

M&A and Corporate Governance Newsletter

Directors Serving Two Masters—What Are the Rules of the Road?

Diane Holt Frankle¹ Partner

It is common for one or more directors of corporations, whether publicly held or private, to hold a seat on a board of directors by virtue of a particular stockholder or group of stockholders. There are many examples of such director/stockholder relationships.

Perhaps the most common example is a company which has received a significant investment from venture capital or private equity firms; here, the company typically provides a right, either through a charter provision or a shareholder rights agreement, to those significant investors to designate one or more directors to be nominated for board seats, and a voting agreement among significant stockholders to vote in favor of the firms' designees.

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Another common example is an operating subsidiary where the parent corporation, while retaining majority control, has provided equity to the subsidiary's employees, and yet as majority holder, designates and elects all or most of the directors of the subsidiary. Further, in the public company context, we often see activist stockholders negotiating with a board to have one or more designees added to the board. Debtholders and unions may also have rights to designate one or more directors.

These directors, sometimes referred to as "constituency directors," may have day jobs as employees of the venture capital or private equity firm, parent corporation, activist hedge fund, lender or union which designated them for the board seat they now hold. If so, such directors owe separate duties to their employer. Family stockholders might appoint a family member as a director. Sometimes these directors serve on multiple portfolio companies on behalf of a particular stockholder. In these cases, the directors can be seen to have personal interests aligned with the stockholder who appointed them.

In other cases, director nominees are selected by the stockholder because these persons have business experience and judgment the stockholder believes will be helpful to the corporation, and these directors have no other relationship with the stockholder. Constituency directors may receive compensation or other benefits from the corporation for their service as a director. As noted above, in some cases a constituency director may also be an employee of the stockholder, or its affiliate, or may have some other compensation arrangement with the

stockholder or affiliate.² What issues should directors, elected by virtue of a particular stockholder or group of stockholders, keep in mind, and what standards apply to these directors while they serve on a board of directors?

² One ongoing controversy relates to a potential arrangement between an activist and a director nominee on the activist's slate to compensate that director either upon election or during service by that director. Activists have sought to recruit independent directors with relevant industry experience to their slates. These arrangements are designed to induce a nominee with relevant business experience to run as part of the activist slate. The agreements may provide a payment to the activist upon election, and possibly an alternative payment if, for example, the shares of the company increase by a defined amount. Some public corporations have adopted bylaws prohibiting directors with such agreements from serving as directors of the corporation, and they have been criticized as "golden leashes." Proxy advisory firms like ISS may recommend a vote against directors who approve such a bylaw without stockholder approval.

Governance commentators have raised the question of whether this type of arrangement creates a potential conflict for the director; some commentators have argued that it isn't clear whether the purportedly independent director is working for the activist or for all shareholders. Other commentators suggest that these arrangements could create a risk to board cohesion because the director party to this type of arrangement would have different financial incentives than other board members. Other critics see these arrangements as encouraging short-term thinking in the management of a corporation. ISS has noted that these arrangements must be reviewed carefully, considering the size of the payment and whether they might incent the director to push riskier strategies. This type of arrangement must in any case be disclosed to stockholders in connection with the election contest if it is in effect at that time, and also should be disclosed post-election on an ongoing basis if such an agreement is in effect, if required under SEC rules. The bottom line question is whether these arrangements align the director with the interests of all shareholders.

Earlier this year, ISS announced its support for a contractual arrangement between Third Point and two sitting directors of Dow Chemical up for election at Dow's annual meeting after the settlement of a proxy contest brought by Third Point; the Third Point arrangement based director payments on the performance of Dow shares over three and five years, assuming the directors are still on the board, regardless of whether Third Point continues to own Dow shares. See http://dealbook.nytimes.com/2013/11/25/a-debate-over-paying-board-nominees-of-activist-funds/?_r=0; and <http://www.wsj.com/articles/proxy-adviser-iss-blesses-pay-for-activists-directors-at-dow-1429725478>.

Duty of Care and Duty of Loyalty Owed by All Directors to All Stockholders

Section 141(a) of the General Corporation Law of the State of Delaware (the DGCL) provides that the corporation's business and affairs are managed by or under the direction of its board of directors. Delaware courts explain that "[i]n performing their duties, the directors owe fundamental duties of loyalty and care to the corporation and its shareholders."³ The Delaware Supreme Court has explained that there is "no dilution" of the duty of loyalty when a director 'holds dual or multiple fiduciary obligations.' If the interests of the beneficiaries to whom the dual fiduciary owes duties are aligned, then there is no conflict."⁴ Thus, as long as the constituent stockholders' interests are aligned with the interests of all stockholders (i.e., if such stockholders simply wish to grow the business successfully), a special relationship between a director and a particular stockholder does not create a legal issue. If instead the *constituent stockholder* has a special interest different than some or all other stockholders on a matter being considered by the board, in some cases a constituency director associated with that stockholder director may be viewed as having a potential or actual conflict of interest, as discussed below.

Keep in mind, however, that, for the most part, constituency directors face no conflict in their role as a director as a result of their relationship to the particular stockholder who might have designated them for election. In most matters coming before the board, the

interests of all of the stockholders are completely aligned. In such cases, all directors are intent on the same overall goal, seeking to promote the value of the corporation for the benefit of its stockholders. This goal is truly the job of all directors; as the Delaware Chancery Court recently explained, "by increasing the value of the corporation, the directors increase the share of value available for the residual claimants."⁵ A focus on increasing the aggregate value of the enterprise typically serves the interests of all stockholders. The directors might consider a wide range of matters, from selection and retention of the chief executive officer, to strategy for the corporation, to compensation or governance decisions, to oversight of the financial controls and even to the sale of the company, where the stockholders' interests are not divergent. In each case, directors are called upon to act in what they reasonably perceive as the best interest of the corporation and its stockholders to enhance the overall value of the corporation.

What issues should directors, elected by virtue of a particular stockholder or group of stockholders, keep in mind, and what standards apply to these directors while they serve on a board of directors?

Of course, constituency directors may have differing views from their fellow directors, which may, but do not necessarily, derive from their relationship with the stockholders who designated them to the board. Like all directors, these constituency directors come to the board with their own experience and their own point of view on the right or best ways to build stockholder value. Beyond that,

³ *In re Trados S'holder Litig.*, 73 A.3rd 17, 48 (Del. Ch. 2013).

⁴ *In re Trados S'holder Litig.*, 73 A.3rd 17, 46 (Del. Ch. 2013), citing *Weinberger v. UOP, Inc.*, 457, 701, 710 (Del. 1983)(citations omitted).

⁵ *Id.* at 48.

constituency directors may be provided with information or perspectives from their stockholder designee giving them a particular point of view on issues that arise, including the methods most likely to result in value creation. As an example, the venture capital designee might tap into the venture fund's deep experience in building successful companies, and might therefore disagree with a founder of the company sitting on the board about the best way forward in a tough business climate. Another example might be a director appointed by virtue of an activist hedge fund, who might have a more short-term view of value creation, while a founder director might have a much longer time horizon for value creation. One could expect, of course, that a stockholder with a particular point of view would recruit a director nominee presumed to be aligned with those views. So long as the constituency director is applying his or her judgment and seeking to enhance the value of the corporation, he or she is acting in the best interests of the corporation and all the stockholders.

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Exercising Independent Judgment

Note, however, that the constituency director must exercise his or her own judgment on the matter facing the board in fulfilling his or her duties to the corporation and stockholders. Once elected or appointed as a director, the director is not permitted to simply defer to the advice or wishes of the stockholder who

designated him or her for appointment when deciding corporate matters. Instead the director must decide each matter that comes before the board of directors in the best interests of the corporation and all stockholders, and may not favor the interests of the stockholder who brought about its directorship.

Once elected or appointed as a director, the director is not permitted to simply defer to the advice or wishes of the stockholder who designated him or her for appointment when deciding corporate matters.

Said another way, the “duty to act for the ultimate benefit of stockholders does not require that directors fulfill the wishes of a particular subset of the stockholder base.”⁶ Indeed, “during their term of office, directors may take good faith actions that they believe will benefit stockholders, even if they realize that the stockholders do not agree with them.”⁷ One court explained, “the corporation law does not operate on the theory that directors in exercising their powers to manage the firm, are obligated to follow the wishes of a majority of the shares. In fact, directors, not shareholders, are charged with the duty to manage the firm.”⁸

Thus, regardless of whether the director is an employee of the stockholder, or simply owes his director position to the stockholder, the

⁶ *Id.* at 38 (citations omitted).

⁷ *Id.*, citing *In re Lear Corp S'holder Litig.*, 967 A.2d 640, 655 (Del. Ch. 2008) (“Directors are not thermometers, existing to register the ever-changing sentiments of stockholders . . .”).

⁸ *Paramount Communs Inc. v. Time Inc.*, 1989 Del. Ch. LEXIS 77, 1989 WL 79880, at *30 (Del. Ch. 1989), *aff'd in pertinent part*, *Time*, 571 A.2d 1140, 1150 (1989); see also *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 641 (Del. Ch. 2008).

director cannot blindly follow the instructions of that stockholder in deciding matters as a director. Instead, the director must exercise his or her independent judgment on the matter. As the Delaware Supreme Court explained:

Independence means that a director's decision is based on the corporate merits of the subject before the board rather than extraneous considerations or influences. While directors may confer, debate, and resolve their differences through compromise, or by reasonable reliance upon the expertise of their colleagues and other qualified persons, the end result, nonetheless, must be that each director has brought his or her own informed business judgment to bear with specificity upon the corporate merits of the issues without regard for or succumbing to influences which convert an otherwise valid business decision into a faithless act.⁹

As noted above, the director can and should consider information available to the director, including information provided by the director's own experience or by the stockholder in question, but then must form a view of the matter as a director independently from any position taken by the stockholder. This may mean that such director draws a conclusion different from that favored by the stockholder who was the instrument of his or her appointment or election.

A good modern example of directors making their own judgment, instead of just deferring to or following the instructions of their nominating stockholder, can be seen in the

recent takeover battle between Airgas and Air Products.¹⁰ Air Products launched a tender offer in February 2010 to acquire Airgas, and then succeeded in electing three directors to the Airgas Board as a result of a proxy contest in September 2010. One of the three directors explained to ISS, a proxy advisory service, during the proxy contest, that, if he were elected, "he would immediately represent all the shareholders of Airgas." After the stockholder meeting, the Airgas Board, including these three directors nominated by Air Products, evaluated an updated five-year plan presented by management, and heard advice from three financial advisors, including a new financial advisor hired at the request of the three new directors. The Airgas Board, including the three newly seated directors nominated by Air Products, then voted against accepting Air Products' most recent bid and in favor of maintaining the "poison pill" or rights plan currently in place. This decision, based on a review of the information presented to the Airgas board, was contrary to the publicly expressed opinions of Air Products, who had nominated the three directors, and also contrary to the desires of a majority of the Airgas stockholders, who were in favor of a deal.¹¹

¹⁰ *Air Products & Chemicals v. Airgas*, 16 A.3rd 48 (Del. Ch. 2011).

¹¹ Chancellor Chandler explained: "[Air Products] ran a slate committed to taking an independent look and deciding for themselves afresh whether to accept the bid. The Air Products Nominees apparently 'changed teams' once elected to the Airgas board (I use that phrase loosely, recognizing that they joined the Airgas board on an 'independent' slate with no particular mandate other than to see if a deal could be done). Once elected, they got inside and saw for themselves why the Airgas board and its advisors have so passionately and consistently argued that Air Products' offer is too low . . . The incumbents now share in the rest of the board's view that Air Products' offer is inadequate—this is not a case where the insurgents want to redeem the pill but they are unable to convince the majority." *Id.* at 128.

⁹ *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984).

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The Chancery Court was called upon to review the Airgas board's decision with respect to these two matters. While acknowledging that the Airgas stockholders disagreed with the Airgas board, the Chancery Court held that the Airgas board was complying with its fiduciary duties in retaining the rights plan preventing the Air Products tender offer from closing. In commenting on the role of the three directors elected by Air Products, Chancellor Chandler made it clear that there was no requirement that the nominees agree with the incumbents. He explained: "Air Products could have chosen three 'independent' directors who may have a different view of value than the current Airgas board, who *could act in a manner that would still comport with their exercise of fiduciary duties, but would perhaps better align their interests with those of the short-term arbs*, for instance. As an example, Air Products could have proposed a slate of three Lucian Bebchuks (let's say Lucian Bebchuk, Alma Cohen, and Charles Wang) for election. *In exercising their business judgment if elected to the board, these three academics might have reached different conclusions than Messrs. Clancey, Miller, and Lumpkins did*—businessmen with years of experience on boards who got in there, saw the numbers, and realized that the intrinsic value of Airgas in their view far exceeded Air Products' offer. Maybe Bebchuk et al. *would have been more skeptical*. Or maybe they would have gotten in, seen the numbers, and acted just as the

three Air Products Nominees did. But the point is, Air Products chose to put up the slate that it did."¹² Thus, the court confirms that once elected, constituency directors are required to exercise their own independent judgment.

Conflicts of Interest and Independence

A corollary of the requirement that directors need to form their own independent judgment on issues that come before the board, is that directors must consider whether they have a conflict of interest in a matter that comes before the board, or may lack independence with respect to the matter at hand, because of a particular interest held by their stockholder opposed to or different from the interests of all stockholders. As the Delaware Chancery Court explained:

"[A] disabling "interest," as defined by Delaware common law, exists in two instances. The first is when (1) a director personally receives a benefit (or suffers a detriment), (2) as a result of, or from, the challenged transaction, (3) which is not generally shared with (or suffered by) the other shareholders of his corporation, and (4) that benefit (or detriment) is of such subjective material significance to that particular director that it is reasonable to question whether that director objectively considered the advisability of the challenged transaction to the corporation and its shareholders. The second instance is when a director stands on both sides of the challenged transaction. . . .

¹² *Id.* at 123 FN 487.

“Independence” does not involve a question of whether the challenged director derives a benefit from the transaction that is not generally shared with the other shareholders. Rather, it involves an inquiry into whether the director’s decision resulted from that director being controlled by another. A director can be controlled by another if in fact he is dominated by that other party, whether through close personal or familial relationship or through force of will. A director can also be controlled by another if the challenged director is beholden to the allegedly controlling entity. A director may be considered beholden to (and thus controlled by) another when the allegedly controlling entity has the unilateral power (whether direct or indirect through control over other decision makers), to decide whether the challenged director continues to receive a benefit, financial or otherwise, upon which the challenged director is so dependent or is of such subjective material importance to him that the threatened loss of that benefit might create a reason to question whether the controlled director is able to consider the corporate merits of the challenged transaction objectively.¹³

Directors must consider whether they have a conflict of interest in a matter that comes before the board, or may lack independence with respect to the matter at hand, because of a particular interest held by their stockholder opposed to or different from the interests of all stockholders.

What types of relationships might give rise to either a conflict of interest or a lack of independence? First, and foremost, the Delaware Supreme Court has made clear that “it is not enough to charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election. That is the usual way a person becomes a corporate director.”¹⁴ Thus, the mere fact that a director was elected by virtue of a significant stockholder is insufficient evidence to suggest either a conflict of interest or a lack of independence.

What relationships or benefits might then suggest either a lack of independence or a conflict of interest for a constituency director? An example of a personal conflict of interest that could arise in the relationship between a director and the stockholder might be a payment, like a bonus, triggered by consummation of a particular transaction desired by the stockholder and being considered by the board. This payment would be a benefit conferred on the director, not enjoyed by all stockholders. An example of influence that might impact the constituency director’s independent judgment on the issue before the board might be the director’s full-time employment relationship with the stockholder or its affiliate, which would

¹³ *Orman v. Culman*, 794 A.2d 5, 25 n.50 (Del. Ch. 2002).

¹⁴ *Aronson v. Lewis*, 473 A.2d 805, 816 (Del. 1984).

suggest that the director is “beholden to” the stockholder. Family relationships could also raise the issue of influence. Or perhaps the director has been placed on more than one board by the stockholder, and is receiving compensation from those directorships. Allegations of past personal or business relationships, without more, will not raise an independence issue, but the Delaware Chancery Court has explained that:

Although mere recitation of the fact of past business or personal relationships will not make the Court automatically question the independence of a challenged director, it may be possible to plead additional facts concerning the length, nature or extent of those previous relationships that would put in issue that director’s ability to objectively consider the challenged transaction.¹⁵

Thus, the courts would need to review whether a person who serves as director for a stockholder in multiple companies received benefits from those directorships, and has a relationship with the stockholder that would prevent him or her from being able to consider decisions regarding the stockholder objectively. “Independence means that a director’s decision is on the merits of the subject before the board rather than extraneous considerations or influences.”¹⁶

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Once a benefit or influence is identified, the next question is whether the benefit or influence is material to the director. As the Delaware Chancery Court explained:

The key issue is not simply whether a particular director receives a benefit from a challenged transaction not shared with the other shareholders, or solely whether another person or entity has the ability to take some benefit away from a particular director, but whether the possibility of gaining some benefit or the fear of losing a benefit is likely to be of such importance to that director that it is reasonable for the Court to question whether valid business judgment or selfish considerations animated that director’s vote on the challenged transaction.¹⁷

Keep in mind that the need for an analysis of a constituency director’s conflicts or independence arises where the director is also aware that the stockholder has a material interest different from other stockholders with respect to some matter being considered by the board. As noted above, in most cases, the interests of all stockholders will be aligned. In some cases, though, a particular stockholder

¹⁵ *Orman v. Cullman*, 794 A.2d at 25 n.50

¹⁶ *Aronson*, 473 A.2d at 816.

¹⁷ *Id.*

might have a special interest, different from all stockholders, in a transaction before the board. Obvious examples of transactions raising a special interest of the stockholder are where a corporation is evaluating a real estate or other commercial transaction with the stockholder or one of its affiliates, or where the stockholder or its affiliate is making an investment in the company. Similarly, if the stockholder is an owner of a company which the corporation is considering for an acquisition, or which is making a proposal to buy the corporation, the stockholder has an interest different from other stockholders.

A director who is beholden to a preferred stockholder should recognize that the interest of his or her constituent stockholder in some cases may not be aligned with the interests of the residual stockholder, creating a potential conflict of interest for that director.

The transaction might however not be with the stockholder directly, but the stockholder might still have a special interest not shared by all stockholders. For example, such a director employed by the stockholder may know that the stockholder has a particular time horizon for its investment. Imagine a situation where a director is reviewing a proposed merger. The director may recognize that the merger proposal does not adequately value the company based on its business and prospects, but may also understand that it could be closed quickly and provides the particular stockholder with sufficient cash to allow it to meet some pressing current debt obligations. In this example, assume that the director's constituent stockholder does not care that the company is being sold at a discount to its fair value, because current

liquidity needs outweigh its own interest in getting the best price and terms for the company. But what about the other stockholders? In this type of situation, the constituency director should recognize that his stockholders' interests may be different from the interests of all of the stockholders.¹⁸

An issue like this also arises for a director designated or appointed by preferred stockholders, where the goal for such stockholders might be simply to obtain their liquidation preference. These preferred holders may be indifferent to maximizing the value of the corporation, whether because their return is fixed, and additional return doesn't benefit them, or because they have a different time horizon than the common stockholders. Directors are required to strive to "maximize the value of the corporation for

¹⁸ It is worth noting that liquidity needs alone will not be deemed a differing interest, without additional facts showing a board decision driven by that interest to a judgment contrary to the interests of all stockholders. In *In Re Synthes, Inc. Shareholder Litigation*, 50 A.3d 1022 (Del. Ch. Aug. 17, 2012), Chancellor Strine rejected the general notion that a CEO stockholder breached his duty of loyalty simply because he was a large stockholder, who allegedly had liquidity needs due to "retirement objectives" and wanted liquidity for his shares, which he could not achieve by selling blocs on the open market without adversely impacting the stock price. In *Synthes*, however, there were no allegations that the stockholder had pushed for a quick sale. The board, not the stockholder, determined to explore the sale of the company and the marketing of the company was pursued in a deliberate and thoughtful process. Compare the facts alleged in a case where the Chancery Court refused to dismiss a complaint in *In Re Answers Corp. Shareholders Litigation*, 2012 WL 1253072 (Del. Ch. 2012) (allegations that controlling stockholder allegedly pushed for a transaction before public stockholders knew of improved financial results, allegedly because controlling stockholders wanted liquidity quickly and believed a higher price would jeopardize a sale); however, the Chancery Court later granted motions for summary judgment by defendants. 2014 WL 463163 (Del. Ch. 2014). Absent facts suggesting a board process tainted by the large stockholder interest, in contrast to interests of all stockholders, Chancellor Strine explained in *Synthes* that "a fiduciary's financial interest in a transaction as a stockholder (such as receiving liquidity value for [its] shares) does not establish a disabling conflict when the transaction treats all stockholders equally."

the benefit of its residual claimants, the ultimate beneficiaries of the firm's value, and not for the benefit of its contractual claimants [the preferred stockholders].¹⁹ Thus, a director who is beholden to a preferred stockholder should recognize that the interest of his or her constituent stockholder in some cases may not be aligned with the interests of the residual stockholder, creating a potential conflict of interest for that director. "[T]he VC firms' ability to receive their liquidation preference could give the VC directors a divergent interest in the Merger that conflicted with the interests of the common stock."²⁰

Another example might be a sale of a subsidiary by a parent corporation with minority stockholders.²¹ In one case dealing with this type of conflict, Atlantic Richfield owned 80 percent of ARCO Chemical.²² The parent wanted to sell the subsidiary, and could have vetoed any transaction it had not approved. The court affirmed the right of the majority stockholder to sell or vote its shares without regard for the minority. Nonetheless the court held that subsidiary's directors owed a duty of loyalty to all of its stockholders. The directors were obligated "to make an informed and deliberate judgment, in good faith, about whether the sale proposed by the majority shareholder will result in maximization of value for the minority shareholders."²³ The board could not abdicate its duty by simply deferring to the judgment of the controlling stockholder. The court held that the board, comprised primarily of employees of the parent, was required to use a special

committee to make an independent judgment as to whether the transaction maximized value for all stockholders.

What must a director do in a case where he or she knows that there is a conflict of interest or a relationship that might prevent him or her from exercising independent judgment on a transaction where the constituent stockholder has an interest different from other stockholders? The constituency director has a duty to disclose to the board any potential conflict of interest that arises as a result of the director's relationship with the stockholder, and which may impact the director's independent judgment or impair his or her ability to act in the best interests of all the stockholders. Other directors should also be alert to those potential conflicts.

In such cases, the board may ask the director to recuse himself from the deliberations. The Delaware courts have expressed concerns where an interested director is present during the decision-making process.²⁴ One court observed, "[T]he single flaw in the non-affiliated directors' decision-making process was their failure to insist that [two conflicted directors] absent themselves entirely from that process."²⁵ Thus, the directors who do not have the conflict of interest will be well served to deliberate without the conflicted director present to avoid any taint of undue influence from the conflicted director.

¹⁹ *Id.* at 41, at 64 and 76-77.

²⁰ *Id.* at 47.

²¹ See *Warshaw v. Calhoun*, 221 A.2d 487, 492 (Del. 1966); *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 719 (Del. 1971).

²² *McMullin v. Beran*, 765 A.2d 910 (Del. 2000).

²³ *McMullin*, 765 A.2d at 919.

²⁴ See *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 1 A.3rd 310, 326-27 (Del. Ch. 2010)(presence of founder/chairman interfered with deliberations); *Emerald Partners v. Berlin*, 2003 WL 21003437 (Del. Ch. 2003); *aff'd* 840 A.2d 641 (Del. 2003).

²⁵ *Emerald Partners v. Berlin*, 2003 WL 21003437, at *28; *aff'd* 840 A.2d 641 (Del. 2003)("the single flaw in the non-affiliated directors' decision-making process was their failure to insist that [two conflicted directors] absent themselves entirely from that process.").

The Delaware courts have expressed concerns where an interested director is present during the decision-making process.

Where there is a controlling or majority stockholder, the participation in the deliberations by a constituency director, particularly one closely affiliated, such as an employee or partner, may give rise to an inference that the controlling stockholder dictated the result of those deliberations. In cases where independent directors not affiliated with the controlling stockholder comprise less than a majority of the directors, the board may set up a special committee of independent directors, so that there is an independent board committee making the decision.²⁶ Where no special committee is used, but a majority of the directors are interested, the courts will apply an entire fairness standard, and the interested directors have a risk of being found to have breached their duty of loyalty.²⁷

In cases where independent directors not affiliated with the controlling stockholder comprise less than a majority of the directors, the board may set up a special committee of independent directors, so that there is an independent board committee making the decision.

Confidentiality and Information Sharing

Directors who have relationships with stockholders face some additional issues relating to the information directors receive in the ordinary course. Directors often receive information that if prematurely disclosed outside the corporation may adversely affect the corporation, including confidential information about strategy, customers and suppliers, contract negotiations, sensitive personnel matters, compliance matters and financial results.

Under the umbrella of the duty of loyalty also comes the obligation that a director maintain the confidential nature of the information the director receives in connection with his or her duties.²⁸ Constituency directors, like other directors, must be careful not to disclose confidential information in a way that might harm the corporation, breaching their fiduciary duty.²⁹ The Chancery Court has explained:

A director may not harm the corporation by, for example, interfering with crucial financing efforts in an effort to further [his own] objectives. Moreover, he may not use confidential information, especially information gleaned because of his board membership, to aid a third party

²⁶ See e.g., *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110, 1117 (Del. 1994); *Kahn v. Tremont Corporation*, 694 A.2d 422 (Del. 1997).

²⁷ *In re Trados S'holder Litig.*, 73 A.3rd at 64 and 76-77. Vice Chancellor Laster notes the danger of "conflict blindness" and "conflict denial" for venture directors, while ultimately concluding that the common holders would not have received any more if the transaction had a fair process.

²⁸ *Henshaw v. American Cement Corp.*, 252 A.2d 125 (Del. Ch. 1969).

²⁹ *Shocking Technologies v. Michael*, 2012 WL 4482838 (Del. Ch. 2012)(director held to breach his fiduciary duty of loyalty by providing confidential information to investor; shared information about the company's negotiating position and lack of competing bids with potential investor to discourage investment in order to increase leverage of his stockholder constituent).

which has a position necessarily adverse to that of the corporation.”³⁰

A corporation can seek a remedy from a director who provides information to individuals who are adverse to the corporation or not entitled to the information, for the breach of the director’s fiduciary duty.³¹ Courts have held that a confidentiality agreement is unnecessary for directors, because the obligation to keep sensitive, confidential information safe and undisclosed is already included within the directors’ duty of loyalty to the corporation.³²

Constituency directors, like other directors, must be careful not to disclose confidential information in a way that might harm the corporation, breaching their fiduciary duty.

The flip side of the duty to maintain confidentiality is the desire of constituency directors to share information with constituent stockholders who have a vested interest in the company. Directors affiliated with venture capital and private equity funds regularly report to the funds about their portfolio companies. Investors in publicly held corporations may not wish to receive confidential information to permit active trading, but some may have longer investment horizons and seek reports on the status of the company, although this type of reporting must be carefully restricted to prevent further dissemination or misuse of the information.

The flip side of the duty to maintain confidentiality is the desire of constituency directors to share information with constituent stockholders who have a vested interest in the company.

Information sharing is permitted under Delaware law.³³ In a recent case, the Chancery Court explained: “When a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder’s representative, then the stockholder is generally entitled to the same information as the director.”³⁴

The courts’ position with respect to information sharing is a practical accommodation to the reality of the business world. One could imagine that if a bright line rule prohibited information sharing, either the rule would be observed “in the breach” or investors would stop investing. Care should be taken by the director, however, to avoid any risk of harm to the corporation from such information sharing. Indeed, the rule assumes that the stockholder’s interest is aligned with the corporation and that the stockholder is not, for example, a competitor. It is best practice to have a confidentiality agreement in place between the corporation and the stockholder, as is the case in most private company information rights agreements. Having such an agreement in place protects both the director and the corporation. Even without that restriction, the stockholder will be viewed as an insider for purposes of insider trading. Directors should be aware that the

³⁰ *Id.* at *9.

³¹ *Henshaw v. American Cement Corp.*, 252 A.2d at 129.

³² *Id.* at 127 and 129.

³³ *Kalisman v. Friedman*, 2013 WL 1668205 (Del. Ch. 2013), *Moore Business Forms, Inc. v. Cordant Holdings Corp.*, 1996 WL 307444 (Del. Ch. 1996); *AOC Limited Partnership v. Horsham Corp.*, 1992 WL 97220, at *1 (Del. Ch. 1992).

³⁴ *Kalisman v. Friedman*, 2013 WL1668205 at *6.

corporation could have a claim against both the stockholder and the director for any harm that comes from the disclosure.

It is best practice to have a confidentiality agreement in place between the corporation and the stockholder, as is the case in most private company information rights agreements.

Conclusion

A constituency director owes the same duties as all other directors, including an undivided duty of loyalty, to act in the best interests of the corporation and all of its stockholders. This means the director cannot simply defer to the wishes of his or her stockholder, but rather must exercise independent judgment on the matters that come before the board of directors.

If a director has a conflict of interest arising with regard to a matter involving the stockholder, because of a personal benefit not available to all stockholders, or the director is not able to make an independent judgment on

the matter relating to the stockholder due to his or her relationship with the stockholder or its affiliates, then the director must disclose this conflict of interest or influence, and should recuse himself from the deliberations to avoid the risk that his participation taints the board's decision.

Directors owe a duty of confidentiality regarding all confidential information they receive in their fiduciary capacity. Directors will be permitted to share information with constituents who have a stake in the corporation and whose interests are not opposed to the corporation, so long as the corporation can assure that the information will be kept confidential.



Diane Holt Frankle

Partner

diane.frankle@kayescholer.com

+1 650 319 4518

Delaware Chancery Court Holds Appraisal Rights Are Lost When Shares Are Transferred From DTC to Custodial Banks' Nominees

Nicholas O'Keefe Partner

In a recent appraisal proceeding, Vice Chancellor Laster held that institutional shareholders lost their appraisal rights when title to their shares was transferred from Cede & Co. (DTC's nominee) to nominees of the custodial banks through which the institutions' shares were held. See *In re Appraisal of Dell Inc.*, C.A. No. 9322-VCL (July 13, 2015). In granting summary judgment for Dell, Vice Chancellor Laster held that retitling the shares in the names of the custodial banks violated the "Continuous Holder Requirement" (described below) under Delaware's appraisal statute. However, in lengthy dicta, Vice Chancellor Laster explained that his hands were tied by Delaware Supreme Court precedent. Vice Chancellor Laster urged the Supreme Court to treat DTC participants as record holders and the DTC position list as part of the corporation's books and records, for purposes of interpreting the appraisal statute.

Background

The decision involved an appraisal action by five institutions in connection with Dell's 2013 going-private transaction. The institutions held shares of Dell common stock in street name through custodial banks. The shares were therefore reflected on Dell's stock transfer records as being held of record by Cede & Co., DTC's nominee. In order to exercise appraisal rights, as explained further below, the five institutions had to cause DTC to demand appraisal on their behalf.

In accordance with its customary procedures for appraisal shares (to avoid inadvertently surrendering the shares for merger consideration), DTC removed the shares from the DTC FAST Account and caused physical stock certificates to be delivered to the custodial banks. The physical stock certificates could have been issued in the name of Cede & Co. However, the custodial banks had internal procedures that only permitted them to hold stock certificates issued in the names of the banks' own nominees. As a result, the custodial banks arranged for Dell's transfer agent to reissue the stock certificates in the names of their respective nominees.

The "Continuous Holder Requirement"

Section 262 of the Delaware General Corporation Law (DGCL) sets forth the statutory requirements for exercising appraisal claims in mergers involving Delaware corporations, like Dell. Only "holders of record" are entitled to exercise appraisal rights (known as the "Record Holder Requirement"). In order for holders of record to pursue appraisal claims for their shares, they must have "continuously [held] such shares [from the date of making an appraisal demand] through the effective date of the merger" (known as the "Continuous Holder Requirement").

The summary judgment motion turned on the implications of changing the name on the

share certificates from DTC's nominee to the custodial banks' nominees. Vice Chancellor Laster first looked at the meaning of "holder of record," and noted that it was not defined under the appraisal statute or any other provision of the DGCL. Vice Chancellor Laster noted that Chancery Court precedent equated it to "the person appearing on the corporate records as the owner of stock in the corporation." See *Engel c. Magnavox Co.*, 1976 WL 1705 (Del. Ch. Apr. 22, 1976). He then considered what the "records" of the corporation are for purposes of determining legal ownership.

The summary judgment motion turned on the implications of changing the name on the share certificates from DTC's nominee to the custodial banks' nominees.

Whether "Records" Include DTC Position List for Purposes of Determining "Holders of Record"

Vice Chancellor Laster noted that if the only relevant records are those maintained by Dell or its Transfer Agent, then Dell was entitled to summary judgment because retitling the shares caused record ownership to change. Vice Chancellor Laster then engaged in a lengthy explanation of why the term "records" should include the DTC position list. According to Vice Chancellor Laster, such an approach would appropriately recognize the role of DTC and the DTC position list, which are integral parts of the federal share immobilization policy that was adopted in response to a paperwork crisis in the late 1960s and early 1970s that threatened to overwhelm US securities markets.

In *Dell*, Vice Chancellor Laster stated that he disagreed with the Supreme Court's views that a legislative cure was required, and that "what constitutes the records of the corporation for purposes of determining who is a "holder of record" is a quintessential issue of statutory interpretation appropriate for the judiciary to address."

Vice Chancellor Laster noted that he previously considered whether DTC participants could be treated as holders of record, in the context of whether shares they held could be voted without a DTC omnibus proxy, in *Kurz v. Holbrook*, 989 A.2d 140 (Del. Ch. 2010). Reversing on appeal on other grounds, the Supreme Court characterized the discussion as dictum, and indicated that the topic required a legislative cure. In *Dell*, Vice Chancellor Laster stated that he disagreed with the Supreme Court's views that a legislative cure was required, and that "what constitutes the records of the corporation for purposes of determining who is a "holder of record" is a quintessential issue of statutory interpretation appropriate for the judiciary to address."

Early Precedent, Which Invoked Need for Certainty and Ability of Shareholders to Hold Shares Directly, Predated Federal Policy of Share Immobilization Through DTC

Vice Chancellor Laster then reviewed the relevant jurisprudential history. He discussed the decision in *Schenck v. Salt Dome Oil Corp.*, 34 A.2d 249 (Del. Ch. 1943), *rev'd*, 41 A.2d 583 (Del. 1945), where the Supreme

Court held that only a registered stockholder, and not a beneficial owner, was entitled to exercise appraisal rights. The Supreme Court in that case invoked the need for certainty, and reasoned that where shares were beneficially held through a broker, the decision to use a broker was a voluntary one, and thus the customer should bear the risks of that decision.

Vice Chancellor Laster noted that the *Salt Dome* decision predated the formation of DTC by three decades, and did not anticipate the compulsory nature of DTC's role. In addition, the *Salt Dome* decision did not consider what documents might encompass the appropriate records for determining registered status and whether, after formation of DTC, they might include the DTC position list. Vice Chancellor Laster then discussed the decision in *Olivetti Underwood Corp. v. Jacques Coe & Co.*, 217 A.2d 683 (Del. 1966), in which the Supreme Court expanded its decision to *Salt Dome* by stating that corporations "should avoid becoming involved in the affairs of registered stockholders vis-à-vis beneficial owners." *Id.* at 686.

Vice Chancellor Laster noted that the 1967 revisions to the DGCL, which codified the Record Holder Requirement, incorporated the qualifications and limitations in the above case law. In addition, the 1967 amendments did not specify what constitute the appropriate records for determining who the stockholders of record are. The 1967 revisions predated the federal policy of share immobilization. According to Vice Chancellor Laster, in the 1970s, as "the SEC implemented the federal policy of share immobilization . . . Delaware decisions largely ignored this development . . . and treated [DTC] as a matter of convenience that resulted exclusively from the private

contractual relationship between a broker and its clients."

Supreme Court Missed Opportunity to Adopt New Approach in *Enstar*

In the appraisal decision *Enstar Corp. v. Senouf*, 535 A.2d 1351 (Del. 1987), the Supreme Court continued to adhere to precedent and treated the failure by holders in street name to cause Cede & Co. to make an appraisal demand as a failure of the brokers through which they held their shares, which was not the corporation's concern. The Supreme Court continued to view ownership through DTC as the shareholder's choice, and not as a necessary consequence of the federal policy of share immobilization.

Vice Chancellor Laster criticized the approach taken by the *Enstar* court on several grounds. First, although "it is true theoretically that any particular investor could opt out of the depository system and chose to hold in record name, only a few could do so before the system would break down. . . . The system was imposed by Congress and the SEC, and almost-universal participation is a de facto requirement." Second, the Supreme Court in *Enstar* viewed DTC as only imposing costs on the corporation but did not recognize the benefits the corporation received through DTC having enabled public securities markets to operate. Third, the Supreme Court reiterated the *Salt Dome* court's concern about the difficulties corporations would face in having to look beyond the stock ledger, even though the DTC position list was readily available. Finally, the Supreme Court in *Enstar* asserted that the nominee relationship was not a concern for the merging corporation. This ignored the fact that when a public corporation's shareholders vote on a merger,

the corporation must go through DTC to undertake a broker search for purposes of mailing proxy materials.

Vice Chancellor Laster viewed the *Enstar* decision as a missed opportunity to update Delaware law so that the law appropriately reflected the role of DTC.

Vice Chancellor Laster viewed the *Enstar* decision as a missed opportunity to update Delaware law so that the law appropriately reflected the role of DTC. Vice Chancellor Laster noted, however, that the *Enstar* court did not rule on whether DTC participants should be treated as record holders, and the court did seem to view construing the Record Holder Requirement as an appropriate exercise of judicial authority.

Treating DTC Participants as Record Holders Could Lead to Judicial Developments in Appraisal Arbitrage Cases

Vice Chancellor Laster also briefly discussed the rise of appraisal arbitrage following the holding in *In re Appraisal of Transkaryotic Therapies, Inc.*, 2007 WL 1378345 (Del. Ch. May 2, 2007), that funds that bought shares after the record date for the merger could seek appraisal for those shares without having to show that the shares were not voted in favor of the merger. The holding turned on the fact that Cede & Co. remained the record holder throughout the relevant period. The actions of the appraisal arbitrage fund, as beneficial holder, were irrelevant. Vice Chancellor Laster noted that looking through DTC would not eliminate the ability to seek appraisal for shares acquired after the record date. He expressed his view that appraisal arbitrage

may be beneficial in a free market economy and should not be legally prohibited. Vice Chancellor Laster stated that looking through to DTC's participants would nonetheless be an improvement on the current legal approach. If DTC participants were treated as holders of record, a more nuanced jurisprudence could be developed. For example, if a block of shares was purchased from a broker, it may be possible to verify how those shares were voted, for purposes of determining compliance with the appraisal statute's requirement that appraisal shares should not have been voted in favor of the merger.

Vice Chancellor Laster concluded that under current law, Dell's motion for summary judgment had to be granted. However, he made clear that if he were not encumbered by precedent, he would hold that the concept of a "stockholder of record" includes the DTC position list, which may have led to a different result.

Vice Chancellor Laster made clear that if he were not encumbered by precedent, he would hold that the concept of a "stockholder of record" includes the DTC position list.

Key Takeaways

The *Dell* decision has a number of implications:

- First, Delaware corporations in appraisal proceedings should inquire as to whether appraisal petitioners have similarly transferred title to shares from Cede & Co. to another entity in violation of the Continuous Holder Requirement. After the *Dell* decision, appraisal petitioners are likely to be attuned to the risks of doing so.

However, there may be appraisal actions that predate the *Dell* decision where such transfers have taken place.

- Second, custodial banks should consider re-examining their policies regarding holding stock certificates issued in the name of Cede & Co. Custodial banks will presumably want to avoid alienating their customers by requiring certificates to be retitled, where doing so will result in the loss of appraisal rights, as it did in *Dell*.
- Third, Vice Chancellor Laster's opinion was an express invitation to the Delaware Supreme Court to adopt a new approach. It will be interesting to see whether the Supreme Court does so, if this decision is appealed. If the Supreme Court does endorse Vice Chancellor Laster's views, it will have implications not only for appraisal proceedings, but also for the proxy voting process.
- Fourth, Vice Chancellor Laster noted that his proposed changes in case law would not prevent appraisal arbitration funds from seeking appraisal with respect to shares purchased after the record date. The decision is, therefore, unlikely to have much of an impact on the appraisal arbitration industry. Moreover, Vice Chancellor Laster's statements that he views appraisal arbitration as a beneficial activity may even provide tacit encouragement to additional fund sponsors looking to get into the appraisal arbitration business.



Nicholas O'Keefe

Partner

nicholas.okeefe@kayescholar.com

+1 650 319 4522

Removing Officers: For Delaware Corporations, Solely the Power of the Board of Directors

Gorman v. Salamone

Tracy A. Belton Associate and Diane Holt Frankle Partner

While stockholders of a Delaware corporation have a variety of statutory powers relating to the governance of a corporation, it has been a longstanding principle of Delaware corporate law that the board of directors are vested with the authority to manage the business and affairs of the corporation and that, accordingly, stockholders “may not directly manage the business and affairs of the corporation, at least without specific authorization in either the statute or the certificate of incorporation.”¹ On July 31, 2015, in *Gorman v. Salamone*, C.A. No. 10183-VCN (Del. Ch. July 31, 2015),² the Delaware Court of Chancery (the Court) reaffirmed this principle, concluding that a bylaw amendment granting stockholders the ability to remove corporate officers was invalid because such right would “unduly constrain the board’s ability to manage the Company.”

A bylaw amendment granting stockholders the ability to remove corporate officers was invalid because such right would “unduly constrain the board’s ability to manage the Company.”

Facts³

Plaintiff John J. Gorman is a stockholder and board member of Westech Capital Corp. On July 7, 2014, Gorman “supposedly” (according to the amended complaint) acted by stockholder written consent to amend Westech’s bylaws to allow stockholders to remove and replace corporate officers (the Amended Bylaw). The Amended Bylaw provided, in part, that:

Any officer may be removed, with or without cause, at any time by the Board or by the stockholders acting at an annual or special meeting or acting by written consent. . . . The Board shall, if necessary, immediately implement any such removal of an officer by the stockholders. . . . Any vacancy occurring in any elected office of the Corporation may be filled by the Board except that any vacancy occurring as a result of the removal of an officer by the stockholders shall be filled by the stockholders.

Gorman then immediately removed the current Westech CEO, Gary Salamone, and

¹ CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d 227, 232 (Del. 2008).

² <http://courts.delaware.gov/opinions/download.aspx?ID=227860>

³ The litigants in this suit are involved in an ongoing dispute over the composition of the board of directors of Westech Capital Corp., which has engendered numerous visits to the Delaware Chancery Court and Delaware Supreme Court and many twists and turns. However, this article will focus on one substantive issue raised in this particular case that is of general interest—the stockholder-adopted bylaw regarding the stockholders’ power to remove and appoint officers.

elected himself to the role. Westech's bylaws grants the CEO a board seat. Gorman, as the new CEO, assumed the CEO board position, vacating his former director seat. Gorman then elected Craig Biddle to fill his vacated board seat.

Gorman filed suit in the Court seeking confirmation that, among other things, Salamone was no longer the CEO or a director of the company.

Analysis

Gorman argued that Section 142(b) of the Delaware General Corporate Law (the DGCL) authorizes stockholders to set in the bylaws the manner in which corporate officers are replaced. Section 142(b) of the DGCL provides that:

Officers shall be chosen in such manner and shall hold their offices for such terms as are prescribed by the bylaws or determined by the board of directors or other governing body. Each officer shall hold office until such officer's successor is elected and qualified or until such officer's earlier resignation or removal. Any officer may resign at any time upon written notice to the corporation.

The Court rejected Gorman's argument, noting that Section 142(b) of the DGCL "does not speak to how corporate officers may be removed, never mind grant stockholders such a power. Rather, it only allows bylaws to establish a method for selecting officers and to dictate their terms of office." The Court observed that although the statutory provision references officer removal, it is "silent regarding how that [removal] can be effectuated." Similarly, the Court considered Section 142(e), but concluded that this

provision provides "no guidance on how corporate officers can be removed, it only addresses how to fill vacancies."

The Court next addressed whether, although the Amended Bylaw was not expressly authorized by Section 142, its adoption was nonetheless authorized under Section 109 of the DGCL, which grants stockholders the authority to adopt and amend bylaws. The Court acknowledged that "stockholders do generally have a broad power to adopt and amend bylaws 'relating to the business of the corporation, the conduct of its affairs, and the rights or powers or the rights or powers of its stockholders, directors, officers or employees,'" but clarified that "the stockholders' right to amend bylaws is not unlimited." Section 109(b) of the DGCL provides that bylaws cannot contain any provision that is inconsistent with law or with the certificate of incorporation. The Court explained that "[s]tockholders' ability to amend bylaws is 'not coextensive with the board's concurrent power, and is limited by the board's management prerogatives under Section 141(a).'"⁴

The Court explained that "[s]tockholders' ability to amend bylaws is 'not coextensive with the board's concurrent power, and is limited by the board's management prerogatives under Section 141(a).'"

Under Section 141(a), the role of the board is to manage the business and affairs of the corporation, and "stockholders may not directly manage such business and affairs . . . without specific authorization in either the

⁴ Gorman, C.A. No. 10183-VCN citing CA, Inc. v. AFSCME Emps. Pension Plan, 953 A.2d at 232.

statute or the certificate of incorporation.”⁵ Bylaws therefore may not “mandate how the board should decide substantive business decisions, but . . . [they may] define the process and procedure by which those decisions are made.”⁶

The question facing the Court, therefore, was whether removing an individual from corporate office was a substantive business decision that should be within the powers of the board of directors and not the stockholders. The Court’s “reflexive answer” to this question was that yes, it is a substantive business decision that “would allow stockholders directly to manage corporate business and affairs.” The Court explained that “a primary way by which a corporate board manages a company is by exercising its independently informed judgment regarding who should conduct the company’s daily business.” Indeed, the Court observed that “[h]ow a board without the power to control who serves as CEO could effectively establish a long-term corporate strategy is difficult to conceive.” The Court cites numerous authorities for the oft-stated proposition that “a board’s most important task is to hire, monitor and fire the CEO.” Thus, the decisions relating to the hiring and removal of a CEO are clearly “substantive business decisions.”

Gorman argued that the Amended Bylaw “merely prescribes the procedure by which Westech’s officers are elected and removed: it defines who may select and replace officers.” He noted that the Amended Bylaw did not prevent the board from removing officers or from filling vacancies not created by stockholders. He argued the Amended Bylaw therefore did not interfere with the board’s

prerogatives, but simply “allows the stockholders to have input into who serves as an officer” and that the Amended Bylaw “merely specifies the mechanism for selecting and removing officers.”

The Court cites numerous authorities for the oft-stated proposition that “a board’s most important task is to hire, monitor and fire the CEO.” Thus, the decisions relating to the hiring and removal of a CEO are clearly “substantive business decisions.”

The Court concluded otherwise, “because the Amended Bylaw does more than simply dictate how officers are appointed and removed.” Instead, the Amended Bylaw actually permitted “**the stockholders** to remove and replace officers without cause, which would allow them to make substantive business decisions for the Company” (emphasis added). The Court explains that the Amended Bylaw was “apparently intended to take an important managerial function from the Board.” Indeed, the Court observed that the Amended Bylaw “was never intended to be process-related. Gorman aimed to usurp the Board’s authority in order to gain power over the Company, which has been subject to an ongoing control dispute.” Thus, the Amended Bylaw “would clearly provide stockholders with more than an advisory function.”

The Court also noted that the Amended Bylaw allowed the stockholders to compel board action. Thus, the Amended Bylaw required the board to immediately implement the removal of an officer by the stockholders. The Court observed that such mandated action could potentially be in conflict with the board members’ fiduciary duties if the directors determined that the Company would be best

⁵ Id.

⁶ Id. at 234-5.

served otherwise. Moreover, the Court took notice that the Amended Bylaw created the possibility of a potential “infinite loop” in which stockholders and the board took turns removing and replacing officers—a situation that would certainly negatively impact the Company’s ability to carry on its business. The Court determined that the Amended Bylaw was invalid, and thus the removal of the CEO was of no effect; that portion of the Complaint was dismissed.

If the Court had permitted stockholders to remove and appoint officers through adoption of bylaws, activist stockholders would have received a powerful new tool. Not surprisingly, the Court viewed this proposed stockholder power as inconsistent with existing Delaware law.

The Court observed in *dicta* that a “bylaw that merely prescribed a method for officer removal by the board would perhaps be permissible.” The Court also left open the possibility that “there might be extraordinary circumstances that might require shareholder intervention in the officer-designation process.” The Court also did not determine whether a bylaw could grant stockholders the ability to elect individuals directly to vacant corporate positions. The Court explained that there is scholarly and legal support both against and in favor of this stockholder power but did not indicate which way the Court would likely decide when faced with the issue.

Implications

This case adds to the developing body of law clarifying the respective rights of stockholders and the board of directors to govern the corporation through adoption of bylaws. If the Court had permitted stockholders to remove and appoint officers through adoption of bylaws, activist stockholders would have received a powerful new tool. Not surprisingly, the Court viewed this proposed stockholder power as inconsistent with existing Delaware law. The Court thus holds inviolate the authority of the board of directors to manage the corporation, confirming that the proper way for stockholders to influence these management decisions is through their power to elect the board of directors.



Tracy A. Belton
Associate

tracy.belton@kayescholer.com
+1 212 836 8859



Diane Holt Frankle
Partner

diane.frankle@kayescholer.com
+1 650 319 4518

Do NDAs Deserve a Closer Look?

Glynn K. Christian Partner and **Nikki Mondschein** Associate

One of the first steps in M&A discussions is for the parties to enter into a non-disclosure or confidentiality agreement (**NDA**). NDAs are usually based on a trusty template—dusted off, the parties' names inserted and executed quickly with very little discussion.

While the NDA may seem to be the simplest of all of the documents in an M&A transaction, it may deserve a closer look, particularly where a strategic buyer may be preferred over a financial buyer or in the context of an auction sale with multiple bidders. Because a strategic buyer is looking for synergies to create opportunities for growth, it often will have competitive products or services, overlapping customers or suppliers, or may even be a customer of the seller. While these synergies may bring significant value if the deal closes, they also may create risk for the seller if the deal does not close.

When drafting NDAs, there are a number of points to consider that were probably last weighed when that trusty template was originally drafted. Below are a few key items to consider when preparing or reviewing an NDA in these contexts:

1. **Parties.** A typical NDA is a straightforward contract between two parties, the seller on one hand and the buyer on the other. However, this may not provide the protections a seller may require or give the buyer the flexibility it needs. For example, if the seller or the target has multiple entities, does the seller actually have the right to disclose the information on behalf of all of those entities? Does the

NDA allow the buyer to disclose the seller's confidential information to its affiliates as well as any third-party legal and financial advisors? The answers to these questions may vary depending on the type of information being disclosed, particularly if any of the information is personally identifiable information (PII) that may require consent for disclosure to these entities or for use in the context of an M&A transaction. The seller or the target should not risk being in breach of data protection statutes or triggering breach notification statutes by disclosing PII to third parties who are not bound by the NDA. Consider what information is likely to be disclosed, which entities will be disclosing the information and which entities will be involved in the due diligence or receiving the information.

Does the NDA allow the buyer to disclose the seller's confidential information to its affiliates as well as any third-party legal and financial advisors? The answers to these questions may vary depending on the type of information being disclosed.

Each party also should be made aware of who is and is not authorized to receive confidential information, and this should be clearly stated in the NDA. Before allowing any affiliate or third-party advisors to be an authorized recipient under an NDA, both parties should be satisfied that the buyer will be able, and willing, to comply with its obligations and enforce the confidentiality obligations on its

authorized affiliates and third-party advisors once it receives confidential information. Moreover, depending on who will be the authorized recipient (for example, a third-party advisor that does not owe any duty of confidentiality to the buyer), the seller may also want to require such party to enter into a back-to-back NDA imposing the same obligations on the third-party advisor that are imposed on the buyer. Today, it is increasingly common for the seller to provide information directly to a buyer's external legal counsel or investment bankers, so ensuring such disclosure is covered by the NDA is critical if such recipients are to have a duty to maintain the confidentiality of such information.

Each party also should be made aware of who is and is not authorized to receive confidential information, and this should be clearly stated in the NDA.

2. **Scope.** A typical definition of "Evaluation Materials" or "Confidential Information" is one like the example below:

"Evaluation Material" means all information, data, documents, agreements, files and other materials, whether disclosed orally or disclosed or stored in written, electronic or other form or media, which is obtained from or disclosed by the Disclosing Party or its Representatives before or after the date hereof regarding the Company, including, without limitation, all analyses, compilations, reports, forecasts, studies, samples and other documents prepared by or for the Recipient which contain or otherwise reflect or are generated from such information, data,

documents, agreements, files or other materials. The term "Evaluation Material" as used herein does not include information that: (i) at the time of disclosure or thereafter is generally available to and known by the public (other than as a result of its disclosure directly or indirectly by the Recipient or its Representatives in violation of this Agreement); (ii) was available to the Recipient from a source other than the Disclosing Party or its Representatives, provided that such source, to Recipient's knowledge after reasonable inquiry, is not and was not bound by a confidentiality agreement regarding the Company; or (iii) has been independently acquired or developed by the Recipient without violating any of its obligations under this Agreement.

While this type of definition works for many situations, it may need to be revised depending on the types of information or materials the seller or target will make available. For example,

- If the seller or target obtained any of the material being shared from a third party, then the seller should determine if there is an underlying agreement with that third party containing different or additional confidentiality restrictions around disclosing the material. Certain agreements disclosed as Evaluation Materials may also contain confidentiality restrictions under which disclosure may constitute a material breach of those agreements.
- If any of the information or materials includes PII, then the exclusions around information that is publicly available

may need to be clarified such that PII that might be available publicly (e.g., names, email addresses, phone numbers) is not inadvertently excluded from the definition of Evaluation Materials or Confidential Information and thus, excluded from the NDA's protections. Depending on the jurisdiction where such PII is transferred or stored, statutory obligations under certain jurisdictions impose restrictions on the ways individuals and companies handle PII and such restrictions would apply regardless of whether PII is subject to an NDA.

- Should the existence of the NDA itself, or the terms and conditions of the NDA, or the discussions or negotiations of the parties in connection with the potential transaction, also be treated as confidential? Confidentiality as to these matters is typically really important to the disclosing party, who could be harmed if even rumors as to discussions with the other party begin to circulate. If so, consider if the language is drafted such that it actually might permit either party to disclose the NDA's existence and terms, as well as the negotiations of the parties in connection with the potential transaction (e.g., is the NDA or its terms defined as Evaluation Material of each party?).

Certain agreements disclosed as Evaluation Materials may also contain confidentiality restrictions under which disclosure may constitute a material breach of those agreements.

3. **Non-Disclosure and Use Restrictions.**

The NDA should specifically proscribe what the buyer can do with, and how it may use, the Evaluation Materials, and require the buyer and its authorized representatives to hold the information in strict confidence.

Typically, the NDA will require the buyer to apply the same standard of care to the seller's confidential information as it applies to its own; however, this may not be a high enough standard depending on the type of information being disclosed.

Moreover, as noted above, if the Evaluation Materials contains PII (e.g., employee names/compensation), the obligations to protect the Evaluation Materials also need to include typical data protection standards. If the seller or target has customers, suppliers or employees in countries requiring consent to disclose such PII, then the seller should evaluate if the PII even may be made available without obtaining consent from the relevant party or individual. It is unlikely that a seller will have the resources to do this or would want to risk publicity around a potential sale and should consider what information it may be able to disclose without consent or whether to redact such PII from the Evaluation Materials. For example, rather than disclosing employment agreements, the seller or target may simply disclose a form agreement used for its employees. To avoid interpretation issues, the NDA also should clearly set forth any intended exceptions to the non-disclosure requirements. For example, instead of permitting disclosure of the Evaluation Materials as "legally required," consider the more specific, "in compliance with the legal requirements of a competent judicial, administrative or regulatory authority, such as in response to a subpoena or court order, or as otherwise

compelled by securities laws or stock exchange rules.”

Typically, the NDA will require the buyer to apply the same standard of care to the seller’s confidential information as it applies to its own; however, this may not be a high enough standard depending on the type of information being disclosed.

4. **Return or Destroy.** The seller will want the right to require the buyer and its authorized recipients to destroy or return to it documents containing confidential information. This provides an important level of control over any copies that the buyer and its authorized representatives make, or any document that the seller or its authorized representatives create based on the confidential information. The following types of provisions may dilute the ability of the seller or target to protect its confidential information and should be considered carefully:

- An NDA may contain a residuals clause designed to allow the receiving party and its authorized recipients to freely use confidential information retained in the unaided memory of their personnel. In the context of an M&A transaction, a residuals clause undermines the integrity of the confidentiality obligations in the NDA. For example, what if the Evaluation Material is the seller’s technology roadmap for its solution, including new features that may be patentable? This type of information can be easily remembered and a residuals clause may give the receiving party an out from its confidentiality obligations.

- In some M&A transactions, the potential buyer may “kick the tires” on the seller’s product or solution or there may be meetings between the parties that turn into joint brainstorming sessions. In these situations, the NDA may need to have intellectual property provisions, including a license setting out the limits of such tire kicking, clarifying ownership of the IP, including any IP that may be created based upon the Confidential Information, and excluding any other express or implied licenses.

Particularly in light of the heightened sensitivity around confidential information in the context of an M&A transaction, as well as the recent trend toward increased scrutiny of privacy law practices by regulatory authorities, the parties in an M&A transaction can get ahead of potential issues by thinking beyond the “standard” template. If we can help provide further guidance on the above, or if there are particular issues that come up in the context of a transaction, feel free to reach out to us.



Glynnna K. Christian

Partner

glynnna.christian@kayescholer.com

+1 212 836 8390



Nikki Mondschein

Associate

nikki.mondschein@kayescholer.com

+1 212 836 7426

Another Tool in the Toolbox: SEC Makes Clear That Regulation A Can Be Used in M&A Transactions

Christopher Peterson Partner

On June 19, 2015, the final rules to amend Regulation A under the Securities Act of 1933 became effective. Of particular interest to M&A practitioners, on August 6, 2015, the SEC issued its most recently updated compilation of Compliance and Disclosure Interpretations (the C&DI). The C&DI makes clear that Regulation A can be used in merger or acquisition transactions that otherwise meet the requirements of Regulation A.¹ Regulation A may be particularly useful in circumstances where a potential acquirer wants to issue equity securities as acquisition consideration without registration under the Securities Act but the facts of the proposed acquisition limit the availability of the Regulation D exemption.

Overview of Regulation A

As amended, Regulation A provides an exemption for certain US and Canadian companies that are not otherwise required to file reports under the Securities Exchange Act of 1934 to raise up to \$50 million in a 12-month period. Regulation A offerings have been historically rare, particularly when compared to the frequency of Regulation D offerings, and the new Regulation A is

intended to increase the utility of the exemption.

Regulation A provides an exemption for certain US and Canadian companies that are not otherwise required to file reports under the Securities Exchange Act of 1934 to raise up to \$50 million in a 12-month period.

Regulation A now includes two tiers: Tier 1 for smaller offerings raising up to \$20 million in any 12-month period and Tier 2 for offerings raising up to \$50 million in any 12-month period.² The primary advantage of a Tier 2 offering compared to a Tier 1 offering (other than the higher maximum offering amount of \$50 million) is that the registration and qualification requirements under state blue sky securities laws are preempted by Regulation A for Tier 2 offerings.³

The general eligibility, filing and ongoing reporting requirements of Regulation A are summarized below.

¹ **Question:** Can Regulation A be relied upon by an issuer for business combination transactions, such as a merger or acquisition? **Answer:** Yes. The final rules do not limit the availability of Regulation A for business combination transactions, but, as the Commission (SEC Rel No. 33-9497) indicated, Regulation A would not be available for business acquisition shelf transactions, which are typically conducted on a delayed basis. [June 23, 2015]

² Under Tier 2, up to \$15 million of the \$50 million aggregate offering may consist of secondary sales, provided that the selling securityholder component cannot exceed 30 percent of the aggregate of the initial offering and any subsequent Regulation A offering in the 12 months thereafter.

³ Tier 1 offerings under Regulation A may be of limited utility for issuers because Tier 1 offerings remain subject to state blue sky securities laws, similar to Regulation A offerings before the JOBS Act.

Eligible Issuers and Securities

The Regulation A exemption is generally available to issuers organized and having their principal place of business in the United States or Canada that are not otherwise required to file reports under the Exchange Act. Certain types of issuers are ineligible to offer or sell securities under Regulation A, including (i) SEC reporting companies, (ii) blank check companies, (iii) investment companies and (iv) entities issuing fractional interests in oil, gas or mineral rights. Regulation A now also includes bad-actor disqualification provisions that are largely consistent with those included in Rule 506(d) under the Securities Act.

The securities that may be offered under Regulation A are limited to equity securities (including warrants), debt securities and debt securities convertible or exchangeable into equity interests, including any guarantees of such securities.

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Initial Filing and Delivery Requirements

An issuer that seeks to rely on Regulation A must file and qualify an offering statement on Form 1-A. The offering statement may be submitted for nonpublic review by the SEC. As with emerging growth companies under Section 102(b)(1) of the JOBS Act (EGCs), if an issuer opts for confidential review, the offering statement must be filed publicly not

less than 21 calendar days before qualification of the offering statement. Form 1-A requires relatively streamlined disclosure compared to a Form S-1 or Form S-4 and the general requirements of Form 1-A may be summarized briefly as follows:

- **Part I.** Requires certain basic information regarding the issuer and its eligibility; the offering details; the jurisdictions where the securities will be offered; and sales of unregistered securities.
- **Part II.** Contains the narrative portion of the offering statement, including basic information about the issuer; material risks; use of proceeds; a business overview; an MD&A type discussion; executive officers' and directors' compensation; beneficial ownership information; related party transactions; and a description of the offered securities. While similar to Part I of Form S-1, the disclosure requirements are less extensive.
- **Financial Statements.** Both Tier 1 and Tier 2 issuers are required to file balance sheets and other required financial statements as of the two most recently completed fiscal year-end dates. Tier 1 issuers may file unaudited financial statements (provided that they have not already obtained audited financial statements for other purposes), but Tier 2 issuers are required to file audited financial statements.

Issuers domiciled in the United States must prepare their financial statements in accordance with US GAAP while Canadian issuers may prepare their financial statements in accordance with either US GAAP or International Financial Reporting

Standards as issued by the International Accounting Standards Board.⁴

Form 1-A requires relatively streamlined disclosure compared to a Form S-1 or Form S-4.

Ongoing Reporting Requirements

Tier 1 Issuers. Tier 1 issuers are not subject to any ongoing reporting obligations other than the obligation to provide certain information (such as the date the offering commenced, the price and total amount of securities sold and net proceeds to the issuer) on Form 1-Z within 30 days after the completion or termination of the offering.

Tier 2 Issuers. Tier 2 issuers must provide the same information as Tier 1 Issuers. In addition, Tier 2 issuers are required to file ongoing statements with the SEC via EDGAR, specifically annual reports on Form 1-K; semi-annual reports on Form 1-SA; and current event reports on Form 1-U.

Form 1-K is similar in scope to the Form 1-A filed in connection with the Regulation A offering. Form 1-K contains information regarding business operations for the prior three fiscal years (or since inception); related person transactions; beneficial ownership of voting securities by directors, executive officers and ten-percent owners; the biographies of directors, officers and significant employees; compensation of the three highest paid executive officers or directors for the last three fiscal years; a scaled MD&A for the last two fiscal years and audited financial statements. The financial statements

included in the Form 1-K must be prepared on the same basis and are subject to the same audit requirements as the financial statements included in the Form 1-A offering statement for Tier 2 offerings. Form 1-K must be filed within 120 calendar days after the issuer's fiscal year end.

The semi-annual report on Form 1-SA is similar to a Form 10-Q, subject to scaled disclosure requirements. The report is generally required to be filed within 90 days after the end of the first six months of the issuer's fiscal year end.⁵

Form 1-U, is analogous to Form 8-K and is required to be filed by Tier 2 issuers upon the occurrence of certain significant events such as fundamental changes in the business; bankruptcy or receivership; a material modification to the rights of security holders; changes in control; principal executive officer, financial officer or accounting officer departures; or unregistered sales of ten percent or more of outstanding equity securities.

Regulation A in M&A Transaction

Despite some uncertainty resulting from the Regulation A adopting release, the C&DI makes clear that Regulation A can be used in merger and acquisition transactions.

Acquirers regularly use Regulation D to issue merger consideration in the form of securities, and this practice will undoubtedly continue. However, the use of Regulation D can prove

⁴ Consistent with the treatment of EGCs under the JOBS Act, Regulation A permits issuers to delay implementing new accounting standards.

⁵ The requirement to file Form 1-A commences following the most recent fiscal year for which full financial statements were included in the Form 1-A offering statement or, if the Form 1-A offering statement included six-month interim financial statements for the most recent full fiscal year, then for the first six months of the following fiscal year.

difficult in certain circumstances, such as an acquisition of a target company with a significant number of stockholders who are not accredited investors. In such circumstances, many potential acquirers may be reluctant to issue securities as consideration since it would likely require the issuer to file a registration statement on Form S-4 and thereafter become subject to the ongoing reporting requirements of the Exchange Act.

Despite some uncertainty resulting from the Regulation A adopting release, the C&DI makes clear that Regulation A can be used in merger and acquisition transactions.

Potential acquirers in these circumstances may now consider using Regulation A. While these issuances will be subject to the limits and requirements outlined above, the relatively streamlined requirements of Regulation A could make it a useful tool for M&A practitioners.



Christopher Peterson

Partner

christopher.peterson@kayescholer.com

+1 212 836 8861

Chicago Los Angeles Silicon Valley
Frankfurt New York Washington, DC
London Shanghai West Palm Beach

KAYE | SCHOLER

Kaye Scholer's *M&A and Corporate Governance Newsletter* is edited by Silicon Valley Partner Diane Frankle. Feedback or suggested article ideas can be sent to diane.frankle@kayescholer.com or by contacting her at +1 650 319 4518.

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