised.

By providing surviving corporations the absolute right to prepay appraisal amounts and to cut off statutory interest, Delaware may have, at the margins, lessened the incentive for stockholders to bring or prolong appraisal actions.

Intermediate-Form Mergers

Section 251(h) of the DGCL provides a mechanism for an acquiror to consummate a two-step takeover (i.e., a tender offer to purchase a majority of the shares of a public company followed

by a second-step merger to acquire the remaining shares not tendered in the offer) without the need to obtain shareholder approval on the second-step merger, thereby avoiding the cost and delay involved in preparing and distributing a Schedule 14C information statement prior to the shareholder vote on the second-step merger. The amendments implemented by the legislation resolve various interpretive and practical issues that had arisen in connection with implementation of transactions structured to comply with Section 251(h), particularly those involving rollover of target equity.

The legislation clarifies that Section 251(h) is applicable to a corporation that has a class or series of stock listed on a national securities exchange or held of record by more than 2,000 holders immediately prior to the execution of the merger agreement, even if not all classes or series of stock of such corporation are so listed or held. The amendments also clarify that the offer for a target corporation's stock may be consummated pursuant to separate offers for separate classes or series of stock.

In addition, the amendments to Section 251(h)(3) provide that, for purposes of determining whether the acquiror holds sufficient shares to approve the merger, it may include any rollover stock (defined below) and shares of stock of the target corporation held by any person that owns, directly or indirectly, all of the outstanding stock of the offeror, or that is a direct or indirect wholly-owned subsidiary of such person or persons (collectively, offeror affiliates). "Rollover stock" is defined as any shares of stock of the target corporation that are the subject of a written agreement requiring such shares to be transferred, contributed or delivered to the offeror or any offeror affiliate in exchange for stock or other equity interests in the offeror or any offeror affiliate, so long as such shares are in fact so transferred, contributed or delivered before the effective time of the merger. The amendments also clarify the circumstances under which certificated and uncertificated shares of stock of the target corporation are deemed "received" for purposes of Section 251(h)(3).

The amendments to Section 251(h)(5) also provide that rollover stock and shares of the target corporation that are owned at the commencement of the offer by the target corporation, the offeror, and any of their direct or indirect wholly-owned subsidiaries, may be excluded from conversion in the merger into the right to receive the merger consideration.

Other Matters

Section 111 of the DGCL provides that any civil action to interpret, apply, enforce or determine the validity of the provisions of various instruments, documents or agreements may be brought in the Delaware Court of Chancery, except to the extent that a statute confers exclusive jurisdiction on a court, agency or tribunal other than the Court of Chancery. The amendments expand the Court of Chancery's jurisdiction to include civil actions involving any instrument, document or agreement (1) to which a corporation and one or more of its stockholders are parties and pursuant to which one or more stockholders sells or offers to sell any stock of the corporation, or (2) by which a corporation agrees to sell, lease or exchange any of its property or assets and which by

its terms provides that one or more stockholders approve of or consent to such sale, lease or exchange.

The amendments also include technical changes regarding the quorum and voting requirements for board committees and subcommittees, the execution of stock certificates, and procedures to revoke dissolution or restore or revive a corporation's certificate of incorporation.

## TAX UPDATE

### *Treasury Issues Regulations Intended to Deter "Inversion" Transactions and Prevent Earnings Stripping from U.S. Subsidiaries*

In April 2016, the Treasury Department and the Internal Revenue Service took a series of steps to deter so-called "inversion" transactions and tax planning used by non-U.S. companies to reduce the tax liabilities of their U.S. affiliates. While these regulations are unlikely to stop inversions in their tracks, they are likely to slow down activity considerably. They are likely to affect assessments by management, shareholders, and boards of directors of the merit of engaging in certain transactions and the premiums offered in anticipation of future tax benefits. Specifically, Treasury and the IRS:

- Finalized previously announced guidance that substantially reduces the tax benefits available to companies that "invert" and expands the situations in which these rules apply.
- Adopted new temporary regulations that prevent a U.S. company from skirting the U.S. inversion rules through a combination with a foreign acquirer that has increased in size through recent U.S. acquisitions. This rule, which will have broad application in many potential cross-border transactions, was reported to have blocked the Pfizer-Allergan combination.
- Proposed regulations that curb "earnings stripping" through the issuance of related party debt. This practice has been used by U.S. companies to make deductible interest payments to foreign affiliates that reduce U.S. tax liabilities. Although the proposed earnings stripping regulations would have broad applicability if finalized in their current form, they would particularly affect inverted companies, which often use affiliate debt to reduce U.S. taxes.

Inversion Regulations

Typically, in an inversion, a U.S. corporation is acquired by a smaller foreign company, at least partly in exchange for stock. This structure has become attractive to U.S. companies in recent years, as it has permitted U.S. companies to (i) shift taxable income from the U.S. to another jurisdiction with lower tax rates and (ii) access "trapped-cash" in foreign subsidiaries without incurring U.S. tax. Often the foreign country has in place an income tax treaty with the United States (e.g., Ireland, the United Kingdom, or Luxembourg), which eliminates U.S. withholding tax on outbound payments.

Under the U.S. anti-inversion rules, if a U.S. target is acquired by a foreign company which does not have substantial business activities in the foreign country in which it is created or organized, and the former shareholders of the target are deemed to own at least 60 percent of the acquirer immediately after the deal closes, the U.S target is limited in its ability to utilize losses from other sources to offset gains from transfers of stock or property as part of the acquisition. If the former target shareholders are deemed to own 80 percent or more of the acquirer, that acquirer is treated as a domestic corporation for U.S. tax purposes.

The new regulations include provisions designed to protect the integrity of the 60 and 80 percent thresholds. One set of rules is aimed at pre-transaction "non-ordinary course distributions" that would reduce the size of the U.S. target. These rules add back most distributions made during the three years preceding the acquisition and treat them as if they were exchanged for additional stock of the foreign acquirer. A second set of rules is designed to prevent foreign companies from circumventing the percentage thresholds by completing one or more acquisitions in which the foreign acquirer grows in size by acquiring U.S. targets. Previously, such serial transactions could enhance the ability of a foreign corporation to combine with a U.S. company seeking to invert because the foreign acquirer's shareholders could own sufficient equity to prevent the inversion rules from applying. These new rules exclude from the calculation of the shareholder ownership thresholds any stock of the foreign acquirer that is attributable to acquisitions of other U.S. targets for stock within the previous three years. These new rules were made effective as of April 4, 2016 and, notably, did not permit the "grandfathering" of deals that had already been signed. As a result, the regulations have had an immediate effect on current inversion deal activity.

Proposed Earnings Stripping Regulations

The proposed earnings stripping regulations, if finalized, will fundamentally affect the tax treatment of certain related party debt issuances. Where applicable, the proposed rules reclassify all or a portion of a related party debt instrument as equity, which has the effect of disallowing U.S. tax deductions for purported "interest payments." The proposed rules also require the taxpayer to substantiate its ability to timely satisfy its obligation and to contemporaneously document the borrowing according to certain prescribed criteria. Because these rules are proposed to be effective as of April 4, 2016, they must be considered in connection with any current related party debt issuance and acquisition finance planning.

Although Treasury and the IRS indicated in 2014 that new rules could be adopted to prevent "inverted" companies from "stripping" taxable income out of the U.S. and into low-tax jurisdictions through intercompany debt arrangements, the proposed regulations can apply equally outside of the inversion context and even if the recipient of the interest payment is not in a low tax jurisdiction. The proposed rules will have particular importance for cross-border M&A transactions involving U.S. targets. In the past, acquisition financing and post-closing related party debt planning has often offered substantial tax "synergies" that can substantially affect deal premiums. While opportunities will remain to achieve these types of benefits, they will be increasingly difficult to achieve without careful planning.

The proposed rules apply not only to "inbound" financing of U.S. targets, but also to loans by U.S. entities to their foreign affiliates, including foreign targets or acquisition vehicles. The proposed rules also potentially apply to certain purely domestic loans between U.S. companies that are not part of a consolidated group, including REITs. In short, the proposed rules mark a dramatic shift in tax policy, and will affect taxpayers in a broad range of circumstances.

**SEC UPDATE**

In a case that may reflect a notable change in the SEC's views on broker-dealer registration issues in the private equity industry, a private equity fund adviser agreed to settle SEC charges that it engaged in broker activity and charged brokerage fees without registration, and committed other securities laws violations. On June 1, 2016, Blackstreet Capital Management, LLC (Blackstreet) was censured, and Blackstreet and its principal owner and managing member Murry N. Gunty agreed to cease and desist from further violations and pay more than $3.1 million to settle the proceeding.

Following an inspection and investigation, the SEC found that Blackstreet performed brokerage services for and received brokerage fees from portfolio companies, instead of using investment banks or registered broker-dealers to provide such services, and that Blackstreet and Mr. Gunty engaged in conflicted transactions, improperly used fund assets and failed to adequately disclose certain fees and expenses that were charged to the funds and/or the portfolio companies. In addition, the SEC determined that Blackstreet failed to adopt and implement reasonably designed compliance policies and procedures to prevent violations of the Investment Advisers Act of 1940 (Advisers Act) and its rules arising from the alleged improper conduct.

The Securities Exchange Act of 1934 (1934 Act) defines a broker as "any person engaged in the business of effecting transactions in securities for the account of others." In determining whether a person is a broker, the SEC typically focuses on whether the person receives transaction-based compensation and participates in important parts of a securities transaction, including solicitation, negotiation or execution. According to the SEC order, Blackstreet provided brokerage services and received transaction-based compensation in connection with the acquisition and disposition of portfolio companies, which caused Blackstreet to be acting as a broker. The services included soliciting deals, identifying buyers or sellers, negotiating and structuring transactions, arranging financing, and executing the transactions. The SEC also found that Blackstreet and Mr. Gunty violated securities laws by (1) charging portfolio companies "operating partner oversight fees," (2) using fund assets to pay for political and charitable contributions and entertainment expenses, (3) acquiring a departing employee's interest in certain portfolio companies and taking other actions in violation of a fund's governing documents, and (4) failing to adopt and implement policies and procedures reasonably designed to prevent violations of the Advisers Act. The settlement included disgorgement of transaction fees of $1,877,000, related prejudgment interest and a civil monetary penalty of $500,000.

The Blackstreet case is the first enforcement action in which the SEC has taken the position that the receipt of portfolio company transaction fees requires a PE adviser to register as a broker-

dealer. Although there have been some conflicting messages from the SEC, the case appears to be a departure from previous public comments by the SEC Staff.

Although the Blackstreet enforcement action does, as noted, include Advisers Act violations, the SEC's press release clearly emphasizes the failure to register and includes the following statement by Andrew J. Ceresney, Director of the SEC Enforcement Division: "The rules are clear: before a firm provides brokerage services and receives compensation in return, it must be properly registered within the regulatory framework that protects investors and informs our markets. Blackstreet clearly acted as a broker without fulfilling its registration obligations."

An SEC administrative proceeding settlement does not have precedential value and of course depends on the facts of the case. However, the order suggests that the SEC now may not see any distinction between the activities of PE advisers and other persons engaged in the business of effecting securities transactions for others and therefore subject to registration. To that extent, prior Staff comments with implications to the contrary should be questioned. It now appears that the SEC may apply traditional broker-dealer analysis to the registration question for PE advisers, which is hard to square with the policy judgment presumably underlying the M&A Brokers no-action letter that brokerage activity in connection with change in control transactions of private companies does not require registration.

Both the SEC press release and order state that Blackstreet received compensation for the broker services provided to its portfolio companies. Notably, the Blackstreet case does not appear to involve failure to disclose such compensation to investors; the order observes that the fund agreements at issue "expressly permitted [Blackstreet] to charge transaction or brokerage fees." The Blackstreet order does not indicate that management fees for the Blackstreet funds were subject to any transaction fee offset. For this reason, the status of prior Staff comments that a 100% management fee offset obviates the need for broker-dealer registration is uncertain. At a minimum, care should be taken that a PE adviser not registered as a broker-dealer is not receiving other forms of compensation for brokerage services rendered to portfolio companies.

The SEC may have been emboldened in pursuing the broker-dealer registration issue with Blackstreet by the explicit reference to brokerage services in the Blackstreet fund agreements, as well as by the seemingly questionable conduct underlying the other securities law violations. However, in the wake of the Blackstreet action and the absence of any forward-looking guidance from the SEC, PE advisers should carefully review their activities to determine whether registration is required. The risks of failing to register when required include disgorgement of transaction fees, penalties, interest, and censure and cease and desist orders. In addition to these administrative remedies, the SEC can also resort to the courts and seek a permanent or temporary injunction as well as civil penalties. The 1934 Act also imposes liabilities on controlling persons and persons who aid and abet others who violate the 1934 Act. In theory, the SEC could ask the Department of Justice to institute criminal proceedings. As most states have their own statutes requiring broker-dealer registration, state enforcement actions could also result. Finally, a transaction in which an unregistered broker is involved could be subject to rescission in a private action under the 1934 Act or similar state laws.

At this stage, it is unclear whether the SEC's strong stance in the Blackstreet action was triggered by unique facts and circumstances, and so it remains difficult to predict how the reasoning will be applied to other PE firms in other scenarios. Because the stakes are so high, private equity firms and their advisors will need to monitor developments. It is hoped that the SEC will provide more definitive guidance in the near future.

**UK UPDATE**

Following the outcome of the recent Brexit Referendum, in the short term, very little has changed or is likely to change in terms of the legal framework for carrying out M&A transactions in the UK. Ultimately, this is a matter of domestic (and not EU) law and market practice. There are, of course, aspects of EU law which have had a material effect on the way deals in the UK get done and whilst the timetable to the UK actually leaving the EU remains opaque, the following aspects are, or are likely to be, of material importance:

- the UK's access to the single market and any terms imposed to gain access. This is more of a business issue than a straight legal issue but is at the heart of the EU framework and will influence UK M&A significantly;

- merger control regulation, as the UK will likely cease to be relevant when assessing the availability of a single clearance across the EU. That said, the UK merger control regime remains a voluntary regime and there is no expectation that it will change;

- the continuation of the TUPE regime, a European regime requiring the automatic transfer of workers when the undertaking they work for transfers to a new owner. Whilst the regime is complicated and has a material (and not always positive) impact on asset deals in particular, the regime is relied on by certain industries, such as outsourcing, and so may be retained by the UK in the same form;

- the continuation of the EU passporting regime to businesses regulated by the UK's Financial Conduct Authority. This is one of the hottest topics in the London financial market and many businesses are already applying for authorisations elsewhere in the EU to mitigate the impact;

- the impact of Brexit in the legal due diligence process. This varies depending on the nature of the business being diligenced. Even at this stage, it is possible to identify those sectors and business that are more vulnerable in certain 'Brexit' scenarios. Obvious examples of these would include any business with significant cross-border sales of goods or services which will need to consider the potential impact of customs tariffs if the UK loses access to the single market. Equally, any business whose workforce relies heavily on non-UK EU citizens may be impacted if any UK exit treaty involves restrictions on such EU citizens coming to (or continuing to) work in the UK; and

- the ongoing integration (or not) of certain legal regimes across the EU. In many cases, the EU regime has been modelled on the UK (e.g. public M&A and listing regimes) and the UK will likely continue to be at the forefront of developing practice. Equally, M&A market practice across the EU has tended to conform to UK/US market practice and we would expect that to continue. It will be important to consider in the future, however, where EU market practice or regulation diverges and whether the UK considers it important to bridge any gap for the sake of harmonisation for the benefit of international business.

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