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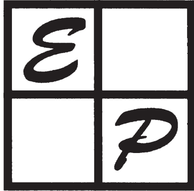

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What's the Big Deal? Why Some Seemingly Material Acquisition Agreements Might Never See the Light of Day

By Jim Moloney, Mike Titera and Kevin Hill of Gibson, Dunn & Crutcher LLP

Multi-billion dollar acquisitions often make headlines, but ever wonder why the terms of the related acquisition agreements are sometimes not disclosed, or the agreements filed with the SEC? For example, Microsoft announced via press release in May of 2011 that it had entered into an agreement to acquire Skype for $8.5 billion, yet the company did not file an Item 1.01 Form 8-K.[1]

This is not unusual for many large, acquisitive companies.[2] Below we examine how companies determine whether to disclose an acquisition agreement.[3] Item 1.01 of Form 8-K requires that, within four business days of entering into a material definitive agreement, a public company disclose certain information concerning that agreement, such as the date of the agreement, the identities of the parties, and a brief description of its terms and conditions. Similarly, subject to certain exceptions, Items 601(b)(2) and (b)(10) of Regulation S-K require that material plans of acquisition and material contracts not made in the ordinary course of business, respectively, be filed as exhibits to, among other things, registration statements and periodic reports.

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[1] Press Release, Microsoft, "Microsoft to Acquire Skype for $8.5 Billion" (May 10, 2011) *available at* http://news.microsoft.com/2011/05/10/microsoft-to-acquire-skype/ (announcing acquisition of Skype for $8.5 billion). (Note: As of June 30, 2011, Microsoft had total assets of $108.7 billion.) An announcement regarding the acquisition was disclosed by Microsoft under Item 8.01 of Form 8-K, but neither a description of the agreement nor the agreement itself was filed.

[2] See, *e.g.*, the following acquisitions where no disclosure of the acquisition agreements was made under Item 1.01 of Form 8-K: Press Release, Microsoft, "Microsoft to acquire Nokia's devices & services business, license Nokia's patents and mapping services" (September 3, 2013) (announcing acquisition of certain Nokia businesses for EUR 3.79 billion (approx. $5 billlion)); Press Release, Microsoft, "Minecraft to join Microsoft" (September 15, 2014) (announcing acquisition of Mojang and the company's Minecraft franchise for $2.5 billlion); Press Release, Cisco, "Cisco Completes Acquisition of NDS" (July 31, 2012) (announcing acquisition of NDS Group, Ltd. for approximately $5 billion); Press Release, PR Newswire, "Pfizer to Acquire King Pharmaceuticals, Inc." (October 12, 2010) (announcing acquisition of King Pharmaceuticals, Inc. for approximately $3.6 billion).

[3] While an acquirer may decide not to disclose an acquisition agreement, if the target is a public company, the acquisition agreement may be deemed material by the target and thus disclosed in an Item 1.01 Form 8-K filed by the target in any event.

TABLE OF CONTENTS

– What's the Big Deal? Why Some Seemingly Material Acquisition Agreements Might Never See the Light of Day 1

– The Quest for Universal Ballots: Might Boards Benefit Too? 5

– The Continuing Importance of Process in Entire Fairness Review: *In re Nine Systems* 7

– Amendment to Delaware's Statute of Limitations Rules: Drafting Tips 12

– Respecting Boilerplate: Scope and Communications Provisions 13

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So, as a practical matter, what facts are relevant when companies must decide whether a multi-billion dollar acquisition agreement should be disclosed in a Form 8-K and later filed as an exhibit with the SEC? Both Item 1.01 of Form 8-K and Item 601(b)(10) of Regulation S-K are typically viewed as guideposts when evaluating whether the agreement is (1) material and (2) outside the ordinary course of business.[4]

The Materiality Analysis

So, how can a multi-billion dollar agreement not be material such that full disclosure is not required? Materiality, in a contract disclosure context, possesses the same elusive qualities as it does elsewhere in the securities laws. The term "material" is defined neither under Item 1.01 of Form 8-K nor under Items 601(b)(2) or (b)(10) of Regulation S-K. Thus, companies must look instead to general standards of materiality as defined in SEC rules, judicial decisions, and administrative guidance. Citing *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 449 (1976) and *Basic, Inc. v. Levinson*, 485 U.S. 224, 231 (1988), the SEC Staff has stated that information is material if "there is a substantial likelihood that a reasonable shareholder would consider it important in making an investment decision. To fulfill the materiality requirement, there must be a substantial likelihood that a fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[5] By its very nature this opaque definition ascribed to materiality precludes reliance on bright line rules or any precise formula, requiring instead a case-by-case analysis of both quantitative and qualitative factors.[6]

Although the SEC has not established a definitive formula to apply when determining whether a particular acquisition is material, companies can still use quantitative thresholds as a starting point in their materiality analysis.[7] It is helpful to note that the SEC has adopted some numerical value comparisons in certain contexts. Most importantly for a discussion of acquisition agreements, under Item 601(b)(10)(ii)(C), contracts for the sale or acquisition of any property, plant and equipment where the consideration exceeds 15 percent of the company's fixed assets must be included as exhibits even if they were made in the ordinary course of business.

Another helpful guideline, Item 2.01 of Form 8-K, provides that a completed acquisition of assets involves a "significant amount of assets" where the consideration exceeds 10 percent of the company's total assets.[8]

Also, Rules 1-02(w) and 3-05(b)(2) of Regulation S-X specify when an acquisition of a "business" is material for financial reporting purposes by applying three tests: an investment test, asset test and income test. The results of these tests are measured against specific thresholds of 20%, 40% and 50% to determine the periods for which financial statements of an acquired business must be filed.

Without going into too much detail on what constitutes a "business," and applying a similar logic, companies will often begin their analysis with these thresholds.[9] Of course, any such preliminary analysis should be supplemented by a thoughtful consideration of factors unique to the agreement and the company. Staff guidance, consistent with established case law, makes clear that no single fact is determinative of whether

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[4] The disclosure requirements in Item 1.01 of Form 8-K and Item 601(b)(10) of Regulation S-K are not identical. Yet, the adopting release for the 2004 amendments to Form 8-K states, "New Item 1.01 requires the disclosure of material definitive agreements entered into by a company that are not made in the ordinary course of business. The item parallels Items 601(b)(10) of Regulation S-K with regard to the types of agreements that are material to a company, a standard already familiar to reporting companies." SEC Release No. 33-8400, "Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date," August 23, 2004, available at *http://www.sec.gov/rules/final/33-8400.htm*. Except for a few minor differences between the two rules, practitioners generally view the standard for disclosure under Item 1.01 of Form 8-K and Item 601(b)(10) of Regulation S-K as comparable.

[5] SEC Release No. 33-7881 (Aug. 15, 2000).

[6] The Staff has specifically advised against making materiality determinations through the application of any single quantitative formula, stating that both quantitative and qualitative factors must be taken into account. SEC Release No. SAB 99 (Aug. 12, 1999).

[7] The SEC Staff has not objected to the use of such guideposts as an initial step in other contexts. *See* Securities and Exchange Commission, Staff Accounting Bulletin No. 99 (not objecting to the use of a 5 percent threshold in an accounting context).

[8] Instruction 4 to Item 2.01 of Form 8-K further states that "[a]cquisitions of individually insignificant businesses are not required to be reported . . . unless they are related businesses . . . and are significant in the aggregate."

[9] *See, e.g.* Exar Corporation, Correspondence to SEC dated August 5, 2013 (using a 10 percent threshold to determine materiality) *available at* http://www.sec.gov/Archives/edgar/data/753568/000143774913011185/filename1.htm, *see also* Debt Resolve Inc., Correspondence to the SEC dated February 06, 2012 (same) *available at* http://www.sec.gov/Archives/edgar/data/1106645/000147793212000214/filename1.htm.

information is material to investors.[10] A transaction, therefore, should not automatically be designated as material or immaterial simply because it lands above or below any of the thresholds mentioned above.

Qualitative questions to consider when evaluating the materiality of an acquisition agreement include:

1. How acquisitive is the acquirer?
2. Does the acquisition represent an expansion into a new line of business or a significant departure from the acquirer's strategic plan?
3. How similar are the assets of the target and acquiring company?
4. Does the acquisition give rise to a new reporting segment for SEC and accounting purposes?

A company's materiality determination can come down to such tenuous qualitative factors, depending on the circumstances.

As one might expect, decisions not to file an acquisition agreement can subsequently be challenged after the fact by the Staff. For example, in a comment letter regarding a Form S-1 filed by Marketo, Inc., the Staff asked the issuer how it determined that an acquisition agreement was not a material definitive agreement, while at the same time the issuer was indicating (through an Item 2.01 Form 8-K) the transaction related to the acquisition of a significant amount of assets and that it intended to file financial statements and pro forma information pursuant to Rule 3-05 and Article 11 of Regulation S-X in connection with the acquisition.

Counsel's response illustrates the analysis the company undertook in determining that the acquisition agreement was not material. In addition to a quantitative comparison of relative size of the target and various key metrics, the issuer also analyzed qualitative factors, noting the following: (1) the target's product offerings were complementary to and expanded the reach of the issuer's existing products and services, but did not represent a new line of business for the issuer; (2) the acquisition was not expected to materially change the market segments in which the issuer competed; (3) the target's product offerings and pipeline were not critical to the future development of the issuer's products; (4) the acquisition was not a material departure from the issuer's pre-existing strategic plan; and (5) no members of the target's management team were expected to become directors or executive officers of the issuer.

Ultimately, the Staff did not require Marketo to file the acquisition agreement or make the disclosure that would have been required by Item 1.01 of Form 8-K.[11] As illustrated by this situation, while the Staff may scrutinize a company's decision not to disclose an acquisition agreement, at the end of the day, deference will often be given to companies and their counsel so long as the analysis is reasonable.

Accordingly, the factors described above, along with other qualitative factors specific to each individual company, should be assessed in determining whether a reasonable investor would find more detailed information regarding the acquisition agreement useful in making an investment decision. The inherent flexibility associated with this standard provides companies with at least some leeway in reaching reasoned conclusions.

"Ordinary Course of Business" Analysis

Item 1.01 of Form 8-K states that a material definitive agreement must be disclosed if "not made in the ordinary course of business." Item 601(b)(10)(ii) further explains that contracts made in the ordinary course

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[10] *See* SEC Release No. 33-7881, at 10 (Aug. 15, 2000) (citing Basic Inc. v. Levinson, 485 U.S. 224, 236 (1988), in which the Supreme Court held: "A bright-line rule indeed is easier to follow than a standard that requires the exercise of judgment in the light of all the circumstances. But ease of application alone is not an excuse for ignoring the purposes of the securities acts and Congress' policy decisions. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality, must necessarily be over- or underinclusive.")

[11] *See* Marketo, Inc., Correspondence to the SEC dated January 24, 2014 (evaluating a number of qualitative factors in addition to applying a series of quantitative tests) available at http://www.sec.gov/Archives/edgar/data/1490660/000110465914004115/filename1.htm, *see also* Exar Corporation, Correspondence to SEC dated August 5, 2013 (arguing that an acquisition agreement was not material and did not need to be disclosed because (1) the acquisition was consistent with the company's historical practice of acquiring synergistic assets and complementary businesses; (2) the company's cash resources were not depleted and its common stock was only minimally diluted as a result of the acquisition; and (3) the company did not enter into a new line of business with the acquisition) available at http://www.sec.gov/Archives/edgar/data/753568/000143774913011185/filename1.htm.

of business are those that "ordinarily accompan[y] the kind of business conducted by the registrant and its subsidiaries." An ordinary course determination involves comparing the nature of the contract with the nature of the company's business. While a particular acquisition agreement may fall outside the ordinary course for a company that rarely engages in such transactions, it could very well fall within the ordinary course of business for a particularly acquisitive company.[12]

But the significance of this aspect of the analysis should not be overstated. The mere fact that a company engages in many acquisitions will not render an otherwise material acquisition immaterial or unworthy of disclosure. The fact remains, however, that the more acquisitions completed, the less significant the next acquisition will become, especially for large corporate conglomerates. A company's size and the scope of its operations could also render an agreement ordinary. Overall, a company must evaluate the conditions relevant to its business and differentiate between those contracts that ordinarily accompany the business and those that do not.

Conclusion

In determining whether to disclose the terms of an acquisition agreement and file the agreement with the SEC, companies must exercise significant judgment in analyzing the materiality and nature of the transaction with the advice of their legal and financial advisors. The decision to file or not will generally turn on whether the acquisition agreement is (1) material and (2) outside the ordinary course of business for the particular company. These determinations must be made on a case-by-case basis, factoring in the specific circumstances of the situation. While the rules cited above may be used as general guidelines, a detailed examination of both quantitative and qualitative measures often will be critical to reaching the final informed determination of whether to report.

[12] It is not uncommon for large public companies to undertake numerous large acquisitions in a single year, especially in the technology and social media sectors. According to its 2013 Annual Report, Yahoo, Inc. made 26 acquisitions in 2013, the largest of which wherein the consideration was publicly announced was for $1.1 billion. Similarly, according to its 2013 Annual Report, IBM made ten acquisitions for a total of $3.1 billion in 2013, the largest of which was for $2 billion. Neither company disclosed a single acquisition agreement in an Item 1.01 Form 8-K during that year. Similarly, Valeant Pharmaceuticals is believed to have made two dozen acquisitions in 2013, and only its acquisition of Bausch and Lomb for approximately $8.7 billion was disclosed via Item 1.01 of a Form 8-k.

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The Quest for Universal Ballots: Might Boards Benefit Too?

By Tom Ball, Senior Managing Director, Morrow & Co.

The universal ballot, which has been sought after by shareholder activists for many years, is squarely on the SEC's radar. At the October 9th meeting of the SEC's Investor Advisory Committee, SEC Chair Mary Jo White speaking broadly about the proxy system, specifically mentioned the use of a universal ballot in proxy contests. Regarding the universal ballot, Ms. White remarked, "…this is a very important issue for investors and other market participants, and is also—like so many other parts of the proxy system—tied to a range of other critical issues." To address these proxy plumbing issues, she said the SEC "…will hold a roundtable early next year on a number of proxy matters, including universal ballots."

A universal ballot would list board nominees for both management and a dissident shareholder on the same ballot, enabling effective vote splitting on the election of directors. Under the current regime, it is very difficult for a shareholder to vote for nominees from each of the competing slates.[1] The universal ballot has the potential to substantially change the dynamics in contested director elections. While activists have led the push for universal ballots, in practice, the universal ballot could also have strategic benefits for corporate boards in certain situations.

The Big Hurdle: The Bona Fide Nominee Rule

To implement a universal ballot in the US, changes will need to be made to the proxy rules. Under the existing proxy rules, in a proxy contest, a nominee up for election as a director can only be named in a proxy statement—and on a proxy card—if they have consented to being named in the proxy statement and to serve if elected. This is known as the "bona fide nominee" rule. As a result of this rule, a dissident shareholder can't list management nominees on its proxy card—unless the management nominees have consented (and vice versa).

Historically, there have been virtually no proxy contests in the US where the management and dissident candidates have consented to being named on each side's proxies. As a result, in most proxy contests, it is very difficult for shareholders to "split the ticket" and vote for a combination of dissident and management nominees.

While there are ways in which to split your vote, practically speaking, most shareholders are limited to voting on either management's proxy card or the dissident's, regardless of if they wish to split their vote for nominees on each competing slate. The same, of course, holds true for the voting recommendations provided by ISS and Glass Lewis in proxy contests.

A split vote recommendation by ISS or Glass Lewis can have unintended consequences.[2] For example, in a change-of-control situation, ISS and Glass Lewis could decide that change is necessary on the board, but not a change-of-control, and recommend a split vote on the dissident's proxy card (e.g., vote "for" three of the dissident nominees and "Withhold" on four). Since an institutional shareholder following the recommendation would be giving all its vote on the dissident proxy card and no votes to management, in a worst case scenario, this could result in all of the dissidents being elected, and a change of control.

As a result, there has been a call over the years for eliminating—or amending—the bona fide nominee rule so that nominees for both the management and dissident slates can be listed on one universal ballot (also known as a "universal proxy"). This call has come primarily from labor and public pension funds and has support from ISS and the Council of Institutional Investors, in addition to interest on the part of the SEC's Investor Advisory Committee.

In September 2013, CII members approved a policy calling for the use of universal ballots. Following up on this, CII increased its pressure in January by sending a rulemaking petition to the SEC requesting

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[1] The most effective way to vote for a combination of management and dissident nominees is by attending the shareholder meeting and voting by ballot. There are also ways that institutional shareholders can split the ticket by instructing their broker or bank (or Broadridge), but the process can take time and may be subject to challenge.

[2] When the proxy advisory firms make a split vote recommendation, they instruct institutions to vote on either the dissident or management proxy card and vote for some of the nominees and withhold on the remaining nominees.

that the agency amend the proxy rules to eliminate the bona fide nominee rule and introduce universal ballots in *all* contested elections.

The SEC is also focusing on the topic of a universal ballot, primarily due to the interest of its Investor Advisory Committee. In July 2013, the IAC recommended that the SEC amend the bona fide nominee rule to allow for universal ballots. The IAC recommendation differed from CII in that the use of the universal ballot would be optional and could only be used in connection with a short slate contest (where the dissident is seeking only a minority of the board).

Over the years, in proxy contests, ISS has recommended split votes in many instances. In its split recommendations, ISS has noted the limitations of the current proxy system to allow for effective vote splitting, saying it is "…one of the weaknesses of the current voting regime as it applies to proxy fights"—and that "ISS supports a universal split vote/ballot option for all shareholders."

A Little History

While the bona fide nominee rule inhibits the use of a universal ballot, there is some limited history in the US with the universal ballot.[3] In 2009, Bill Ackman of Pershing Square ran a proxy fight at Target. Early in the fight, Pershing lobbied Target to allow for a universal ballot. Target rejected the request and the universal ballot did not see the light of day.

In late April 2013, Tessera Technologies, which was in a proxy fight with Starboard Value and Opportunity Master Fund, Ltd., sent a letter to Starboard proposing that they consent to the use of a universal proxy card. While Starboard acknowledged "the potential benefits for using a universal ballot", they rejected the request because it could cause delays and confusion.

Despite Starboard's rejection, in May 2013, Tessera sent out supplemental proxy materials with a form of universal proxy card that would allow shareholders to vote for two of Starboard's nominees by writing in the name of the nominees. However, the SEC opposed Tessera's use of such a proxy card and, as a result, the company was forced to send another letter to shareholders noting the SEC's objection and warning shareholders that "…votes on the Revised Version of the Company's form of supplemental proxy card may ultimately be deemed invalid in any subsequent litigation."

Strategic Considerations for Management Using Universal Ballots

As its brief history indicates, attempts to use the universal ballot have been made by both management and dissidents and, interestingly, have been rejected by both sides as well. This may point to the fact that while shareholders have traditionally been the champions of the universal ballot, there is utility in a universal ballot for management as well.

If the SEC were to amend the proxy rules and allow for the optional use of a universal ballot, the strategic consideration for using a universal ballot would be fact-specific and based on the shareholder profile, the influence of ISS and Glass Lewis, the particulars of the situation and, ultimately, your view on the outcome of the vote. In addition, if your opponent were to opt for using a universal ballot, this may force your hand.

For example, if there are concerns about a possible split recommendation from ISS and/or Glass Lewis, by choosing a universal ballot, you may avoid the unintended consequences of a split ballot recommendation as outlined above, where shareholders are forced to vote on only one proxy card. The universal ballot could increase the chances that at least some of your nominees are elected.

It will also be interesting to observe how corporate bylaws will be amended should the SEC bless the universal ballot.

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[3] The universal ballot has been used successfully in Canada, most prominently in the Canadian Pacific / Pershing Square proxy contest in 2012.

The Continuing Importance of Process in Entire Fairness Review: *In re Nine Systems*

By Krishna Veeraraghavan and Scott Crofton of Sullivan & Cromwell LLP

In a decision with significant implications for the venture capital community, the Delaware Court of Chancery in *In re Nine Systems Corp. S'holder Litig.* recently called into question the ability of directors who approve transactions subject to the entire fairness standard of review to demonstrate compliance with fiduciary duties by establishing a fair price and relying on that price to overcome process deficiencies. In *Nine Systems*, Vice Chancellor Noble applied the entire fairness standard of review and found that even though the valuation used in a recapitalization was fair to minority stockholders because their shares had no value before the recapitalization occurred, the approving directors had breached their fiduciary duties because the process that was followed in implementing the recapitalization was grossly unfair.

Like many start-up companies, streaming media start-up Nine Systems had a relatively small board comprised of representatives of four institutional investors and the CEO. While it is not per se improper for a director of a Delaware corporation to also be a fiduciary to another beneficiary, a director faces an inherent conflict of interest if the interests of the fiduciary's beneficiaries diverge.

This dual-fiduciary problem is commonplace in financing transactions at start-ups, and in *Nine Systems*, Vice Chancellor Noble found that the plaintiffs had established that a majority of the company's directors were conflicted dual-fiduciaries standing on both sides of a 2002 recapitalization transaction. Because procedural safeguards involving the use of an independent special committee of the board and/or a vote of a majority of the non-conflicting stockholders were not employed, the defendant directors had the burden of establishing the entire fairness of the recapitalization.

An entire fairness review in Delaware involves objective consideration of two factors, fair dealing and fair price, and the court must ultimately make a unitary fairness conclusion based upon the totality of the circumstances. Last year, the Delaware Court of Chancery in *In re Trados Inc. S'holder Litig.* found that a transaction that did not satisfy the fair process prong nevertheless satisfied the entire fairness standard of review.

In reaching that conclusion, Vice Chancellor Laster in *Trados* determined that because Trados' defendant directors proved that Trados did not have a reasonable prospect of generating value for the common stockholder plaintiffs, their approval of a merger in which only management and the preferred stock received merger consideration did not constitute a breach of fiduciary duties notwithstanding a variety of shortcomings in the process the board followed in approving the merger.

The court's reasoning in *Trados* gave the venture capital community, in which many start-up companies have boards of directors that are majority-controlled by a small number of institutional venture capital investors that are often subject to entire fairness review, comfort that deficiencies in a fair process can be overcome in the event in which stockholders receive a fair price. In *Nine Systems*, despite a finding that the valuation of the recapitalization was fair because Nine Systems' equity had no value prior to the recapitalization, the court found that the a breach of fiduciary duties had occurred due to the unfairness of the process. In reaching this conclusion, Vice Chancellor expressly rejected the defendants' contention that *Trados* stands for "the broad proposition that a finding of fair price, where a company's common stock has no value, forecloses a conclusion that the transaction was not entirely fair."

While "fair price" is typically the predominant consideration in an entire fairness review, *Nine Systems* illustrates that a finding of "fair price" is necessary but cannot be sufficient; if the facts of a transaction reveal a grossly unfair process, then directors can be found to have breached their fiduciary duties even if the transaction price was fair. Ultimately, the fair process inquiry is highly fact-dependent, and directors expecting an entire fairness inquiry can take steps to create a good record to blunt the possibility of a fiduciary duty breach being found on process grounds.

Background

Nine Systems (f/k/a Streaming Media Company) was founded in 1999 and suffered severe cash shortages in its early years. 54% of Nine Systems' outstanding stock and 90% of its debt was held by three investors:

Wren Holdings, LLC, Javva Partners, LLC and Catalyst Investors, L.P. Each investor had a director designee on its board. The fourth director was the CEO and the fifth director was a representative of Lipper & Co., an investment firm that had introduced a number of minority stockholders to Nine Systems.

At a Nine Systems board meeting that was hastily called in December 2001 to address the company's cash flow issues, the board reviewed a series of alternatives, including a potential recapitalization that would facilitate strategic acquisitions of other streaming media companies. The Lipper board representative could not attend the meeting due to a religious conflict which the board was aware of but failed to accommodate, and a pattern of excluding the Lipper board representative persisted throughout the recapitalization process. When the Lipper board representative learned of the potential recapitalization, he sent a harshly worded letter to the other directors objecting to its terms, including its dilutive effect on existing stockholders. An independent financial advisor was not hired by the board to evaluate the recapitalization. In early 2002, Andrew Dwyer, who was not on the Nine Systems board but who owned just under half of Wren, presented the Nine Systems board with his "back of the envelope" valuation of the company, which valued the entire company at $4 million. Dwyer did not review his valuation analyses with the board and, at trial, the directors could not explain how Dwyer had valued Nine Systems at $4 million. Dwyer also presented proposed terms of the capitalization to fund two strategic acquisitions.

Wren and Javva offered to fund the entire $2.5 million and defendants testified that they believed that Nine Systems would fail unless it completed the acquisitions contemplated by the restructuring. Wren and Javva board representatives also privately offered the Catalyst board representative the right for Catalyst to invest on the same terms as Wren and Javva in the recapitalization within 90 days after the recapitalization. This right was not offered or disclosed to the Lipper board representative or any other stockholder. The board approved the recapitalization, to be funded by Wren and Javva, by a vote of 4-1 with the Lipper board representative dissenting. In response to the Lipper board representative's criticism, Dwyer revised the transaction to make it slightly less dilutive to existing stockholders.

The Lipper board representative objected again to the dilution, but, in what Vice Chancellor Noble characterized as an attempt "to make the best out of the situation," he agreed to vote in favor of the recapitalization subject to certain conditions. These conditions included a requirement that if any subsequent capital raise was not unanimously approved, the shareholders whose designee dissented from the transaction would receive a right to redeem at a value equal to 1.5x its face amount. The other directors agreed to those conditions, and the recapitalization was unanimously approved. However, Nine Systems failed to include the conditional redemption right the board had agreed to in the definitive recapitalization documentation. Finally, during the time between the board's approval of the recapitalization and its final closing, the terms of the recapitalization were revised in a manner that was advantageous to Wren and Javva.

Wren, Javva and Catalyst, as holders of 54% of Nine Systems' stock, approved by written consent amendments to Nine Systems' charter that were necessary to implement the recapitalization. Nine Systems provided notice to stockholders in connection with the approval of charter amendments needed to facilitate the recapitalization; however, that notice failed to identify the participants in and the terms of the recapitalization. After the recapitalization was complete, Nine Systems subsequently failed to hold annual stockholder meetings, engaged in only sporadic communication with stockholders and did not provide them with complete information about the company's capitalization structure.

Nine Systems' economic fortunes gradually improved, until it was sold to Akamai Technologies, Inc. for $175 million in 2006. The investors who purchased new preferred stock in the recapitalization received an almost 2,000% return on investment. The plaintiffs subsequently brought suit, arguing that the entire fairness of the recapitalization had not been proven due to both an inadequate price and an inadequate process.

Application of Entire Fairness Test

Vice Chancellor Noble conducted a comprehensive review of both parties' valuation of the company at the time of the recapitalization; this review was complicated by the existence of multiple sets of contemporaneous management projections, which the court considered and determined were all wholly unreliable. The court ultimately decided that the equity value of the company before the recapitalization occurred was $0. This finding was consistent with the finding in *Trados* that the equity value of the

company was $0, which in turn led the court in *Trados* to determine that the transaction was completed at a fair price.

However, this is where *Nine Systems* and *Trados* diverge. In *Trados*, Vice Chancellor Laster found that the defendants had proved that the transaction was fair, even though:

- the defendants' trial testimony on fair dealing issues was contrary to the contemporaneous documents and their earlier testimony;
- Trados' directors had failed to consider the common (non-controlling) stockholders;
- Trados' directors did not adopt procedural protections; and
- Trados' directors sought to exit the transaction without recognizing the conflict of interest presented by the transaction in which only the controlling preferred stockholders received consideration.

In so ruling, the court in *Trados* cited the Delaware Supreme Court's characterization of the proper test of fairness as being whether "the minority stockholder shall receive the substantial equivalent in value of what he had before." While the *Trados* court acknowledged that prior decisions had recognized that an unfair process can infect the price, resulting in a breach and warranting remedy, the court declined to find that process flaws constituted a breach of fiduciary duties.

In *Nine Systems*, in contrast, the court found that the process flaws were so fundamental that they constituted an independent breach of fiduciary duties. The court rejected the defendants' contention that *Trados* stood for the proposition that if plaintiff stockholders' equity is valueless, that determination would foreclose a conclusion that a transaction is not entirely fair. Instead, the court characterized *Trados'* holding as reinforcing the principle that a court's conclusion as to entire fairness is contextual. Vice Chancellor Noble explained that he could not reach a conclusion solely on the basis of fair price because the Nine Systems recapitalization process was grossly inadequate.

In reaching its decision, the court emphasized the fair price inquiry at trial was severely hampered by the unfairness of the process by which the board came to the $4 million valuation despite the absence of reliable projections, the Nine Systems board's lack of understanding of Dwyer's valuation, the decision to exclude the Lipper board representation in key discussions and the decision not to engage an independent financial advisor. While some of these critiques could be read to mean that a poor process can render fair price undeterminable, Vice Chancellor Noble did not characterize his decision in that manner.

Rather, he found the price to be fair but obtained through a grossly inadequate process. In Vice Chancellor Noble's eyes, to find that the recapitalization satisfied the entire fairness standard would "render the unitary conclusion" relating to fair process and fair price meaningless, even though the fair price component is the preponderant consideration in most circumstances. Ultimately, the decision, and the extensive description of the recapitalization transaction contained in the opinion, underscore the point that entire fairness is contextual. While *Trados* set aside some "bad facts" about the process that was followed, there is a line of "grossly unfair" dealing beyond which a Delaware court is unwilling to find entire fairness. Whether that line is crossed depends on the specific facts and circumstances at issue, but *Nine Systems* highlights for venture capital investors the importance of establishing reliable valuations that are understood by the board (whether through the use of financial advisors or otherwise), involving all board members in deliberations, communicating honestly with stockholders about the transaction and implementing transactions on substantially the terms approved by the board.

Remedy

Despite the finding of fiduciary breach, the court declined to award monetary damages to plaintiffs due to their speculative nature—not least because Nine Systems' growth seems to have been driven by one of the acquisitions completed as a result of the recapitalization. The court did, however, grant leave to submit a petition for attorneys' fees. Interestingly, in a discussion regarding the question of what stockholders are entitled to beyond a fair price, the court referred in a footnote to prior decisions that raised the possibility of establishing a "fairer" price depending on the facts and the nature of the loyalty breach, but did not pursue such an analysis.

Practical Advice for Practitioners

The intensive fact-based analysis conducted by the court in *Nine Systems* renders it unique in some respects. However, the case contains a number of takeaways for practitioners to bear in mind when advising all clients, and particularly start-up and private companies that may not currently have a strong corporate governance system in place:

- Procedural Safeguards. The implementation of certain effective procedural safeguards in connection with a transaction in which a majority of the board is conflicted can shift the burden of proof or change the standard of review to a more defendant-friendly standard. After the plaintiffs in *Nine Systems* established that a majority of the board was conflicted, the defendant directors had the burden of establishing entire fairness. Under Delaware law, the ultimate burden of proof will be shifted to the plaintiff if a transaction was either (i) approved by either an independent special committee of the board or (ii) approved by the vote of the majority of non-controlling stockholders (a "majority-of-the-minority" vote).

  Nine Systems did not attempt to implement either of these safeguards. Earlier this year in *Kahn v. M&F Worldwide Corp.*, the Delaware Supreme Court held that the business judgment rule would apply to a squeeze-out merger in which both of these procedural safeguards were used. However, the safeguards must be effective—the special committee should have negotiating power, including the right to say no, and should be entitled to freely engage independent advisors, and the stockholder vote should be fully informed, uncoerced, and an *ab initio* condition of completing the transaction. By implementing effective procedural safeguards, a company can reduce the risk of litigation arising, and if litigation arises, provide the company with an improved record and more deferential judicial review.

  However, these safeguards come at a cost: they are administratively burdensome, they can be time consuming and they can be expensive. Further, that expense needs to be weighed against the limited remedies that may be available in situations where fair price has been established. In circumstances where implementing safeguards would be impracticable, a company may decide to forego these safeguards, but should nonetheless bear the other items on this list in mind.

- Observe Basic Corporate Formalities. Calling board meetings with adequate notice, designating a person to take minutes, finalizing minutes on a timely basis, retaining a book of minutes and obtaining board approval of significant amendments to a previously approved deal are fundamental board corporate governance concepts. The *Nine Systems* opinion describes how the Nine Systems board minutes were revised several months after the meetings in question by a relative of one of Wren's representatives who may or may not have attended the meetings. The court viewed these revised minutes with skepticism.

- Active Presence of Independent Directors. Having active and engaged independent directors on a board of directors can help a process survive scrutiny on judicial review. Nine Systems had only one disinterested director who was occupied with a business crisis at his primary job and had poor relationships with the other directors. The other directors repeatedly scheduled meetings at times he could not attend despite his objections and held informal discussions among the other directors without his involvement. The court even referred to the possibility of the defendant directors having personal disdain or animosity towards the sole independent director. Even if a special committee is not employed, having multiple independent directors and fully involving them in the board process can help establish a better record for subsequent judicial review.

- Understanding of Valuation. Nine Systems did not hire a financial advisor. The court noted that "[a]lthough hiring an independent financial advisor is not prescribed by Delaware law, the presence of an advisor would demonstrate that the board was reasonably informed about [Nine Systems'] value." Further, Section 141(e) of the Delaware General Corporation Law protects a director who relies in good faith upon reports presented to the company by any person as to matters the director reasonably believes are within such person's

professional or expert competence and who has been selected with reasonable care. Nine Systems was in financial distress at the time of the recapitalization, but the court found that the argument that the company could not afford a financial advisor was undermined by the fact that Nine Systems had engaged three agencies roughly contemporaneously to work for months on a possible name change.

If a company entering into a transaction is unable or unwilling to engage a financial advisor, it is of particular importance that the directors understand how the transaction is being valued. The court sharply criticized the lack of understanding of valuation by the Nine Systems director defendants because they relied on, without knowing what financial analyses were used, an owner of Wren's valuation that the court characterized as "a series of handwritten guesstimates scratched out on a single piece of paper" and that was not updated when the deal terms changed.

- Full and Fair Disclosure. The court in Nine Systems explained that the company's material disclosure shortcomings in the description of the recapitalization to stockholders were "powerful evidence of unfair dealing." When directors make disclosures to their stockholders, they have an obligation to provide an accurate, full and fair characterization of events.

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Amendment to Delaware Statute of Limitations Rules: Drafting Tips

By Craig Menden of Cooley LLP

A recent amendment to Delaware law clarifies certain statute of limitations rules, providing parties with increased flexibility to control survival periods for acquisition agreement indemnity provisions and related breach-of-contract claims.

The amendment to the Delaware General Corporation Law (the "DGCL") is described below, along with drafting tips for successfully incorporating these new concepts in your indemnification provisions.

Delaware Statute of Limitations for Breach-of-Contract Claims

Under Delaware law, breach-of-contract claims are generally subject to a three-year statute of limitations period (or four years, in the case of a contract governed by Article 2 of the Delaware UCC). Recent case law from the Delaware Court of Chancery highlighted the application of this restriction to the representations and warranties in an acquisition agreement. Accordingly, parties could not contractually agree to a longer claims period, even for breaches of certain "fundamental" representations and warranties, for which parties often want to extend the time period in which indemnity claims may be raised. In response, Delaware recently amended its code by adopting §8106(c), which expressly permits parties to a contract involving at least $100,000 to contractually extend the time period for making claims, up to a maximum of 20 years.

Drafting Tips for Claims Periods in Acquisition Agreements

– The clearest way to extend the claims period beyond three years is to state a specified time period (*e.g.*, "the fifth anniversary of the Closing Date").

– Using the word "indefinitely" expresses a desire to extend the claims period to the longest permitted time. We expect that this language would most likely result in a claims period that expires on the 20th anniversary of the Closing Date. However, it is conceivable that because this language does not clearly indicate "a period specified in" the contract, a court could conclude that §8106(c) is not satisfied and default to the three year Delaware statute of limitations period for breach of contract.

– Using "statute of limitations" to define the claims period could result in defaulting to the existing three year statute of limitations period for breach of contract claims under Delaware law or, depending on how drafted, could result in the application of another period.

- Because of prior case law, using the phrase "applicable statute of limitations" is likely to default to the original three year statute of limitations.
- Adding a parenthetical such as "(as used in this Section [___], "statute of limitations" does not mean the three year statute of limitations applicable to a claim for breach of contract)" indicates an intent to extend the claims period beyond three years. What claim period will apply will depend on the words used to modify "statute of limitations".
- Using the phrase "statute of limitations applicable to the subject matter of the underlying representation" is inherently ambiguous as applied to most representations (what does it mean when applied to the "Material Contracts" representation, for example). Absent other clarifying language in the contract, there is no way to know in advance what statute of limitations period would be applied since statutes of limitations generally relate to the legal theory used for the cause of action (fraud, tort, breach of contract, etc.) rather than subject matter of a representation (e.g., employment, real property).

Conclusion

Delaware's new §8106(c) creates a useful framework that will permit parties to extend the claims period for specified claims beyond Delaware's three year statute of limitations, but draftspersons need to be careful. Using previously common drafting approaches like "applicable statute of limitations" or "indefinitely" may result in even more ambiguity than before Delaware adopted the new code section. As a result, the language used to describe survival periods or claims period in form acquisition agreements should be revisited in light of §8106(c).

Respecting Boilerplate: Scope and Communications Provisions

By Rob James of Pillsbury Winthrop Shaw Pittman LLP[1]

The charts in this series of *Respecting Boilerplate* articles are intended to facilitate the process of drafting, reviewing, negotiating, and *respecting* boilerplate provisions. The common topics are illustrated in the first column by a "reference" clause—which is assuredly *not* a universally recommended text, and which is neither the most simple nor the most complex possible provision, but one that illustrates the basic purposes. For each reference clause, the second column identifies questions or other comments to consider. These reference clauses are neither necessary nor sufficient for any particular deal, and the comments are far from exclusive (this sentence sounds like boilerplate itself). Nonetheless, the charts may help you select an appropriate subset of general clauses for a specific transaction.

REFERENCE CLAUSE		COMMENTS
SCOPE OF AGREEMENT PROVISIONS		
Amendment. This Agreement may be amended, supplemented or modified only by a written instrument duly executed by or on behalf of each Party [to be charged with the terms of such instrument].		In contracts with more than two Parties, do you want Parties not affected by a change to have the right to sign (or not sign) the amendment? Is consent of any non-party required to change a contract? Compare the treatment of waivers to see if any differences are intended.
Waiver. [illegible]		[illegible]
Entire Agreement. [Except for [list specific agreement(s)],] this Agreement supersedes all prior oral and written discussions and agreements between the parties with respect to [the subject matter hereof], and contains and expresses the [sole and entire] [final, complete and exclusive] agreement between the Parties with respect thereto. [Without limitation, [list specific agreement(s)] are hereby superseded.]		Sometimes called Merger or Integrated Writing. California Code of Civil Procedure §1856(b) uses the "final, complete and exclusive" terminology. Do you want expressly to supersede and disclaim reliance on specific letters of intent, other correspondence, or prior contracts? Or to leave them or ancillary contracts expressly in effect? Watch for the use of the words "excluding" and "including" in such a complex clause. Is "the subject matter hereof" clear, or do you want to be more specific?
Counterparts. [illegible]		[illegible]
Severability. If any term of this Agreement is to any extent invalid, illegal or incapable of being enforced, such term shall be excluded to the extent of such invalidity, illegality or unenforceability; all other terms hereof shall remain in full force and effect so long as the essential terms of the transactions contemplated hereby remain enforceable; and the Agreement shall be construed so as to effect the original intent of the Parties as closely as possible.		What if the unenforceable part is the "quid" of a "quid pro quo"—what should happen to the "quo"? Consider some ability for the dispute resolver to conform severed agreement as closely as possible to the Parties' intent. Covenants not to compete often have a more robust severability clause.

[1] For the complete charts, see http://www.pillsburylaw.com/siteFiles/Publications/RespectingBoilerplate2014.pdf. Copyright © 2014 Pillsbury Winthrop Shaw Pittman LLP.

Further Assurances. [illegible]		[illegible]
Survival of Obligations. Notwithstanding anything to the contrary herein, all rights and obligations of the Parties under this Agreement cease upon the [Termination Effective Date,] except for the rights and obligations under Sections [__].		A survival clause is used to identify obligations under an agreement that continue after termination. Different rules may apply to different kinds of termination. Many contracts are silent on the subject of survival rather than endeavoring to cover all scenarios. Robust survival clauses often accompany confidentiality and indemnity obligations.
COMMUNICATIONS PROVISIONS		
Notices. [illegible]		[illegible]
If to X, to: [legal entity name] [mailing address—not Post Office box for couriers] [Facsimile/email:] Attn: [officer title or individual name] With a mandatory copy, which by itself does not constitute notice, to:		
[illegible]		[illegible]
Announcements. Neither Party may issue any press release or make any public announcement with respect to this Agreement without the prior written consent of the other Party, [such consent not to be unreasonably withheld,] except (a) the Parties shall issue a joint press release in the form of Exhibit [__] immediately following the execution and delivery of this Agreement, and (b) either Party may make any disclosures required by Law or applicable securities exchange.		Are you concerned with non-public announcements, such as internal notices to a party's own employees? Do you want to regulate how Parties respond to unsolicited outside press or other inquiries? Or to govern how Parties deal with customers, suppliers, employees and other stakeholders?

Confidentiality. Except as otherwise required by Law, the Party to which disclosures are made ("Recipient") shall not, and shall cause each of its employees, agents, and representatives (collectively, "Representatives") not to, (i) [illegible] (ii) [illegible] Promptly upon the disclosing Party's written request [define termination or other triggering circumstances], Recipient shall, and shall cause its Representatives to, return to the disclosing Party or destroy all Confidential Information. If Recipient destroys the Confidential Information, it shall certify that it has done so in writing and promptly deliver that certificate to the disclosing Party.		The confidentiality provision may be superseded or supplemented by an independent Non-Disclosure Agreement ("NDA"). The NDA may be provided to others as evidence of the confidentiality obligations, rather than needing to disclose the whole transactional agreement itself. [illegible] [illegible] Do you want to permit disclosure to prospective buyers or lenders, at least if they sign confidentiality agreements? Do you want a unilateral confidentiality obligation, or a bilateral one? Do you want to place an outside time duration on the confidentiality obligation?
"Confidential Information" means (A) [illegible] (B) [illegible] Confidential Information excludes information that (W) [illegible] (X) [illegible] (Y) [illegible] (Z) [illegible]		[illegible] [illegible] [illegible] Some confidentiality clauses contain especially robust specific performance and injunctive relief provisions, and may confirm (rather than exclude) the exposure to consequential damages in the event of breach.

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