Business Law—The Life of a Deal

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Friday, November 3, 2017
8:30 a.m.–5:15 p.m.

5.75 General CLE credits and 1 Ethics credit
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SCHEDULE

7:30  Registration

8:30  Recent Developments in Delaware Corporate Law
     Michael Allen, Richards Layton & Finger PA, Wilmington, DE

9:30  Before the Deal: Nondisclosure Agreements, Letters of Intent, and Preliminary Due Diligence
     Amanda Loupin-Bartlett, Schwabe Williamson & Wyatt PC, Portland OR
     Meghan Williams, Miller Nash Graham & Dunn LLP, Vancouver, WA

10:30 Break

10:40 Breakout A: Best Drafting Practices: Buy-Sell Provisions in Operating Agreements
     Heather Kmetz, Sussman Shank LLP, Portland, OR

     Breakout B: Best Drafting Practices: Common M&A Drafting Mistakes
     Marco Materazzi, Emerge Law Group, Portland, OR

11:25 Transition Break

11:30 Breakout C: Operating Agreements: Allocation and Tax Issues
     Mark LeRoux, Tonkon Torp LLP, Portland, OR

     Breakout D: Updates and Trends in M&A
     Kara Tatman, Perkins Coie LLP, Portland, OR
     Roy Tucker, Perkins Coie LLP, Portland, OR

12:30 Lunch
     ✦ James B. Castle’s Leadership Award Ceremony
     ✦ Student Scholarship Awards
     ✦ Business Law Section Annual Meeting

2:00 Negotiation Exercise
     Matthew Larson, Hathaway Larson LLP, Portland, OR
     Erich Merrill, Jr., Miller Nash Graham & Dunn LLP, Portland, OR

3:00 How to Avoid Post-Closing Disputes
     The Honorable David Brewer, Eugene, OR
     Donald Churnside, Gaydos Churnside & Balthrop PC, Eugene, OR

4:00 Break

4:15 Common Risk Management and Ethical Issues Affecting Business Lawyers
     Holli Houston, Professional Liability Fund, Tigard, OR
     Kenneth Landis, Attorneys’ Liability Assurance Society Inc., Chicago, IL

5:15 Adjourn
FACULTY

Michael Allen, Richards Layton & Finger PA, Wilmington, DE. Mr. Allen is a director in the firm’s Corporate Department and a member of the department’s Corporate Advisory Group. He counsels corporations, officers, directors, board committees, and stockholders in connection with a wide variety of transactional and advisory matters, including mergers and acquisitions, divestitures, recapitalizations, proxy contests, stockholder meetings, and corporate governance issues. Mr. Allen’s practice also involves rendering legal opinions on Delaware corporate law issues. Mr. Allen is a frequent speaker regarding Delaware law practice and developments. He is admitted to practice in Delaware.

The Honorable David Brewer, Eugene, OR.

Donald Churnside, Gaydos Churnside & Balthrop PC, Eugene, OR. Mr. Churnside represents clients in trials, hearings, and mediation and arbitration with matters relating to general business, intellectual property, estate planning, creditors’ rights, real estate, construction, and land use. Mr. Churnside is past chair of the Oregon State Bar Legal Ethics Committee, has served on the Oregon State Bar Debtor-Creditor, Real Estate & Land Use, and Business Law section executive committees, and has been a member of the Lane County Bar Association board of directors, the Oregon State Bar Continuing Legal Education Committee, and the Oregon State Bar Futures Task Force. He has contributed articles on contract law and the execution and foreclosure of liens to Oregon State Bar legal publications. Mr. Churnside is a frequent speaker on collection law and debtor-creditor issues.

Holli Houston, Professional Liability Fund (PLF), Tigard, OR. Ms. Houston serves as a claims attorney for the PLF, where she is responsible for investigating and evaluating claims made against lawyers. She also regularly assists lawyers in avoiding malpractice claims and coming up with creative solutions to complicated problems. Prior to joining the PLF, Ms. Houston was in private practice focusing on the defense of lawyers in malpractice litigation. She also taught Legal Research and Writing at the University of Oregon School of Law. Ms. Houston is past chair of the Oregon State Bar Legal Ethics Committee and Uniform Civil Jury Instructions Committee.

Heather Kmetz, Sussman Shank LLP, Portland, OR. Ms. Kmetz is a tax lawyer and chair of the firm’s Business Group. She assists individuals and businesses in establishing tax-sensitive wealth preservation plans and transactions and serves as outside corporate counsel for a variety of closely held businesses, helping them to develop and transition their businesses. Ms. Kmetz is Secretary of the Oregon State Bar Taxation Section and a member of the American Bar Association Taxation Section, the Oregon State Bar Business Law Section and Estate Planning and Administration Section, and the Multnomah Bar Association. She has authored several articles and is an active lecturer. Ms. Kmetz is licensed to practice in Oregon and Washington, and she holds a certificate in federal taxation from Lewis and Clark Law School.

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Matthew Larson, Hathaway Larson LLP, Portland, OR. Mr. Larson focuses on mergers and acquisitions, corporate finance, and general corporate matters for companies and individuals throughout the Pacific Northwest. His clients include private equity buyers and other active business acquirers in financial and strategic transactions. Mr. Larson also represents private target companies in mergers and acquisitions. His corporate finance experience includes early-stage debt and equity financing, private placements, and registered offerings. In addition, he provides general outside counsel services to many of his clients and their portfolio companies. He is chair of the Oregon State Bar Securities Regulation Section. Mr. Larson is a frequent speaker on mergers and acquisitions and Oregon corporate law.
**Mark LeRoux**, *Tonkon Torp LLP, Portland, OR.* Mr. LeRoux’s practice emphasizes federal, state, and local taxation and the relationship and impact those areas of taxation have on both business transactions and personal investments. He also engages in a general business practice, with a particular emphasis on partnerships and limited liability companies. Additionally, he represents clients in tax controversies before the Tax Court, IRS, and similar state and local courts and agencies. He is a member of the American Bar Association, the Multnomah Bar Association, the Oregon State Bar Taxation Section Executive Committee, and the Committee on the Revised Uniform Partnership Act. Mr. LeRoux coauthored the section on “Involuntary Conversions” for the *Bender Federal Tax Service* and the chapter on “Subchapter S Taxation” for *Advising Oregon Businesses*. Mr. LeRoux holds an LL.M. in Taxation from the New York University School of Law.

**Amanda Loupin-Bartlett**, *Schwabe Williamson & Wyatt PC, Portland OR.* Ms. Loupin-Bartlett focuses her practice on business transactions, including mergers and acquisitions, securities offerings, and commercial lending. She volunteers with the Lewis and Clark Small Business Legal Clinic and serves as a mentor to Willamette law and business school students.

**Marco Materazzi**, *Emerge Law Group, Portland, OR.* Mr. Materazzi is a general business lawyer with a practice focused on emerging growth companies, mergers and acquisitions, corporate finance, and a range of other business matters. He has significant experience advising clients with respect to corporate governance, intellectual property protection, regulatory compliance, entity structure, shareholder agreements, and general contract negotiation. He serves on the Oregon State Bar Securities Regulation Section Executive Committee.

**Erich Merrill, Jr.**, *Miller Nash Graham & Dunn LLP, Portland, OR.* Mr. Merrill focuses on corporate transactions, private securities offerings, and intellectual property protection and licensing for clients involved in technical industries such as software, biotechnology, and instrument manufacturing. He has counseled clients in the acquisition or sale of businesses in the United States and internationally.

**Kara Tatman**, *Perkins Coie LLP, Portland, OR.* As a business law attorney, Ms. Tatman works on complex transactions nationwide and globally. Her practice includes mergers and acquisitions, securities compliance, capital markets, and corporate governance. In addition to her work with public companies, she also counsels emerging companies and their founders. Ms. Tatman is a member of the Oregon State Bar Business Law Section Executive Committee.

**Roy Tucker**, *Perkins Coie LLP, Portland, OR.* Mr. Tucker focuses his practice on public offerings, mergers and acquisitions, securities compliance, and corporate governance and restructurings. He has represented issuers and underwriters in numerous public offerings and regularly advises corporate clients and private equity firms on mergers, asset sales, and leveraged buyouts.

**Meghan Williams**, *Miller Nash Graham & Dunn LLP, Vancouver, WA.* Ms. Williams concentrates her practice in general business and real estate law. She assists clients with entity formation and corporate governance, sales and acquisitions of companies, and contract review, negotiation, and management. In addition, she advises clients with respect to commercial and residential leasing transactions, real estate purchases and sales, and real estate loans. With respect to real estate matters, she represents landlords, tenants, purchasers, and sellers. Ms. Williams is president of the Washington Women Lawyers Clark/St. Helens Chapter and a member of the Oregon State Bar Corporate Counsel Section Executive Committee, the Clark County Bar Association, the Multnomah Bar Association, and Oregon Women Lawyers. She is a frequent contributor to Miller Nash’s real estate development blog, From the Ground Up.
Chapter 1
Recent Developments in Delaware Corporate Law

Michael Allen
Richards Layton & Finger PA
Wilmington, Delaware

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Michael D. Allen is a director of Richards, Layton & Finger, P.A., Wilmington, Delaware. Although Richards, Layton & Finger acted as counsel in some of the cases discussed herein, the views expressed do not necessarily represent views of the Firm or its clients. Portions of this outline are drawn from materials prepared by other members of Richards, Layton & Finger and have been used in other presentations and continuing legal education workshops.
Introduction

These materials summarize and explain the significance of various recent (decided in the last three years) decisions of the Delaware Supreme Court, Delaware Court of Chancery, Delaware Superior Court and U.S. District Court for the District of Delaware regarding Delaware corporate law. These materials also highlight amendments to the Delaware General Corporation Law that became effective in 2015 and 2016 and proposed amendments to the Delaware General Corporation Law that would become effective in 2017.

I. RECENT DECISIONS OF DELAWARE COURTS.

A. Business Combinations.


In In re Saba Software, Inc. Stockholder Litigation, 2017 WL 1201108 (Del. Ch. Mar. 31, 2017), the Court of Chancery refused for the first time to apply the cleansing effect available under Corwin v. KKR Fin. Holdings LLC, 125 A.3d 304 (Del. 2015), to a stockholder vote approving a merger, finding that plaintiff pled sufficient facts alleging that the stockholder vote was neither fully informed nor uncoerced.

The Court’s determination was based on a unique set of facts. As uncovered by the Securities and Exchange Commission (the “SEC”), Saba Software, Inc. (“Saba” or the “Company”) had engaged in financial fraud between 2008 and 2012, overstating its pretax earnings during that period by $70 million. Saba repeatedly and publicly provided assurances that it would restate and correct its financials, but never did. On April 9, 2013, because of Saba’s failure to correct its financial statements, NASDAQ suspended trading of Saba’s stock. On June 12, 2013, NASDAQ delisted Saba, and Saba’s common stock began trading over-the-counter. The SEC filed a complaint against Saba in early September 2014. On September 24, 2014, Saba announced that it had reached a settlement with the SEC regarding the allegations of financial fraud. The settlement required, among other things, that the Company restate its financials by February 15, 2015, or the SEC would deregister Saba’s common stock.

Saba had been exploring strategic alternatives for several years before these events. At a board meeting on November 19, 2014, the board formed a committee comprised of three members to direct a sales process (the “Ad Hoc Committee”). In early December 2014, the Ad Hoc Committee was advised that the restatement of Saba’s financials was unlikely to be completed on time. At that point, Saba was progressing towards a transaction with a private equity firm from which it had received its only indication of interest.

On December 15, 2014, Saba announced that it would not be able to complete the required restatement of its financials by the February 15, 2015 deadline and that it was evaluating strategic alternatives. This news caused Saba’s stock price to fall from its post-settlement high of $14.08 to $8.75 per share. Nonetheless, a group of analysts set a price target...
for Saba stock of $17 per share and gave it a “Buy” rating, and the board doubled down on its efforts to consummate a sale of the Company.

In early 2015, Saba received several communications from companies interested in purchasing Saba, including Vector Capital Management, L.P. (“Vector”), one of Saba’s former lenders. On January 20, 2015, Saba announced its intention to enter into a definitive acquisition agreement prior to the restatement deadline if the board determined that a sale was in the best interests of the Company. Vector resubmitted its indication of interest to acquire Saba at $9.00 per share on February 2, 2015. The same day, the closing price for Saba’s stock was $9.45. The Ad Hoc Committee met the next day to consider Vector’s offer.

Despite the fact that several potential bidders had signed non-disclosure agreements and the Company continued to receive new indications of interest, on February 9, 2015, Saba’s board approved, and the next day announced, a merger with an affiliate of Vector for $9.00 per share. One day before agreeing to the merger, the board had awarded itself equity awards that would convert into cash upon a change in control. The SEC deregistered Saba’s stock nine days after the announcement of the merger. Plaintiff, a former Saba stockholder, then brought suit against the individual members of Saba’s board alleging breach of fiduciary duty. On March 26, 2015, Saba’s stockholders voted to approve the merger.

The Court found that plaintiff had pled facts suggesting that the stockholder vote was neither fully informed nor uncoerced, and that these alleged facts undermined the cleansing effect of the stockholder vote under Corwin. The Court held that plaintiff had pled two reasonably conceivable material omissions from the Company’s proxy statement. First, the Court concluded that Saba’s stockholders could not have made a fully informed decision without an explanation for Saba’s repeated failure to restate its financials. This omission was material because, according to the Court, Saba’s failure to restate its financials “spurred the sales process” and “materially affect[ed] the standalone value of Saba going forward.” Without knowing why Saba had repeatedly failed to restate its financials or whether there was any likelihood of Saba restating its financials and becoming reregistered with the SEC, stockholders could not make an informed decision whether to support the merger. Second, the Court agreed that the proxy statement failed to disclose adequately the range of post-deregistration options potentially available to Saba. Although Delaware law does not normally require disclosure of alternatives to a given transaction, the Court determined that the dynamic of the deregistration, which “dramatically affected the environment in which the Board conducted the sales process,” required the board to disclose the Company’s other prospects.

The Court also held that the Corwin cleansing effect did not apply because the pleadings supported a reasonable inference that the stockholder vote was coerced. The Court found the board’s failure to act to restate its financials in the face of a known duty to act led to “situational coercion” and “may have wrongfully induced the Saba stockholders to vote in favor of the Merger for reasons other than the economic merits of the transaction,” because Saba’s stockholders found themselves in the precarious position of choosing between holding on to “recently-deregistered illiquid stock or accepting the Merger price of $9 per share, consideration that was depressed by the Company’s nearly contemporaneous failure once again to complete the restatement of its financials.” The Court determined that Saba’s stockholders were left with “no practical alternative but to vote in favor of the Merger.”
Because the stockholder vote did not cleanse the merger under Corwin and because the challenged transaction involved a change in control, the Court determined that the Revlon enhanced scrutiny standard would apply.

Saba’s directors further argued that the claims should be dismissed because (i) plaintiff lacked standing to bring what defendants argued were derivative claims once the merger was consummated, and (ii) the directors were exculpated from any monetary liability by the Section 102(b)(7) provision in Saba’s certificate of incorporation.

The Court concluded that plaintiff’s claims were direct because the complaint challenged the directors’ actions during the merger process. The Court also determined that the facts pled concerning Saba’s repeated failure to restate its financials and the rushed, forced stockholder vote that followed justified a pleading-stage inference of bad faith, and the late-stage equity awards to the directors prior to the transaction supported an inference that the board members had breached their duty of loyalty, stating non-exculpated claims.


Following the Delaware Supreme Court decision in Corwin v. KKR Financial Holdings LLC, 125 A.3d 304 (Del. 2015), the Delaware courts have clarified and extended the application of the decision. In Corwin, the Delaware Supreme Court affirmed the Court of Chancery’s ruling that the business judgment rule is the appropriate standard of review for a merger transaction that is not subject to the entire fairness standard of review and is approved by a fully informed, uncoerced vote of the disinterested stockholders. In so holding, the Delaware Supreme Court cited the “long-standing policy of [Delaware] law . . . to avoid the uncertainties and costs of judicial second-guessing” in such situations. In 2016 and early 2017, the Delaware courts have consistently applied Corwin, reinforcing that long-standing policy.

In Singh v. Attenborough, 137 A.3d 151 (Del. 2016), for example, the Delaware Supreme Court clarified that the business judgment rule irrebuttably applies to post-closing judicial review of a merger transaction that receives the fully informed, uncoerced vote of the disinterested stockholders. Although the Delaware Supreme Court in Singh noted that the Court of Chancery correctly found that a fully informed, uncoerced vote of disinterested stockholders invoked the business judgment rule, the Court held that the Court of Chancery erred by next proceeding to consider whether plaintiffs stated a claim for breach of the duty of care. In so doing, the Court explained that the Court of Chancery failed to “give [the] standard-of-review-shifting effect to the vote.” When the business judgment rule standard of review is invoked because of a fully informed, uncoerced vote of disinterested stockholders approving a transaction, a post-closing action for monetary damages will be dismissed absent a well-pled waste claim.
The Delaware courts next grappled with the extent to which Corwin applied to so-called “intermediate form mergers” accomplished under Section 251(h) of the General Corporation Law of the State of Delaware (“Section 251(h)”). Under Section 251(h), subject to the satisfaction of certain specified statutory conditions, a merger can be consummated without a vote of the target stockholders where, immediately following the consummation of a tender or exchange offer, the stock irrevocably accepted for purchase or exchange pursuant to such offer and received by the depositary prior to the expiration of such offer, together with the stock otherwise owned by the consummating corporation or its affiliates and any rollover stock, equals at least such percentage of the shares of stock of the target corporation that, absent Section 251(h), would be required to adopt the merger agreement. Thus, in contrast with the Corwin and Attenborough mergers, mergers approved under Section 251(h) do not require a stockholder vote.

In In re Volcano Corporation Stockholder Litigation, 143 A.3d 727 (Del. Ch. 2016), the Court of Chancery held that when the fully informed, uncoerced and disinterested stockholders approve a merger under Section 251(h) by tendering their shares pursuant to the tender offer, that approval has the same cleansing effect under Corwin, and the business judgment rule irrebuttable applies to the merger. In Volcano, upon the expiration of the tender offer constituting the first step in a Section 251(h) merger, stockholders representing the holders of 89.1% of the issued and outstanding shares of common stock of the target corporation had validly tendered and not withdrawn their shares. Plaintiffs contended, in relevant part, that the board of directors approved the merger in an uninformed manner and the directors were motivated by certain benefits they received as a result of the merger, including the vesting of stock options and restricted stock units and the execution of a consulting agreement between one of the directors and the buyer. The defendants moved for dismissal for failure to state a claim and argued for an extension of Corwin to preclude judicial review of the board’s conduct in negotiating and approving the Section 251(h) merger. The Court held that, in the context of a Section 251(h) merger, the acceptance of the tender offer by a majority of fully informed, disinterested stockholders has the same cleansing effect as a vote in favor of the merger. In reaching its holding, the Court reasoned that there is no basis for distinguishing a stockholder’s acceptance of a tender offer as part of a Section 251(h) merger from a stockholder’s vote in favor of a long form merger. The Court noted that in a Section 251(h) merger, the board of directors retains its involvement (and concomitant fiduciary duties) in negotiating the terms of the tender offer under Section 251(h), and such a tender offer has built-in protections against coercion: the tender offer must be for all outstanding stock and the back-end merger must be accomplished as soon as practicable. After determining that Corwin applied, the Court ruled that plaintiffs failed to adequately plead that the stockholders were uninformed, and, in the absence of a waste claim, the Court dismissed the complaint. The Volcano decision was affirmed by the Delaware Supreme Court on February 9, 2017. No. 372, 2016 (Del. Feb. 9, 2017).

Other recent decisions from the Court of Chancery address whether Corwin applies when the board’s approval of a transaction is alleged to have resulted from a tainted process. In City of Miami General Employees’ & Sanitation Employees’ Retirement Trust v. Comstock, 2016 WL 4464156 (Del. Ch. Aug. 24, 2016), the Court dismissed a complaint for failure to state a claim after applying Corwin to a merger transaction that garnered the approval of holders of 97.6% of the shares that voted and 81.7% of all shares. Plaintiffs brought a post-closing damages action alleging breaches of the duties of disclosure and loyalty. Plaintiffs argued that a majority of the
directors were interested in a transaction with the buyer because they hoped to serve as directors of the surviving entity, and that the chief executive officer and chairman tainted the process by which the board considered the transaction through certain alleged deceptions. After dismissing the disclosure claim, the Court analyzed the loyalty claim by first ruling that the complaint failed to allege that a majority of the directors were interested and failed to allege adequately that the chief executive officer and chairman tainted the board’s process by deception. Although the Court ultimately dismissed the complaint under *Corwin*, the fact that the Court considered the potential conflicts among the corporation’s directors suggested that *Corwin* may not preclude judicial review of a tainted sales process. On appeal, the Delaware Supreme Court affirmed the judgment of the Court of Chancery.

In *Larkin v. Shah*, 2016 WL 4485447 (Del. Ch. Aug. 25, 2016), plaintiffs filed a post-closing breach of fiduciary duty action seeking damages as compensation for an allegedly flawed sales process that netted inadequate consideration. The merger was accomplished under Section 251(h), and the stockholders approved the transaction by tendering approximately 78% of the shares into the tender offer. The Court of Chancery determined that “the business judgment rule irrebuttable applies if a majority of disinterested, uncoerced stockholders approve a transaction *absent a looming conflicted controller*” (emphasis in original). Stated differently, “[i]n the absence of a controlling stockholder that extracted personal benefits, the effect of disinterested stockholder approval of the merger is review under the irrebuttable business judgment rule, even if the transaction might otherwise have been subject to the entire fairness standard due to conflicts faced by individual directors.” In *Larkin*, the Court rejected the assertion that venture capital funds holding a 23.1% block of common stock constituted a control group in the absence of any facts suggesting that those stockholders influenced the board’s free exercise of judgment. Thus, finding that there was no controlling stockholder that extracted personal, non-ratable benefits, the Court held that the acceptance of the tender offer by stockholders holding approximately 70% of the shares not contractually bound to tender invoked *Corwin*.

Most recently, in *In re Solera Holdings, Inc. Stockholder Litigation*, 2017 WL 57839 (Del. Ch. Jan. 5, 2017), the Court of Chancery applied *Corwin* to dismiss a complaint alleging a breach of fiduciary duty claim against the directors who approved the acquisition of a corporation by a private equity firm. Before reaching the merits as to whether the uncoerced vote of the disinterested stockholders to approve the merger was fully informed, the Court clarified how the burden of proof operates when applying *Corwin* to a merger transaction. Distinguishing between the burden of proving that a vote is fully informed (which burden the Court found was properly allocated to defendants) from the burden of pleading disclosure deficiencies, the Court explained that allocating the burden of pleading disclosure deficiencies to defendants would “create an unworkable standard, putting a litigant in the proverbially impossible position of proving a negative.” As such, the Court explained that “a plaintiff challenging the decision to approve a transaction must first identify a deficiency in the operative disclosure document, at which point the burden would fall to defendants to establish that the alleged deficiency fails as a matter of law in order to secure the cleansing effect” of the stockholder vote under *Corwin*. Rejecting concerns about the fairness of requiring a plaintiff to plead disclosure deficiencies before obtaining discovery, the Court noted the ability of a plaintiff to conduct a books and records inspection under Section 220 of the General Corporation Law of the State of Delaware in non-expedited stockholder litigation to uncover information in support of such disclosure claims, as well as the ability of plaintiffs to avail themselves of the relatively low “colorability” pleading
standard to obtain discovery in respect of such disclosure claims before a stockholder vote is taken on the transaction.


In In re EZCORP Inc. Consulting Agreement Derivative Litigation, 2016 WL 301245 (Del. Ch. Jan. 25, 2016), the Court of Chancery denied a motion to dismiss derivative claims challenging a series of payments between a corporation and its controlling stockholder, even though those payments had been approved by the Audit Committee of the corporation's board. After review of extensive case law, the Court concluded that the weight of authority called for application of the entire fairness standard at the pleading stage, with the possibility that an evidentiary showing of independent committee approval could support a shift in the burden of proof later in the case. The Court determined that such transactions could be subject to dismissal at the pleading stage under the business judgment rule only where the transaction is approved by both an independent committee of the board and a majority of the minority stockholders.

Headquartered in Austin, Texas, EZCORP Inc. ("EZCORP" or the "Company") provided instant cash solutions through a variety of products and services, including pawn loans, other short-term consumer loans, and purchases of customer merchandise. The plaintiff stockholder brought suit challenging the fairness of three advisory service agreements between the Company and defendant Madison Park, LLC, an affiliate of the Company's controlling stockholder, Phillip Cohen. Cohen was the sole stockholder of the general partner of the limited partnership that held all of the Company's voting common stock. Thus, Cohen held 100% of EZCORP's voting power, but only 5.5% of its equity.

In May 2014, the Audit Committee terminated the renewal of one of the service agreements, allegedly due in part to the committee's concern about the fairness of the relationship between the Company and Madison Park. In early July, the stockholder-plaintiff made a demand under Section 220 of the Delaware General Corporation Law to inspect the Company's books and records relating to the service agreements. Nine days after the books and records demand arrived, Cohen responded to the termination by removing three directors (including two members of the Audit Committee that had terminated the agreements and the Company's CEO) from the board; another director resigned the same day.

The Court considered at length the appropriate standard of review for transactions in which a corporation's controlling stockholder receives a non-ratable benefit. The Court noted that, in an ordinary case involving self-dealing between a corporation and its controlling stockholder, the standard of review is entire fairness and the burden of proof rests on the defendants. However, in the context of a cash-out merger, the Delaware Supreme Court has held that application of the business judgment rule is appropriate if, but only if, the transaction is conditioned ab initio on both the affirmative recommendation of a sufficiently authorized, independent and disinterested committee of the board and the affirmative vote of a majority of the minority stockholders. See Kahn v. M & F Worldwide, 88 A.3d 635 (Del. 2014). If the controlling holder agrees to use only one of these protections, however, "then the most that the controller can achieve is a shift in the burden of proof such that the plaintiff challenging the transaction must prove unfairness."
The Court then considered a controversy posed in the case law: whether challenges to controlling-stockholder transactions other than cash-out mergers may be dismissed under the business judgment rule where the transaction is conditioned on either approval by an independent and disinterested board committee or approval by a majority of the minority stockholders, but not both. After an extensive review of cases taking both sides of that issue, the Court concluded that the weight of the authority called for a broader application of the entire fairness framework.

The Court also considered the tension between that conclusion and the demand futility analysis articulated in *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984), a case in which the Delaware Supreme Court had reversed (on discretionary interlocutory review) the Court of Chancery's denial of a motion to dismiss a derivative suit challenging a transaction with a 47% stockholder that had been approved by a majority disinterested and independent board, but not by the corporation's stockholders. The Supreme Court in *Aronson* held that, unless a stockholder plaintiff pleads particularized facts calling into question the board's ability to exercise properly its independent and disinterested business judgment in responding to a demand to institute suit, a board's refusal to sue is subject to business judgment review. After extended discussion of post-*Aronson* case law, the Court determined that *Aronson* applies only to the demand-excusal context and does not provide an independent basis for changing the substantive standard of review of controlling stockholder transactions.

After finding that the operative standard of review was entire fairness with possible burden shifting based on the Audit Committee's approval of the service agreements, the Court held that the complaint supported a reasonable inference that the agreements were not entirely fair. Among the factors that the Court found to raise such inference were: (i) Cohen's voting control despite having only a 5.5% equity stake; (ii) the long history of advisory service agreements between the Company and Cohen's affiliates; (iii) the amount and timing of the payments; (iv) the minimal resources of Madison Park; (v) the duplication between the services Madison Park provided and the capabilities of the Company management; (vi) the lack of similar service agreements at any of EZCORP's peer companies; (vii) the decision by two members of the Audit Committee to cancel the renewal of one agreement; and (viii) Cohen's retaliation against those board members.

The Court added that at the motion to dismiss stage, the involvement of the Audit Committee in the transactions does not defeat the fiduciary duty claim because a determination of whether an independent committee is "well-functioning" requires a "fact intensive inquiry."

The Court next turned to its analysis under Court of Chancery Rule 23.1. The Court found that reasonable doubt existed as to the ability of a majority of the directors to exercise independent and disinterested business judgment over a demand, and thus that demand was excused. Notably, the Court found demand excused as to a retired board member whom Cohen brought out of retirement and reappointed after removing three directors in July 2014. While the Court acknowledged the general rule that a director's nomination or election by an interested party is, by itself, insufficient to raise a reasonable doubt about his independence, "it is not necessarily irrelevant." The Court found that this director's alleged "eagerness to be of use," combined with his participation as an Audit Committee member in approving some of the
challenged agreements, could support the reasonable inference that "Cohen wanted to bring back a cooperative member of the placid antebellum regime."

d. **Corwin v. KKR Financial Holdings LLC, 125 A.3d 304 (Del. 2015).**

In *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), the Delaware Supreme Court affirmed a ruling by the Court of Chancery granting the defendants' motions to dismiss a suit challenging the acquisition of KKR Financial Holdings LLC ("KFN") by KKR & Co. L.P. ("KKR"). The Court held that the business judgment rule is the appropriate standard in post-closing damages suits involving mergers that are not subject to the entire fairness standard and that have been approved by a fully informed, uncoerced majority of the disinterested stockholders, even where such approval is statutorily required.

In December 2013, KKR and KFN executed a stock-for-stock merger agreement, which was subject to approval by a majority of KFN shares held by persons other than KKR and its affiliates. The merger, which was priced at a premium of 35% to market, was approved in April 2013 by an independent board majority and by a majority of disinterested stockholders.

Following the merger, nine lawsuits challenging the merger were brought in the Court of Chancery and consolidated. Plaintiffs alleged that (i) the members of the KFN board breached their fiduciary duties by agreeing to the merger, and (ii) KKR breached its fiduciary duty as a controlling stockholder by causing KFN to enter into the merger agreement. Plaintiffs' control claims focused on the facts that a KKR affiliate managed the company's day-to-day operations and that KFN's primary business was financing KKR's leveraged buyout activities.

The Court of Chancery dismissed the complaint, finding that KKR, which owned only 1% of KFN's stock, was not a controlling stockholder. Additionally, the Court of Chancery held that the business judgment rule would apply to the merger because the merger was approved by a majority of the shares held by the disinterested, fully informed stockholders of KFN.

The Supreme Court, sitting en banc, unanimously affirmed the judgment of the Court of Chancery. With respect to the control issue, the Court found that the plaintiffs had not alleged sufficient facts to support the argument that KKR had effective control of the board and could therefore prevent KFN's board from exercising its own independent judgment in determining whether to approve the merger. To support this finding, the Court noted that KKR "owned less than 1% of the stock, had no right to appoint any directors, and had no contractual right to veto any board decision." Accordingly, the Court rejected the plaintiffs' control claims.

The Court further held that the business judgment standard of review would apply to the merger "because it was approved by a majority of the shares held by disinterested stockholders of KFN in a vote that was fully informed." The Court also declined to review the Court of Chancery's holding on the non-applicability of *Revlon*, finding that even if *Revlon* applied to the merger, the voluntary approval by an informed majority of disinterested stockholders was sufficient to support application of the business judgment rule. The Court stated that *Revlon* and *Unocal* were not designed to address post-closing claims for money damages, but rather to
provide stockholders and the Court of Chancery the ability to address merger and acquisition decisions before closing.

In so holding, the Court agreed with the Court of Chancery's interpretation of Gantler v. Stephens, 965 A.2d 696 (Del. 2009). In Gantler, the Supreme Court stated that ratification is limited to circumstances where a fully informed stockholder vote approves director action that does not legally require stockholder approval in order to become effective. Using this interpretation, plaintiffs argued that the merger should be subject to heightened scrutiny regardless of the statutorily required stockholder vote approving the merger. The Court rejected this argument, finding that Gantler was a narrow decision that focused on the meaning of the term "ratification," and was not meant to overturn Delaware's "long-standing body of case law" regarding the effect of fully informed stockholder approval.

The Supreme Court noted, however, that its holding applies only to fully informed and uncoerced votes of disinterested stockholders. Thus, the business judgment rule is not invoked if material facts regarding the merger are not disclosed to the voting stockholders.


In C&J Energy Services, Inc. v. City of Miami General Employees' and Sanitation Employees' Retirement Trust, 107 A.3d 1049 (Del. 2014), the Delaware Supreme Court reversed the Court of Chancery's decision to grant an "unusual" 30-day preliminary injunction of the merger between C&J Energy Services, Inc., a Delaware corporation ("C&J"), and a division of Nabors Industries Ltd., a Bermuda company ("Nabors"). As an inversion transaction, the merger was structured such that C&J would acquire a subsidiary of Nabors, with Nabors retaining a majority of the surviving company's equity. Although it was the buyer, C&J bargained for a passive, post-signing "fiduciary out" to accept a superior proposal and for a relatively low termination fee.

Although the Court of Chancery found that C&J's board was fully informed as to C&J's value, and there was no finding that the board was conflicted, the Court of Chancery found it was "plausible" that the board had violated its duties under Revlon to seek the highest immediate value reasonably available, because the board did not engage in an active pre- or post-signing market check. The Court of Chancery enjoined the stockholder vote for 30 days and required C&J to shop itself, stating that the solicitation of proposals during that period would not breach the merger agreement.

The Delaware Supreme Court held that the Court of Chancery had misapplied the standard for issuance of a preliminary injunction, which requires the moving party to establish a "reasonable probability of success on the merits," and not (as the Court of Chancery formulated its finding) "a plausible showing of a likelihood of success on the merits." The Supreme Court also ruled that the Court of Chancery's analysis was based on the incorrect proposition that a company selling itself is required to conduct an active marketing process for its board to satisfy its duties under Revlon. After reiterating that there is no "single blueprint" that a board must follow when conducting a sales process, the Supreme Court stated that "when a board exercises
its judgment in good faith, tests the transaction through a viable passive market check, and gives its stockholders a fully informed, uncoerced opportunity to vote to accept the deal, [the Court] cannot conclude that the board likely violated its Revlon duties."

Finally, the Supreme Court held that the Court of Chancery's mandatory preliminary injunction was improper because it was not issued on a factual record made after trial or on undisputed facts and because it stripped an innocent third party (Nabors) of its contractual protections while simultaneously binding that party to consummate the transaction.

2. **Aiding and Abetting Liability.**


In *RBC Capital Markets, LLC v. Jervis, 129 A.3d 816 (Del. 2015)*, the Delaware Supreme Court affirmed a post-trial decision by the Court of Chancery holding that a financial advisor was liable for aiding and abetting breaches of fiduciary duty by directors of a corporation during a sale of control transaction. In doing so, the Court held that the evidence supported a finding that the advisor had the necessary scienter for an aiding and abetting claim; that is, the financial advisor "knowingly participated" in the breach by "exploiting its own conflicted interests to the detriment of [the corporation] and by creating an informational vacuum." The Court refused to require contribution from directors (who had previously settled with the stockholder-plaintiffs), because the board was exculpated from monetary liability under the Company's Section 102(b)(7) provision. The Court confirmed, however, that Section 102(b)(7) protections do not extend to third parties.

In December 2010, the board of Rural/Metro Corporation ("Rural" or the "Company") formed a Special Committee to explore strategic alternatives. While the Special Committee was authorized to hire a financial advisor to help explore these options, it was not expressly authorized to initiate a sale process. After interviewing two other financial advisors, the Special Committee engaged RBC Capital Markets ("RBC") as its primary financial advisor. In its presentation to the Special Committee, RBC had recommended a sale of the Company in a coordinated effort with the sale of Rural's competitor, Emergency Medical Services Corporation ("EMS"), because "healthcare was 'strong'" and selling the Company at that point in time was "opportunistic." But RBC "did not disclose that proceeding in parallel with the EMS process served RBC's interest in gaining a role on the financing trees of bidders for EMS." RBC sought to use as an "angle" its role as a sell-side advisor to secure a buy-side financing role for the EMS deal, which could entitle RBC to "$60.1 million in fees from the Rural and EMS deals."

After contacting several private equity firms, six submitted indications of interest, and ultimately, Warburg Pincus LLC submitted the highest bid of $17.25 per share. RBC unsuccessfully solicited a "buy-side financing role from Warburg," but did not disclose its attempt to the Special Committee. RBC and Moelis & Company ("Moelis"), the Special Committee's secondary financial advisor, provided fairness opinions. The Court of Chancery found that "RBC worked to lower the analyses in its fairness presentation so Warburg's bid looked more attractive. Specifically, the trial court found that RBC made a series of changes to its fairness analysis" without disclosing these changes to the Special Committee. That analysis was sent to the board just three hours before its meeting to decide on the deal. The board
approved the merger with Warburg in March 2011, and in June 2011, the merger closed, after approval by the Company’s stockholders.

The class plaintiffs sought relief against Rural’s directors for breaches of fiduciary duty and against RBC and Moelis for aiding and abetting those breaches. Rural’s directors and Moelis settled, and RBC went to trial. Post-trial, the Vice Chancellor held that RBC was liable for aiding and abetting breaches of the directors’ duty of care and duty of disclosure. Specifically, the trial court held that the board breached its duty of care under Revlon’s enhanced scrutiny standard after an unreasonable sales process, and that the board failed to disclose material information in its proxy statement regarding RBC’s valuation process and conflicts. Concluding that RBC had knowingly aided and abetted these breaches, the Court of Chancery found RBC liable for $75.7 million. This represented 83% of the damages, which the Court determined was reasonable, given the Delaware Uniform Contribution Among Tortfeasors Act and RBC’s responsibility as a joint tortfeasor.

The Delaware Supreme Court affirmed. First, after concluding that Revlon applied, the Court reviewed the trial court’s holding that Rural’s board breached its duty of care under enhanced scrutiny. The Court of Chancery had found that the board’s pursuit of the transaction was outside the range of reasonableness, because "RBC did not disclose that proceeding in parallel with the EMS process served RBC's interest in gaining a role on the financing trees of bidders for EMS," and that these actions "impeded interested bidders from presenting potentially higher value alternatives." The board, according to the Court, should have been aware of the negative implications of this dual-track structure and should have had a mechanism to identify RBC’s conflicts. "[D]irectors need to be active and reasonably informed when overseeing the sales process, including identifying and responding to actual or potential conflicts of interest," and "the board should require disclosure of, on an ongoing basis, material information that might impact the board's process" when there is a conflicted advisor.

The Court of Chancery also had found that Rural's board was not "adequately informed as to Rural's value," including that the "Company's value on a stand-alone basis exceeded what a private equity bidder willingly would pay." And because the directors were not "well-informed" as to the value, their decision was "devoid of important efforts" necessary to "to protect . . . stockholders and to ensure that the transaction was favorable to them." The "informational vacuum created by RBC" also made it impossible for stockholders to check the board and ensure that they had diligently contemplated the decision to sell the Company. This informational vacuum also contributed to the Court of Chancery's holding that Rural's board had violated its duty of disclosure by failing to disclose RBC's conflicts fully and characterize RBC’s analysis accurately. The Supreme Court affirmed these rulings.

Next, the Court held that RBC had aided and abetted the board's breaches. The Court affirmed the trial court's "narrow holding" that "if [a] third party knows that the board is breaching its duty of care and participates in the breach by misleading the board or creating the informational vacuum, then the third party can be liable for aiding and abetting." Even though "the requirement that the aider and abettor act with scienter makes an aiding and abetting claim among the most difficult to prove," the Court found that the requisite scienter had been shown because RBC "intentionally duped" the board into breaching its duty of care and engaged in "fraud on the Board" by knowingly creating the informational vacuum.
Finally, the Court rejected RBC's argument that it had a right to contribution from joint tortfeasors, noting that the settlement agreements barred such a right. Importantly, the Court also held that Rural's Section 102(b)(7) exculpatory provision did not shield RBC from liability. "While Section 102(b)(7) insulates directors from monetary damages stemming from a breach of the duty of care, its protection does not apply to third parties such as RBC." The intended legislative purpose of Section 102(b)(7) was not to "safeguard third parties and thereby create a perverse incentive system wherein trusted advisors to directors could, for their own selfish motives, intentionally mislead a board only to hide behind their victim's liability shield."

3. **Deal Protection Devices.**


   In *In re Comverge, Inc. Shareholders Litigation, 2014 WL 6686570* (Del. Ch. Nov. 25, 2014), the Delaware Court of Chancery granted in part the defendants' motion to dismiss a post-closing stockholder challenge to the acquisition of Comverge, Inc. ("Comverge") by H.I.G. Capital, L.L.C. ("HIG"), which acquisition the Court had previously declined to enjoin. The plaintiffs alleged that Comverge's board of directors (the "Board") breached its fiduciary duties by: (i) failing to bring suit against HIG for an alleged breach of a non-disclosure agreement ("NDA") between the parties; (ii) conducting a flawed sale process that failed to maximize value for Comverge's stockholders; and (iii) agreeing to preclusive deal protection measures that prevented Comverge from soliciting alternative bidders. The plaintiffs also claimed that HIG had aided and abetted the Board in breaching its fiduciary duties.

Comverge had lost money every year of its existence and had long sought, to no avail, to solve its liquidity problems through various types of transactions. In November 2011, HIG contacted Comverge to express an interest in acquiring the company. In February 2012, the Board declined HIG's offer to buy the company for $2.25 per share, in part because another bidder had suggested interest in a transaction with Comverge at a higher price. An affiliate of HIG thereafter acquired certain notes issued by Comverge, which allegedly violated the two-year standstill provision of the NDA. Following notification of HIG's actions, the Board considered, but ultimately decided against, suing HIG for breach of the NDA. The notes gave HIG significant leverage over Comverge because they carried the right to accelerate Comverge's debt and provided HIG with prior approval rights over any acquisition transaction. HIG promptly took advantage of its leverage by notifying Comverge that it was in default under the notes and indicating that it would accelerate the debt under the notes unless the Board accepted HIG's new, lower-priced offer to acquire the company for $1.50 per share. After further negotiation with HIG, the Board agreed to a merger with HIG at a price of $1.75 per share. At the time of the Board's approval of the merger, Comverge's stock was trading at $1.88 per share. The merger agreement included a go-shop period during which HIG agreed not to exercise its blocking rights under the notes. During the go-shop period, Comverge had the right to terminate the transaction to pursue a superior proposal by paying HIG a total fee of 5.55% of the deal's equity value. After the go-shop period, the total payment required to terminate the agreement rose to 7% of the deal's equity value. In addition, Comverge entered into a $12 million bridge financing agreement with HIG pursuant to which Comverge issued HIG notes that were convertible at HIG's election into shares of Comverge common stock at a conversion price of $1.40 per share, which was...
$0.35 lower than the deal price and $0.48 lower than the then-current trading price of Comverge's shares.

The Court granted the defendants' motion to dismiss in part, finding that the Board's decision not to sue on the NDA and the Board's sale process did not violate the Board's fiduciary duties. The Court held that the Board's decision to pursue a sale transaction rather than uncertain, costly and potentially time-consuming litigation against HIG based on a possible violation of the NDA was reasonable, especially in light of Comverge's dire financial situation. With respect to the plaintiffs' sale process claims, the Court found that the Board had engaged in "hard-fought" negotiations with HIG, and had canvassed the market and considered alternatives to the transaction over an 18-month period before agreeing to the merger. While the sale process ultimately resulted in a lower deal price than HIG's initial offer due to HIG's superior bargaining position after acquiring the notes, the Court found that the Board's conduct at most amounted to a breach of the duty of care and did not support a claim for a non-exculpated breach of the duty of loyalty.

The Court also dismissed the aiding and abetting claims against HIG. The Court noted that Delaware case law recognizes an aiding and abetting claim if the acquirer in a merger induces the target board to breach its fiduciary duties "by extracting terms which require the opposite party to prefer its interests at the expense of the shareholders." While recognizing that HIG's "hard-nosed and aggressive" negotiating strategy was designed to take advantage of Comverge's precarious financial position, the Court concluded that HIG had not exploited self-interest on the part of the members of the Board in a manner that would give rise to liability for aiding and abetting a breach of fiduciary duty.

Finally, the Court found that it was conceivable that the combined effect of the termination fee, the expense reimbursement and the convertible bridge loan could have had an impermissibly preclusive effect on potential alternative bidders. The Court noted that, even at the lower end, the combined termination fee and potential expense reimbursement would be 5.55% of the equity value of the transaction and would test the limits of what the Court had found to be within a reasonable range for termination fees in its past decisions. At the higher end, the Court noted that the plaintiffs had contended that the combined fees and Comverge stock issuable under the notes upon termination of the merger agreement could amount to as much as 11.6% to 13.1% of the equity value of the transaction. In light of the potential magnitude of the combined fees and in the context of a deal with a negative premium to market, the Court held that it was reasonably conceivable that the Board had acted unreasonably in adopting the potentially preclusive deal protection measures and refused to grant the defendants' motion to dismiss in respect of the plaintiffs' claim that the Board breached its fiduciary duties in agreeing to such measures.

4. **Disclosures.**


In *Vento v. Curry, 2017 WL 1076725 (Del. Ch. Mar. 22, 2017)*, the Court of Chancery preliminarily enjoined a special meeting of stockholders of Consolidated Communications Holdings, Inc. (“Consolidated” or the “Company”) to vote on a proposed issuance of the
Company’s common stock in connection with a proposed merger. Finding information concerning the compensation to be received by the Company’s financial advisor and its affiliates in connection with providing a portion of the financing for the merger to be both material and quantifiable, the Court determined that Consolidated had failed to disclose this information “in a clear and transparent manner” to its stockholders.

On December 3, 2016, Consolidated entered into a merger agreement with FairPoint Communications, Inc. (“FairPoint”), under which Consolidated would acquire FairPoint in a stock-for-stock merger. The merger was expected to close in mid-2017. Morgan Stanley & Co. LLC (“Morgan Stanley”) served as the lead financial advisor for Consolidated, and an affiliate of Morgan Stanley committed to provide part of the debt financing for the merger. NASDAQ listing rules obliged Consolidated to secure a vote of its stockholders approving the issuance of the shares to be used as merger consideration. In a Form S-4 Registration Statement filed on January 26 and amended on February 24, 2017 (the “Amended Registration Statement”), Consolidated announced a special meeting of the Company’s stockholders to be held on March 28, 2017, to vote on the proposed share issuance.

On March 3, 2017, a stockholder plaintiff filed an action alleging that the Company’s directors breached their fiduciary duties by failing to disclose in the Amended Registration Statement details concerning the amount of compensation Morgan Stanley expects to earn in connection with providing a portion of the debt financing for the merger. Specifically, the Amended Registration Statement disclosed the fees paid to Morgan Stanley by both Consolidated and FairPoint in connection with current and prior advisory and financing services, but stated only that the Morgan Stanley affiliate would receive “additional fees” from Consolidated for providing a portion of the debt financing for the merger. On March 14, 2017, plaintiff filed a motion for a preliminary injunction to suspend the stockholder vote until the Company further amended the Amended Registration Statement to disclose this information.

Defendants did not dispute that the fees to be earned by the Morgan Stanley affiliate in connection with merger financing were both material and quantifiable. They noted instead that the Amended Registration Statement identified (as a pro forma balance sheet adjustment) the total amount of the fees to be paid for the financing commitment, and a separate Form 8-K, filed several weeks earlier, had attached the commitment letter showing that the Morgan Stanley affiliate would provide approximately 40% of the committed financing. On that basis, defendants argued that the Amended Registration Statement enabled a stockholder to estimate that the Morgan Stanley affiliate would receive approximately 40% of the fee amount.

The Court rejected defendants’ argument. Relying on the “buried facts” doctrine, the Court found it unreasonable to require stockholders to embark on a “scavenger hunt to try to obtain a complete and accurate picture of a financial advisor’s financial interests in a transaction,” which, the Court reiterated, is information critical to the stockholders’ assessment of how much weight to afford a financial advisor’s analysis of a proposed transaction. The Court therefore determined that “there is simply no excuse for Consolidated’s failure to disclose that information in a clear and transparent manner.” The Court thus found that it was probable that plaintiff would succeed on the merits of his disclosure claim, and that the remaining elements of the preliminary injunction test were met.
The Court enjoined the meeting until five days after Consolidated supplemented its disclosures to provide a “clear and direct explanation of the amount of financing-related fees” Morgan Stanley and its affiliates would receive in connection with the merger, if approved.


In In re Trulia, Inc. Stockholder Litigation, 129 A.3d 884 (Del. Ch. 2016), the Delaware Court of Chancery refused to approve a class action settlement that called for marginal disclosures in exchange for a broad release of stockholder claims. In so doing, the Court announced that moving forward it would review such "disclosure settlements" with increased scrutiny.

The case arose from the stock-for-stock merger between online real estate companies Zillow, Inc. and Trulia, Inc. Shortly after the merger was announced in July 2014, four plaintiffs filed class action complaints seeking to enjoin the merger and alleging that the directors of Trulia breached their fiduciary duties by including misleading disclosures in the joint proxy statement. Within days, however, the plaintiffs agreed to release their claims if Trulia would provide supplemental disclosures about the financial opinion the Trulia directors relied upon when approving the transaction. Trulia provided the disclosures, and the stockholders of both companies subsequently adopted the merger agreement. A formal settlement agreement was then submitted to the Court for approval, which (i) sought certification of a class consisting of all Trulia stockholders as of the date the merger was first announced through the closing date; (ii) included a broad release of "any claims arising under federal, state, statutory, regulatory, common law, or other law or rule" held by members of the proposed class relating in any way to the merger (with a limited carve-out for antitrust claims); and (iii) permitted plaintiffs' counsel to seek an award of attorneys' fees totaling $375,000.

The Court rejected the proposed settlement because the supplemental disclosures failed to provide a material benefit to the Trulia stockholders and were insufficient to justify the broad release of claims. In reaching this decision, the Court held that certain disclosures were immaterial because they contained information that was already publicly available, while other disclosures, which restated specific data points used by Trulia's financial advisor, were immaterial because Delaware law only requires companies to provide a summary of the financial advisor's opinion and not every detail necessary to recalculate the advisor's analysis.

In addition to its ruling, the Court unambiguously announced its intention to review "disclosure settlements" in the future with heightened scrutiny. The Court acknowledged that defendants involved in deal litigation have strong incentives to settle quickly—particularly if such settlements can be obtained by offering minimal disclosures in exchange for a broad release of stockholder claims. The Court explained, however, that its prior willingness to approve settlements calling for marginal disclosures, sweeping releases of stockholder claims and six-figure attorney fees had led to an explosion of lawsuits that "serve[] no useful purpose." Stressing how it can be problematic to adjudicate disclosure claims in the context of settlement-approval proceedings, the Court further explained that such proceedings are non-adversarial, leaving the Court to determine the materiality of supplemental disclosures without the benefit of a full record or consulting opposing briefs. Given the surge in deal litigation and the risk that
stockholders are losing potentially valuable claims that have not been adequately investigated, the Court proposed two solutions.

First, the Court recommended that disclosure claims be litigated outside of a settlement-approval proceeding and in an adversarial context. One such context would be a preliminary injunction motion, where plaintiffs would bear the burden of showing that disclosure of the omitted fact would likely have been material to a reasonable investor. Another context is when plaintiffs' counsel apply to the Court for an award of attorneys' fees after defendants voluntarily decide to supplement their proxy materials by making one or more of the disclosures sought by plaintiffs, thereby mooting some or all of their claims. In this situation, defendants are incentivized to oppose excessive fee requests.

Second, to the extent parties continue to pursue disclosure-based settlements, the Court warned that such settlements are "likely to be met with continued disfavor" by the Court unless the supplemental disclosures address a "plainly material misrepresentation or omission," and the subject matter of the proposed release is narrowly circumscribed to encompass nothing more than disclosure claims and fiduciary duty claims concerning the sale process.

Should supplemental information not be "plainly material," the Court recommended appointing an amicus curiae, paid for by both parties, to assist the Court in evaluating the alleged benefits of the supplemental disclosures. Finally, to mitigate the risk that parties will seek out forums willing to approve disclosure settlements of no genuine value, the Court also called on its sister courts in other states to adopt similar practices.

Following the settlement hearing, the Court noted that the parties agreed to narrow the release to exclude unknown claims, foreign claims, and claims arising under state or federal antitrust law. However, the Court held that this narrowed release was still overbroad as it was not limited to solely disclosure claims and fiduciary duty claims concerning the decision to enter into the merger.

5. **Merger Agreement Construction.**


In *Chicago Bridge & Iron Company N.V. v. Westinghouse Electric Company LLC, 2016 WL 7048031 (Del. Ch. Dec. 5, 2016)*, the Court of Chancery held, pursuant to the language of a purchase agreement between Chicago Bridge & Iron Company N.V. ("Seller" or the "Company") and Westinghouse Electric Company LLC ("Buyer"), that a dispute over the post-closing purchase price adjustment was to be submitted to and resolved by an independent auditor.

In 2015, an acquisition vehicle controlled by Buyer purchased a subsidiary of Seller. The purchase agreement between the parties provided for a purchase price of $0, subject to a purchase price adjustment at closing (the "Closing Date Adjustment") and the potential for deferred future payments. The purchase price for the transaction was to be determined by a complex pricing mechanism tied to the difference between the contractually defined target net working capital amount of $1.174 billion and the net working capital amount as calculated by the
parties post-closing. The purchase price thus had the potential to vary greatly depending upon the Closing Date Adjustment.

In advance of closing, Seller was required to prepare a closing payment statement containing a “good faith estimate” of the closing date purchase price. The closing payment statement was to be prepared in accordance with generally accepted accounting principles ("GAAP"). On December 28, 2015, Seller provided Buyer with a closing payment statement estimating net working capital as approximately $1.6 billion, exceeding the contractual target net working capital amount and suggesting that Seller was owed $428 million.

Following closing, Buyer was likewise required to submit a closing statement, prepared in accordance with GAAP, containing Buyer’s “good faith calculations” of the purchase price at closing. Buyer’s closing statement estimated the net working capital amount at closing as negative $976,500,000, which implied that Seller owed Buyer $2.15 billion. The difference stemmed from four changes that Buyer made to Seller’s closing payment statement: (i) reducing an outstanding receivable identified on the Company’s balance sheet as “claim cost” by 30% based on Buyer’s objection under GAAP to Seller’s estimate of “100 percent collectability” of this receivable; (ii) adjusting the claim cost receivable by establishing a claim cost reserve and deducting the amount of the reserve; (iii) increasing by 30% Seller’s estimate of the cost to complete the Company’s ongoing projects; and (iv) deducting a liability of $432 million relating to Seller’s acquisition of the Company that Buyer claimed was improperly omitted under GAAP.

While Seller initially used the dispute resolution mechanism found in the purchase agreement to resolve its objections to Buyer’s closing statement adjustments, Seller changed course and, on July 21, 2016, initiated litigation against Buyer. Buyer moved for judgment on the pleadings, arguing that the dispute resolution mechanism was the mandatory path for resolving the parties’ disagreements.

Claiming that Buyer breached the terms of the purchase agreement and the implied covenant of good faith and fair dealing in its calculation of the Closing Date Adjustment, Seller argued that the purchase agreement’s terms precluded Buyer from “making any adjustments to items that appeared on the Company’s balance sheet or adding liabilities with the avowed goal of complying with GAAP,” as Seller had represented that its financial statements complied with GAAP. Buyer argued that it did not give up its right to raise issues of GAAP compliance when calculating the Closing Date Adjustment, and that in any event, the purchase agreement required the parties to submit their dispute to an independent auditor.

The purchase agreement provided that if the parties were unable to resolve objections to the Closing Date Adjustment within thirty days, either party could submit the dispute to an independent auditor. Under the purchase agreement, the “determinations of the Independent Auditor were ‘final, conclusive, binding, non-appealable and incontestable by the parties . . . for any reason other than manifest error or fraud.’”

Relying on OSI Systems, Inc. v. Instrumentarium Corp., 892 A.2d 1086 (Del. Ch. 2006), Seller argued that the independent auditor’s role was “limited to ‘pure mathematics’ and should not extend to determinations of GAAP compliance.” To buttress this argument, Seller pointed to the size of the potential adjustment, noting that then-Vice Chancellor Strine had relied on the size
of the dispute in *OSI* as one factor supporting his holding that the dispute should not be referred to the independent accountant. Buyer argued that the dispute resolution provision in *OSI* materially differed from the dispute resolution provision in the purchase agreement, and that the language interpreted in *Alliant Techsystems, Inc. v. MidOcean Bushnell Holdings, L.P.*, 2015 WL 1897659 (Del. Ch. Apr. 24, 2015), was a more analogous precedent.

The Court, disregarding the potential size of the adjustment as a factor and holding that the language in the purchase agreement was unambiguous, agreed with Buyer. As in *Alliant*, the Court found that the independent auditor’s authority under the dispute resolution provision to determine “any and all matters that remain in dispute with respect to the [Closing Date Adjustment] and the calculations set forth therein” was sufficiently broad to include determinations about GAAP compliance. Because the independent auditor had exclusive authority to resolve the parties’ disputes over the Closing Date Adjustment under the plain language of the purchase agreement, the Court granted judgment on the pleadings in favor of Buyer.

On June 27, 2017, the Delaware Supreme Court reversed the Court of Chancery’s ruling, holding that the Independent Auditor did not have authority to adjudicate the issue of GAAP compliance, but instead only had authority under the purchase agreement to address a narrow range of disputes regarding changes in accounting practices or business practices midway through the transaction. Accordingly, the Delaware Supreme Court ruled that the Buyer should be enjoined from submitting arguments based on the Company’s historical financial statements and practices to the Independent Auditor.


In *IAC Search, LLC v. Conversant LLC*, 2016 WL 6995363 (Del. Ch. Nov. 30, 2016), the Court of Chancery held that certain provisions in an asset purchase agreement collectively constituted a “clear disclaimer of reliance on extra-contractual statements” and barred plaintiff’s claim that defendant had fraudulently induced plaintiff to purchase one of its subsidiaries.

In 2013, IAC Search, LLC (“Buyer”) purchased six subsidiaries of ValueClick, Inc. (“Seller”). Following closing, Buyer alleged that Seller had misrepresented certain information to Buyer about its internet ad placing business, including by falsifying performance metrics concerning ad revenue for one subsidiary, Investopedia, and that Seller had omitted several material transactions from financial statements. The allegedly misleading information was shared with Buyer during the due diligence process but was not expressly incorporated into the contract. Buyer asserted that it had relied on this information when calculating the possible increases in traffic and revenue Buyer could generate, and so was fraudulently induced to purchase Investopedia. Unlike Buyer’s other claims, claims for fraud were not limited by the contractual indemnity cap. Seller moved to dismiss the fraud claim and several separate claims for alleged breaches of the asset purchase agreement.

In determining whether Buyer’s claim for fraud would survive the motion to dismiss, the Court examined the purchase agreement between the parties. The purchase agreement contained a standard integration clause, a disclaimer by Seller that it was not making any extra-contractual
representations, and an acknowledgment by Buyer that Seller was not making any representations or warranties in respect of information provided during due diligence unless such information was expressly included elsewhere in the purchase agreement. The Court compared these three provisions to the anti-reliance language litigated in *Abry Partners V, L.P. v. F & W Acquisition LLC*, 891 A.2d 1032 (Del. Ch. 2006), and the more recent decisions in *Prairie Capital III, L.P. v. Double E Holding Corp.*, 132 A.3d 35 (Del. Ch. 2015), and *FdG Logistics LLC v. A&R Holdings, Inc.*, 131 A.3d 842 (Del. Ch. 2016). In *Abry Partners*, the Court explained that “murky integration clauses, or standard integration clauses without explicit anti-reliance representations, will not relieve a party of its oral and extra-contractual fraudulent representation.” To bar such claims, the *Abry Partners* Court explained, would require an integration clause to “contain language that can be said to add up to a clear anti-reliance clause by which the plaintiff has contractually promised that it did not rely upon statements outside the contract’s four corners in deciding to sign the contract.” In *Prairie Capital*, however, the Court explained that no “magic words” are required to disclaim reliance, and the requisite anti-reliance language can be found by considering more than one provision in an agreement, such as “a standard integration clause and a clause representing ‘affirmatively’ what information a buyer relied on.” In *FdG Logistics*, the Court further clarified that in order to bar a fraud claim, a disclaimer of reliance “must come from the point of view of the aggrieved party,” meaning that the party asserting the fraud claim must be the one to have disclaimed reliance on extra-contractual representations.

The Court held that although the anti-reliance language contained in the purchase agreement was not as explicit as that encouraged in *Abry Partners*, the integration clause, Seller’s disclaimer, and Buyer’s acknowledgement could be viewed together as defining “the universe of information on which [Buyer] relied and did not rely when it entered into the [purchase] [a]greement.” The Court explained that “the critical language in the Agreement” was Buyer’s express acknowledgement that Seller was not making any representation with respect to information received in due diligence “unless such information is expressly included [in the Agreement] in a representation and warranty.” The Court found that this provision was “substantively identical” to the contract provision in *Abry Partners* that had defined the information upon which the buyer in that case had relied. The Court also noted that in its acknowledgment, Buyer had “represented that it is a ‘sophisticated purchaser’ that had made its ‘own independent investigation’…with the assistance of ‘expert advisors’ before entering into the Agreement,” and to allow Buyer to assert a fraud claim after making this representation would “excuse a lie made by [Buyer] in writing.”

The Court therefore granted the motion to dismiss as to the fraud claim. The Court separately considered and denied the motion to dismiss as to claims for breaches of the asset purchase agreement.


In *Cigna Health & Life Insurance Company v. Audax Health Solutions, Inc.*, 107 A.3d 1082 (Del. Ch. 2014), the Delaware Court of Chancery found invalid features of a private company merger agreement that required stockholders, as a condition to receiving their merger consideration, to submit a letter of transmittal agreeing to provide a release of all claims against
the acquirer and that further required stockholders to indemnify, for an indefinite period of time, the acquirer for claims arising from the seller's breach of representations and warranties.

The opinion arose from the acquisition of Audax Health Solutions, Inc. ("Audax") by Optum Services, Inc. ("Optum"). In connection with the merger, certain stockholders of Audax executed support agreements that included: (i) a release of all claims against Optum and its affiliates, (ii) an agreement to be bound by the terms of the merger agreement, specifically including the provisions indemnifying Optum and its affiliates for any breaches of the representations and warranties, and (iii) an appointment of a stockholder representative. In order to receive the merger consideration under the merger agreement, stockholders who did not execute the support agreements were required to execute the letter of transmittal containing the release. Following the merger, Cigna Health and Life Insurance Company ("Cigna"), a holder of preferred stock of Audax who did not execute a support agreement and refused to execute the letter of transmittal, challenged, among other things, the validity of the release in the letter of transmittal and the indemnification provisions of the merger agreement.

On Cigna's motion for judgment on the pleadings, the Court held that the purported release in the letter of transmittal was unenforceable due to a lack of consideration. In so holding, the Court rejected the defendants' argument that the release was integral to the overall transaction, noting that provisions in the merger agreement that required the letter of transmittal to be in form and substance reasonably acceptable to the acquirer did not indicate that the stockholders would be required to agree to the release. The Court further explained that endorsing the defendants' position would permit buyers to force post-closing conditions or obligations not referenced in the merger agreement on the stockholders in a letter of transmittal. Accordingly, the Court found that the release constituted a new obligation that was unenforceable absent consideration. The Court held that the merger consideration could not constitute consideration for the release because the stockholders had already become entitled to it by operation of law upon the closing of the merger.

The Court also held that the indemnification provisions were unenforceable against stockholders who had not executed the support agreements. In response to Cigna's challenges to the indemnification provisions, the defendants argued that the indemnification obligation was substantively no different from an escrow arrangement, which is common in private company mergers and has previously been recognized by the Delaware courts as enforceable. Despite noting the economic similarities between the indemnification provisions and an escrow arrangement, the Court found that "the merger consideration here more aptly can be described as cash, subject to an open-ended post-closing price adjustment." In this connection, the Court explained that such price adjustments are permissible under Delaware law if they comply with Section 251 of the General Corporation Law of the State of Delaware (the "DGCL"), which requires a merger agreement to set forth a determinable merger consideration by stating the cash, property, rights or securities which the stockholders are entitled to receive in the merger.

In determining whether the indemnification provisions violated Section 251 of the DGCL, the Court distinguished the facts at hand from those in Aveta, Inc. v. Cavallieri, 23 A.3d 157 (Del. Ch. 2010). In Aveta, the Court of Chancery found that the post-closing price-adjustment procedures in a merger agreement (which included an earn-out, adjustments based on the company's financial statements, and a potential claw-back) were permissible under Section
251 of the DGCL. The Court noted that, unlike the merger agreement in *Aveta*, the indemnification provisions in the Audax-Optum merger agreement were not limited in terms of the amount of money that might be subject to a claw-back or the time period during which Optum could potentially bring a claim for indemnification. Rather, the indemnification structure in the Audax-Optum merger agreement continued indefinitely and made the value of the merger consideration indeterminable. Accordingly, the Court held that the merger agreement failed to set forth the value of the merger consideration as required by Section 251 of the DGCL because of the open-ended and unlimited indemnification provisions. The Court further held that the indemnification provisions were unenforceable against stockholders who did not specifically agree to such obligations by executing the support agreements or the merger agreement itself.

The Court specifically noted the narrow scope of the opinion and clarified that it was not deciding issues relating to (i) escrow agreements generally, (ii) the general validity of post-closing price adjustments requiring direct repayment from stockholders, (iii) whether a time-limited price adjustment that covers all of the merger consideration may be valid, or (iv) whether an indefinite adjustment period as to a portion of the merger consideration may be valid. Instead, the Court explained that it was the combination of the indefinite and contingent nature of the entirety of the consideration payable under the Audax-Optum merger agreement that resulted in the violation of Section 251 of the DGCL.


In *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP*, 80 A.3d 155 (Del. Ch. Nov. 15, 2013), the Court of Chancery interpreted Section 259 of the General Corporation Law of the State of Delaware to hold that all privileges—including the attorney-client privilege—pass in a merger from the acquired corporation to the surviving corporation. Specifically, the Court held that, without a contractual provision to the contrary, even the seller's pre-merger attorney-client communications with respect to the merger itself would pass to the surviving corporation. The Court suggested that parties concerned about this issue should "use their contractual freedom in the manner shown in prior deals to exclude from the transferred assets the attorney-client communications they wish to retain as their own."

In a fact-intensive, 76-page motion to dismiss opinion, *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP*, 2014 WL 6703980 (Del. Ch. Nov. 26, 2014), the Delaware Court of Chancery largely denied the defendants' motions to dismiss fraud claims arising out of the sale of Plimus, a private Delaware corporation (the "Company"), to Great Hill, a private equity fund. The Court analyzed the specific factual allegations of a complaint that had been amended following the Court's earlier opinion holding that the Company's privileges, including pre-sale communications with counsel, passed to Great Hill in the merger by which it acquired the Company. See *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP*, 80 A.3d 155 (Del. Ch. 2013). The Court found that the amended complaint stated a claim for civil conspiracy and aiding and abetting fraud against a private equity fund that before the sale was the Company's single largest stockholder and had two designees on the Company's five-person board of directors. The Court also held that the amended complaint stated a claim for fraud against the selling private equity fund's two director designees.
The *Great Hill* opinion provides significant insight into issues arising in connection with private company M&A transactions, applying well-established law in the context of detailed factual allegations of fraud.

6. **Implied Covenant of Good Faith and Fair Dealing.**


   In *Lazard Technology P'rs, LLC v. QinetiQ North America Operations LLC, 114 A.3d 193 (Del. Apr. 23, 2015)*, the Delaware Supreme Court affirmed the Court of Chancery's post-trial bench ruling and held that defendant-below did not breach an earn-out provision in a merger agreement or the implied covenant of good faith and fair dealing.

   In 2009, QinetiQ North America Operations, LLC (the "buyer"), a defense and security technology company, acquired Cyveillance, Inc. (the "company"), a cyber-technology company. The buyer paid $40 million for the company up front and was obligated to make additional earn-out payments of up to $40 million if the company achieved certain revenue targets over a defined period. Section 5.4 of the merger agreement prohibited the buyer, post-closing, from "taking [ing] any action to divert or defer [revenue] with the intent of reducing or limiting the Earn-Out Payment." At the close of the earn-out period, revenues had not reached the level required to generate an earn-out.

   Lazard Technology Partners, LLC, which represented former stockholders of the company (collectively, the "seller"), filed suit in the Court of Chancery on August 29, 2011 (C.A. No. 6815-VCL) against the buyer. The seller alleged that the buyer breached both Section 5.4 of the merger agreement and the implied covenant of good faith and fair dealing by failing to take actions to achieve revenue sufficient to generate an earn-out. In a bench ruling following post-trial argument, the Court of Chancery entered judgment in favor of the buyer on both claims. With respect to the breach of contract claim, the Court concluded that the literal terms of Section 5.4 required a showing of intent, which the seller could not establish. The Court construed the implied covenant of good faith and fair dealing to prohibit only conduct undertaken with intent to reduce or avoid an earn-out payment altogether, consistent with the language of Section 5.4.

   The Delaware Supreme Court affirmed. The Court agreed that Section 5.4 employed an intent standard, not a knowledge standard, and rejected the seller's assertion that the contract precluded conduct by the buyer that the buyer knew would compromise the seller's ability to receive an earn-out payment. On the implied covenant claim, the Court noted both the specific standard in Section 5.4 and the negotiating history (in which the seller had sought tighter objective controls on the buyer's post-closing conduct, but had failed to obtain them), stated that the Court of Chancery "was very generous in assuming that the implied covenant of good faith and fair dealing operated at all as to decisions affecting the earn-out," and held that the Court of Chancery had correctly concluded that the implied covenant "did not inhibit the buyer's conduct unless the buyer acted with the intent to deprive the seller of an earn-out payment."

In *Orckit Communications Ltd. v. Networks* Inc. *et al.*, C.A. No. 9658-VCG (Del. Ch. Jan. 28, 2015) (TRANSCRIPT), the Delaware Court of Chancery granted defendant Networks's motion to dismiss a claim that it had wrongfully terminated an agreement to purchase patents from plaintiff Orckit. The purchase of the patents was contingent upon the issuance of an approval by an Israeli government agency, and the agreement provided that "the terms in the ... Approval shall be satisfactory in the sole discretion (which for purposes of this condition shall not, to the extent permitted by law, be subject to the implied covenant of good faith and fair dealing) of Networks." The Court held that, under the agreement, whether the terms of the approval were satisfactory to Networks was "a decision that is unreviewable in the sense that, if it is timely taken, the defendant could then...terminate."

Plaintiff Orckit had alleged that, under the agreement, Networks's exercise of its sole discretion was qualified by either (i) a "commercially reasonable efforts" standard appearing elsewhere in the contract, or (ii) a default good faith standard that could not be disclaimed, and that, under either standard, Networks had breached the agreement. The Court rejected both arguments. In regard to the first, the Court found it unreasonable to assume that the parties would expressly disclaim the application of the implied covenant of good faith and fair dealing only to impose a higher standard. Further, the Court held that basic "canons of construction" provided that a specific discretionary standard in a particular provision controls over a general one elsewhere in a contract. In regard to the second, the Court, emphasizing that "Delaware is a contractarian state" and that "the language that the parties have agreed to … governs the enforcement of contracts," stated that the provision's "language … could not be any clearer," and that it was, in fact, "as clear as it gets."

**B. Stockholder and Creditor Litigation.**

1. **Appraisal Actions and Proceedings.**

a. **In re Appraisal of Dell Inc., 143 A.3d 20 (Del. Ch. 2016).**

In *In re Appraisal of Dell Inc.*, 143 A.3d 20 (Del. Ch. 2016), the Court held that fourteen mutual funds sponsored by T. Rowe Price & Associates, Inc. (“T. Rowe”) as well as institutions that relied on T. Rowe to direct the voting of their shares (the “T. Rowe Petitioners”) were not entitled to an appraisal of their shares of Dell Inc. in connection with Dell’s go-private merger, because the record holder had voted the shares at issue in favor of the merger, thus failing to meet the “dissenting stockholder” requirement of Section 262 of Delaware’s General Corporation Law. The T. Rowe Petitioners held their shares through custodians. The custodians, however, were not record holders of the shares; they were participants of the Depository Trust Company, which held the shares in the name of its nominee, Cede & Co., which, for purposes of Delaware law, was the record holder. As the record holder, Cede had the legal right to vote the shares on the Dell merger and to make a written demand for an appraisal of the shares.

The Court noted that, through a “Byzantine” system, Cede was constrained to vote the T. Rowe Petitioners’ shares in accordance with T. Rowe’s instructions. Although T. Rowe had
publicly opposed the merger, due to its internal voting processes, it had in fact submitted instructions to vote the T. Rowe Petitioners’ shares in favor of the merger. To assist in its voting processes, T. Rowe had retained Institutional Shareholders Services Inc. (“ISS”). On matters on which a stockholder vote was sought, the voting system generated default voting instructions. In the case of management-supported mergers, such as Dell’s merger, the default voting instructions were to vote in favor of the merger.

The special meeting of Dell’s stockholders to vote on the merger was originally scheduled for July 18, 2013. For that meeting, T. Rowe confirmed that its shares were to be voted against the merger. Dell opened the July 18 meeting for the sole purpose of adjourning it. After a series of subsequent adjournments, the special meeting was held on September 12, 2013. Shortly before the meeting, the voting system generated a new meeting record, which had the effect of replacing the prior instructions (i.e., “against”) with new default instructions (i.e., “for”). After the switch, no one from T. Rowe logged into the ISS system to check the status of its voting instructions. As a result, the T. Rowe Petitioners’ shares were voted in accordance with the new default instructions—that is, they were voted in favor of the merger, a fact that came to light after certain of the T. Rowe Petitioners submitted filings required by federal law disclosing their vote.

Section 262 of Delaware’s General Corporation Law confers appraisal rights upon a stockholder of record who holds shares on the date an appraisal demand is made, continuously holds the shares through the effective date of the merger, submits a demand for appraisal in compliance with the statute, and has not voted in favor of the merger or consented to it in writing. The Court noted that Section 262’s requirements could be read as “all-or-nothing propositions,” such that a stockholder of record, like Cede, would be foreclosed from asserting appraisal rights if it voted a single share in favor of the merger. The Court observed that the Delaware Supreme Court, recognizing that a broker or nominee may hold shares of record on behalf of multiple clients, has permitted a stockholder of record to split its vote and seek appraisal for shares not voted in favor of the merger. The key consequence of such vote splitting, the Court stated, is that a record holder can only seek appraisal for the specific shares that were not voted in favor of the merger. The key consequence for the T. Rowe Petitioners is that their shares held of record by Cede, having been voted in favor of the Dell merger, were not entitled to appraisal rights.

In arriving at its holding, the Court noted that language in several of its recent “appraisal arbitrage” opinions, if read literally, would preclude it from considering anything other than Cede’s aggregated votes on the merger. The Court stated, however, that there was no evidence in those cases regarding how the particular shares were voted. The Court concluded that the appraisal arbitrage cases deal only with the situation involving the absence of proof; they do not stand for the proposition that, where evidence as to how the shares were voted exists and the parties can introduce it, the Court is precluded from considering it.

The Court’s solution was to provide that, once an appraisal petitioner has made out a prima facie case that its shares are entitled to appraisal (which, where the shares are held of record by Cede, it can meet by showing that there were sufficient shares held by Cede that were not voted in favor of the merger to cover the appraisal class), the burden shifts to the respondent corporation to demonstrate that Cede actually voted the shares for which appraisal is sought in
favor of the merger. The Court noted that the corporation could introduce public filings or other evidence from providers of voting services, such as internal control numbers and voting authentication records. If the corporation demonstrates that Cede (or any other record holder) actually voted the shares for which appraisal rights have been asserted in favor of the merger, the requirements of Section 262 will not have been met, and the petitioner will not be entitled to an appraisal of those shares.


In two recent post-trial opinions in appraisal cases under 8 Del. C. § 262, the Court of Chancery addressed the importance of merger price and process as well as the reliability of discounted cash flow (DCF) analyses in determining fair value. In *Merlin Partners LP v. AutoInfo, Inc.*, 2015 WL 2069417 (Del. Ch. Apr. 30, 2015), Vice Chancellor Noble found that, where there was an adequate sale and negotiation process conducted at arm's length and there were no reliable cash flow projections from which to make a DCF analysis nor available alternate valuations, the price received in the merger, $1.05 per share, was the best indication of fair value at the time of the merger. Two months later, in *In re LongPath Capital, LLC v. Ramtron International Corporation*, 2015 WL 4540443 (Del. Ch. June 30, 2015), Vice Chancellor Parsons similarly determined that there were no reliable means of appraisal valuation other than the merger price, but also found that the fair value at the time of the merger was $0.03 below the deal price of $3.10 per share after accounting for synergies.

Under Section 262, stockholders who choose not to participate in certain merger transactions may petition the Court to determine the fair value of their stock. "Fair value" represents "the value to a stockholder of the firm as a going concern, as opposed to the firm's value in the context of an acquisition or other transaction." To determine fair value, the Court independently evaluates the evidence and may consider techniques or methods that are generally considered acceptable in the financial community and otherwise admissible in court. Depending on the case, the Court may rely upon a DCF analysis, a comparable transactions analysis, a comparable companies analysis, or the merger price itself. Delaware courts tend to favor a DCF model over other available methodologies in an appraisal proceeding. However, a DCF analysis has "much less utility" in cases where the transaction was an arm's-length merger or where the data inputs used in the model are not reliable.

After struggling financially, AutoInfo began a sale process. As part of the process, Stephens Inc., AutoInfo's financial advisor retained to assist with the sale process, asked management to prepare five-year financial projections that were "aggressively optimistic" for use in marketing AutoInfo. AutoInfo's management had never prepared multi-year projections before, and the company's CEO described the process as "a bit of a chuckle and a joke." Despite this, AutoInfo engaged in an extensive sales process, with Stephens contacting 164 potential strategic and financial buyers, 70 of which entered into non-disclosure agreements. Several bidders submitted letters of intent, including Comvest, which signed a letter of intent at $1.26 per share but eventually reduced its price to $1.05 per share after discovering problems with the reliability of AutoInfo's financial information.
Merlin Partners filed an appraisal action and, relying on two comparable companies analyses and a DCF analysis prepared by its financial expert, argued that the fair value of the company was $2.60 per share. The Court first found that Merlin's DCF analysis deserved little deference because Merlin had failed to establish the credibility of the management projections upon which it relied. Not only were they AutoInfo's first attempt at such projections, they had also been specifically prepared to "paint the most optimistic and bright current and future condition of the company" possible in connection with the sales process. The Court also gave no weight to Merlin's comparable companies analyses because the companies used for comparison differed significantly in size from AutoInfo (from more than twice to 300 times its size) and also used store-based business models rather than AutoInfo's riskier agent-based model. Conversely, AutoInfo's expert relied on merger price, and the Court found that it could place "heavy weight" on a merger price in the absence of any other reliable valuation analysis. Finding that fair value was the deal price, the Court noted that the merger was the result of a competitive and fair auction because AutoInfo: (1) retained an investment bank experienced in the transportation industry using an incentive-based fee structure; (2) contacted numerous companies in the sales process; (3) formed a special committee; (4) was sold at a premium to market; and (5) had no other topping bid emerge between announcement and closing of the merger.

In Ramtron, after rejecting Cypress Semiconductor Corporation's bear hug letter to acquire all of its shares, as well as engaging in a subsequent sales process that involved its advisor contacting twenty-four potential buyers and executing nondisclosure agreements with six of those potential buyers, Ramtron engaged in negotiations with Cypress. After rejecting two more offers from Cypress, Ramtron agreed with Cypress on a final transaction price of $3.10 per share. LongPath, which acquired its shares after announcement of the merger, demanded appraisal and argued that fair value was $4.96 per share. The Court determined that LongPath's DCF analysis was not appropriate because it relied on management projections prepared by newer employees who were creating multi-year projections for the first time, which also utilized a point-of-sale revenue recognition methodology rather than Ramtron's historic point-of-purchase method. As further evidence of the unreliability of the projections, the Court noted that they were created after Cypress's bear hug letter, in anticipation of potential litigation or a hostile takeover bid, and that Ramtron, which already had a questionable track record at forecasting, prepared separate projections to provide to its bank. The Court also afforded no weight to LongPath's comparable transactions analysis, as the petitioner's expert had a "dearth of data points" and could only point to two comparable transactions with vastly different multiples. Instead, the Court found it could give "one-hundred percent weight" to merger price as evidence of fair value when the merger resulted from a proper process. Here, only one company, Cypress, ever made a bid even after an active solicitation process, and Ramtron could and did repeatedly (and publicly) reject Cypress's overtures, after which Cypress raised its price. In addition, the Court determined that it was appropriate to subtract LongPath's estimate of net synergies of $0.03 per share (which was reached by netting negative revenue synergies and transaction costs from Ramtron's estimate of positive synergies) from the merger price to reach a fair value determination of $3.07 per share.

As these decisions illustrate, even though Delaware courts "tend to favor a DCF model in appraisal proceedings," they will be willing to rely entirely upon or afford substantial weight to the merger price to determine fair value where there is reason to question the reliability of the
underlying management projections and where no other viable alternate valuation technique exists.


In two opinions issued the same day, the Delaware Court of Chancery addressed standing requirements under Delaware's appraisal statute, Section 262 of the General Corporation Law of the State of Delaware. In both Merion Capital LP v. BMC Software, Inc., 2015 WL 67586 (Del. Ch. Jan. 5, 2015), and In re Appraisal of Ancestry.com, Inc., 2015 WL 66825 (Del. Ch. Jan. 5, 2015), the Court found that a 2007 amendment to the appraisal statute did not impose a "share-tracing" requirement on an appraisal petitioner's right to demand appraisal of shares acquired after the record date for determining the stockholders entitled to vote on a merger. In so doing, the Court rejected a potential obstacle to so-called "appraisal arbitrageurs" that seek to use Delaware's appraisal process to capitalize on potentially undervalued transactions by purchasing shares of the target company's stock after announcement of a merger.

In BMC Software, petitioner Merion Capital LP ("Merion") sought appraisal for 7.6 million shares of common stock of BMC Software, Inc. ("BMC") that were purchased after the record date for a going-private merger. Merion, the beneficial owner of the shares, requested its broker to direct the nominee record holder of its shares to demand appraisal with respect to the purchased shares on Merion's behalf, but the broker refused. Merion then transferred record ownership of the shares into its own name and delivered a formal demand for appraisal to the company. BMC argued that, in order to have standing to pursue its appraisal claims, Merion had the burden of showing that each share it acquired after the record date had not been voted in favor of the merger by the previous holders. The Court rejected this contention and held instead that the unambiguous language of the appraisal statute required Merion to show only that the record holder of the shares that made the demand (in this case, Merion itself) had not voted the shares in favor of the merger.

In Ancestry.com, Merion sought appraisal for 1,255,000 shares of common stock of Ancestry.com, Inc. ("Ancestry") purchased after the record date for a cash-out merger. Unlike in BMC Software, Merion never transferred its shares into record name, but instead directed Cede & Co., the nominee record holder of the shares, to demand appraisal on Merion's behalf. As permitted by a 2007 amendment to the appraisal statute, Merion, in its capacity as the beneficial owner of the shares, filed a petition for appraisal in the Court of Chancery. Ancestry.com argued that since Merion, as the beneficial owner of the shares, filed the petition for appraisal, Merion was required to show that it (rather than the record holder, Cede & Co.) did not vote the shares in favor of the merger. Moreover, Ancestry.com argued that because Merion acquired beneficial ownership of its shares after the record date, Merion was also required to show that its predecessor beneficial owners did not vote in favor of the merger. The Court rejected this argument as well, holding that an appraisal petitioner is only required to show that the record holder held of record at least as many shares not voted in favor of the merger as the number for which appraisal demands were submitted.
In both *BMC Software* and *Ancestry.com*, the Court identified, but declined to address, the potential for a theoretical "over-appraisal" scenario, in which a record holder (such as Cede & Co.) would hold shares as nominee for many beneficial owners, would follow those beneficial owners' voting instructions, and would end up owning of record fewer shares not voted in favor of the merger than the number of shares as to which the record holder demanded appraisal. The Court noted that such a theoretical problem at most threatened the policy goals of the appraisal statute, but did not render the statute absurd or inoperable.

2. **Advance Notice Bylaws.**


   In *Hill International, Inc. v. Opportunity Partners L.P., 119 A.3d 30 (Del. 2015)*, the Delaware Supreme Court affirmed the Court of Chancery's grant of mandatory injunctive relief enjoining Hill International, Inc. ("Hill") from conducting any business at its 2015 annual meeting, other than convening the meeting for the sole purpose of adjourning it for a minimum time period, in order to permit Opportunity Partners ("Opportunity"), the stockholder-plaintiff, to present certain items of business and director nominations at Hill's 2015 annual meeting.

   The key issue in the case was whether Opportunity had complied with Hill's advance notice bylaw in submitting its proposed business and nominations. On April 30, 2014, Hill publicly disclosed in its 2014 definitive proxy statement that it anticipated that its 2015 annual meeting would be "on or about June 10, 2015" and that stockholders who wished to submit a proposal for the 2015 annual meeting must submit their proposal no later than April 15, 2015. The following year, on April 13, 2015, Opportunity delivered to Hill a notice of its intent to propose business and nominate two directors at Hill's 2015 annual meeting. On April 30, 2015, Hill filed its definitive proxy statement for its 2015 annual meeting and announced that its 2015 annual meeting would be held on June 9, 2015. Subsequently, on May 5, 2015, Hill asserted that Opportunity's April 13 notice was defective because it failed to include information about the director nominees required by the bylaws. On May 7, Opportunity delivered another notice to Hill of its intent to present at the 2015 annual meeting two different proposals than had been included in its April 13 notice as well as nominations for election to Hill's board of the same two nominees as had been named in the April 13 letter. On May 11, Hill notified Opportunity that its notice was untimely under Hill's advance notice bylaw and that its proposals and nominations would not be presented at the 2015 annual meeting. Opportunity brought suit in the Court of Chancery claiming its notice was timely under Hill's bylaws.

   Unlike many advance notice bylaws where stockholder notice of intent to make nominations or propose business is required to be delivered some number of days prior to the anniversary of the prior year's meeting or the mailing of the prior year's proxy statement, Hill's advance notice bylaw provides:

   To be timely, a stockholders' notice must be delivered to or mailed and received at the principal executive offices of the Corporation not less than sixty (60) nor more than ninety (90) days prior to the meeting; provided, however, that in the event that less than seventy
(70) days' notice or prior public disclosure of the date of the annual meeting is given or made to stockholders, notice by a stockholder, to be timely, must be received no later than the close of business on the tenth (10th) day following the day on which such notice of the date of annual meeting was mailed or such public disclosure was made, whichever first occurs.

In support of its contention that Opportunity's notice was untimely, Hill argued that the disclosure in its 2014 definitive proxy statement that the annual meeting would be "on or around June 10, 2015" constituted prior public disclosure of the date of the meeting such that Opportunity was required to notify Hill of its intent to propose business and nominations not less than 60 days prior to the meeting. In response, Opportunity claimed that the first notice of the date of the meeting – June 9, 2015 – was not given until April 30, less than 70 days prior to the date of the annual meeting, such that its May 7 notice was timely.

The Court of Chancery agreed with Opportunity, explaining that, although Hill could have triggered the requirement for at least 60 days advance notice of proposals and nominations by announcing the specific date of the meeting prior to the filing of its definitive proxy statement, because it did not, Opportunity had 10 days from the date of the filing to submit its notice to Hill. Therefore, because the May 7 notice was timely, the Court of Chancery held that Opportunity would suffer irreparable harm absent injunctive relief and the balance of hardships favored Opportunity, Opportunity was entitled to mandatory injunctive relief.

Reviewing the bylaws de novo, the Delaware Supreme Court held that Hill's "clear and unambiguous" advance notice bylaw required Hill to provide notice of the specific day – and not a range of possible days – on which the annual meeting was to occur in order to trigger the time periods under the advance notice bylaw. In particular, the Court explained:

The plain meaning of "the date" means a specific day – not a range of possible days. The 2014 Proxy Statement's reference to "on or about June 10, 2015" does not refer to "the date" of Hill's 2015 Annual Meeting. Rather, "on or about" refers to an approximate, anticipated, or targeted time frame that is intended to encompass more than one "date" – i.e., June 10 – apparently in order to give Hill some flexibility in scheduling. Thus, the 2014 Proxy Statement did not provide "prior public disclosure of the date" of Hill's 2015 Annual Meeting.

As such, because Hill did not provide notice of the specific date of its annual meeting until it filed its proxy statement for the 2015 annual meeting on April 30, 2015 announcing the June 9 date, the Court held that Opportunity's May 7 notice was timely.

In affirming the Court of Chancery's grant of mandatory injunctive relief, the Delaware Supreme Court provided additional guidance to practitioners in drafting advance notice bylaws. Notably, the Court suggested that corporations could avoid the situation in which Hill found itself by either pegging the notice period for timely stockholder proposals and director nominees
to the anniversary date of the corporation's prior annual meeting or by publicly announcing the specific date of its annual meeting prior to the sending of notice of such annual meeting in the manner required by Section 222 of the Delaware General Corporation Law, which requires, among other things, that such notice be sent not more than 60 days prior to the annual meeting. The Court noted that the Hill board had fixed the June 9, 2015 date of the 2015 meeting on March 12, 2015, but made no announcement when it did so.

Corporations with advance notice bylaws that key the notice period for stockholder proposals and nominations off the current year's meeting date rather than the anniversary of the prior year's annual meeting or the mailing of the prior year's proxy statement should not rely on the statement of anticipated meeting date in the prior year's proxy statement as announcing the meeting date and should make public announcement of the specific meeting date once it has been fixed. Alternatively, to avoid having the window for business proposals and nominations opened after they have filed their proxy materials, corporations may want to consider amending their advance notice bylaws to key the notice period from the anniversary of the prior year's annual meeting or the date of mailing of the prior year's proxy statement.

3. Fee-Shifting Bylaws.


   In Solak v. Sarowitz, 2016 WL 7468070 (Del. Ch. Dec. 27, 2016), the Court of Chancery denied in part a motion to dismiss a declaratory judgment and breach of fiduciary duty action challenging a fee-shifting bylaw adopted by the board of directors of Paylocity Holding Corporation (“Paylocity” or the “Company”). The Court rejected a ripeness challenge and held on the merits that the fee-shifting bylaw was facially invalid under Section 109(b) of the General Corporation Law of the State of Delaware (the “DGCL”), which the Court read as creating a blanket prohibition on “‘any provision’ that would shift fees ‘in connection with an internal corporate claim’ without regard to where such a claim is filed.”

   The Delaware General Assembly amended Section 109(b) of the DGCL after the Delaware Supreme Court’s ruling in ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554 (Del. 2014), in which the Delaware Supreme Court held that a bylaw adopted by the board of directors of a Delaware nonstock corporation that shifted litigation expenses in an “intra-corporate litigation” to a plaintiff who failed substantially to obtain the relief sought was facially valid under the DGCL. As amended, Section 109(b) prohibits “any” bylaw “that would impose liability on a stockholder for the attorneys’ fees or expenses of the corporation or any other party in connection with an internal corporate claim.” Effectively limiting ATP to nonstock corporations, the amendment, which became effective on August 1, 2015, addressed concerns that stock corporations would adopt similar bylaws and that stockholders would be deterred from enforcing otherwise meritorious claims as a result. New Section 115 of the DGCL, which permits a corporation to include a mandatory Delaware forum selection provision in its certificate of incorporation or bylaws in respect of internal corporate claims, was adopted and become effective concurrently with the amendment to Section 109(b).

   On February 2, 2016, the Paylocity board amended its bylaws to adopt new Article VIII, which contained two provisions. New Section 8.1 added an exclusive forum provision
designating the Delaware courts as the “sole and exclusive forum” for internal corporate claims. New Section 8.2 contained a fee-shifting provision requiring any stockholder who became involved in an action in another forum (absent a written waiver of the applicability of the fee-shifting bylaw by the Company), and failed to obtain a judgment on the merits that substantially achieved the full remedy sought, to reimburse Paylocity for its litigation expenses, including attorneys’ fees. On February 5, 2016, Paylocity filed a Form 8-K with the Securities and Exchange Commission disclosing the adoption of Article VIII. On May 5, 2016, plaintiff brought an action seeking a declaratory judgment that the fee-shifting bylaw violated Sections 109(b) and 102(b)(6) of the DGCL, and alleging that the Paylocity directors breached their fiduciary duties in adopting the fee-shifting bylaw.

Defendants moved to dismiss the complaint under Court of Chancery Rule 12(b)(1) for lack of subject matter jurisdiction, on the theory that plaintiff’s claims were not ripe for review because no Paylocity stockholder had filed an action outside of Delaware triggering the fee-shifting bylaw and plaintiff had not pled an intent to do so. Rejecting this argument, the Court reasoned that the fee-shifting bylaw would likely inhibit any stockholder from filing a claim that might trigger it. Declining review under these circumstances would thus mean that the validity of Paylocity’s fee-shifting bylaw might never be subject to judicial review, despite the likelihood that other corporations would adopt similar, potentially invalid bylaws. The risk of “perpetuating uncertainty concerning the permissibility of fee-shifting bylaws,” especially in light of the recent amendments to the DGCL, compelled the Court to review the validity of the fee-shifting bylaw.

Defendants also advanced several arguments in favor of the validity of the fee-shifting bylaw under Section 109(b). The Court rejected defendants’ argument that the simultaneous amendment of Section 109(b) and enactment of Section 115 required those provisions to “be read in tandem” such that the Section 109(b) provision would permit fee-shifting only for actions filed in violation of a forum selection provision adopted pursuant to Section 115. The Court determined that nothing in the plain text of Section 109(b) or Section 115 indicated that the legislature intended to create such an exception to Section 109(b).

The Court reached a similar conclusion with regard to defendants’ argument that fee-shifting remains permissible at common law. Distinguishing the case relied upon by defendants, El Paso Natural Gas Co. v. TransAmerican Natural Gas Corp., 669 A.2d 36 (Del. 1995), the Court found that existing common law pertaining to fee-shifting provisions applies to contractual provisions, not bylaws. The Court also ruled that the amendment to Section 109(b) was in direct conflict with the common law as established in ATP, negating any inference that stock corporations were permitted to adopt fee-shifting bylaws. The Court then turned to defendants’ argument that the savings clause in Paylocity’s fee-shifting bylaw “carve[d] out all interpretations inconsistent with Delaware law” and likewise rejected it, holding that a savings clause cannot negate a facial challenge to the validity of a bylaw where the bylaw has been found entirely invalid.

The Court then granted defendants’ motion to dismiss with respect to plaintiff’s remaining allegations. In particular, the Court held that plaintiff failed to state a claim for breach of fiduciary duty. Paylocity’s directors were exculpated from breaches of the duty of care pursuant to a Section 102(b)(7) provision in its certificate of incorporation, and plaintiff did not plead that any of the directors were interested or lacked independence. Thus, the Paylocity directors would be subject to personal liability only if they were found to have acted in bad faith.
The Court found that the bare allegation that the fee-shifting bylaw was adopted after the Section 109(b) provision took effect was insufficient by itself to support a reasonable inference of scienter. Furthermore, although the presence of the savings clause could not resuscitate the facially invalid fee-shifting bylaw, it negated any inference that the directors knew they would be violating the law in adopting it.

b. **Strougo v. Hollander, 111 A.3d 590 (Del. Ch. 2015).**

In *Strougo v. Hollander*, 111 A.3d 590 (Del. Ch. 2015), the first opinion of the Delaware Court of Chancery to address the validity of a fee-shifting bylaw since the Delaware Supreme Court's opinion in *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014), the Court held that a corporation's fee-shifting bylaw adopted after the consummation of a 10,000-to-1 reverse stock split did not apply to the stockholders whose entire interest was cashed out in the split. Although noting the "serious policy questions implicated by fee-shifting bylaws in general," the Court based its holding on the timing of the bylaw's adoption. The Court held that the bylaw did not apply to the stockholders whose entire interest had been cashed out in the split, because Section 109 of the DGCL does not authorize a bylaw that "regulates the rights or powers of former stockholders who were no longer stockholders when the bylaw was adopted." The Court clarified, however, that its conclusion does not mean that a stockholder whose interest in the corporation is eliminated ceases to be subject to the corporation's bylaws. Instead, the Court held that, "[i]n determining the bylaw provisions that should apply to a lawsuit initiated by a former stockholder challenging the terms of a cash-out transaction, . . . the governing bylaws are those in effect when the former stockholder's interest as a stockholder was eliminated." After that date, a stockholder ceases to be a party to the "corporate contract" and accordingly ceases to be bound by subsequent amendments to that contract.

4. **Director Removal.**


In *Frechter v. Zier*, 2017 WL 345142 (Del. Ch. Jan. 24, 2017), the Court of Chancery denied defendants’ motion to dismiss plaintiff’s declaratory judgment and breach of fiduciary duty action challenging a bylaw of Nutrisystem, Inc. ("Nutrisystem" or the “Company”) that required a supermajority vote of the Company’s stockholders to remove directors. Also granting plaintiff’s motion for summary judgment in part, the Court held that the bylaw, in requiring greater than a majority vote of the Company’s outstanding shares to remove directors, violated Section 141(k) of the Delaware General Corporation Law (the “DGCL”), which the Court determined “unambiguously confers on a majority the power to remove directors.”

On January 7, 2016, the Company announced that its board had approved an amendment to Nutrisystem’s bylaws. Pre-amendment, the relevant bylaw had allowed Nutrisystem stockholders to remove directors only (i) for cause and (ii) upon the affirmative vote of two-thirds of all outstanding shares of Company stock. The amendment struck the “for cause” requirement in response to the Court’s bench decision in *In re VAALCO Energy, Inc. Stockholder Litigation*, C.A. No. 11775-VCL (Del. Ch. Dec. 21, 2015) (TRANSCRIPT), interpreting this requirement as unlawful, but left the supermajority voting requirement unchanged.
On February 24, 2016, a stockholder-plaintiff brought an action alleging that the Nutrisystem directors had breached their fiduciary duties by enacting an unlawful bylaw to entrench themselves in office, and seeking a declaratory judgment that the bylaw as amended violated Section 141(k) of the DGCL, which provides that “[a]ny director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors.” Defendants moved to dismiss the complaint. Plaintiff cross-moved for partial summary judgment as to his declaratory judgment claim, stipulating that if the Court found in favor of plaintiff on this claim, plaintiff would withdraw the fiduciary duty claim.

Defendants argued that Section 216 of the DGCL, which permits corporations to adopt “bylaws … specify[ing] … the votes that shall be necessary for … the transaction of any business,” implicitly permits corporations to adopt bylaws allowing directors to be removed by a greater or lesser vote than the majority of outstanding shares specified in Section 141(k). Defendants also contended that the lack of mandatory language in the statute evidenced a legislative intent to allow boards of directors to establish the vote required to remove directors.

The Court rejected defendants’ “unnatural” interpretation of Section 141(k), finding that it would render meaningless the statutory grant to the holders of a majority of the outstanding stock of the power to remove directors. The Court noted that defendants’ reading of Section 141(k) was further weakened by Vice Chancellor Laster’s finding in VAALCO Energy that the language of Section 141(k) providing that directors “may” be removed with or without cause prohibits bylaws barring stockholders from removing directors without cause. The Court therefore concluded that because Section 141(k) grants stockholders the power to remove directors by a simple majority vote, Nutrisystem’s bylaws cannot lawfully require a greater vote.


In In re Vaalco Energy, Inc. Stockholder Litigation, C.A. No. 11775-VCL (Dec. 21, 2015) (TRANSCRIPT), the Court of Chancery granted the plaintiffs' motion for summary judgment and invalidated certain provisions of Vaalco's certificate of incorporation and bylaws, which provided that members of its board of directors could only be removed for cause. The Court held that the default rule under Section 141(k) of the Delaware General Corporation Law (the "DGCL") that directors "may be removed, with or without cause" may be limited to removal only for cause solely in corporations that either (i) have a board classified pursuant to Section 141(d) of the DGCL (i.e., a staggered board), or (ii) provide for cumulative voting pursuant to Section 214 of the DGCL.

Before its 2010 annual meeting, Vaalco had a staggered board and provisions in its certificate of incorporation and bylaws mandating that directors could be removed only for cause. In 2010, Vaalco de-staggered its board, but failed to remove the provisions of its certificate and bylaws providing for removal of directors for cause only. After a group of dissident stockholders announced its intention to remove certain members of Vaalco's board in late 2015, Vaalco asserted that these provisions prohibited such action without cause. In response, the group of stockholders brought an action seeking a declaratory judgment that
Vaalco's certificate of incorporation and bylaw provisions permitting only for-cause removal of directors were void under Section 141(k).

Section 141(k) provides that "[a]ny director or the entire board of directors may be removed, with or without cause, by the holders of a majority of the shares then entitled to vote at an election of directors" except in the case of a corporation with either (i) a staggered board, or (ii) cumulative voting. The defendants advanced several arguments in favor of the validity of the Vaalco certificate of incorporation and bylaw provisions, including the alleged fact that approximately 175 public Delaware corporations had similar provisions in their governing documents regarding director removal despite lacking a staggered board or cumulative voting. Of these, the Court found most persuasive the defendants' argument that Section 141(d) permits a classified board to "be divided into 1, 2 or 3 classes," and thus allows for a board to be classified into a single class. Accordingly, the defendants argued that a single-class board would be classified for the purposes of Section 141(k), and could properly be subject to removal for cause only.

The Court, however, rejected this argument, which, in its view, would create a "somewhat oxymoronic concept of a single-class classified board." In so holding, the Court relied upon commentary on the 1974 amendments to the DGCL, which explained that the language in Section 141(d) permitting a board to be "divided into 1, 2 or 3 classes" was intended to clarify that the right of any class or series of stock to elect one or more directors would not create an additional class of directors and did not support the notion of a single-class classified board. Additionally, while Vaalco advanced its interpretation of Section 141(d), it never actually established that its board was classified. Thus, the Court alternatively held that, even if Section 141(d) permitted a single-class classified board, Vaalco did not have such a board.

Following the ruling described above, the plaintiffs' bar began sending demand letters to the 175 companies identified by the defendant in Vaalco. Suits have been filed against several of those companies. For companies that have de-staggered their boards within the last several years, it may be worthwhile to determine whether similar issues exist before the plaintiffs' bar initiates contact.

5. Derivative Actions and Claims.


In Sandys v. Pincus, 152 A.3d 124 (Del. Dec. 5, 2016), the Delaware Supreme Court reversed the Court of Chancery’s dismissal of a derivative suit for failure to plead demand excusal, holding that plaintiff had pled facts, including co-ownership of an airplane and interlocking business relationships, that created a pleading-stage reasonable doubt as to the ability of a majority of the board to adequately consider a demand.

In the derivative action below, stockholder plaintiff alleged that members of the board of directors of Zynga Inc. (“Zynga”) breached their fiduciary duties by approving exceptions to lock-up agreements and other trading restrictions that allowed certain officers and directors, including its controlling stockholder, to sell their shares in a secondary offering before Zynga announced earnings for the first quarter of 2012 (which earnings announcement reflected a
decline in certain of Zynga’s operating metrics). Analyzing the board’s actions under the Rales test, the Court of Chancery found that plaintiff failed to plead sufficient particularized facts showing that a majority of the Zynga board lacked independence and that a demand on the board would have been futile, and granted the defendants’ motion to dismiss.

Writing for the majority, Chief Justice Strine disagreed with the Court of Chancery’s findings with respect to the independence of three Zynga directors. Although the Court noted that the case “again highlight[ed] the wisdom of the representative plaintiff bar heeding the repeated admonitions of [the Delaware Supreme Court] to make a pre-suit investigation into the board’s independence,” it found that plaintiff pled enough particularized facts at the pleading stage to create a reasonable doubt that a majority of the directors could impartially consider a demand.

In particular, the Court disagreed with the Court of Chancery’s determination as to the independence of a director who, together with her spouse, co-owned a plane with Mark Pincus, Zynga’s controlling stockholder and former chief executive officer. The Court characterized such co-ownership as a “powerful and unusual fact” that was indicative of a very close personal relationship that would heavily influence such director’s ability to impartially consider a demand.

The Court further disagreed that two other directors, who were partners at a venture capital firm that controlled more than 9% of Zynga’s equity, were able to impartially consider a demand. The venture capital firm affiliated with those directors invested in other companies that had ties to Mr. Pincus and to another director who was given an exemption to sell in the secondary offering. The Court noted that these “interlocking relationships” could “give rise to human motivations that would materially affect the parties’ ability to impartially consider a demand adverse to each other.”

In addition, in considering the independence of these two directors, the Court referenced Zynga’s filings with the Securities and Exchange Commission showing that the board had determined that those directors did not qualify as independent under the NASDAQ rules. In considering this factor at the trial court level, the Court of Chancery found that plaintiff failed to allege why the directors lacked independence under the NASDAQ rules in support of his demand excusal claim and that without this additional information, the directors’ lack of independence under the NASDAQ rules and the other facts pled by plaintiff were insufficient to question the directors’ independence. The Delaware Supreme Court disagreed, stating that “to have a derivative suit dismissed on demand excusal grounds because of the presumptive independence of directors whose own colleagues will not accord them the appellation of independence creates cognitive dissonance that our jurisprudence should not ignore.” Although the Court did agree with the Court of Chancery that the Delaware independence standard is context-specific and does not perfectly marry with the standards of the stock exchange, the Court noted that the criteria NASDAQ has articulated as bearing on independence are relevant under Delaware law and likely influenced by Delaware law. As such, the Court held that, where plaintiff pled facts suggesting that directors have a mutually beneficial ongoing business relationships with a company’s controller and “the company’s own board has determined that the directors . . . cannot be considered independent, a reasonable doubt exists under Rales.”
Justice Valihura dissented, stating that she would have affirmed the Court of Chancery decision. With respect to the directors affiliated with the venture capital firm, Justice Valihura noted that in the absence of further facts, such as facts relating to the size, profits or materiality of the investments and interests that plaintiff had pled in support of his demand futility claim, the investments and interests (as pled) were insufficient to raise a reasonable doubt as to the directors’ independence. Justice Valihura further noted that the fact that such directors were designated as not independent under the NASDAQ rules was relevant, but not dispositive, to the independence analysis and that, in the absence of pleadings as to why such directors were determined not to be independent, it was not difficult to conceive a situation in which a director might not be independent under stock exchange rules but yet be independent for demand futility purposes. Justice Valihura also noted, with respect to the close personal relationship that the majority opinion inferred from co-ownership of a plane, that plaintiff had only pled that the co-ownership of the plane constituted an existing business relationship between the director and Mr. Pincus. Accordingly, because plaintiff had not pled specific factual allegations in support of a disabling personal relationship between the director and Mr. Pincus, the dissent stressed that the Court could not and should not consider facts outside the complaint in its analysis of whether a particular relationship is of a “bias-producing nature.”


In In re Molycorp, Inc. Shareholder Derivative Litigation, 2015 WL 3454925 (Del. Ch. May 27, 2015), the Court of Chancery granted under Rule 12(b)(6) defendants' motions to dismiss a derivative complaint that alleged breaches of fiduciary duties, among other claims, in connection with a secondary stock offering that was initiated at the request of Molycorp, Inc.'s private equity investors pursuant to the terms of a Registration Rights Agreement.

In 2010, before Molycorp's initial public offering, certain private equity investors executed a Stockholders Agreement and a Registration Rights Agreement with the company. The Stockholders Agreement granted the investors the right, among others, to nominate directors to Molycorp's board. The Registration Rights Agreement granted the investors a contractual right to have Molycorp register their shares for a secondary offering upon demand by the private equity investors. Under the Registration Rights Agreement, the private equity investors were also granted the right to have their shares given priority over any shares offered by the company in a secondary offering.

In 2011, the private equity investors invoked their rights under the Registration Rights Agreement to cause Molycorp to offer their shares in a secondary offering. In the offering, the private equity investors and certain directors of Molycorp sold shares of Molycorp stock at $51 per share, generating approximately $575 million. Molycorp, on the other hand, conducted a private offering of convertible notes, which raised only $223 million. During this period, as plaintiffs alleged in the complaint, Molycorp was in financial distress and in need of capital. At the time of the challenged secondary offering, the private equity investors owned approximately 44 percent of the company's outstanding stock and had nominated four directors. As result, plaintiffs asserted that the private equity investors and the company's directors breached their fiduciary duties by favoring the interests of certain private equity stockholders over the interests
of the company. Among other arguments, plaintiffs asserted that the board should have delayed the secondary offering and allowed Molycorp to make its own offering in order to raise capital.

Defendants moved to dismiss plaintiffs' complaint pursuant to Court of Chancery Rule 23.1 for failure to make a demand on the board of directors and pursuant to Court of Chancery Rule 12(b)(6) for failure to state a claim. Because the Court dismissed the complaint for failure to state a claim, it did not address defendants' Rule 23.1 arguments, nor did it decide which standard of review applied to the breach of fiduciary duty claims. The Court, however, assumed without deciding that a majority of the directors had disqualifying interests by reason of personal gains or fiduciary relationships with the private equity investors and that demand would be excused.

In opposition to the motions to dismiss, plaintiffs asserted that defendants sold their stock and prevented the company from participating in the secondary offering at a time when Molycorp needed funding. The Court rejected plaintiffs' argument and observed that "[a]ppointment by a powerful shareholder does not automatically render a director's decision suspect" and that it is not wrong, without more, for a director to buy or sell company shares. Indeed, the Court noted, "[i]f such conduct were actionable, 'directors of every Delaware corporation would be faced with the ever-present specter of suit for breach of their duty of loyalty if they sold stock in the company on whose Board they sit.'"

In granting defendants' motions to dismiss, the Court observed that the Registration Rights Agreement informed the context in which defendants were acting and could not be ignored. Importantly, plaintiffs did not contend that the Registration Rights Agreement was invalid or unenforceable. Instead, plaintiffs essentially argued that Molycorp's board of directors should have interfered with the private equity investors' contractual rights. The Court declined to accept plaintiffs' argument. Indeed, the Court noted that "[a] finding otherwise could discourage would-be investors from funding start-ups for fear that their investment value will not be preserved despite disclosed, carefully negotiated agreements." Accordingly, the Court granted defendants' motions to dismiss.


In Quadrant Structured Products Company, Ltd. v. Vertin, 115 A.3d 535 (Del. Ch. May 4, 2015), the Delaware Court of Chancery denied defendants' motion for summary judgment, held that Delaware law imposes neither a continuous insolvency nor an irretrievable insolvency requirement, and found sufficient evidence in the record to support a reasonable inference that the debtor corporation was insolvent on the date the complaint was filed. In so holding, the Court provided an in-depth analysis of creditor derivative standing following the Delaware Supreme Court's decision in N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007).

The individual defendants are members of the board of directors of the corporate debtor, Athilon Capital Corp. Athilon's equity is wholly owned by defendant Merced Capital LP. Plaintiff Quadrant Structured Products Company, Ltd. is an owner of debt securities issued by Athilon. In this action, Quadrant alleged that following Merced's acquisition of Athilon, the
board took numerous actions to benefit Merced at the expense of Athilon's other stakeholders. In February 2015, the defendants moved for summary judgment on the theory that Athilon had returned to solvency and Quadrant therefore had lost standing to pursue any derivative claims.

The Court first analyzed in depth Delaware law on creditor breach of fiduciary duty claims, both before and after *Gheewalla*. The Court concluded that *Gheewalla* and the cases following it implemented a new regime in evaluating such claims. The current regime holds that there is no longer any zone of insolvency, no cause of action for deepening insolvency, and no fiduciary duties owed directly to creditors. Therefore, after *Gheewalla*, there is no need under Delaware law for derivative standing hurdles that may be "unnecessary and counterproductive impediments to the effective use of the derivative action as a meaningful tool for oversight." Directors of Delaware corporations are already sufficiently protected by other aspects of Delaware law.

In addressing defendants' argument that Delaware law should recognize a continuous insolvency requirement, the Court also looked to the purposes of a derivative action. Derivative suits are intended to remedy wrongdoing by directors and allow equitable owners to increase the company's value. Creditors share each of those incentives when a company is insolvent, and continue to have such incentives as long as they remain a creditor of the company. Thus, the Court concluded that the proper analogy in the creditor derivative context is a continuous creditor requirement, not a continuous insolvency requirement. In addition, the Court found that depriving creditors of standing to pursue derivative claims on behalf of a company that goes back and forth over the insolvency line while the equity is owned entirely by one stockholder would lead to a "failure of justice" because conflicted fiduciaries could prevent the corporation or its stockholders from pursuing valid claims.

For these reasons, among others, the Court held that "to maintain a derivative claim, the creditor-plaintiff must plead and later prove that the corporation was insolvent at the time suit was filed. The creditor-plaintiff need not, however, plead and prove that the corporation was insolvent continuously from the time of suit through the date of judgment." Finally, the Court also held that the proper test to assess creditor derivative standing at the time the litigation is filed is to determine whether the company "has liabilities in excess of a reasonable market value of its assets." While this test potentially conflicts with certain passages quoted in *Gheewalla*, which were originally written in the receivership context, the Court drew a distinction between claims in the receivership setting and fiduciary duty claims of creditors. Using this test, Quadrant's showing that Athilon's GAAP balance sheet showed a $300 million negative equity value was sufficient to create an issue of material fact as to Athilon's solvency at the time suit was filed.

6. **§ 205 Actions.**


Two recent decisions by the Delaware Court of Chancery have helped to define the contours of the Court's authority in proceedings under Section 205 ("Section 205") of the
General Corporation Law of the State of Delaware (the "DGCL"). In *In re Genelux Corporation*, 126 A.3d 644 (Del. Ch. 2015), the Court of Chancery held that a corporation cannot use Section 205 to invalidate prior corporate acts, and in *In re Baxter International Inc.*, C.A. No. 11609-CB (Del. Ch. Jan. 15, 2016) (TRANSCRIPT), the Court of Chancery held that a corporation cannot use Section 205 as a means to ensure the validity of future corporate acts.

Section 205, which became effective April 1, 2014, and was amended effective August 1, 2015, confers jurisdiction on the Court of Chancery to determine the validity of defective corporate acts and stock issuances. Since Section 205 was enacted in 2014, the Court of Chancery has used its powers under Section 205 to resolve issues relating to a corporation's valid existence, including confirming the identity of the members of the corporation's board of directors (see *In re Trupanion*, C.A. No. 9496-VCP (Del. Ch. Apr. 28, 2014) (ORDER)), and to validate defective stock issuances (see *In re Numoda Corporation Shareholders Litigation*, C.A. No. 9163-VCN (Del. Ch. Jan. 30, 2015) and *In re CertiSign Holding, Inc.*, C.A. No. 9989-VCN (Del. Ch. Aug. 31, 2015)). However, both *Genelux* and *Baxter* involved unique petitions that had the potential to expand the scope of the Court of Chancery's authority under Section 205 beyond the validation of past defective corporate acts.

In *Genelux*, Genelux Corporation ("Genelux") petitioned the Court of Chancery to invalidate 1.5 million shares of Genelux's Series A Preferred shares (the "Disputed Shares") that Genelux purportedly issued to Aladar Szalay, one of Genelux's founders ("Szalay"), under Section 205 and to declare the elections of two directors invalid under Section 225 of the DGCL as a result of the invalid issuance of the Disputed Shares. Genelux claimed that the Disputed Shares were invalid because, among other things, (i) the Disputed Shares were allegedly issued in exchange for shares of Genelux common stock that were invalid; (ii) Szalay released his claim to the Disputed Shares in a settlement of litigation with a third party; (iii) the issuance of the Disputed Shares was not supported by valid consideration; and (iv) Genelux was fraudulently induced by Szalay to issue the Disputed Shares.

Before reaching the merits of Genelux's claims with respect to the validity of the Disputed Shares, the Court of Chancery addressed the threshold issue of whether Section 205 can be used to invalidate purportedly defective corporate acts. Genelux argued that because Section 205(a)(4) authorizes the Court of Chancery to determine the validity of any stock (and not just putative or defective stock), the Court of Chancery should have the ability to determine that the stock subject to the petition is invalid. Szalay argued that Section 205, when read as a whole, only granted the Court of Chancery the power to validate defective stock issuances, not stock issuances that have been treated by the corporation as valid as evidenced by, in this case, the issuance of stock certificates, entries in the corporate stock ledger and board resolutions. The Court of Chancery found that the plain language of Section 205 was ambiguous as to whether the Court of Chancery is permitted to invalidate corporate acts. Accordingly, the Court looked to extrinsic evidence—including the legislative synopsis of House Bill 127 (which became Section 205 and Section 204 of the DGCL), the other provisions of Section 204 and Section 205, and commentary in Delaware law treatises concerning Section 205—to resolve the ambiguity.

After reviewing these materials, the Court of Chancery concluded that Section 205 is a "remedial statute" that was only designed to "cure otherwise incurable defective corporate acts, not a statute to be used to launch a challenge to stock issuances on grounds already available
through the assertion of plenary-type claims based on alleged fiduciary duty or common law fraud or a Section 225 action, if the stock had been voted." Thus, the Court of Chancery dismissed for failure to state a claim Genelux's petition under Section 205 seeking a declaration that the Disputed Shares were invalid. The Court of Chancery also dismissed Genelux's Section 225 claims, concluding that (i) Genelux had failed to prove by a preponderance of the evidence that it did not approve the issuance of the shares of common stock for which the Disputed Shares were exchanged; (ii) the settlement did not include a general release of claims that Szalay may have against Genelux; (iii) the exchange of the shares of common stock and Szalay's release of his claims to additional shares of Genelux constituted valid consideration for the issuance of the Disputed Shares; and (iv) Szalay's conduct in pressing Genelux to issue the Disputed Shares in connection with an unrelated third-party financing did not rise to the level of fraud.

In Baxter, the certificate of incorporation of Baxter International Inc. ("Baxter") contained a provision that stated that Article SIXTH of the certificate of incorporation could not be amended without the vote of at least "two-thirds of the holders of all the securities of [Baxter] then entitled to vote on such change" (the "voting provision"). Baxter planned to seek an amendment of Article SIXTH at its upcoming annual meeting, and its board of directors adopted a resolution (the "voting resolution") stating that the board had determined to count votes on the amendment on a "per share basis, rather than on a per capita basis," even though the voting provision, on its face, seemed to call for a per capita vote and previous public disclosures indicated that Baxter had counted votes subject to the provision on a per capita basis in the past. Baxter filed a petition with the Court of Chancery under Section 205 requesting that the Court validate the voting resolution as well as the voting standard set forth in the voting resolution. In effect, Baxter requested the Court to declare that the voting resolution properly provided that the upcoming vote on the amendment to the certificate should be determined on a per share basis, rather than a per capita basis. Although Baxter's Section 205 petition was initially unopposed, the Court of Chancery appointed Richards, Layton & Finger, P.A. as special counsel to file an opposition brief if no stockholder came forward to oppose the petition after notice was given.

The Court of Chancery, issuing its ruling from the bench after oral argument, distinguished between determining the validity of the voting resolution itself and determining the proper voting standard for the proposed certificate amendment. The Court of Chancery indicated that it could address under Section 205 the validity of the voting resolution if there had been some defect in its adoption (for example, if it was not adopted by a sufficient number of directors), but that Section 205 did not permit the Court to provide an opinion on the underlying contents of the voting resolution.

Moreover, the Court of Chancery determined that Section 205 did not empower the Court to validate future corporate acts. While Baxter argued that a corporate act had already occurred because the board had adopted the voting resolution, the Court of Chancery pointed out that the annual meeting where the vote on the amendment was to occur had not been held and might never occur. The Court of Chancery likened Baxter's Section 205 petition to a request for an advisory opinion on an unripe issue and dismissed the case. However, the Court of Chancery acknowledged that Section 205 is a flexible statute "intended to promote equitable outcomes and to provide certainty to stockholders," and that relief under Section 205 may be possible under appropriate circumstances. The Court of Chancery noted that if Baxter held its annual meeting, received sufficient votes counted on a per-share basis to amend, and actually amended its
certificate of incorporation on that basis, Baxter would have a stronger argument that the Court should validate the amendment under Section 205 because a corporate act would have actually occurred.

7. **Dissolution.**


   In *The Huff Energy Fund, L.P. v. Gershen, 2016 WL 5462958 (Del. Ch. Sept. 29, 2016)*, the Court of Chancery rejected a significant stockholder’s claim that the implementation and adoption of a plan of dissolution was subject to enhanced scrutiny under *Revlon* and *Unocal*. Furthermore, finding that the adoption of the plan of dissolution had been approved by a fully informed, non-coerced vote of the stockholders, the Court held that under *Corwin* the business judgment rule irrebuttably applied to the board’s decision to approve the plan of dissolution and granted the defendants’ motion to dismiss.

   In *Huff Energy*, The Huff Energy Fund, L.P. (“Huff Energy”), the holder of approximately 40% of the issued and outstanding shares of common stock of Longview Energy Company (“Longview”), challenged the adoption and implementation of a plan of dissolution in connection with the sale of a significant portion of Longview’s assets. The plan of dissolution and asset sale were approved by Longview’s board of directors and stockholders following Longview’s active pursuit of a liquidity event that had allegedly been motivated by the desire of Longview’s chief executive officer and chief operating officer (each of whom also served as a director) to trigger the significant severance payments upon a change of control under their employment agreements. At the board meeting to approve the sale and dissolution, one of the directors designated by Huff Energy who was present abstained from voting due to “the insufficiency of information and the rushed nature of the process.” The abstention and the reasons for it were not disclosed in the proxy statement soliciting the vote of Longview’s stockholders. Following the adoption and implementation of the plan of dissolution, Huff Energy filed an action in the Court of Chancery against Longview and the directors not designated by Huff Energy, alleging, among other things, that the directors had breached their fiduciary duties and had violated a stockholder agreement in adopting and implementing the plan of dissolution.

   Addressing Huff Energy’s fiduciary claims, the Court held that Huff Energy had failed to allege facts allowing for a reasonable inference that a majority of the board acted under a disqualifying conflict of interest with respect to the decision to adopt and implement the plan of dissolution. The Court then turned to Huff Energy’s claims that the decision was subject to enhanced scrutiny under *Revlon* or *Unocal*. With respect to the applicability of *Revlon*, the Court explained that policy concerns implicated by “final stage” transactions such as a cash sale, breakup or change of control transaction were not present in the dissolution context because Longview would continue its existence for a period of at least three years following its dissolution to wind up its affairs. During the wind-up period, the board would maintain its control over Longview and would retain its duty to act in the best interests of Longview’s stockholders as well as its creditors. Accordingly, because the adoption of the plan of dissolution did not constitute a final stage transaction or otherwise constitute a change of control implicating *Revlon* concerns, the Court held that *Revlon* did not apply.
With respect to the applicability of *Unocal*, the Court was unpersuaded by Huff Energy’s argument that adoption and implementation of the plan of dissolution constituted the adoption of an “unreasonable poison pill” due to, among other things, the inability of Longview to purchase any additional shares of common stock following Longview’s dissolution. Noting that the only allegations in the complaint that supported Huff Energy’s argument that *Unocal* applied to the dissolution were that the adoption of the plan of dissolution constituted a defensive measure designed to wrest control over a sale process from Huff Energy and its director designees and that the defendant directors perceived Huff Energy as a threat to the chief executive officer’s power over Longview, the Court found that Huff Energy had failed to cite any support for the proposition that such allegations implicated the “omnipresent specter” present in cases invoking *Unocal* scrutiny. In particular, the Court noted that the adoption and implementation of a plan of dissolution avoids any specter of entrenchment due to the fact that following dissolution, the corporation is required to wind up its affairs. Accordingly, the Court held that *Unocal* did not apply.

Following its determination that *Revlon* and *Unocal* did not apply, the Court noted that even if the adoption and implementation of the plan of dissolution did implicate some form of enhanced scrutiny, the approval of the plan of dissolution by the Longview stockholders cleansed the transaction, thereby irrebuttably reinstating the protection of the business judgment rule under *Corwin*. In so holding, the Court rejected Huff Energy’s argument that the vote of the stockholders was not fully informed due to the failure of the proxy statement to include the fact that Huff Energy’s designee had abstained from the decision to approve the dissolution and the reasons for his abstention. Stating that Delaware law is clear that individual directors need not state the grounds of their judgment for or against a proposed stockholder action, the Court further explained that the fact of an abstention was not material because the adoption of the plan of dissolution did not require unanimous approval. Accordingly, because the information was not material and the omission of the information was not misleading, the Court held that Huff Energy failed to plead that the stockholder vote was uninformed. As such, and in the absence of any allegations that the stockholder vote was coerced or tainted by interestedness, the Court held that *Corwin* applied and dismissed the fiduciary claims against the director defendants.

In addition to rejecting the fiduciary claims raised by Huff Energy, the Court also held that the approval of the plan of dissolution did not constitute a breach of the stockholder agreement between Longview, Huff Energy and the other stockholders party thereto. As a preliminary matter, the Court upheld settled Delaware law that only a party to an agreement may be sued for breach of such agreement and held that individual Longview directors could not be held individually liable for a breach of the stockholder agreement because those directors had not signed the stockholder agreement in an individual capacity.

With respect to Huff Energy’s claims that Longview breached the stockholder agreement, Huff Energy highlighted, among other things, a provision that required unanimous board approval of “any action or omission that would have a material adverse effect on the rights of any Shareholder, as set forth in [the stockholder agreement].” In rejecting Huff Energy’s claim that the approval of the plan of dissolution triggered the unanimous board approval requirement, the Court held that the requirement only applied to rights created by the agreement, such as the right to designate two directors to the board (which the Court noted “continue[d] without infringement throughout the winding up process”) and not rights merely referenced in such
agreement, such as the right of Huff Energy to transfer shares of its Longview stock. The Court was also unpersuaded that the approval of the plan of dissolution violated a covenant under the stockholder agreement that Longview “continue to exist,” which the Court noted “appear[ed] to be nothing more than a recognition by Longview that it will remain in good standing as a Delaware corporation” and was not a provision that required Longview to “exist eternally unless Huff Energy agrees otherwise.”

8. **Stock Option Plans.**


   In *In re Investors Bancorp, Inc. Stockholder Litigation, 2017 WL 1277672 (Del. Ch. Apr. 5, 2017)*, the Court of Chancery granted defendants’ motion to dismiss claims challenging the adoption of an equity compensation plan by the board of directors of Investors Bancorp, Inc. (“Investors Bancorp” or the “Company”). The Court held that because the plan contained discrete limits with respect to director equity awards, the ratifying effect of approval of the plan by a fully informed stockholder vote extended to individual awards made pursuant to the plan.

   The Company was created in December 2013 through a “mutual-to-stock” reorganization transaction of a two-tier mutual holding company bearing the same name. Following the reorganization, the surviving Company’s board was comprised of twelve directors, including ten non-employee directors, the chief executive officer, and the chief operating officer.

   Seven of the ten non-employee directors served on the compensation committee of the board, which is charged with making recommendations to the board concerning director compensation. On December 15, 2014, the compensation committee met to set compensation for the upcoming year. The committee recommended the board maintain the existing compensation arrangements for non-employee directors and maintain the base salaries of the chief executive officer and chief operating officer, but increase the cash incentive component of their compensation packages.

   On March 24, 2015, the board approved the Company’s 2015 Equity Incentive Plan, which reserved approximately 31 million shares for various types of equity-based awards for the Company’s officers, employees, non-employee directors, and service providers. Within that ceiling, the plan limited the number of shares of each type that could be issued and the number of shares the Company could award to any one employee or director, as well as the maximum percentage of total shares available to be awarded that could be issued to non-employee directors in the aggregate.

   The plan was submitted to stockholders at the Company’s 2015 annual meeting. Over 96% of the shares voted at the meeting—representing nearly 80% of the total shares then outstanding—voted to approve the plan. The proxy statement for the annual meeting disclosed the purpose and limits of awards pursuant to the plan. The proxy statement also disclosed that the number, type, and terms of any specific awards to be made pursuant to the plan would remain subject to the compensation committee’s discretion and would not be determined until after stockholder approval of the plan.
On June 23, 2015, based on the compensation committee’s post-approval recommendations, the board approved equity incentive awards to the non-employee and employee directors that had an aggregate fair value as of the grant date of approximately $51.5 million. The Company announced the equity awards in a Schedule 14A Proxy Statement issued on April 14, 2016. Three complaints were filed shortly thereafter and were soon consolidated.

In reviewing plaintiffs’ claims in respect of the non-employee director grants, the Court presumed that, because every member of the board who made the decision to grant the awards received a special benefit from the decision, “entire fairness [would be] the default standard of review.” To overcome the entire fairness standard, defendants needed to establish that the stockholders’ approval of the plan had the effect of ratifying the awards, in which case the board’s decision would be subject to the presumption of the business judgment rule.

Plaintiffs raised three principal arguments in response to the affirmative defense of ratification. First, plaintiffs claimed that the awards were not ratifiable because the plan lacked a “self-executing” feature (i.e., one that would provide for fixed amounts of awards to the non-employee directors with no board discretion to increase or enhance such awards) or “meaningful limits” on the amount of awards. Second, plaintiffs claimed that the board could have sought stockholder approval of the specific grants, but failed to do so. Finally, plaintiffs claimed that the stockholder ratification was ineffective because the stockholder vote was not fully informed.

The Court concluded that the plan was not so broad as to preclude ratification. The Court rejected plaintiffs’ attempt to analogize the plan to the equity incentive plan that was reviewed under entire fairness in Calma v. Templeton, in which the Court had concluded that the stockholders’ adoption of the “broad parameters” of a plan that covered multiple beneficiaries and had no specific limits on the magnitude of awards to non-employee directors was insufficient to ratify subsequent grants to the non-employee directors. Rather, the Court determined that the fact that the plan was a company-wide “omnibus stock plan,” as opposed to a director-specific plan, was not dispositive. Analogizing to the Court’s decision in In re 3COM Shareholders Litigation, the Court determined that the “key point is the specific focus on the limit or limits imposed on awards to various beneficiaries of the plan.” The Court found that the board, in seeking stockholder approval of the plan, had not sought a “blank check” on awards to directors; instead, the stockholders were advised when approving the plan of the maximum number of shares of each type of award available, limits pertaining to non-employee and executive directors, and the magnitude of the potential awards board members could make to themselves when approving the plan.

As the grants to the non-employee directors were made within the confines of the specific limits indicated by the stockholder-approved plan, the board’s decision to make the grants was reviewable only for waste, which plaintiffs had not pled. Accordingly, the Court dismissed plaintiffs’ claims challenging the non-employee director grants.

The Court separately rejected plaintiffs’ disclosure-based claims, holding that demand on the board was not excused in respect of the specific grants of equity compensation to the executive officer defendants in the absence of facts indicating that the executive officers would not have supported the awards to non-employee directors had their own awards not been approved and because the votes of the executive officers were not required for approval of the plan.
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The Court’s decision has been appealed to the Delaware Supreme Court.


In \textit{CDX Holdings, Inc. v. Fox}, 141 A.3d 1037 (2016), the Delaware Supreme Court, applying a “clearly erroneous” standard of review, deferred to the Court of Chancery’s findings of fact and upheld the Court of Chancery’s determination that a corporation breached its stock option plan in connection with a spinoff and merger transaction.

Caris Life Sciences, Inc. (“Caris”), a privately held Delaware corporation, operated three business units: Caris Diagnostics, TargetNow, and Carisome. With the goal of securing financing for TargetNow and Carisome and generating a return for its stockholders, Caris sold Caris Diagnostics (its only consistently profitable business unit) to Miraca Holdings, Inc. (“Miraca”). To facilitate the transaction, Caris conducted a spinoff by first transferring ownership of TargetNow and Carisome to a new subsidiary and then spinning off that subsidiary to Caris’s stockholders. Following the consummation of the spinoff, Caris was merged with a wholly owned subsidiary of Miraca (the “Merger” and, together with the spinoff, the “Transaction”). The Court found that the Transaction was structured in this manner to minimize taxes.

Following the Merger, holders of options granted under Caris’s 2007 Stock Incentive Plan (the “Plan”) brought claims against Caris asserting that the Plan had been breached in connection with the Transaction. Under the terms of the Plan, each Caris option holder had the right to receive in the Merger the amount by which the Fair Market Value (as defined in the Plan) of each share exceeded the exercise price. Under the Plan, Fair Market Value was defined as an amount determined by the board of directors of Caris (the “Board”). The Board was also the administrator under the Plan. Under the Plan, the Board’s good faith determination of Fair Market Value was conclusive unless it was the result of an arbitrary and capricious process. The Plan also required the Board, as administrator, to adjust the options to account for the spinoff. Plaintiff claimed that Caris breached the Plan because members of management, not the Board, determined the value that the option holders would receive in the Transaction. Plaintiff further claimed that, regardless of who made the determination, the process utilized was arbitrary and capricious and therefore the determination was not made in good faith.

The Court of Chancery found that, rather than the Board, Caris’s chief financial officer (who was also its chief operating officer) had made the value determination required under the Plan, which determination was later signed off on by Caris’s founder. The Court further found that regardless of who made the value determination, the value received by the option holders in the Transaction was not determined in good faith because the value determination was made to obtain tax-free treatment of the spinoff rather than to accurately ascertain the Fair Market Value of the stock under the Plan. Finally, the Court found that the chief financial officer engaged in an arbitrary and capricious process to determine such value. In accordance with these findings, the Court of Chancery concluded that Caris breached the Plan and awarded plaintiff damages, plus pre- and post-judgment interest.

Upon review, the Delaware Supreme Court, in a majority opinion, noted that findings of historical fact are subject to the deferential “clearly erroneous” standard of review. The Court explained that it “must give deference to findings of fact by trial courts when supported by the
record, and when they are the product of an orderly and logical deductive reasoning process, especially when those findings are based in part on testimony of live witnesses whose demeanor and credibility the trial judge has had the opportunity to evaluate.” Stating that “the record in this appeal compels an application of that standard of appellate review,” the Delaware Supreme Court affirmed the judgment of the Court of Chancery.

In a lengthy dissent, Justice Valihura disagreed with the majority opinion and concluded that because “[t]he Court of Chancery’s ultimate findings are logically disconnected from the record evidence before it, from the trial court’s own immediate, on the record impressions of the trial, and from the requirements of the legal test established by the Plan,” the Court of Chancery’s findings were not entitled to deference. In this regard, Justice Valihura noted, among other things, that plaintiff was required to prove that the board breached its contractual duty of subjective good faith either by demonstrating that the board acted in subjective bad faith or by showing that it consciously disregarded a known duty to act. Notwithstanding the requirement that plaintiff make such a showing, the dissent found that the Court of Chancery did not make, and that the record below did not support, any finding that the Board acted in subjective bad faith or consciously disregarded a known duty to act. In support of this finding, the dissent noted, among other things, that the Board engaged legal counsel and hired an independent advisor to assist the directors in determining the Fair Market Value of the stock in connection with the Transaction.

In addition to the foregoing reasons for not according deference the Court of Chancery’s conclusions, the dissent also stated that such conclusions were not entitled to deference due to the Court of Chancery’s implicit rejection of trial testimony of the directors on the basis of a “hindsight bias” theory. The dissent explained: “In my view, this Court should be skeptical of court rulings predicated on social science studies, particularly where, as here, such theories impact a trial court’s own post-trial impressions of the testimony offered.”


In In re Wal-Mart Stores, Inc. Delaware Derivative Litigation, 2016 WL 2908344 (Del. Ch. May 13, 2016), the Court of Chancery, applying Arkansas law, held that plaintiff stockholders were precluded from arguing demand futility in a derivative action filed in Delaware because the same issue had already been fully litigated and decided in an Arkansas court by adequate representatives in privity with the stockholder plaintiffs in the Delaware action. On this basis, the Court of Chancery granted the defendants’ motion to dismiss.

In 2012, the New York Times published an article alleging that employees of a foreign subsidiary of Wal-Mart Stores, Inc. (“Wal-Mart”), Wal-Mart de Mexico (“WalMex”), had bribed Mexican government officials. After the publication of the New York Times article, Wal-Mart stockholders filed fifteen derivative suits in Delaware and Arkansas, Wal-Mart’s place of incorporation and Wal-Mart’s headquarters, respectively.

Plaintiffs in the actions filed in the Court of Chancery (the “Delaware Plaintiffs”) demanded inspection of Wal-Mart’s books and records under Section 220 of the General
Corporation Law of the State of Delaware ("Section 220"), seeking to uncover information in support of their derivative claims. Following Wal-Mart’s production of certain documents in response to the Section 220 demand, the Delaware Plaintiffs filed a complaint under Section 220 alleging deficiencies in Wal-Mart’s document production (the “220 Action”). Ultimately, the Delaware Plaintiffs obtained some of the additional documents sought, but the 220 Action took three years to resolve and involved proceedings in the Court of Chancery and an appeal to the Delaware Supreme Court.

In the actions filed in Arkansas, plaintiffs did not seek access to Wal-Mart’s books and records, and instead determined to move forward with their lawsuit without waiting for the outcome of the 220 Action. Wal-Mart moved to dismiss the Arkansas complaint for failure to adequately allege demand futility. About a month before the 220 Action was resolved, Wal-Mart prevailed on its motion to dismiss in Arkansas, and the Arkansas case was dismissed with prejudice.

After the 220 Action was resolved, the Delaware Plaintiffs filed a complaint alleging a single count of breach of fiduciary duty related to the alleged cover-up of the WalMex bribery. Wal-Mart then moved to dismiss the Delaware action, arguing, among other things, that the Arkansas judgment precluded the Delaware Plaintiffs from re-litigating demand futility.

The Court of Chancery, analyzing the issue under Arkansas law, concluded that the Delaware Plaintiffs were precluded from re-litigating demand futility in light of the Arkansas judgment because: (i) the issue was the same in both actions; (ii) the issue was actually litigated in Arkansas; (iii) the issue was determined by a valid and final judgment; (iv) the determination was essential to the judgment; (v) although the Delaware Plaintiffs were not the same parties as the Arkansas plaintiffs, they were in privity; and (vi) the Delaware Plaintiffs were adequately represented in the Arkansas litigation.

Although the Court’s analysis involved whether the elements of issue preclusion were met under Arkansas law, including whether the Delaware Plaintiffs were adequately represented in the Arkansas litigation, the Court’s holding has implications for multi-forum litigation. As explained in the Court’s analysis, the Delaware Supreme Court has previously noted that there is no requirement that a plaintiff bring an action under Section 220 in order to be considered an adequate representative under Delaware law, but Delaware courts have also encouraged plaintiffs to use all of the “tools at hand” (including Section 220) to investigate derivative claims before filing suit. The Court of Chancery concluded that while the Arkansas plaintiffs’ litigation strategy may have been “imperfect” and the decision not to pursue books and records under Section 220 potentially “ill-advised,” it was not “so grossly deficient as to render them inadequate representatives” for purposes of the issue preclusion analysis. Thus, while pursuing a pre-suit Section 220 demand may have provided the Delaware Plaintiffs with useful information to support their claim against Wal-Mart’s directors, they were ultimately unable to pursue such claim due to the actions of plaintiffs in another jurisdiction.

The Court of Chancery’s decision was appealed to the Delaware Supreme Court and, on January 18, 2017, the Court remanded the case back to the Court of Chancery for the limited purpose of answering the following question: “In a situation where dismissal by the federal court in Arkansas of a stockholder plaintiff’s derivative action for failure to plead demand futility is held by the Delaware Court of Chancery to preclude subsequent stockholders from pursuing

10. **Dividends, Repurchases and Redemptions.**


   In *The Frederick Hsu Living Trust v. ODN Holding Corp., 2017 WL 1437308 (Del. Ch. Apr. 25, 2017)*, the Court of Chancery dismissed claims of unlawful redemption of preferred stock by ODN Holding Corporation (“ODN” or the “Company”), but denied a motion to dismiss claims that ODN’s directors and officers improperly favored the interest of the Company’s controlling stockholder in connection with the Company’s redemption of preferred stock to the detriment of the long-term interests of ODN’s stockholders.

   In 2008, funds sponsored by venture capital firm Oak Hill Capital Partners (“Oak Hill”) invested $150 million in internet technology company Oversee.net, which formed ODN as a holding company to facilitate the investment. Oak Hill received shares of Series A Preferred Stock from the Company in return for its investment. The terms of the preferred stock included a mandatory redemption right after five years—provided that ODN had sufficient surplus, calculated in accordance with Section 160 of the Delaware General Corporation Law (the “DGCL”), and “funds legally available” to effect the redemptions. The Company had an obligation to generate funds for redemptions through “‘reasonable actions (as determined by [ODN’s] Board of Directors in good faith and consistent with its fiduciary duties).’”

   Plaintiff alleged that, beginning in 2011, Oak Hill caused the Company to shift from a growth-oriented strategy to a single-minded focus on amassing cash reserves that could be used for redemptions, beginning with selling two of ODN’s four lines of business for a third of the price it had paid for them. By the end of 2012, the Company had accumulated a $50 million reserve. Shortly before Oak Hill’s redemption rights became exercisable, ODN appointed a special committee tasked with evaluating the Company’s options for raising capital and negotiating the terms of any redemptions. In turn, the special committee tasked three ODN officers with creating a proposal for Oak Hill. The officers, whose employment agreements granted them special payments if the Company redeemed at least $75 million of the preferred stock, advised the special committee that the Company required a cash reserve of only $10 million. They proposed that the Company use the remaining $40 million of accumulated cash and borrow an additional $35 million in order to redeem $75 million worth of the preferred stock, conditioned upon Oak Hill’s agreement not to seek redemption of the rest of its preferred stock until 2017. This proposal was unacceptable to Oak Hill, and the Company and Oak Hill were unable to reach an agreement before the redemption right matured.

   On February 1, 2013, Oak Hill informed the special committee that it intended to exercise its redemption right on February 13, the earliest possible date. Knowing that the Company did not have sufficient funds to redeem the preferred stock in full, Oak Hill proposed that the Company make a redemption payment of $45 million. In exchange for this payment, Oak Hill
would agree to delay additional redemption payments until year-end 2013, but would have the right to cancel the forbearance agreement and demand additional redemptions on thirty days’ notice. Despite the fact that Oak Hill had no ability to compel the Company to make redemptions except out of legally available funds, the accrual of which was subject to the board’s business judgment, the special committee resolved to recommend that the board accept Oak Hill’s terms. The special committee realized that redeeming $45 million would leave the Company with a reserve of only $5 million, but the officers had revised their assessment of the necessary cash reserve down to $2 million.

On February 13, 2013, Oak Hill demanded redemption in full. The Company reclassified Oak Hill’s preferred stock as a current liability on its balance sheet in the amount of $150 million in accordance with generally accepted accounting principles (“GAAP”). When the board met to consider Oak Hill’s redemption demand on February 27, 2013, however, it did not treat the preferred stock as a current liability, which would have resulted in the Company having a deficit of $60 million and being unable to redeem any of the preferred stock. The board instead concluded that the Company had sufficient surplus as required by Section 160 of the DGCL to redeem $45 million of preferred stock. ODN made the $45 million payment to Oak Hill on March 18, 2013. Over the next year and a half, the Company implemented a restructuring and sold all but two segments of its business, and used the funds generated by these actions to complete a second redemption of $40 million in September 2014. The aggregate $85 million in redemption payments triggered the officers’ bonuses.

On March 15, 2016, plaintiff sued, alleging that the Company unlawfully redeemed the preferred stock and that by deliberately selling 92% of the income-generating assets of ODN to amass enough cash to effect the redemptions, various defendants breached their duty of loyalty, aided and abetted those breaches, or were unjustly enriched.

The Court rejected the claim that the redemptions violated Section 160 of the DGCL. Notwithstanding the Company’s GAAP-driven reclassification of the preferred stock as a current liability, the Court determined that ODN had sufficient surplus at the time of the redemption. The Court explained that Delaware law treats preferred stock as equity rather than debt, and even a matured redemption right does not convert the holder of preferred stock into a creditor. The Court also held that the complaint failed to plead facts supporting a reasonable inference that the Company would become insolvent as a result of the redemptions, noting that the Company still had $23 million in net assets following the redemptions and a reduced need for cash given its reduced operational footprint.

However, the Court denied the motion to dismiss the claims of breach of fiduciary duty, except as to one director who had resigned in 2011. The Court allowed claims to proceed against the directors (including Oak Hill’s designees on the board, who had abstained from the votes to redeem Oak Hill’s preferred stock), the officers, and Oak Hill itself (both as controlling stockholder and as an alleged aider and abettor).

The Court discussed at length the interplay between the directors’ fiduciary obligations—which generally oblige them to strive to maximize value for the benefit of residual claimants, and
do not oblige them to protect preferred stockholders’ special contractual rights—with the Company’s contractual obligation to “take all reasonable actions (as determined by the [ODN] Board of Directors in good faith and consistent with its fiduciary duties)” to generate sufficient legally available funds to redeem the preferred stock. The Court rejected the claim that the Company’s contractual obligation to Oak Hill superseded the directors’ fiduciary duty to the stockholders, writing that “[e]ven with an iron-clad contractual obligation, there remains room for fiduciary discretion because of the doctrine of efficient breach.” The Court observed that plaintiff alleged that the directors acted disloyally by selling off ODN’s businesses to raise cash to satisfy a future redemption obligation before any contractual obligation to redeem Oak Hill’s preferred stock existed, an allegation that was strengthened by the fact that the redemption provisions contained a fiduciary out to the board’s obligation to raise funds to pay for the redemption.

The Court also discussed the standard of review applicable to a transaction involving a controlling stockholder. Noting that the complaint alleged that Oak Hill exercised control over several of the challenged decisions and that the members of the special committee were subject to well-pleaded allegations of breach of the duty of loyalty, the Court determined that the use of a special committee, without a separate majority-of-the-minority stockholder vote, would not suffice to reduce the standard of review from entire fairness to business judgment. The Court further held that the allegations of misconduct against the special committee members were sufficient to preclude the Court from determining at the pleading stage that the use of the special committee shifted the burden of proof under the entire fairness standard from the defendants to the plaintiffs.

C. Corporate Governance Issues.

1. Directors and Officers


In Pell v. Kill, 135 A.3d 764 (Del. Ch. 2016), the Court of Chancery granted a preliminary injunction enjoining the implementation of a plan to reduce the size of a classified board and to reduce the number of directors in the class of directors standing for election at the next annual meeting that was adopted to neutralize the threat of a proxy contest by one of the corporation’s directors.

In March 2015, Cogentix Medical, Inc. (“Cogentix”), a medical device manufacturer and developer, was formed through a stock-for-stock merger between Vision-Sciences, Inc. (“VSI”) and Uroplasty, Inc. (“Uroplasty”). Cogentix’s classified board consisted of eight members: five former Uroplasty directors and three former VSI directors. Robert C. Kill, the former Uroplasty chief executive officer, president, and chairman, continued in those roles at Cogentix; Lewis C. Pell, co-founder and former chairman of VSI, served as a director. The board was divided into three classes. Class I consisted of three directors, including Pell, former VSI director Howard I. Zauberma, and former Uroplasty director James P. Stauner. The Class I directors’ terms expired in 2016.
Shortly after the merger, disputes arose between Pell and Kill. In February 2016, Pell sent his fellow directors a letter in which he announced his desire to change Cogentix’s management and signaled his willingness to run a proxy contest. Pell was largely critical of Cogentix’s performance under Kill and expressed his belief that Kill had too much control over Cogentix and the board. Two days after the letter was sent, the board held a regularly scheduled meeting, at which it selected the date for its annual meeting and discussed Pell’s letter. After the meeting, the remaining directors chose sides between Pell and Kill, with the VSI-legacy directors siding with Pell and the Uroplasty-legacy directors siding with Kill.

Hoping to avoid a proxy contest, Kill and his strongest supporters—Uroplasty-legacy directors Kevin H. Roche and Kenneth H. Paulus—devised a plan whereby Roche and Paulus would lead the outside directors to identify director nominees who might be acceptable to both Pell and Kill. If a negotiated resolution failed, the three believed Pell would launch a proxy contest to elect himself, Zauberman, and a third Class I director who would be allied with Pell. If Pell succeeded, the board would move from a five-to-three majority in favor of the Uroplasty-legacy directors to a four-four split.

Kill, Roche, and Paulus came up with a “Plan B” to avoid a proxy fight—a board reduction plan that would reduce the size of the board from eight to five directors, with the number of Class I directors reduced from three to one and Class II directors reduced from three to two (after the resignation of a Class II Uroplasty-legacy director) (the “Board Reduction Plan”). Following Pell’s formal nomination of three Class I directors, the board passed the Board Reduction Plan, with the three VSI-legacy directors voting against it.

In April 2016, Pell filed suit in the Court of Chancery, seeking a preliminary injunction to prevent the Board Reduction Plan from taking effect. In determining whether Pell had established a reasonable probability of success on the merits, the Court explained that enhanced scrutiny would apply to the board’s adoption of the Board Reduction Plan. The Court stated that enhanced scrutiny applies “[w]hen there is director conduct ‘affecting either an election of directors or a vote touching on matters of corporate control.’” The Court explained that the Board Reduction Plan affected an election of directors because it reduced the number of seats that the stockholders could vote on from three to one. As such, the Board Reduction Plan had “a clear and obvious effect on the ability of the stockholders ‘to vote either contrary to the will of the incumbent board members generally or to replace the incumbent board members in a contested election.’” It also touched on matters of corporate control because, prior to the plan’s adoption, control over Cogentix “was in play” as the stockholders could have elected three directors that could have formed a new board majority. After the adoption of the Board Reduction Plan, however, the stockholders could only re-elect one incumbent director, without affecting the composition of the board or the direction of Cogentix.

Applying enhanced scrutiny in the context of reviewing director action affecting stockholder voting, the Court explained that enhanced scrutiny requires defendants to prove “(i) that their motivations were proper and not selfish, (ii) that they ‘did not preclude stockholders from exercising their right to vote or coerce them into voting in a particular way,’ and (iii) that the directors’ actions ‘were reasonable in relation to their legitimate objective.’” The Court went on to note that when a vote involves an election of directors or touches on matters of corporate control, the directors’ justification must not only be reasonable, but must be “compelling.” The Court noted that the burden of showing a “compelling” justification requires directors to
establish a closer fit between means and ends and serves as a reminder that courts should approach such situations with a “gimlet eye.”

The Court, assuming that defendants’ motives were proper and not selfish, nevertheless found that Pell had established a reasonable probability of success on the merits due to the unlikelihood of defendants establishing that the Board Reduction Plan was not preclusive. The Court explained that “[f]or a measure to be preclusive, it must render a successful proxy contest realistically unattainable given the specific factual context.” The Court held that in the current context, the Board Reduction Plan made a successful proxy contest realistically unattainable by both eliminating the possibility of success for two board seats (due to the reduction from three seats to one seat) and preventing the stockholders from establishing a new board majority. The Court further noted that even if the Board Reduction Plan was not viewed as preclusive, defendants would likely not be able to show a compelling justification for the plan due to the Court’s determination that the director defendants approved the plan because it “enabled them to avoid a proxy contest . . . that could shift control at the Board level.”

In its discussion of Pell’s likelihood of success on the merits, the Court observed that the results may have been different if the Board Reduction Plan had been approved on a “clear day”—that is, approved not in response to an anticipated proxy contest, but for otherwise legitimate objectives.

In granting the preliminary injunction, the Court further determined that there was a threat of irreparable harm to the stockholders if the injunction was not granted due to the fact that the Board Reduction Plan preordained the results of the annual meeting, thereby depriving the stockholders of their right to vote. Additionally, the Court found that granting the injunction would result in no hardship to the defendant directors. As a result of such determinations, the Court preliminarily enjoined defendants from completing the Board Reduction Plan by reducing the number of seats from seven to five and fixing the number of Class I seats at one until the Court rendered a final decision on the merits.


In *Gorman v. Salamone, 2015 WL 4719681 (Del. Ch. July 31, 2015)*, the Delaware Court of Chancery held that a stockholder-adopted bylaw amendment that purported to grant stockholders the authority to remove corporate officers over the objection of the corporation's board of directors was invalid under Delaware law. In so holding, the Court found that the amended bylaw, which permitted stockholders to remove and replace officers without cause, would allow stockholders to "make substantive business decisions" for the corporation and thereby "unduly interfere with directors' management prerogatives" under Section 141(a) of the General Corporation Law of the State of Delaware (the "DGCL").

The Court of Chancery's opinion in *Gorman* is the most recent installment in an ongoing dispute over the composition of the board of directors of Westech Capital Corp. (the "Company" or "Westech"). *See In re Westech Capital Corp., 2014 WL 2211612 (Del. Ch. May 29, 2014)* (designating a four-member board and determining the composition thereof), *aff'd in part, rev'd in part sub. nom. Salamone v. Gorman, 106 A.3d 354 (Del. 2014)* (designating a five-member board and determining the composition thereof). Critical to both the Court of Chancery's earlier
post-trial opinion (the "Chancery Post-Trial Opinion") and the Delaware Supreme Court's opinion on appeal was the operation of a voting agreement that required the stockholders party thereto to vote, or cause to be voted, their shares of stock to elect as directors the individuals designated in the manner provided in the agreement. In this respect, the voting agreement provided, among other things, for the election of the Company's chief executive officer as a director, provided that if for any reason the chief executive officer were to cease to serve as the chief executive officer, the stockholders party to the agreement were required to vote their shares to remove the chief executive officer from the board and to elect the new chief executive officer to the board.

Following the Chancery Post-Trial Opinion, John Gorman, as the Company's majority stockholder, acted by written consent to amend the bylaws of the Company to provide, among other things, that "[a]ny 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 pursuant to Section 2.8 of these Bylaws. The Board shall, if necessary, immediately implement any such removal of an officer by the stockholders." In reliance on the amended bylaw, Gorman then removed Gary Salamone as the Company's chief executive officer and elected himself to fill the resulting vacancy. Following his appointment as chief executive officer, Gorman sought to appoint a new director to serve in his newly vacant director seat. Thereafter, Gorman filed suit in the Court of Chancery seeking confirmation that, among other things, Salamone was no longer the chief executive officer or a director of the Company.

The Court of Chancery held that the amended bylaw was invalid, stating that "Delaware law does not allow stockholders to remove directly corporate officers through authority purportedly conferred by a bylaw." The Court of Chancery rejected Gorman's argument that Section 142(b) of the DGCL (providing that "[o]fficers shall be chosen in such manner . . . as [is] prescribed by the bylaws or determined by the board of directors") and Section 142(e) of the DGCL (providing that "[a]ny vacancy occurring in any office . . . shall be filled as the bylaws provide") permitted the adoption of a bylaw that would allow stockholders to remove and replace officers. In this regard, the Court explained that neither Section 142(b) nor Section 142(e) expressly provided guidance on how officers may be removed, but only on the manner in which officers could be selected and the manner in which any vacancy in an office could be filled. Thus, the Court found that the amended bylaw was not authorized by Section 142 of the DGCL. In reaching this conclusion, the Court noted that, prior to its 1967 revision, the DGCL explicitly authorized directors or stockholders to elect corporate officers, and notes that Professor Earnest Folk, in the first edition of his treatise on the DGCL, commented that the 1967 revision intended no substantive change. That commentary stated that, while the phrase "by directors or officers" was deleted and the phrase "in the manner provided by the bylaws" was added, the changes were not intended to effect any substantive change as to who may choose the officers.

Turning to the argument that stockholders generally have the power under Section 109 of the DGCL to adopt and amend bylaws "relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees," the Court nonetheless held that the amended bylaw was outside the scope of bylaws permitted by Section 109. In particular, the Court noted that the amended bylaw required the board to "immediately implement any such removal of an officer by the stockholders," thereby allowing the stockholders to remove an officer over the objection of the board.
Explaining that such a directive, if enforceable, "could compel board action, potentially in conflict with its members' fiduciary duties," the Court held that the "stockholders' right to remove officers for any (or no) reason would unduly constrain the board's ability to manage the Company." As a result of such undue constraint, the Court held that the amended bylaw was invalid and that any actions taken in reliance thereon, including the removal of Salamone as chief executive officer, were of no effect.

Notably, the amended bylaw also provided that "[a]ny vacancy occurring in any elected office of the Corporation may be filled by the Board except that any such vacancy occurring as a result of the removal of an officer by the stockholders shall be filled by the stockholders." The Court of Chancery expressly declined to address the validity of this provision, stating that "[t]he Court need not (and does not) analyze [the vacancy-filling] aspect of the Amended Bylaw because its validity is irrelevant to the matter at hand." The Court noted, however, that "[p]ermitting stockholders to set the mode for officer replacement would allow them to dictate a procedure, and would not necessarily step unduly on management's toes."

2. § 220 Actions.


In a post-trial decision, the Court of Chancery ordered respondent Yahoo! Inc. to produce additional documents in response to plaintiff Amalgamated Bank's demand to inspect Yahoo's books and records pursuant to 8 Del. C. § 220. Amalgamated Bank v. Yahoo! Inc., 132 A.3d 752 (Del. Ch. Feb. 2, 2016). In doing so, the Court interpreted Section 220 to provide for the production of electronically stored information in addition to physical documents.

The facts centered on Yahoo's hiring of Henrique de Castro as its chief operating officer in October 2012 and de Castro's subsequent termination just 14 months later. The Court of Chancery examined the details surrounding: (i) the involvement of Yahoo's board of directors and Compensation Committee in the hiring process, (ii) the value of de Castro's compensation package, (iii) the termination of de Castro, (iv) the payout de Castro received upon termination, and (v) the alleged unilateral involvement of Yahoo's CEO, Marissa Mayer, in the hiring and firing of de Castro and the construction of his compensation package.

Amalgamated filed its first demand for inspection of Yahoo's books and records on February 24, 2014, for the purpose of investigating "potential mismanagement, including mismanagement in connection with the payment of compensation to a corporation's officers and directors." Throughout 2014, Amalgamated and Yahoo engaged in negotiations surrounding the demand, and Yahoo eventually produced 677 pages of documents. When Yahoo denied Amalgamated's demand for additional categories of documents, Amalgamated filed suit on March 10, 2015.

The Vice Chancellor's opinion offers clarification on what is sufficient to meet the statutory "form and manner" requirements necessary for bringing a books and records demand under 8 Del. C. § 220. Yahoo argued that Amalgamated failed to prove that it owned Yahoo stock at the time the demand was filed because the proof submitted by Amalgamated was dated
three days before the date demand was made—as opposed to being dated the same day as the demand—but the Court rejected that argument. The Vice Chancellor ruled that Section 220 only requires "documentation sufficient in time to the date of demand as to be consistent with and corroborate the averment of stock ownership made in the demand itself." Additionally, the Court found that Amalgamated was not required to provide Yahoo with an ongoing stream of ownership records to confirm continuous ownership of stock.

The Court also analyzed the sufficiency of Amalgamated's stated purpose of demanding inspection of Yahoo's books and records to investigate potential corporate wrongdoing in connection with de Castro's hiring and firing. Distinguishing Se. Pa. Transp. Auth. v. Abbvie, Inc., 2015 WL 1753033 (Del. Ch. Apr. 15, 2015), aff'd, 2016 WL 235217 (Del. Jan. 20, 2016), the Court held that Amalgamated had not limited its stated purposes to investigating potential causes of action that would be subject to exculpation, but rather had met the "credible basis" standard with respect to its potential claims for breach of the duty of good faith and waste.

The Court then turned to the scope of inspection. Amalgamated sought production of emails and other files of Yahoo's CEO, Marissa Mayer. The Court found that "[t]he evidence establishes that the Mayer Documents are necessary for a meaningful investigation of de Castro's hiring," due to the direct and personal involvement Mayer had with the negotiations and hiring of de Castro. The Court reached a similar conclusion with regard to Mayer's documents relating to de Castro's termination. The Court ruled that the "scope of the production of the Mayer Documents will include email and other electronic documents, which count as corporate books and records." The Vice Chancellor rejected Yahoo's argument that such documents are not subject to 8 Del. C. § 220 because the language of the statute does not explicitly mention electronic information. The Court reasoned that "[a]s with other categories of documents subject to production under Section 220, what matters is whether the record is essential and sufficient to satisfy the stockholder's proper purpose, not its source." The Court further clarified that the production of Mayer's emails should include emails from any personal account she may have used to conduct Yahoo business.

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The Vice Chancellor also ordered Yahoo to produce emails and other electronically stored documents in the possession of the members of Yahoo's Compensation and Leadership Development Committee, to the extent those documents related to de Castro's hiring or termination. The Court also ordered additional production of documents relating to Yahoo's director recruitment process.

The Court rejected Amalgamated's request for production of documents reflecting consultations with counsel. Recognizing that those documents could be subject to production, notwithstanding the attorney-client privilege and work-product doctrine, under Garner v. Wolfinbarger, 430 F.2d 1093 (5th Cir. 1970), the Court determined that it would require Yahoo to log communications with counsel relating to the subjects of the inspection, to the extent those communications were identified in searching for documents produced pre-litigation or in response to the Court's order. The Court left open the possibility that Amalgamated might later show that these privileged documents might be essential to the proper purpose of inspection.

Finally, on an issue of first impression, the Vice Chancellor found that any further document production by Yahoo "is conditioned on Amalgamated agreeing that the entirety of
Yahoo's production in response to the Demand is incorporated by reference in any derivative action complaint it files relating to the subject matter of the demand." The Court explained the basis for this condition as a means to protect Yahoo and the Court from the filing of a complaint based on "cherry-picked documents," and to prevent Amalgamated from forging a complaint based on a few documents taken out of context.

D. Controlling Stockholder Issues.


In In re Cornerstone Therapeutics Inc. Stockholder Litigation, 115 A.3d 1173 (Del. 2015), the Delaware Supreme Court resolved two consolidated interlocutory appeals. In the underlying cases (In re Zhongpin Inc. Stockholders Litigation, 2014 WL 6735457 (Del. Ch. Nov. 26, 2014) and In re Cornerstone Therapeutics Inc. Stockholder Litigation, 2014 WL 4418169 (Del. Ch. Sept. 10, 2014)), the Court of Chancery refused to dismiss independent directors because the governing standard of review was held to be entire fairness.

The Supreme Court reversed and remanded, holding that a "plaintiff seeking only monetary damages must plead non-exculpated claims against a director who is protected by an exculpatory charter provision to survive a motion to dismiss, regardless of the underlying standard of review for the board's conduct—be it Revlon, Unocal, the entire fairness standard, or the business judgment rule." Therefore, even in a situation where entire fairness applies ab initio, independent directors may seek dismissal under a charter provision authorized by 8 Del. C. § 102(b)(7) where the plaintiffs are solely seeking monetary relief.


In four opinions issued within three months of one another, four different members of the Delaware Court of Chancery have considered, at the motion to dismiss procedural stage, whether allegations in a complaint were sufficient to establish that a minority stockholder constituted a controlling stockholder under Delaware law. In In re KKR Financial Holdings LLC Shareholder Litigation, 101 A.3d 980 (Del. Ch. 2014), In re Crimson Exploration Inc. Stockholder Litigation, 2014 WL 5449419 (Del. Ch. Oct. 24, 2014), and In re Sanchez Energy Derivative Litigation, 2014 WL 6673895 (Del. Ch. Nov. 25, 2014), the Court concluded that the minority stockholder at issue did not constitute a controlling stockholder, while in In re Zhongpin Inc. Stockholders Litigation, 2014 WL 6735457 (Del. Ch. Nov. 26, 2014), the Court found that allegations that a minority stockholder controlled a company and its board of directors were sufficient to withstand a motion to dismiss.
Chapter 1—Recent Developments in Delaware Corporate Law

**KKR Financial** involved a suit challenging the acquisition of KKR Financial Holdings LLC ("KFN") by KKR & Co. L.P. ("KKR"). The Court held that KKR, which owned less than 1% of KFN's stock, was not a controlling stockholder despite allegations that a KKR affiliate managed the day-to-day business of KFN and that KFN was used primarily as a public vehicle for financing KKR-sponsored transactions. In dismissing the complaint, the Court focused on whether KKR had the ability to control the board of directors of KFN and found that the complaint lacked any allegation that KKR had a contractual right to appoint members of the board of directors, that KKR dictated any specific course of action to the board of directors, or that KKR prevented the members of the board of directors from exercising their judgment in determining whether or not to approve the merger with KKR. Accordingly, the Court held that the plaintiffs had failed to demonstrate that it was reasonably conceivable that KKR was a controlling stockholder under Delaware law and dismissed the complaint.

In **Crimson Exploration**, the plaintiffs alleged that Oaktree Capital Management and its affiliates ("Oaktree") collectively controlled Crimson Exploration Inc. ("Crimson") based on Oaktree's ownership of 33.7% of Crimson's voting stock, its status as a large creditor of Crimson and its designation of a majority of Crimson's directors and senior management (including three directors employed by Oaktree). After reviewing relevant Delaware precedent, the Court explained that a minority stockholder will not be considered a controlling stockholder unless the minority stockholder actually controls the board's decisions about the challenged transaction. The Court then found that the complaint had failed to plead specific allegations that Oaktree controlled the actions of the board of directors during its negotiation of the merger. Thus, although the Court noted its hesitancy to conclude that the complaint's other allegations could not conceivably state a claim that Oaktree was a controller, the Court ultimately decided that the plaintiffs' complaint (which the Court characterized as supplying "little in the way of specific allegations of control") nevertheless failed to show that Oaktree was conflicted as to the transaction or received some unique benefit from the transaction, and consequently failed to plead that the entire fairness standard applied to the transaction.

In **Sanchez Energy**, the Court examined the controller issue in the context of a derivative action governed by the stricter pleading requirements of Court of Chancery Rule 23.1. The Plaintiffs argued that the failure to make a demand on the board of directors of Sanchez Energy Company should be excused because two of the company's co-founders and the collective owners of 21.5% of its stock, A.R. Sanchez Jr. (the company's board chairman) and his son A.R. Sanchez III (the company's chief executive officer), were controlling stockholders who exercised direct managerial control over the company, and the transaction at issue involved another company in which they were investors. While the plaintiffs had alleged that the Sanchezes directed the company's management, the Court found that they did not exercise greater control over the company than that typical of a chief executive officer. Further, citing **KKR Financial** and **Crimson Exploration**, the Court held that, absent particularized allegations that the Sanchezes controlled the decisions of the board of directors with respect to the challenged transaction, the plaintiffs failed to plead sufficiently that the Sanchezes were controlling stockholders under Delaware law.

In contrast to **KKR Financial**, **Crimson Exploration** and **Sanchez Energy**, the Court in **Zhongpin** denied a motion to dismiss, finding that the plaintiffs had sufficiently pleaded indicia of domination to raise an inference that Xianfu Zhu, the founder of Zhongpin Inc. ("Zhongpin"),
was a controlling stockholder under Delaware law. Zhu held 17.3% of the outstanding voting stock of Zhongpin and was also Zhongpin's chairman of the board and chief executive officer. The plaintiffs, former stockholders of Zhongpin, challenged a going-private transaction in which Zhu acquired all of the company's outstanding stock, alleging that Zhu was a controlling stockholder that stood on both sides of the transaction. Unlike in Sanchez Energy, the Court determined that the plaintiffs' allegations (gleaned primarily from the company's own disclosures in a Form 10-K filed with the Securities and Exchange Commission) supported an inference that Zhu exercised significantly more power over Zhongpin than would be expected of a chief executive officer and 17% stockholder. In addition to crediting the plaintiffs' argument that the alleged controller possessed active control over Zhongpin's day-to-day operations, the Court found that the complaint raised an inference that Zhu possessed latent control over Zhongpin through his stock ownership. The Court noted that disclosure in the company's 10-K cited by the plaintiffs implied that Zhu could exercise significant influence over stockholder approvals for the election of directors, mergers and acquisitions, and amendments to the company's bylaws.

In addition, in Zhongpin and another controlling stockholder case recently decided by the Court, In re Cornerstone Therapeutics Inc. Stockholder Litigation, 2014 WL 4418169 (Del. Ch. Sept. 10, 2014), rev'd, 115 A.3d 1173 (Del. 2015), a separate issue arose as to whether, assuming entire fairness review applied to claims against a controlling stockholder, claims against the disinterested directors could nevertheless be dismissed at the pleading stage because they were exculpated from personal liability under a company's certificate of incorporation. The disinterested directors in both cases argued that in the absence of any allegations raising an inference that they breached any non-exculpated duty, the exculpation provision in the company's certificate of incorporation mandated dismissal even if the Court concluded that entire fairness was the operative standard of review. In both Cornerstone and Zhongpin, the Court held that, despite the persuasive force of the argument, precedent directs that the Court must await a developed post-trial record before determining the liability of the directors. In both cases, the independent directors appealed to the Delaware Supreme Court. The Court’s decision was appealed to Delaware Supreme Court and was reversed. See discussion of In re Cornerstone Therapeutics Inc. Stockholder Litigation, 115 A.3d 1173 (Del. 2015), above.

E. Alternative Entities.


In the latest in a series of decisions addressing conflict of interest transactions involving Delaware limited partnerships, the Delaware Supreme Court confirmed in Dieckman v. Regency GP LP, C.A. No. 11130 (Del. Jan. 20, 2017), that although Delaware courts will enforce clear, express and unambiguous language modifying or eliminating default fiduciary duties, a conflict of interest transaction may still run afoul of implied contractual standards.

In Dieckman, the transaction at issue involved a merger of Regency Energy Partners LP, a publicly traded Delaware limited partnership (the "MLP"), with an affiliated entity. To reconcile this inherent conflict of interest, the general partner of the MLP attempted to satisfy two safe harbor mechanisms enumerated in the partnership agreement, either of which could be used to insulate the transaction from legal challenge—"Special Approval" by an independent Conflicts Committee and "Unaffiliated Unitholder Approval." The plaintiff, a common
unitholder of the MLP, alleged that (1) the general partner failed to satisfy the Special Approval safe harbor because there was a conflicted member on the Conflicts Committee, and (2) the general partner failed to satisfy the Unaffiliated Unitholder Approval safe harbor because the general partner made false and misleading statements in a proxy statement to secure such approval. The Court of Chancery, while not reaching the defendants' Special Approval defense, found that the Unaffiliated Unitholder Approval safe harbor had been satisfied because (i) the partnership agreement had eliminated all fiduciary duties, including the duty of disclosure, and (ii) the disclosures expressly required by the partnership agreement had been made. The Court of Chancery therefore granted the defendants' motion to dismiss.

On appeal, the Delaware Supreme Court noted that even when a partnership agreement waives fiduciary duties, investors of publicly traded partnerships still have protections afforded to them through principles of *contra proferentem* (ambiguities are construed against the drafter to give effect to the reasonable expectations of the investors) and the implied covenant of good faith and fair dealing. The Supreme Court focused on the safe harbor process in its entirety and found that the language in the partnership agreement's conflict resolution provision implicitly required the general partner to act in a manner that would not undermine the protections afforded to the unitholders in connection with the safe harbor process.

In analyzing the Unaffiliated Unitholder Approval defense, the Supreme Court noted that the general partner had issued a comprehensive proxy statement, which went far beyond the minimal disclosures required by the express terms of the partnership agreement, to induce the unitholders to approve the merger transaction. The Supreme Court held that once the general partner determined to go beyond the minimal disclosure requirements under the partnership agreement, then—pursuant to the implied covenant of good faith and fair dealing—the general partner had an obligation not to mislead investors. The Supreme Court found that the plaintiff pled facts raising sufficient doubt concerning whether the proxy statement misled investors by creating the false appearance that the Conflicts Committee, which had approved the transaction, was composed solely of unaffiliated and independent persons.

In analyzing the Special Approval defense, the Supreme Court found the general partner had an obligation to form a conflicts committee as set forth in the partnership agreement, which required committee members to be independent from and unaffiliated with the general partner. The plaintiff alleged the general partner created a two-member committee that included an individual who began reviewing the merger transaction while still a member of an affiliate board, which is not consistent with the independent status of the Conflicts Committee members as required by the partnership agreement. The Supreme Court concluded that the plaintiff had raised sufficient doubt as to whether the Conflicts Committee was properly constituted, which would call into question whether the general partner could utilize the safe harbor provisions under the partnership agreement to preclude judicial review of the merger transaction.

The *Dieckman* decision is a reminder that although contractual flexibility afforded to Delaware limited partnerships can be used to provide general partners with significant protections, general partners must still comply with implied contractual responsibilities in the partnership agreement.

In *El Paso Pipeline GP Company, L.L.C. v. Brinckerhoff*, No. 103, 2016 (Del. Dec. 20, 2016), the Delaware Supreme Court reversed the Court of Chancery’s holding that a limited partner maintained standing to pursue his claims challenging a dropdown transaction after the limited partnership was acquired by merger. The Supreme Court rejected the Chancery Court’s holding that the plaintiff’s claims arose out of a breach of the partnership agreement and, therefore, were direct in nature. As the claims were derivative, they passed to the buyer in the merger, thereby extinguishing the plaintiff’s standing.

In the fall of 2010, El Paso Corporation (“El Paso Parent”), which owned El Paso Pipeline GP Company, L.L.C. (the “GP”), the sole general partner of El Paso Pipeline Partners, L.P. (the “MLP”), sold assets to the MLP in a “dropdown” transaction. The plaintiff filed suit derivatively on behalf of the MLP challenging the transaction. While the litigation was pending, Kinder Morgan, Inc. (“Kinder Morgan”) acquired El Paso Parent. After this acquisition, Kinder Morgan acquired the MLP by merger. After the consummation of the MLP merger, the defendants moved to dismiss, arguing plaintiff’s claims were exclusively derivative and that plaintiff lost standing as a result of the merger. The Chancery Court then issued an opinion holding the GP liable for breach of the MLP’s partnership agreement, finding that the conflicts committee of the MLP “did not subjectively believe” that the approval of the dropdown transaction “was in the best interests of the partnership,” and that the MLP suffered $171 million in damages. Subsequently, the Chancery Court denied the defendants’ motion to dismiss. First, the Chancery Court distinguished the case at hand from the test articulated in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, 845 A.2d 1031 (Del. 2004), for determining whether a claim is direct or derivative, stating that “Tooley does not apply to contract rights.” Nevertheless, the Chancery Court analyzed the claim under the two-part test in *Tooley*—which involves an inquiry into (1) who suffered the alleged harm, and (2) who would receive the benefit of any recovery or other remedy—and concluded that plaintiff had asserted a “dual-natured” claim and thus could pursue the claim post-merger. As to the first prong, the Chancery Court found that the dropdown injured the limited partners by reallocating value from the unaffiliated limited partners to the GP and that, because the GP received benefits to the exclusion of the limited partners generally, the limited partners suffered a distinct injury. As to the second prong, the Chancery Court decided that, because both the MLP and the limited partners were harmed, either could recover for the alleged breach.

On appeal, the Supreme Court determined that plaintiff’s claims were and remained derivative. The Supreme Court explained that, while claims for breach of a commercial contract are normally direct in nature, a partnership agreement is not merely a traditional commercial contract; rather, it is the constitutive contract of a partnership and sets forth the rights and duties of the partners. The Supreme Court found the plaintiff’s claim sounded in breach of a contractual duty owed to the MLP and thus applied *Tooley*. As to the first prong, the Supreme Court concluded that the harm alleged in plaintiff’s complaint solely affected the MLP, noting that plaintiff alleged the MLP overpaid for the assets in the dropdown and that overpayment claims are normally treated as harming the entity and are, therefore, regarded as derivative. The Supreme Court noted that, where an entity is alleged to have overpaid for an asset, the entity is harmed through the depletion of its assets, which harms its equity holders derivatively through
the diminution of the value of their interests. The Court further noted that not every breach of a provision of the partnership agreement is “dual” by reason of rights and duties under the partnership agreement flowing to either the limited partners or the MLP. While recognizing that its opinion in *Gentile v. Rossette*, 906 A.2d 91 (Del. 2006), allowed for a dual-natured claim in circumstances where there is both an improper transfer of economic value and voting power from the minority stockholders to the controlling stockholder—so-called “equity dilution” claims—the Supreme Court found the plaintiff’s claims failed to satisfy the unique circumstances presented by *Gentile*. The Supreme Court declined to extend *Gentile* and dual-natured claims to circumstances where the “extraction of solely economic value from the minority by a controlling stockholder constitutes direct injury.”

As to the second prong of *Tooley*, the Supreme Court found that any recovery from the claim would benefit the MLP’s partners *pro rata* in proportion to their partnership interests. The Supreme Court rejected the Chancery Court’s reliance on cases where claims involving “insider transfers” or “stock dilution” were found to be dual-natured. The Supreme Court found that those cases were inapposite, as the plaintiff did not allege that the dropdown affected his voting rights or relative control of the MLP.

While the Supreme Court recognized the Chancery Court’s equitable concerns with a holding that would allow the claims to be extinguished, the Supreme Court declined to change settled law, noting the importance of certainty in the law for all parties. The Supreme Court stated that, in most circumstances, “permitting pending derivative claims to survive a merger would be inefficient and overly costly for public investors” and that “[u]seful transactions would be deterred or priced at a lower value because third-party acquirers would find themselves having bought into litigation morasses, the persistence of which they cannot control.”

In his concurrence, Chief Justice Strine wrote separately to state that the present case “highlights” that *Gentile* “muddies the clarity of [Delaware] law in an important context,” stating that “it ought to be overruled, to the extent it allows for a direct claim in the dilution context when the issuance of stock does not involve subjecting an entity whose voting power was held by a diversified group of public equity holders to the control of a particular interest.” Even in the case of a transaction that shifts control from a disaggregated investor base to a controller, the Chief Justice noted, stockholders would already have a direct claim under *Revlon*, leaving no “gap” for *Gentile* to fill.

This decision provides helpful guidance in finding that the contractual-based nature of Delaware limited partnerships does not eliminate the application of the two-part *Tooley* test when determining whether certain claims involving Delaware limited partnerships are direct or derivative claims.


In *In re El Paso Pipeline Partners, L.P. Deriv. Litig.*, 132 A.3d 67 (Del. Ch. 2015), the Court of Chancery denied a motion to dismiss a suit, in which the Court had already entered a $171 million damages award against the defendants, on the grounds that the plaintiff had lost standing as a result of a post-trial merger. In denying the motion to dismiss, the Court addressed
the distinction between direct and derivative claims while offering its view with respect to dual-natured claims.

Through two transactions in 2010, El Paso Corporation ("El Paso Parent"), which owned the sole general partner of El Paso Pipeline Partners, L.P. (the "MLP"), sold two of its subsidiaries to the MLP. The plaintiff filed suit derivatively on behalf of the MLP challenging each of the transactions. After consolidation of the two lawsuits, the Court granted the defendants' motion for summary judgment as to the first transaction. However, trial was held with respect to the second transaction (the "Fall Dropdown"), following which the Court found that the Fall Dropdown did not receive "special approval" (as defined in the MLP's operating agreement) because the members of the MLP's conflicts committee had failed to form a subjective belief that the transaction was in the best interests of the MLP. Accordingly, the Court found that approval of the Fall Dropdown had breached the partnership agreement and awarded $171 million in damages, the amount of overpayment caused by the breach.

During the pendency of the litigation, Kinder Morgan Inc. acquired El Paso Parent. Shortly after trial Kinder Morgan, El Paso Parent, the MLP, and El Paso Pipeline GP Company, L.L.C. ("El Paso General Partner") consummated a related-party merger, which brought an end of the separate legal existence of the MLP. El Paso General Partner then moved to dismiss the lawsuit on the basis that the plaintiff's claims were exclusively derivative and the plaintiff lacked standing to pursue his claims due to the merger.

The Court rejected the motion to dismiss and found that to the extent Delaware law required it to make a choice between construing the plaintiff's claim as either exclusively derivative or exclusively direct, the claim was direct in nature. The Court reasoned that the plaintiff had proved that El Paso General Partner violated certain provisions of the MLP's partnership agreement, a contract to which the plaintiff and the other limited partners of the MLP were parties. The Court stated that "[g]ranting the motion to dismiss would generate a windfall for the general partner at the expense of the unaffiliated limited partners for whose indirect benefit this suit originally was brought." The Court relied on the public policy underlying the limited partnership statute to give maximum effect to the principle of freedom of contract and enforceability of partnership agreements in finding that limited partners can sue directly to enforce contractual constraints in a limited partnership agreement.

However, the Court declined to accept the defendants' "bipolar" view of classification of the plaintiff's claim as either exclusively direct or exclusively derivative. Instead the Court suggested that the "more appropriate way" to view the claim is as dual-natured with aspects that are both direct and derivative. In reaching this conclusion, the Court analyzed the claim under the two-part Tooley test. The Court found the analysis under Tooley straightforward if the claim were considered one for breach of contract: the limited partners suffered a breach of their contract rights and that breach could be remedied appropriately at the limited partner level. The Court also held that, even setting aside the contractual nature of the claim, the claim was both direct and derivative under Tooley. Specifically, the first prong of the Tooley test, adapted for a limited partnership, asks who suffered the alleged injury, the partnership or the limited partners individually. The Court held, in the context of the plaintiff's claim, the answer was both, because the MLP and its limited partners suffered injuries resulting from El Paso General Partner's breach of the MLP's partnership agreement. The MLP suffered by overpaying in the Fall
Dropdown, and the limited partners suffered because the transaction effectively reallocated value from them to El Paso General Partner. The second prong of the Tooley test asks who would receive the benefit of any remedy, the partnership or the limited partners individually. The Court determined the answer to this second question was either, because Delaware law supported both an entity-level remedy and a limited partner-level remedy with respect to overpayment claims. Therefore, the Court concluded that the plaintiff's claim was dual-natured and could be pursued directly or derivatively.

In dicta, the Court also expressed its view that the treatment of dual-natured claims is an area of Delaware law that warrants further development. Specifically, the Court suggested that when considering how a dual-natured claim should be treated for purposes of whether it can be maintained after a merger, Delaware law should prioritize the individual aspects of the claim such that it survives. However, when considering how a dual-natured claim should be treated for purposes of determining demand futility, Delaware law should prioritize the derivative aspects of the claim. This would preserve the policy goals of screening out meritless claims and protecting the primacy of the board's (or other manager's) management of the entity.

Finally, the Court rejected El Paso General Partner's estoppel argument, finding Delaware law is clear that a plaintiff's characterization of its claims as either direct or derivative is not binding on the Court. The Court ruled that the plaintiff can continue to pursue the claim after the merger and can enforce the $171 million judgment. The Court ordered the current general partner to pay the MLP's unaffiliated limited partners as of the time of the merger their pro rata share of the $171 million award, plus pre- and post-judgment interest through the date of payment, less an amount for a reasonable award of attorneys' fees and expenses.

The Court’s decision was appealed to Delaware Supreme Court and was reversed. See discussion of *El Paso Pipeline GP Company, L.L.C. v. Brinckerhoff*, No. 103, 2016 (Del. Dec. 20, 2016), above.


Delaware courts have consistently held, in the context of Delaware limited partnerships, that clear, express and unambiguous language modifying default fiduciary duties will be enforced. As demonstrated by the post-trial decision in *In re El Paso Pipeline Partners, L.P. Derivative Litigation*, 2015 WL 1815846 (Del. Ch. Apr. 20, 2015), however, even where default fiduciary duties have been modified or eliminated, a conflict of interest transaction may still run afoul of the contractual standards set forth in the partnership agreement.

In *El Paso*, the transaction at issue was the second of two so-called dropdown transactions by which El Paso Pipeline Partners, L.P. ("El Paso MLP") acquired all of the business involving the liquefied natural gas terminal on Elba Island, Georgia, from El Paso Corporation ("Parent"). Parent owned the general partner of El Paso MLP, and thus controlled El Paso MLP. El Paso MLP's partnership agreement eliminated default fiduciary duties and replaced them with a contractual standard requiring that the persons approving an action on behalf of El Paso MLP subjectively believe that the action is in the best interests of El Paso MLP. Here, the conflicts committee responsible for approving the dropdown transaction was
composed solely of independent directors, had engaged its own legal and financial advisors, had received from its financial advisor an opinion that the challenged transaction was fair from a financial point of view to the unaffiliated unitholders of El Paso MLP, and ultimately approved the transaction.

The Court ruled that under El Paso MLP's partnership agreement each conflicts committee member had an affirmative duty to conclude that the challenged transaction was "in the best interests of [El Paso MLP]." The Court found several flaws with the conflicts committee's process and the valuation analysis. More significantly, the Court found that, despite trial testimony to the contrary, the conflicts committee members did not actually conclude that the challenged transaction was in the best interests of El Paso MLP. The Court found that the conflicts committee had focused extensively on the expected accretion from the challenged transaction—i.e., the amount by which the cash distributions for common unitholders of El Paso MLP would be expected to increase—but failed to take sufficiently into account the valuation of the assets being acquired under traditional valuation analyses. As a result of these findings, the Court awarded damages of $171 million, which the Court determined to be the difference between what El Paso MLP actually paid for the assets acquired in the challenged transaction and the fair value of the assets. Notably, only the general partner entity was held liable for the award, as none of the other defendants was a party to the partnership agreement and the plaintiff did not present a meaningful theory of secondary liability.

The El Paso decision is a reminder that, although contractual flexibility afforded to Delaware limited partnerships can be used to provide general partners with significant protections, there is still room for courts to scrutinize compliance with contractual standards.

II. AMENDMENTS TO THE GENERAL CORPORATION LAW.

A. 2017 Amendments

Legislation proposing to amend the General Corporation Law of the State of Delaware (the “DGCL”) has been approved and recommended by the Corporate Council of the Corporation Law Section of the Delaware State Bar Association and has been introduced to the Delaware General Assembly. If enacted, the amendments will, among other things, (i) provide statutory authority for the use of “blockchain” or “distributed ledger” technology for the administration of corporate records, (ii) dispense with the requirement that stockholder consents be individually dated, thereby eliminating a common “foot fault” for the validity of stockholder consents, (iii) update and harmonize the various provisions of the DGCL dealing with the authorization and accomplishment of mergers and consolidations involving different types and forms of entities, and (iv) make other clarifying technical changes.

If enacted, all of the amendments (other than the amendments relating to stockholder action by written consent) will be effective on August 1, 2017. The amendments relating to stockholder action by written consent will be effective only for actions taken by consent having a record date, for purposes of determining the stockholders entitled to consent, on or after August 1, 2017.
1. **The “Blockchain” Amendments**

Several sections of the DGCL have been revised to accommodate the use of “blockchain” or “distributed ledger” technology for the maintenance of corporate records. In general, blockchain or distributed ledger technology allows for the creation of a ledger of transactions shared among a network of participants, rather than relying on a central source. It has been suggested that distributed ledger technology, which has a wide range of applications, is particularly well suited to the maintenance of a stock ledger, as it has the potential to facilitate the timely and accurate settlement of stock issuances and transfers.

The core blockchain amendments, involving Sections 219 and 224 of the DGCL, address the fact that a distributed ledger does not involve a central database. Section 219, which currently requires the corporation to prepare and make a list of its stockholders and specifies the evidentiary effect of the stock ledger, is being revised to add a definition of the term “stock ledger.” As amended, Section 219(c) will define “stock ledger” as “one or more records administered by or on behalf of the corporation in which the names of all of the corporation’s stockholders of record, the address and number of shares registered in the name of each such stockholder, and all issuances and transfers of stock of the corporation are recorded in accordance with [Section 224 of the DGCL].”

Section 224, which currently provides that records “maintained” by the corporation may be kept on, by means of, or in the form of any information storage device or method, subject to specified requirements, is also being updated to accommodate distributed ledger technology. As amended, Section 224 will provide that any records “administered by or on behalf of the corporation” may be kept on, by means of, or in the form of, any information storage device or method, “or one or more electronic networks or databases (including one or more distributed electronic networks or databases).” Section 224 will preserve the requirement that records so kept must be convertible into clearly legible paper form within a reasonable time. The amendments will further provide, with respect to the stock ledger, that the records so maintained must be able to be used to prepare the list of stockholders specified in Section 219 as well as in Section 220 (which deals with stockholder demands to inspect the corporation’s stock ledger, list of stockholders and other books and records). In addition, such records must record the information specified in Section 156 (dealing with the amount of consideration for partly paid shares), Section 159 (relating to the transfer of shares for collateral security, and not absolutely), Section 217(a) (relating to the voting of shares subject to a pledge), and Section 218 (dealing with voting trusts). Finally, such records must record transfers of stock as governed by Article 8 of the Delaware Uniform Commercial Code.

In conjunction with the core blockchain amendments, Sections 151, 202 and 364 of the DGCL are being amended to clarify that the written notices required by those sections may be given by “electronic transmission.” (The provision of notice by electronic transmission is governed by existing Section 232, subsection (c) of which defines “electronic transmission” as “any form of communication, not directly involving the physical transmission of paper, that creates a record that may be retained, retrieved and reviewed by a recipient thereof, and that may be directly reproduced in paper form by such a recipient through an automated process.”) Section 151(f), which currently provides for delivery of written notice to holders of uncertificated stock of the information otherwise required to be set forth on a stock certificate under that section as well as Sections 156, 202(a) and 218(a), is being updated to clarify that such notice may be given
in writing or by electronic transmission. Corresponding changes are being made to Section 202(a), which deals with notice of restrictions on transfer and ownership of securities, as well as Section 364, which deals with notices given by public benefit corporations.

While the 2017 amendments will accommodate the use of distributed ledger technology, not all existing corporations that desire to adopt the technology will be able to administer their stock ledgers through such technology immediately and entirely. Corporations that have certificated stock, for example, will not be able to adopt the technology to administer their stock ledgers as long as their shares remain represented by certificates, as the transfer of certificated stock, under Article 8 of the Delaware Uniform Commercial Code, involves procedures inconsistent with the use of distributed ledger technology for such purposes. Moreover, although Section 158 of the DGCL allows the board of directors to provide by resolution that some or all of any or all classes or series of stock shall be uncertificated shares, it provides that “[a]ny such resolution shall not apply to shares represented by a certificate until such certificate is surrendered to the corporation.” No amendments to Section 158 are being made at this time. Accordingly, corporations with certificated stock that desire to make use of distributed ledger technology to administer their stock ledgers must first take measures to provide that their stock is and shall be uncertificated.

2. Stockholder Consents

Section 228 of the DGCL, which deals with stockholder action by consent in lieu of a meeting, is being amended to dispense with the requirement that each consent bear the date of signature of the stockholder executing the consent. The amendment will address the concerns stemming from *H-M Wexford LLC v. Encorp, Inc.*, 832 A.2d 129 (Del. Ch. 2003), where the Court of Chancery denied the defendants’ motion to dismiss plaintiff’s challenges to the validity of stockholder consents, which challenges were based on the fact that the consents had a “preprinted” date but were not individually dated by the stockholders providing them. The Wexford Court explained that Section 228(c)’s instruction that every written consent shall bear the date of signature of each stockholder is a statutory mandate, thus requiring each consent to be individually dated to be valid. Issues arising out of the Wexford Court’s opinion have called into question the validity of corporate actions taken in reliance on consents that were not signed and dated by stockholders representing a sufficient number of votes to take the action.

Section 228(c), as amended, will continue to provide a sixty-day period for the delivery of consents representing a sufficient number of votes to take the action; however, the amendments will modify the provisions dealing with the commencement of such period. Section 228(c) currently provides that no written consent shall be effective to take corporate action unless, “within 60 days of the earliest dated consent delivered in the manner required by [Section 228],” written consents signed by a sufficient number of holders are delivered to the corporation. As amended, Section 228(c) will provide that the sixty-day period commences on the first date a consent is delivered to the corporation.

Consistent with the foregoing, the 2017 amendments will eliminate from Section 228(c) the current language providing that, where a stockholder has provided that its consent is to become effective at a later time (including a time determined upon the occurrence of an event), “such later effective time will serve as the date of signature.” The 2017 amendments will not change the requirement that, where instructions are given or provision is made for a later
effective time, the later effective time must occur within 60 days after the instruction is given or provision is made. The amendments will also make technical conforming changes to Section 228(d)(1) to eliminate references to the “deemed” dates for electronic consents.

3. Merger Amendments

The 2017 amendments will revise the provisions of the DGCL dealing with the authorization and accomplishment of mergers and consolidations. Despite their length, the merger amendments are primarily technical and clarifying in nature. Most of the amendments are intended to provide consistency among the various sections of the DGCL governing mergers and consolidations, not to effect substantive changes.

First, Section 254 (dealing with mergers or consolidations of domestic corporations and joint-stock or other associations), Section 263 (dealing with mergers or consolidations of domestic corporations and partnerships) and Section 264 (dealing with mergers or consolidations of domestic corporations and limited liability companies) are being amended to expressly permit mergers and consolidations of Delaware corporations with joint-stock or other associations, partnerships and limited liability companies, respectively, formed or organized under the laws of a non-U.S. jurisdiction.

Second, the sections of the DGCL governing mergers or consolidations, as applicable, with non-Delaware entities (i.e., Sections 252, 253, 254, 256, 258, 263, 264 and 267) are being amended to provide that such mergers or consolidations are permitted under Delaware law so long as the laws of the non-Delaware jurisdictions do not prohibit such mergers or consolidations. Currently, certain of those sections require that the laws of the other jurisdictions “permit” such mergers or consolidations, while others require that the other jurisdictions’ laws not “forbid” them. The 2017 amendments will help to ensure maximum flexibility with respect to mergers and consolidations with non-Delaware entities and provide for consistency among the applicable sections of the DGCL.

Third, minor technical amendments are being made to Section 251 (dealing with mergers or consolidations of domestic corporations). Section 251 currently provides that any two or more corporations “existing under the laws of [the State of Delaware]” may merge or consolidate. The 2017 amendments will eliminate the term “existing under the laws of this State,” using instead the phrase “corporations of this State”; no substantive change is intended by the amendment. In addition, Section 251(b)(6), which deals with the treatment of fractional interests in a merger or consolidation, is being amended to clarify and confirm the treatment of such interests, whether of the surviving corporation or of any other corporation or entity the shares, rights or other securities of which are to be received in the merger or consolidation; similar changes dealing with fractional interests are being made to the other applicable sections of the DGCL. Section 251(c) is also being revised to make clear the distinction between the “surviving corporation” of a merger and the “resulting corporation” of a consolidation; similar amendments clarifying the distinction are being made to the other applicable sections of the DGCL.

Fourth, Section 252 (dealing with mergers or consolidations of domestic and foreign corporations), Section 253 (dealing with short-form mergers involving corporations), Section 258 (dealing with mergers or consolidations of domestic and foreign stock and nonstock corporations) and Section 267 (dealing with short-form mergers involving a non-corporate parent
entity) are being amended to employ the use of the term “foreign corporation” as it is defined in Section 371(a) of the DGCL. (Section 371(a) defines a “foreign corporation” as a “corporation organized under the laws of any jurisdiction other than [the State of Delaware].”) The amendments are generally designed to ensure that all such sections deal consistently with mergers or consolidations, as applicable, with a corporation organized under the laws of any jurisdiction other than the State of Delaware.

Fifth, Section 255 (dealing with mergers or consolidations of domestic nonstock corporations), Section 256 (dealing with mergers or consolidations of domestic and foreign nonstock corporations), and Section 257 (dealing with mergers or consolidations of domestic stock and nonstock corporations) are being amended to clarify and confirm the manner in which memberships and membership interests in a nonstock corporation may be treated in a merger. In addition, existing language in Section 257 dealing with the treatment of such interests is being eliminated, as it is redundant of the new language. (The key amendments to Section 257 apply by reference, in the case of Delaware corporations, to Section 258, which deals with mergers or consolidations of domestic and foreign stock and nonstock corporations).

Lastly, the 2017 amendments will update the applicable sections of the DGCL dealing with mergers and consolidations to adopt a consistent convention for the use of the terms “organized” and “formed” as they relate to constituent entities. Under the amendments, the term “organized” is used with respect to corporations and refers to the method by which a corporation is formed, incorporated, created or otherwise comes into being under the laws governing its internal affairs, while the term “formed” is used with respect to entities other than corporations and includes the method by which any such entity is formed, created or otherwise comes into being under the laws of the jurisdiction governing its internal affairs. (Both terms are used with respect to joint stock associations, as such associations may have attributes of being both “organized” and “formed,” depending on the laws of the jurisdiction governing them.)

4. **Effective Time of Section 203 “Opt-Out”**

Section 203 of the DGCL, which deals with restrictions on business combinations between a corporation and an “interested stockholder,” is being amended to clarify when an amendment to the certificate of incorporation or bylaws “opting out” of those restrictions becomes effective. Currently, Section 203(b)(3) provides that the restrictions shall not apply if "the corporation, by action of its stockholders, adopts an amendment to its certificate of incorporation or bylaws expressly electing not to be governed by [Section 203].” It then provides that any amendment so adopted shall be “effective immediately” with respect to corporations that (x) have never had a class of voting stock listed on a national securities exchange or held of record by more than 2,000 holders and (y) have not elected through their certificate of incorporation (or any amendment thereto) to be governed by Section 203 and that, in all other cases, the amendment “shall not be effective until 12 months after the adoption of such amendment, and shall not apply to any business combination between such corporation and any person who became an interested stockholder of such corporation on or prior to such adoption.”

The amendments to Section 203(b)(3) clarify that an amendment to the corporation’s certificate of incorporation opting out of the restrictions on business combinations becomes effective at the date and time such amendment becomes effective under Section 103 of the DGCL (in the case of a corporation that has never had a class of voting stock listed on a national
securities exchange or held of record by more than 2,000 stockholders and that has not elected through its original certificate of incorporation or any amendment thereto to be governed by Section 203) or twelve months after the effective date and time of such amendment (in the case of all other corporations), rather than the time at which the amendment is adopted by a vote of stockholders. In the latter scenario, the amendment electing not to be governed by Section 203 will not apply to any business combination between the corporation and any person who became an interested stockholder of the corporation before, in the case of an amendment to the certificate of incorporation, the date and time at which the certificate filed in accordance with Section 103 becomes effective or, in the case of an amendment to the bylaws, the date of the adoption of such amendment.

5. Annual Reports

Section 374 of the DGCL is being amended to streamline the annual reporting requirements for corporations formed in another jurisdiction and qualifying to do business in the State of Delaware. In addition, Section 502 of Title 8 of the Delaware Code is being amended to clarify the information required to be disclosed in annual reports filed by Delaware corporations with the Secretary of State of the State of Delaware.

B. 2016 Amendments (effective August 1, 2016)

House Bill 371, which contains several important amendments to the General Corporation Law of the State of Delaware (the "DGCL"), was signed by Delaware Governor Jack Markell on June 16, 2016. The 2016 legislation includes, among other things:

1. Section 251(h)—Intermediate-Form Mergers

In 2013, the DGCL was amended to eliminate, subject to certain conditions, the need for a back-end merger vote in a two-step merger involving a front-end tender or exchange offer. Since its adoption, Section 251(h) has become a preferred method of accomplishing a tender offer in public M&A transactions. The 2016 amendments to Section 251(h) are designed largely to clarify the procedures and requirements of the subsection.

Eligibility to Use Section 251(h); Offers for Different Classes or Series of Stock

As originally drafted, Section 251(h) was intended to make the “intermediate-form” merger available principally to public companies. Thus, prior to the 2016 amendments, Section 251(h) provided that, unless expressly required by the certificate of incorporation, no vote of stockholders of a target corporation whose shares are listed on a national securities exchange or held of record by more than 2,000 holders immediately prior to the execution of the merger agreement is required to authorize the merger, so long as the other requirements of the subsection are satisfied. The 2016 amendments to Section 251(h) clarify that the subsection applies to any target corporation that has any class or series of stock listed on a national securities exchange or held of record by more than 2,000 holders immediately prior to the execution of the merger agreement—and that not all classes or series of stock need be so listed or held. Thus, a target corporation whose common stock is listed on a national securities exchange may take advantage of Section 251(h), even if it has a series of preferred stock that is not listed or held of record by more than 2,000 holders. The 2016 amendments also clarify that the offer for the stock of the
target corporation contemplated by the subsection (the “Offer”) may be effected through separate offers for separate classes or series of stock.

Additional Minimum Conditions

The 2016 amendments clarify that that the Offer may be conditioned on the tender of a minimum number or percentage of the shares of the stock of the constituent corporation, or of any class or series thereof.

Rollover Stock

Prior to the 2016 amendments, one of the requirements of accomplishing a merger under Section 251(h) was that, following the consummation of the Offer, the stock irrevocably accepted for purchase or exchange and received by the depositary, plus the stock otherwise owned by the offeror, equals the percentage of stock, and of each class and series thereof, that would otherwise be required to adopt the merger agreement. The 2016 amendments permit, for purposes of determining whether such requirement has been met, the inclusion of shares of stock of the target held by any person that owns, directly or indirectly, all of the outstanding stock of the offeror, or that is a direct or indirect wholly-owned subsidiary of such person or persons or of the offeror (collectively, “offeror affiliates”). The 2016 amendments also provide that shares of stock of the target corporation that are the subject of a written agreement requiring such shares to be transferred, contributed or delivered to the offeror or any offeror affiliate in exchange for stock or other equity interests in the offeror or any offeror affiliate may be counted for purposes of determining whether the minimum condition required by the statute has been met, so long as such shares are in fact so transferred, contributed or delivered before the effective time of the merger (“rollover stock”). The 2016 amendments further provide that rollover stock and shares of the target corporation held in treasury, by any direct or indirect wholly-owned subsidiary of the target, or by the offeror affiliates are excluded from the requirement that they be converted in the merger into, or into the right to receive, the same consideration paid in the Offer. In this manner, the 2016 amendments provide a more direct and efficient means of enabling certain target stockholders to “rollover” their shares in the transaction.

Receipt of Stock

The 2016 amendments clarify the means by which shares of stock of the target corporation are “received” for purposes of the determining whether the minimum tender condition required by the subsection has been satisfied. The 2016 amendments clarify that shares represented by certificates will be “received” upon physical receipt of the certificate, together with an executed letter of transmittal, so long as the certificate representing such shares was not cancelled prior to consummation of the Offer. Under the 2016 amendments, uncertificated shares held of record by a clearing corporation as nominee would be “received” by transfer into the depository’s account by means of an agent’s message, and all other uncertificated shares would be “received” by physical receipt of an executed letter of transmittal by the depository. In all cases, however, under the 2016 amendments, uncertificated shares would cease to be “received” to the extent they have been reduced or eliminated due to any sale of such shares prior to the consummation of the Offer. The 2016 amendments prescribe what constitutes an “agent’s message” for these purposes, specifying that it is a message transmitted by the clearing corporation acting as nominee, received by the depository, and forming part of the book-entry
confirmation, which states that the clearing corporation has received an express acknowledgment from a stockholder that such stockholder has received the Offer and agrees to be bound by the terms of the Offer, and that the offeror may enforce such agreement against such stockholder.

2. **Section 262—Appraisal Rights**

The 2016 amendments amend Section 262 of the DGCL, which governs appraisal rights, in two principal respects. First, the 2016 amendments impose *de minimis* limitation on appraisal claims in certain public company transactions. Second, the 2016 amendments give surviving corporations the option to pay each stockholder entitled to appraisal at an earlier stage of the appraisal proceeding as a means of cutting off the accrual of interest under the statute with respect to the amount paid.

*De Minimis Exception*

To implement the first of these changes, the 2016 amendments provide that the Court of Chancery shall dismiss an appraisal proceeding as to all stockholders otherwise entitled to appraisal rights, unless (1) the total number of shares entitled to appraisal exceeds 1% of the outstanding number of shares of the class or series entitled to appraisal; (2) the value of the consideration for such total number of shares exceeds $1 million; or (3) the merger was effected as a “short-form” merger under Section 253 or Section 267 of the DGCL. The amendment is designed to mitigate the risk that a plaintiff will use the appraisal process solely to gain leverage in a settlement negotiation. That is, the amendment is designed to prevent stockholders from demanding an appraisal in cases where the number of shares (or the value of those shares) is minimal, but the surviving corporation may be inclined to settle the claim to avoid the litigation costs attendant to the appraisal proceeding. As noted above, however, “short-form” mergers would not be subject to the *de minimis* carve-out, because appraisal may be the stockholders’ only remedy in such a merger. In addition, the *de minimis* carve-out would apply only in cases where the shares as to which appraisal is sought were listed on a national securities exchange immediately before the merger or consolidation.

In connection with the foregoing changes, the 2016 amendments provide that, where the corporation has adopted a provision in its certificate of incorporation granting appraisal rights in circumstances where they would not otherwise exist (e.g., in connection with amendments to the certificate of incorporation or sales of all or substantially all of the corporation’s assets), an appraisal proceeding brought thereunder will be dismissed if the *de minimis* carve-out would apply.

*Tender of Payment*

To implement the second of the principal changes to Section 262, the 2016 amendments modify Section 262(h) to provide corporations the option of limiting the accrual of statutory interest on appraisal awards by making an early payment to the appraisal claimants. Prior to the 2016 amendments, Section 262(h) provided that, unless the Court of Chancery determines otherwise for good cause shown, interest on the amount that is determined to be the “fair value” of appraisal shares will accrue from the effective date of the merger through the date of payment of judgment, will be compounded quarterly, and will accrue at 5% over the Federal Reserve discount rate (including any surcharge) as established from time to time during that period. Since
payment of “fair value” in an appraisal proceeding is not made until such amount is determined after trial, interest accrues on the full amount of the award, even if the fair value is ultimately determined to be the same as or less than the consideration paid in the merger. The 2016 amendments permit the surviving corporation to pay the appraisal claimants, at any time before the entry of judgment in the proceeding, a sum of money that it determines to be appropriate.

After making the payment, interest would only accrue upon the sum of (1) the difference, if any, between the amount so paid and the fair value of the shares as determined by the Court of Chancery, and (2) interest theretofore accrued, unless paid at that time. Any surviving corporation electing to make such a payment would be required to make the payment to all of the appraisal claimants, unless the surviving corporation has a good faith basis for contesting a particular claimant’s entitlement to an appraisal of such claimant’s shares, in which case the surviving corporation may elect to make payment only to those stockholders whose entitlement to appraisal is uncontested. The amount that the surviving corporation pays would not give rise to any inference as to the fair value of the shares as to which an appraisal is sought.

3. Section 111—Jurisdiction

Section 111(a) of the DGCL generally provides that any civil action to interpret, apply, enforce or determine the validity of provisions of various documents, agreements and instruments may be brought in the Court of Chancery, except to the extent that a statute confers exclusive jurisdiction on a court, agency or tribunal other than the Court of Chancery. Prior to the 2016 amendments, Section 111(a)(2) of the DGCL conferred such jurisdiction with respect to any instrument, document or agreement by which a corporation creates or sells, or offers to create or sell, any of its stock, or any rights or options respecting its stock. The 2016 amendments modify Section 111(a)(2) to permit the Court of Chancery to exercise subject matter jurisdiction over civil actions involving certain other instruments, documents, or agreements, including (i) those to which a Delaware corporation is a party and pursuant to which one or more holders of the corporation’s stock sell or offer to sell any of such stock, and (ii) those by which a Delaware corporation agrees, subject to specified conditions, to sell, lease or exchange any of its property or assets.

4. Section 141—Board of Directors and Committees

Default Quorum and Voting Requirements for Committees and Subcommittees

The 2016 amendments modify Section 141(c) of the DGCL, which deals with the establishment of committees of the board of directors, to specify the default quorum and voting requirements for committees and subcommittees. After the 2016 amendments, a majority of the directors then serving on a committee or a subcommittee would constitute a quorum (except as otherwise provided in the certificate of incorporation, bylaws, resolutions of the board establishing the committee or resolutions of the committee establishing the subcommittee, provided that in no case may a quorum be less than one-third of the directors serving on the committee or subcommittee). The 2016 amendments also provide that the vote of a majority of the members present at a meeting of the committee or subcommittee at which a quorum is present shall be the act of the committee or subcommittee, unless the certificate of incorporation, the bylaws, the resolutions of the board establishing the committee or the resolutions of the committee establishing the subcommittee require a greater number.
References to Subcommittees

The 2016 amendments clarify that references in the DGCL to board committees (and committee members) will be deemed to include references to subcommittees (and subcommittee members). The 2016 amendments make other conforming changes to Section 141.

5. Section 158—Stock Certificates

Prior to the 2016 amendments, Section 158 of the DGCL provided that every holder of stock represented by certificates shall be entitled to have a certificate signed by, or in the name of the corporation by the chairperson or vice-chairperson of the board of directors, or the president or vice-president, and by the treasurer or an assistant treasurer, or the secretary or an assistant secretary of such corporation representing the number of shares registered in certificate form. (It should be noted that Section 142 also requires the corporation to have officers as may be necessary to enable it to sign instruments and stock certificates.) In recent years, many corporations have dispensed with the offices of “President” and “Treasurer” and have assigned the role historically assumed by the President and Treasurer to the Chief Executive Officer and Chief Financial Officer, respectively. In light of developments in practice, the 2016 amendment to Section 158 provides that any two officers of the corporation who are authorized to do so may execute stock certificates on behalf of the corporation. Thus, as a result of the 2016 amendments, any two duly empowered officers, regardless of their official title in the bylaws, would be authorized to execute stock certificates. The 2016 amendment is not intended to change the existing law that the signatures on a stock certificate may be the signatures of the same person, so long as each signature is made in a separate officer capacity of such person.

6. Section 311—Restoration

The 2016 amendments modify Section 311 of the DGCL to include a procedure to restore a corporation’s certificate of incorporation after it has expired by limitation. This change is consistent with Section 278 of the DGCL, which currently provides that Sections 279 through 282 of the DGCL, relating to corporations that have dissolved, apply to any corporation that has expired by its own limitation. Section 311 is also amended to clarify that a corporation desiring to revoke its dissolution or restore its certificate of incorporation must file all annual franchise tax reports that the corporation would have had to file if it had not dissolved or expired by limitation and pay all franchise taxes that the corporation would have had to pay if it had not dissolved or expired.

7. Section 312—Revival

The 2016 amendments to Section 312 distinguish the procedure to extend the term of a corporation’s certificate of incorporation or to restore a corporation’s certificate of incorporation if it has expired by limitation from the procedure to revive a corporation’s certificate of incorporation when it has become forfeited or void. Under the 2016 amendments, Section 312 applies only to a corporation whose certificate of incorporation has become forfeited or void. Accordingly, the 2016 amendments modify Section 312 such that it uses only the term “revival” to reflect the process for reviving such a corporation. (The 2016 amendments eliminate the terms “renewal,” “extension” and “restoration.”)
The 2016 amendments also clarify and simplify the procedures to be followed by a Delaware corporation to revive its certificate of incorporation after the certificate has become forfeited or void. (The amendments clarify that the provisions of Section 312 do not apply to a corporation whose certificate of incorporation has been forfeited or revoked by the Court of Chancery pursuant to Section 284.) Of significance, the 2016 amendments provide that a majority of the directors then in office, even if less than a quorum, or the sole director in office, may authorize the revival of the certificate of incorporation. The 2016 amendments identify such directors as those who, but for the certificate of incorporation having become forfeited or void, would be the duly elected or appointed directors of the corporation. The 2016 amendments also clarify the process for elections of directors if no directors are in office and the effect of a revival with respect to actions taken by the corporation’s directors, officers, agents and stockholders.

C. **2015 Amendments (effective August 1, 2015, unless otherwise noted)**

Senate Bill 75, which contains several important amendments to the General Corporation Law of the State of Delaware (the "DGCL"), was signed by Delaware Governor Jack Markell on June 24, 2015. The 2015 legislation includes, among other things:

- **Prohibition on Fee Shifting.** The legislation amends Sections 102 and 109 to prohibit "fee shifting" provisions in certificates of incorporation and bylaws of stock corporations.

- **Authorization of Delaware Forum Selection Clauses.** The legislation adds new Section 115 to validate provisions in certificates of incorporation and bylaws that select the Delaware courts as the exclusive forum for "internal corporate claims."

- **Flexibility in Stock and Option Issuances.** The legislation amends Section 152 to provide greater flexibility in stock issuances, and makes corresponding amendments to Section 157 in respect of the authorization of rights and options to purchase stock.

- **Ratification of Defective Corporate Acts and Stock.** The legislation amends Sections 204 and 205 to clarify and streamline the procedures for ratifying defective corporate acts and stock.

- **Public Benefit Corporations.** The legislation amends Section 363 to loosen the restrictions on (x) an existing corporation becoming a "public benefit corporation" and (y) a public benefit corporation ceasing to be a public benefit corporation. It also adds a "market out" exception to the appraisal rights provided in Section 363(b) in connection with a corporation becoming a public benefit corporation.

The amendments (other than the amendments to Section 204, Section 205 and Section 363(b)) became effective on August 1, 2015. The amendments to Sections 204 and 205 apply to resolutions adopted by the board ratifying defective corporate acts or stock on or after August 1, 2015. The amendments to Section 363(b) apply to agreements of merger or consolidation entered into on or after August 1, 2015 and to amendments to the certificate of incorporation approved by the board of directors on or after August 1, 2015.
The 2015 amendments to the DGCL effect, among others, the following significant changes.

1. Prohibition on Fee-Shifting Provisions.

The 2015 legislation invalidates so-called fee-shifting provisions in certificates of incorporation and bylaws of stock corporations. The legislation was proposed in response to the Delaware Supreme Court's ruling in *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014). In *ATP*, the Court held that a bylaw that made the members of a nonstock corporation liable for the corporation's legal expenses in certain intra-corporate disputes was facially valid—which is to say that, without regard to equitable considerations surrounding its adoption or use, the bylaw was not in contravention of law. The new legislation limits the *ATP* Court's ruling to nonstock corporations.

To accomplish the foregoing, the legislation adds new Section 102(f) to the DGCL. The new subsection provides that a certificate of incorporation may not contain any provision imposing liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an "internal corporate claim," as defined in new Section 115 (discussed below). The legislation adds a similar restriction on fee-shifting provisions to Section 109(b) of the DGCL, which deals with the provisions that may be set forth in the bylaws. The legislation also amends Section 114 to provide that the restrictions on fee-shifting provisions do not apply to nonstock corporations.

Although it invalidates fee-shifting provisions in certificates of incorporation and bylaws of stock corporations, the legislation does not prevent the imposition of such provisions pursuant to any writing signed by a stockholder against whom the provision is to be enforced. Thus, corporations may continue to negotiate for fee-shifting provisions with one or more stockholders in private arrangements, including stock purchase agreements or stockholders' agreements.


The 2015 legislation adds new Section 115 to the DGCL, authorizing the certificate of incorporation or bylaws to include forum-selection provisions. Consistent with the Delaware Court of Chancery's holding in *Boilermakers Local 154 Retirement Fund v. Chevron Corporation*, 73 A.3d 934 (Del. Ch. 2013), Section 115 confirms that the certificate of incorporation or bylaws of the corporation may specify that "internal corporate claims" (i.e., claims, including those brought in the right of the corporation, (i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which the DGCL confers jurisdiction upon the Court of Chancery) must be brought solely and exclusively in the Delaware courts, including the federal court.

New Section 115 does not expressly authorize or prohibit provisions of the certificate of incorporation or bylaws that select a forum other than the Delaware courts as an additional forum in which an internal corporate claim may be brought, but it does invalidate any such provision selecting courts outside of Delaware, or any arbitral forum, to the extent such provision would purport to prohibit litigation of internal corporate claims in the Delaware courts. As with the fee-shifting amendments, however, Section 115 does not prevent the application of a provision
selecting a forum other than the Delaware courts pursuant to a stockholders' agreement or other writing signed by the stockholder against whom the provision is to be enforced.

Section 115 is not intended to shield the manner in which a forum-selection provision has been adopted from equitable review, nor is it intended to foreclose judicial review as to whether the terms of any such provision operate reasonably under particular factual circumstances. Moreover, it is not intended to authorize a provision that would purport to foreclose suit in a federal court based on federal jurisdiction, nor is it intended to limit or expand the jurisdiction of the Delaware Court of Chancery or the Delaware Superior Court.


The 2015 legislation amends Section 152 of the DGCL to clarify that the board of directors may authorize stock to be issued in one or more transactions in such numbers and at such times as is determined by a person or body other than the board of directors or a committee of the board, so long as the resolution of the board or committee, as applicable, authorizing the issuance fixes the maximum number of shares that may be issued as well as the time frame during which such shares may be issued and establishes a minimum amount of consideration for which such shares may be issued. The minimum amount of consideration cannot be less than the consideration required pursuant to Section 153 of the DGCL, which, as a general matter, means that shares with par value may not be issued for consideration having a value less than the par value of the shares. The legislation clarifies that a formula by which the consideration for stock is determined may include reference to or be made dependent upon the operation of extrinsic facts, thereby confirming that the consideration may be based on, among other things, market prices on one or more dates or averages of market prices on one or more dates. Among other things, the legislation clarifies that the board (or duly empowered committee) may authorize stock to be issued pursuant to "at the market" programs without separately authorizing each individual stock issuance pursuant to the program. In addition, the legislation allows the board to delegate to officers the ability to issue restricted stock on the same basis that the board may delegate to officers the ability to issue rights or options under Section 157(c) of the DGCL.

4. Consideration for Options and Rights.

Consistent with the amendments to Section 152, the 2015 legislation amends Section 157 of the DGCL, which deals with the creation and issuance of rights and options to purchase stock, to clarify that a formula by which the consideration for stock issued upon the exercise of rights and options is determined may include reference to or be made dependent upon the operation of extrinsic facts, such as market prices on one or more dates, or averages of market prices on one or more dates.

5. Ratification of Defective Corporate Acts.

The 2015 legislation makes several amendments to Section 204 of the DGCL, which sets forth the procedures for ratifying stock or corporate acts that, due to a "failure of authorization," would be void or voidable, to clarify and confirm various aspects of its operation and to provide additional guidance as to the specific requirements for the filing of certificates of validation. The legislation makes conforming amendments to Section 205 of the DGCL, which confers jurisdiction on the Court of Chancery to hear and determine, among other things, the validity of
any ratification effected pursuant to Section 204 and the validity of any corporate act or transaction.

a. Multiple Defective Corporate Acts.

The basic premise of Section 204 is that, to ratify a defective corporate act or stock, the board must first take action to effect the ratification. The board's action must then be submitted to stockholders for adoption if the underlying act is one that requires a stockholder vote, or is one that would have required a stockholder vote, either at the time the ratification is submitted for adoption or at the time the original act was taken. Pre-amendment Section 204 requires that the board adopt a "resolution" setting forth, among other things, the defective corporate act being ratified and provides that, where a stockholder vote is or was required, the stockholders must adopt that resolution. As amended, Section 204 dispenses with the notion of the board's ratifying resolution, requiring instead that the board may initiate the ratification process by approving the ratification of one or more defective corporate acts. Under amended Section 204, it is clear that the board may ratify (or initiate the process to ratify) multiple defective corporate acts in a single set of resolutions. Section 204(c), which deals with the circumstances under which a defective corporate act must be approved by stockholders, has been revised to provide that each defective corporate act—rather than the board's resolution ratifying a defective corporate act—that requires or required a vote of stockholders must be submitted to stockholders for their approval.

b. Ratification of the Failure of the Incorporator to Elect the Initial Board.

New Section 204(b)(2) addresses the situation in which the corporation's initial directors have not been (and were not intended to be) elected in the original certificate of incorporation, and the original incorporator never elected the initial directors or evidence of such election cannot be located. Under the new subsection, the corporation's "de facto" directors may adopt a resolution that ratifies the election of those persons who, despite having not been named in the certificate of incorporation or duly elected by the incorporator as the initial directors, first took action on behalf of the corporation as the board of directors. The new subsection does not, by negative implication or otherwise, preclude the filing of a certificate of correction pursuant to Section 103(f) of the DGCL to correct a certificate of incorporation that was intended to (but did not) name the initial directors, nor does it prevent the incorporator from executing (albeit late) an instrument signed in the manner permitted by Section 108 of the DGCL to elect such initial directors.

c. Stockholder Approval.

Section 204, as originally adopted, was intended to provide that only the holders of valid stock would be entitled to vote on any ratifying resolution required to be submitted to stockholders for adoption. Due to the retroactive effect that Section 204 provides to defective corporate acts, some practitioners raised the concern that the ratification of a defective corporate act arguably would cause putative stock that is "outstanding" at the time of the record date for determining stockholders entitled to vote to be retroactively cured such that holders of putative stock would be deemed to be holders of valid stock entitled to vote as of the earlier record date—and their putative shares would be counted in the ratification vote for quorum and voting purposes. As amended, Section 204(d) makes clear that the only stockholders entitled to vote on the ratification of a defective corporate act, or be counted for purposes of a quorum for such
vote, are the holders of record of valid stock as of the record date for determining stockholders entitled to vote thereon. Section 204(f), which provides the retroactive effect to defective corporate acts, has also been amended to clarify the point.

d. Certificates of Validation.

Pre-amendment Section 204 provides that a certificate of validation must be filed with the Delaware Secretary of State whenever the underlying defective corporate act that is being ratified would have required the filing of an instrument under another section of the DGCL. Those certificates of validation must include a copy of the board's resolutions ratifying the defective corporate act as well as the information that would have been required by such other section of the DGCL. Due to the significant variation in defective corporate acts and the resolutions used to ratify them, certificates of validation, unlike most other instruments filed under the DGCL, tend to lack uniformity. As a result, Section 204(e) has been amended to clarify the requirements in respect of certificates of validation, with the ultimate goal of providing greater uniformity.

As amended, Section 204(e) no longer requires that a certificate of validation include a copy of the board's ratifying resolutions and instead provides that the certificate of validation must set forth specified information regarding the defective corporate act and the related failure of authorization. In addition, Section 204(e) requires different types of information to be set forth on or attached to the certificate of validation depending on the history of filings (or lack thereof) with the Delaware Secretary of State in respect of the applicable defective corporate act. The circumstances under which the certificates would vary are as follows:

- Where a certificate in respect of the defective corporate act had previously been filed and no changes are required to give effect to the ratification of such act, Section 204(e) requires the certificate as previously filed with the Delaware Secretary of State to be attached to the certificate of validation as an exhibit.

- Where a certificate in respect of the defective corporate act had previously been filed and changes are required to that certificate to give effect to the ratification of such act, Section 204(e) requires that a certificate containing all of the information required under the other section of the DGCL, including the changes necessary to give effect to the ratification of the defective corporate act, be attached to the certificate of validation as an exhibit. In that case, the certificate of validation must state the date and time as of which the certificate attached to it would have become effective.

- Where no certificate had previously been filed and the filing of a certificate was required to give effect to the ratification of a defective corporate act, Section 204(e) requires that a certificate containing all of the information required under the other section of the DGCL be attached to the certificate of validation as an exhibit. In that case, the certificate of validation must also state the date and time as of which the certificate attached to it would have become effective.

e. Action by Written Consent and Notice.

Section 204, as originally drafted, included concepts relating to the submission of the board's ratifying resolution to stockholders at a duly called and held meeting. As with virtually
all other sections of the DGCL, Section 204 did not specifically reference the stockholders' power to act by written consent to approve any ratifying resolution, as it was understood that, pursuant to Section 228 of the DGCL, unless otherwise restricted by the certificate of incorporation, stockholders could act by written consent in lieu of a meeting with respect to any matter required or permitted to be acted upon by stockholders at a meeting. Nevertheless, the procedures for notice in cases where stockholders are acting by written consent in lieu of a meeting were viewed as fairly difficult to parse under existing Section 204. The amendments to Section 204 clarify these procedures.

As amended, Section 204(g) expressly provides that, where the ratification of a defective corporate act is approved by consent of stockholders in lieu of a meeting, the notice required by Section 204(g) may be included in the notice required to be given pursuant to Section 228(e). Section 204(g) now clarifies that, where a notice sent pursuant to Section 204(g) is included in a notice sent pursuant to Section 228(e), the notice must be sent to the parties entitled to receive the notice under both Section 204(g) and Section 228(e). Section 204(g) further clarifies that no such notice need be provided to any holder of valid shares that acted by written consent in lieu of a meeting to approve the ratification of a defective corporate act or to any holder of putative shares who otherwise consented thereto in writing.

In addition, Section 204(g) provides that corporations that have a class of stock listed on a national securities exchange may give the notice required by Section 204(g) by means of a public filing with the Securities and Exchange Commission.

f. Validation Effective Time.

Prior to the amendment, Section 204(h)(6) defined "validation effective time" as the later of (x) the time at which the ratification of the defective corporate act is approved by stockholders (or, if no vote is required, the time at which the notice required by Section 204(g) is given) and (y) the time at which any certificate of validation has become effective. As amended, Section 204(h)(6) confirms that, in respect of the ratification of any defective corporate act for which the "validation effective time" is the time at which the stockholders approve the ratification of the defective corporate act, such validation effective time occurs at the time of stockholder approval regardless of whether the stockholders are acting at a meeting or by consent in lieu of a meeting pursuant to Section 228. Although the amendment clarifies that, in such cases, the validation effective time commences upon the stockholders' approval of the ratification of the defective corporate act, a corresponding amendment to Section 204(g) confirms that the 120-day period during which stockholders may challenge the ratification of a defective corporate act commences from the later of the validation effective time and the time at which the notice required by Section 204(g) is given. In light of the corresponding amendment to the commencement of the 120-day challenge period in Section 204(g), Section 204(h)(6), as amended, further provides that where the ratification of the defective corporate act does not require stockholder approval or the filing of a certificate of validation, the validation effective time is the time at which the board of directors adopts the resolutions to approve the ratification of the defective corporate act.

The definition of "validation effective time" has also been amended in a manner that permits the board of directors to fix a future validation effective time for any defective corporate act that does not require the filing of a certificate of validation. Where the board of directors fixes a future validation effective time, such validation effective time may not precede the time at
which a defective corporate act requiring a vote of stockholders is approved by stockholders. Again, the 120-day period during which challenges to the ratification may be brought would commence from the later of the validation effective time and the time at which the notice required by Section 204(g) is given. The amendments are intended to obviate logistical issues that may arise in connection with the delivery of notices in situations where multiple defective corporate acts are being ratified at the same time. As amended, Section 204(h)(6) enables the board to set one date on which the ratification of all defective corporate acts approved by the board will be effective, regardless of when the notice under Section 204(g) is sent or when each defective corporate act would otherwise become effective under Section 204(h)(6).

g. 120-Day Challenge Period.

Consistent with the amendments to Sections 204(g) and 204(h)(6) in respect of the validation effective time and the commencement of the 120-day period during which an action may be brought to challenge the ratification of a defective corporate act, Section 205(f) has been amended to provide that no such action may be brought after the expiration of 120 days from the later of the validation effective time and the time that notice of the ratification is given under Section 204(g), if notice is required to be given under such section.

6. Restatements of Certificates of Incorporation.

In 2014, Section 242 of the DGCL was amended to eliminate the requirement to obtain a stockholder vote on an amendment to the certificate of incorporation to effect a change of the corporation's name. In furtherance of that amendment, Section 245(c) has been amended to clarify that a restated certificate of incorporation need not state that it does not further amend the provisions of the corporation's certificate of incorporation if the only amendment is to change the corporation's name without a vote of the stockholders.

7. Corporate Name.

The 2015 legislation permits the Division of Corporations of the Delaware Secretary of State (the "Division") to waive, under limited circumstances, the requirement with respect to the use of a name that has been reserved for use with the Division or is on the Division's records. Section 102(a)(1)(ii) of the DGCL provides that a Delaware corporation's name as set forth in its certificate of incorporation shall be such as to distinguish it upon the Division's records from the names that have been reserved for use with the Division and from the names on record with the Division of each other corporation, partnership, limited partnership, limited liability company or statutory trust organized or registered as a domestic or foreign corporation, partnership, limited partnership, limited liability company or statutory trust under the laws of the State of Delaware, except with the written consent of the person who has reserved the name of such corporation, partnership, limited partnership, limited liability company or statutory trust. The 2015 legislation adds a further exception such that, without prejudicing any rights of the person who has reserved the name or of such other corporation, partnership, limited partnership, limited liability company or statutory trust, the Division may waive the requirement if the corporation seeking such waiver demonstrates to the satisfaction of the Delaware Secretary of State that (a) such corporation or a predecessor entity previously has made substantial use of the name or a substantially similar name, (b) such corporation has made reasonable efforts to secure such written consent, and (c) the waiver is in the interest of the State of Delaware.

The 2015 legislation makes several changes with respect to the provisions of the DGCL dealing with public benefit corporations. Section 362(c) has been amended to eliminate the requirement that a public benefit corporation include in its name a specific "public benefit corporation" identifier. If the identifier is excluded, however, the corporation must, before issuing or disposing of shares, provide notice to any person acquiring the shares so issued or disposed of that the corporation is a public benefit corporation, unless the issuance is being made pursuant to an offering under the Securities Act of 1933 or the corporation has at the time of issuance a class of stock registered under the Securities Exchange Act of 1934.

The legislation also changes Section 363(a) and Section 363(c) to relax the voting standards required to approve charter amendments or transactions in which a corporation that is not a public benefit corporation becomes a public benefit corporation or its stockholders become stockholders of a public benefit corporation, as well as charter amendments or transactions in which a public benefit corporation ceases to be a public benefit corporation or its shareholders become shareholders of a corporation that is not a public benefit corporation. Prior to the amendments, Sections 363(a) and 363(c) provided that such actions required the approval of 90% of the outstanding shares of each class of stock, whether voting or nonvoting. The new legislation reduces the voting standard on these matters to 66 2/3% of the outstanding shares entitled to vote.

Prior to the 2015 amendments, Section 363(b) provided that stockholders of a corporation that is not a public benefit corporation are entitled to statutory appraisal rights in cases where the corporation amends its certificate of incorporation to become a public benefit corporation or effects a merger or consolidation that results in the shares of its stock becoming, or being converted into the right to receive, shares of a public benefit corporation. The 2015 amendments to Section 363(b) provide a "market out" exception to these rights (similar to the exception that applies to appraisal rights generally under Section 262). Under the amendments, no such appraisal rights are available for shares of stock (or depository receipts in respect thereof) that, at the record date fixed to determine stockholders entitled to receive notice of the meeting of stockholders to act upon any such agreement of merger or consolidation, or to adopt any such amendment, were either listed on a national securities exchange or held of record by more than 2,000 holders, unless, in the case of a merger or consolidation, the holders are required by the terms of the merger to accept anything other than shares of stock (or depository receipts in respect thereof) that will be listed on a national securities exchange or held of record by more than 2,000 holders, cash in lieu of fractional shares (or fractional depository receipts), or any combination of the foregoing.

D. Delaware Rapid Arbitration Act.

On April 2, 2015, Delaware Governor Jack Markell signed a highly specialized arbitration statute into law: the Delaware Rapid Arbitration Act (the "DRAA"). The DRAA provides a quick and inexpensive process for starting an arbitration proceeding, accelerates the arbitration itself to ensure a swift resolution, eliminates confirmation proceedings, and allows for challenges directly to the Delaware Supreme Court.
Speed and efficiency are key features of the DRAA. Arbitrations brought under the new statute must be completed within 120 days of the arbitrator accepting appointment. With the unanimous consent of the parties and the arbitrator, that timeline can be extended to 180 days. Arbitrators who do not issue final awards within the prescribed timeframe face reductions in their fees corresponding to the length of the delay in the issuance of the final award.

The new legislation gives broad powers to expert arbitrators. Arbitrability is determined solely by the arbitrator, who also has the authority to grant a full array of injunctive and other remedies. The arbitrator's final award is deemed confirmed simply by the passage of time. Challenges to the final award are made directly to the Delaware Supreme Court, skipping review by the trial court. Unless altered by contract, such challenges proceed under the narrow Federal Arbitration Act standard of review.

The DRAA was designed to address resolution of disputes where sophisticated parties most need no-nonsense, swift resolution. The DRAA may not be used to resolve disputes involving consumers, and it may only be invoked against parties who sign an express agreement to arbitrate under the DRAA. One of the parties must be a Delaware business entity, although it need not be located in Delaware.

The DRAA was developed by an interdisciplinary team of arbitration practitioners led by Delaware's Chief Justice Leo E. Strine Jr., Delaware's Chancellor Andre G. Bouchard, and Delaware's Secretary of State Jeffrey Bullock. Richards, Layton & Finger lawyers also played key roles in developing the DRAA: two of our partners were deeply involved in drafting the statute, and a third played a principal role in drafting the proposed model rules.
Recent Developments in Delaware Corporate Law
Oregon State Bar Association
Business Law – The Life of a Deal
November 3, 2017

Overview of Discussion Topics

1. 2017 Amendments to the DGCL
2. Standard of Review
3. Contract Construction
4. Preferred Stock Issues
5. Removal of Directors/Officers
6. Board and Director Action
7. Director Compensation
8. Appraisal Rights
Several sections of the DGCL have been revised to accommodate the use of “blockchain” or “distributed ledger” technology for the maintenance of corporate records.

- Distributed ledger technology allows for the creation of a ledger of transactions shared among a network of participants, rather than relying on a central source.

- The blockchain amendments address the fact that a distributed ledger does not involve a central database controlled by the officers of the corporation.
DGCL Amendments – “Block Chain” Amendments

- Section 219 was amended to define “stock ledger” as “one or more records administered by or on behalf of the corporation in which the names of all of the corporation’s stockholders of record, the address and number of shares registered in the name of each such stockholder, and all issuances and transfers of stock of the corporation are recorded in accordance with [Section 224 of the DGCL].”

- Section 224 was amended to provide that any records “administered by or on behalf of the corporation” may be kept on, by means of, or in the form of, any information storage device or method, “or one or more electronic networks or databases (including one or more distributed electronic networks or databases).”

DGCL Amendments – Stockholder Consents

- Section 228 of the DGCL, which deals with stockholder action by consent in lieu of a meeting, was amended to remove the requirement that each consent bear the date of signature of the stockholder executing the consent.

- The amendment addresses concerns stemming from H-M Wexford LLC v. Encorp, Inc., 832 A.2d 129 (Del. Ch. 2003), which brought into question the validity of consents that were not individually dated by the stockholders.

- Section 228(c), as amended, continues to provide a sixty-day period for the delivery of consents representing a sufficient number of votes to take the action.

- Amended Section 228(c) provides that the sixty-day period commences on the first date a consent is delivered to the corporation.
DGCL Amendments – Merger Statutes

- The 2017 amendments make technical and clarifying changes to the merger statutes.
  - Sections 254, 263 and 264 were amended to expressly permit mergers of Delaware corporations with certain non-U.S. joint-stock associations, partnerships and limited liability companies.
  - The sections of the DGCL governing mergers with non-Delaware entities were amended to provide that such mergers or consolidations are permitted under Delaware law so long as the laws of the non-Delaware jurisdictions do not prohibit such mergers.

DGCL Amendments – Effective Time of Section 203 “Opt Out”

- Section 203 of the DGCL (Delaware’s anti-takeover statute) was amended to clarify when an amendment to the certificate of incorporation or bylaws “opting out” of the restrictions becomes effective.
In 2015, in *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), the Delaware Supreme Court held that, following an informed and uncoerced vote of stockholders, the business judgment rule applies to a third-party merger.

In *Singh v. Attenborough*, 137 A.3d 151 (Del. 2016), the Delaware Supreme Court confirmed that the effect of such vote is to insulate any such transaction from judicial scrutiny, absent waste.

In *In re Volcano Corp. S’holder Litig.*, 143 A.3d 727 (Del. Ch. 2016), the Court of Chancery applied *Corwin* to a tender offer followed by a merger under Section 251(h); in *Lax v. Goldman, Sachs & Co.*, No. 372, 2016 (Del. Feb. 9, 2017), the Delaware Supreme Court affirmed.
Standard of Review – Saba Software

- In In re Saba Software, Inc. S’holder Litig., 2017 WL 1201108 (Del. Ch. Mar. 31, 2017), the Court of Chancery declined to apply Corwin to a stockholder-approved third-party merger.
- Following alleged financial fraud, the Company repeatedly failed to restate its financials, resulting in impending de-listing.

- The Court held that the stockholder vote may have been obtained through “situational coercion” resulting from the board’s failure to act (i.e., restate its financials) in the face of a known duty to act.
  - Such failures “may have wrongfully induced . . . [s]tockholders to vote in favor of the [m]erger for reasons other than the economic merits of the transaction.”
  - Stockholders were forced to choose between accepting the merger consideration (allegedly depressed due to the company’s failure to restate its financials and its impending de-listing) and holding illiquid stock (the stock was considered illiquid because by the time the stockholders voted to approve the merger, Saba was de-listed).
  - In addition, the proxy statement failed to disclose the company’s explanation for its failure to restate its financials.
In re Massey Energy Co. Deriv. & Class Action Litig., 160 A.3d 484 (Del. Ch. 2017), the Court of Chancery held that Corwin did not provide a basis for dismissing director oversight claims that were based on events occurring across several years prior to the company’s merger, notwithstanding the fact that (a) such events may have necessitated the sale of the company and (b) a majority of the company’s disinterested stockholders approved the merger.

The Court clarified that in order to invoke Corwin, there must be a proximate relationship between the transaction or issue for which stockholder approval is sought and the nature of the claims to be cleansed as a result of a fully-informed vote.

“The policy underlying Corwin, to my mind, was never intended to serve as a massive eraser, exonerating corporate fiduciaries for any and all of their actions or inactions preceding their decision to undertake a transaction for which stockholder approval is obtained.”

In Sciabacucchi v. Liberty Broadband Corp., 2017 WL 2352152 (Del. Ch. May 31, 2017), the Delaware Court of Chancery held that the Defendants were not entitled to dismissal under the Corwin doctrine due to structural coercion.

Although the Court held that the transactions did not involve a controller so inherent coercion was not applicable, the Court nevertheless found structural coercion because the transaction was structured to include an equity issuance to the company’s largest stockholder.

This issuance was purportedly to finance the acquisition, but the Plaintiff argued that these issuances were not necessary to finance the acquisition and stockholders were forced to accept an equity issuance in order to approve the overall transaction.

The Court explained that the word “‘[c]oercion’ is a loaded term, but a vote so structured... to accept one (allegedly self-interested) transaction (i.e. the Liberty Share Issuances and Voting Proxy Agreement) so as not to lose the benefit of another independent transaction (the acquisition), cannot to my mind be considered uncoerced... If they (the stockholders) voted one way, they could forgo two lucrative deals. If they voted another way, they would transfer value to an insider (and, should Corwin apply, release a potentially valuable fiduciary duty claim).”
Standard of Review – Controlling Stockholder Transactions

- The entire fairness test is the default standard of review for challenges to conflicted controlling stockholder transactions.

- In Kahn v. M&F Worldwide Corp., 88 A.3d 65 (Del. 2014) (“MFW”), the Delaware Supreme Court held that the business judgment standard of review applies to a two-sided controlling stockholder merger when it is conditioned, ab initio, on:
  - Negotiation and approval by an independent, fully functioning and duly empowered special committee that fulfills its duty of care; and
  - The uncoerced, fully informed vote of a majority of the minority stockholders.

Standard of Review – Extension of MFW

- In In re Martha Stewart Living Omnimedia, Inc. S’holder Litig., 2017 WL 3568089 (Del. Ch. Aug. 18, 2017), the Court dismissed claims made against Martha Stewart, the former controlling stockholder of Martha Stewart Living Omnimedia, Inc. (“MSLO”), for alleged breaches of her fiduciary duties in connection with the 2015 sale of MSLO.

- Plaintiffs alleged that Stewart leveraged her position as a controlling stockholder to secure greater consideration for herself through side deals with the buyer. Plaintiffs argued that entire fairness was the appropriate standard of review because Stewart was conflicted.

- The Court held that Stewart was not conflicted because even though she secured side deals with the buyer, her side deals were not “meaningfully different” than her pre-merger arrangements with MSLO.
Standard of Review – Extension of *MFW*

- In determining whether a controlling stockholder’s side deals rendered the controlling stockholder conflicted, the Court looked at whether the side deals with the controller diverted merger consideration from the minority stockholders.

- Because, *inter alia*, the merger consideration was increased following negotiations with Stewart and because the side deals Stewart received were essentially the same as deals Stewart had with MSLO, the Court held that Stewart was not a conflicted controller and was entitled to business judgment review deference.

Standard of Review – Extension of *MFW*

- Further, the Court opined that even if the side deals had rendered Stewart conflicted, the procedural protections provided to the minority stockholders lowered the standard of review to business judgment under *MFW*.

- The Court, in dicta, opined that conflicted one-sided controller transactions are entitled to pleadings-stage business judgment rule deference if the *MFW* protective framework is put into place before the controller and third party begin to negotiate any special arrangement for the controller.

  - The Court defined a conflicted one-sided controlling stockholder transaction as one in which “the controlling stockholder does not stand on both sides of the transaction but exploits its position of leverage on the sell-side to extract ‘different consideration or derive some unique benefit from the transaction not shared with the common stockholders.’”

  - This one-sided controller transaction *ab initio* requirement is different from *MFW* because *MFW* requires conflicted two-sided controller transactions to have the *MFW*-prescribed protective measures in place before merger negotiations commence between the buyer and target company.
Contract Construction

In IAC Search, LLC v. Conversant LLC, C.A. No. 11774-CB (Del. Ch. Nov. 30, 2016), the Court of Chancery held that in a purchase agreement between IAC Search, LLC (“buyer”) and ValueClick, Inc. (“seller”), the buyer’s acknowledgment provision, an integration clause and the seller’s disclaimer of making any extra-contractual representations, collectively, constituted a “clear disclaimer of reliance on extra-contractual statements” and barred the buyer’s fraud claim.

The buyer alleged, inter alia, that because of falsified information provided by the seller, it was fraudulently induced into purchasing Investopedia from the seller.
Contract Construction – *Conversant*

- The Court held that the *buyer’s* strong acknowledgment language agreeing that the seller “was not making any representation concerning information provided during due diligence” unless it was stated elsewhere in the purchase agreement, combined with an integration clause and a disclaimer by seller that it was not making any extra-contractual representations, provided a clear disclaimer of reliance on extra-contractual statements.

- The Court held that while the language could have been stronger (e.g., including a release by buyer of seller for extra-contractual representations), the three provisions defined the “universe of information on which [the buyer] relied and did not rely when it entered into the [purchase] agreement.”

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Contract Construction – *Takeaways*

- Sellers should be able to insulate themselves from fraud claims based on extra-contractual representations, provided the agreement is properly drafted.

- While the agreement need not contain specific wording, sellers should ensure the agreement:
  - includes an integration clause
  - includes a non-reliance provision in which the *buyer* expressly disclaims reliance on extra-contractual representations by the seller
  - includes an exclusive remedy provision tailored to permit only fraud claims based on representations included in the acquisition agreement
  - does NOT include any fraud carve-outs in the disclaimer
Preferred Stock Issues:
Preferred Stock Redemption Rights

• In Frederick Hsu Living Trust v. ODN Holding Corp., C.A. No. 12108-VCL (Del. Ch. Apr. 25, 2017), a common stockholder claimed that directors of ODN Holding Corp. (“ODN”) breached their fiduciary duties by deliberately selling most of the income-generating assets of ODN to amass enough cash to redeem the ODN preferred stock held by Oak Hill.

• Oak Hill had the right to redeem the preferred stock, subject to a waiting period and the existence of sufficient legally available funds.

• The certificate of incorporation required the Board to generate funds for the redemption through “reasonable actions” as determined in good faith and consistent with its fiduciary duties.
Preferred Stock Redemption Rights – *ODN*

- Plaintiffs alleged that the Board sold the company's businesses at “fire sale” prices to generate proceeds for the redemption.

- Although the redemption did not violate Section 160 of the DGCL (as the Company had sufficient surplus), the common stockholders could claim that the directors “breached their fiduciary duties when generating surplus and legally available funds” for the redemption.

- The Court explained that directors can breach their fiduciary duties if they generate funds for redemption in a manner that does not “maximize the value of [the company] over the long-term for the benefit of the undifferentiated equity.”
  - According to the Court, this might require a board to delay or forego generating funds in an “efficient breach” to its obligations.
  - “Efficient breach” was not required in *ODN* because the under the terms of the preferred stock, directors were obligated to generate funds only if doing so was “reasonable” and consistent with their fiduciary duties.
  - Because the directors’ decision to liquidate the subsidiary businesses gave rise to an inference that the directors favored Oak Hill over the long-term interests of the common stockholders, the Court allowed the plaintiff’s breach of fiduciary duty claims to proceed.
Preferred Stock Issues: Liquidation Preferences

- In *In re Appraisal of Goodcents Holdings, Inc.*, 2017 WL 2463665 (Del. Ch. June 7, 2017), the Court held in an appraisal proceeding brought by holders of common stock that a merger did not trigger the preferred stockholders’ liquidation preference.

- In so finding, the Court held that the relevant provision in the corporation’s certificate of incorporation did not entitle the holders of preferred stock to a liquidation preference in the event of a merger, but rather provided the preferred stockholders with a class vote or blocking right over a merger in which they did not receive their liquidation preference.
preferred stock issues:
transfer restrictions

transfer restrictions

- In Henry v. Phixios Holdings, Inc., 2017 WL 2928034 (Del. Ch. July 10, 2017), the Court of Chancery examined stock transfer restrictions under Section 202 of the DGCL.

- In Henry, Phixios Holdings, Inc. ("Phixios") adopted a stockholder agreement containing a stock transfer restriction that allowed Phixios to revoke any employee’s stock if the employee took any action that was “damaging” to Phixios.

- Subsequently, Phixios hired Jon Henry, and Henry received Phixios stock as part of his compensation. Henry’s stock certificates did not contain or note any stock transfer restrictions, and there was nothing in writing to show the restrictions were provided to Henry prior to receiving the stock.
Transfer Restrictions

- Henry’s wife owned and operated a small consulting company, RSH Business Consulting Services (“RSH”). While employed with Phixios, Henry and his wife, through RSH, pursued government contracting opportunities. Phixios claimed that Henry’s pursuit of such contracts was in direct competition with, and damaging to, Phixios in violation of the stock transfer restriction.

- Henry made a Section 220 demand to inspect the books and records of Phixios in order to investigate potential corporate wrongdoing.

- Phixios attempted to revoke Henry’s Phixios stock based on the claim that he violated the company’s stock transfer restriction in the stockholder agreement.

- Henry claimed that he remained a stockholder because he did not have actual knowledge of the stock transfer restrictions before he acquired the stock and never assented to the restrictions after he acquired the stock as required by Section 202 of the DGCL.

The Court of Chancery held that Section 202(a) and (b) of the DGCL “must be read to mean that an existing restriction on the transfer of a security is binding on subsequent purchasers of the securities if:

1. It is noted conspicuously on the certificate representing the security;
2. The stockholder has actual knowledge of the restriction at the time he acquires the stock; or
3. The stockholder consents to be bound by the restriction either through a vote or through a subsequent agreement with the stockholders or with the company.”
   - The Court further noted that this assent must be affirmative.

The Court determined that Henry’s stock certificates did not contain or note the transfer restriction, Henry did not have actual knowledge of the transfer restriction at the time of acquiring the stock and that Henry did not affirmatively assent to the transfer restriction after acquiring the stock. Thus, the Court held that the stock transfer restriction was not binding on Henry and Phixios could not revoke Henry’s stock.
Removal of Directors/Officers

- In *In re Vaalco Energy, Inc. S’holder Litig.,* C.A. No. 11775-VCL (Del. Ch. Dec. 21, 2015) (TRANSCRIPT), the Court of Chancery invalidated provisions of Vaalco’s certificate of incorporation and bylaws providing that directors on a non-classified board could be removed only for cause.

  - Section 141(k) provides directors may be removed by a majority of the outstanding voting power.
  - Section 102(b)(4) permits the certificate of incorporation (but not the bylaws) to increase the default vote required by the DGCL.
In *Gorman v. Salamone*, 2015 WL 4719681 (Del. Ch. July 31, 2015), the Court of Chancery held that a stockholder-adopted bylaw purporting to allow stockholders to remove officers without cause was invalid.

- The bylaw permitted the removal of officers “with or without cause, at any time by the Board or by the stockholders” and required the board to “immediately implement any such removal ... by the stockholders.”

- As it permitted stockholders to “make substantive business decisions” and “unduly interfer[e] with directors’ management prerogatives” under Section 141(a) of the DGCL, the bylaw and actions taken in reliance thereon were invalidated.
Board and Director Action – *Kleinberg*

- In *Kleinberg v. Aharon*, 2017 WL 568342 (Del. Ch. Feb. 13, 2017), the Court held that the appointment of a custodian-director was an appropriate remedy to break a board deadlock that was crippling an innovative sewage-processing company.

- In its recitation of the facts, the Court issued two reminders regarding corporate governance under Delaware law.

  1. First, the Court noted that a director purported to appoint another individual to act on his behalf at a board meeting.
     - The Court informed the parties that under Delaware law, a director cannot act by proxy.

  2. Second, the Court noted that a separate board meeting was conducted in a language that one director did not speak.
     - The Court held that board actions taken at such meeting were invalid because one of the directors was prevented from effectively participating in the meeting as a result of the language barrier.
Director Compensation – Generally

- In general, because directors “stand on both sides” of a decision to fix their own compensation, the decision will not be entitled to the presumption of the business judgment rule but will be tested under the entire fairness standard.

- Stockholder ratification (through fully informed, disinterested vote) may restore the presumption of the business judgment rule.
  
  - Ratification may be prospective, as in the case where stockholders approve an incentive plan providing for grants to directors in specified amounts or within a narrow specified range.
  
  - Ratification may be retroactive, as in the case where the board’s decision is submitted to stockholders for adoption.

Director Compensation – Calma

- In *Calma v. Templeton*, C.A. No. 9579-CB [Del. Ch. Apr. 30, 2015], the Court of Chancery held that the stockholders’ ratification of an equity award plan containing a “generic limit” on the number of awards available was not sufficient to restore the presumption of the business judgement rule to the directors’ decision to make grants to themselves under the plan.
In *In re Investors Bancorp, Inc. S’holder Litig.*, 2017 WL 1277672 (Del. Ch. Apr. 5, 2017), the Court of Chancery granted the director-defendants’ motion to dismiss the plaintiffs’ claims challenging “quite large” equity incentive awards made to the company’s non-executive directors.

- The stockholders’ approval of an equity incentive plan that included sub-limits for non-employee directors was sufficient to provide “advance ratification” of the awards.
- That the sub-limits for non-employee directors were included in an “omnibus plan” that allowed for awards to multiple types of recipients, rather than in a director-specific plan, was irrelevant.
- Decision is currently on appeal in the Delaware Supreme Court.
- Oral Argument was held on October 2, 2017.

**Appraisal Rights**
Chapter 1—Recent Developments in Delaware Corporate Law

Appraisal Rights: Recent Trends

- Significant increase in appraisal demands and litigation over the past several years
  - **2012**: 16 appraisal petitions filed
  - **2015**: 52 appraisal petitions filed
  - **2016**: 76 appraisal petitions filed

Data represent the number of individual appraisal petitions filed, not the number of consolidated actions currently pending in the Court of Chancery.

Appraisal Rights: Fair Value is the Merger Price

- A number of recent decisions have held that the best indication of a corporation’s fair value was the negotiated merger price.

- In these cases, the Court of Chancery focused on:
  - Robust pre-signing auction process;
  - Uncertainty or unreliability of DCF inputs; and
  - Extreme divergence of litigation experts’ opinions.
In *In re Appraisal of Dell Inc.*, 2016 WL 3186538 (Del. Ch. May 31, 2016), the Court determined that the fair value of the common stock of Dell at the time of its sale was $17.62 per share—approximately 28% more than the final merger consideration of $13.75.

The Court noted that the merger process would “sail through” if challenged under fiduciary duty principles, but rejected Dell’s contention that the merger price was the best evidence of Dell’s fair value.

Instead, the Court relied exclusively on the discounted cash flow methodology to determine fair value, giving no weight to the negotiated merger price.

The Court identified three reasons for giving no weight to the merger price:

- The merger price had been limited by the use of an LBO pricing model, which diverges from fair value because of a financial sponsor’s “need to achieve IRRs of 20% or more to satisfy its own investors.”

- “Widespread and compelling evidence” showed that the market undervalued Dell’s stock, creating a “so-called anti-bubble.”

- There was a lack of meaningful price competition in the pre-signing phase of the transaction, and a post-signing go-shop did not establish that Dell stockholders received fair value.

Decision is currently on appeal in the Delaware Supreme Court.

Oral Argument was held on September 27, 2017.
In re Appraisal of PetSmart, Inc.

- In *In re Appraisal of PetSmart, Inc.*, 2017 WL 2303599 (Del. Ch. May 26, 2017), the Court held that the respondent established that the merger “was the result of a proper transactional process comprised of a robust pre-signing auction in which adequately informed bidders were given every incentive to make their best offer in midst of a well-functioning market,” and thus found the deal price to be a reliable indicator of fair value.

- In so holding, the Court expressly rejected the argument that leveraged buyouts will rarely, if ever, produce fair value.
  - The Court determined that the management projections were unreliable and viewed any DCF analysis derived therefrom as less reliable than the deal price.

- As a result, the Court deferred entirely to deal price, holding that such price was equal to the fair value of the appraised shares.

In re Appraisal of DFC Global

- In *In re Appraisal of DFC Global*, 2016 WL 3753123 (Del. Ch. July 8, 2016), the Court of Chancery declined to adopt the deal price as the most reliable indicator of fair value. The Court opined that while the transaction was arm’s-length and subject to a robust pre-signing market check, significant regulatory uncertainty undermined the reliability of the market’s view of DFC’s value.

  - The Court determined an appraised value of $10.30 per share, approximately 8% above the deal price of $9.50, by equally weighting: (1) transaction price, (2) DCF valuation and (3) comparable companies valuation.

- On appeal, the Supreme Court reversed.
  - The Supreme Court held that it was inappropriate for the Court of Chancery to give the deal price only one-third weighting where the transaction had been subject to a robust market check without allegations of self-interest that resulted in an arms-length sale to a third party.
  - The Supreme Court held that under these circumstances, the deal price should have been accorded greater emphasis and remanded the case to the Court of Chancery to reconsider and explain its weighting methodology.
Two recent decisions have held that fair value was below the negotiated merger price.


In both cases, the Court of Chancery:

- Found deal price unreliable as evidence of fair value; and
- Relied primarily on DCF
- Noted significant synergies for the Buyer
This presentation and the material contained herein are provided as general information and should not be construed as legal advice on any specific matter or as creating an attorney-client relationship. Before relying on general legal information or deciding on legal action, request a consultation or information from a Richards, Layton & Finger attorney on specific legal needs.
Chapter 2
Before the Deal

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Before The Deal

Meghan Williams, Miller Nash Graham & Dunn LLP
Amanda Loupin-Bartlett, Schwabe Williamson & Wyatt

Setting The Stage

• Assemble the team
• What lawyers can do to help
Confidentiality Agreements

• Defining “Confidential Information”
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  – Who is a Representative?
  – How is Confidential Information shared?
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• Venue

Due Diligence

• Preliminary
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Letters of Intent

• What is a Letter of Intent?

• Pros
  – Demonstrate commitment
  – Identify deal breakers early on
  – Focus negotiations
  – Preliminary documentation to governing boards, lenders, or other third parties

• Cons
  – Can be costly to negotiate and prepare
  – Lengthened negotiations/impaired deal momentum

Letters of Intent

Non-Binding Provisions

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Letters of Intent

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- Confidentiality
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- Termination
- Governing Law

Key Takeaways
LETTER OF INTENT

This Letter of Intent is between [BUYER] (“Buyer”) and [SELLER] (“Seller”).

RECITALS

A. This Letter of Intent summarizes the principal terms of a proposed transaction being considered by the parties in which Buyer [ or a to-be-formed entity controlled by Buyer ] would buy certain assets of Seller.

B. [SELLING SHAREHOLDERS] (collectively, “Selling Shareholders”) are [ the only ] shareholders of Seller.

C. [DESCRIBE RELATIONSHIP BETWEEN SELLER AND ANY "SELLER RELATION" THAT MAY ENTER INTO ANY OF THE AGREEMENTS SPECIFIED IN SECTION 4]

D. [DESCRIBE RELATIONSHIP BETWEEN BUYER AND ANY "BUYER RELATION" THAT MAY ENTER INTO ANY OF THE AGREEMENTS SPECIFIED IN SECTION 4]

E. The parties desire to negotiate a definitive written asset purchase agreement (the “Definitive Agreement”), and have agreed that Buyer’s attorney will prepare an initial draft of the Definitive Agreement consistent with terms and conditions of this Letter of Intent.

PART ONE – NONBINDING PROVISIONS

Based on the information known to the parties as of the date of this Letter of Intent, the parties propose that the Definitive Agreement be consistent with the nonbinding provisions set forth in this Part One (collectively, the “Nonbinding Provisions”).

SECTION 1 DEFINITIONS

“Assets” means [ substantially all of Seller’s assets, as more specifically set forth in the Definitive Agreement. ] [ all of Seller’s assets, except for the retained assets set forth on Schedule 1. ] [ the assets set forth on Schedule 1. ]

“Assumed Liabilities” means [ substantially all of Seller’s liabilities, as more specifically set forth in the Definitive Agreement. ] [ all of Seller’s liabilities, except for the retained liabilities set forth on Schedule 1. ] [ the liabilities set forth on Schedule 1. ]

SEE SECTIONS 5.5(g), 5.6(d), and 10(a)

SECTION 2 ASSETS AND LIABILITIES

2.1 Assets. At the closing of the Definitive Agreement, Buyer would buy the Assets from Seller and Seller would sell the Assets to Buyer. Buyer would not buy from Seller, and Seller would not sell to Buyer, any of Seller’s assets other than the Assets.

2.2 Liabilities. At the closing of the Definitive Agreement, Buyer would assume the Assumed Liabilities. Buyer would not assume any of Seller’s liabilities other than the Assumed Liabilities.

SECTION 3 PURCHASE PRICE

3.1 Purchase Price. The purchase price for the Assets would be:

USE ONE OR MORE OF THE FOLLOWING SUBSECTIONS, IF APPLICABLE

(a) $[AMOUNT] \{ ; \} \{ , as adjusted in accordance with Section 3.4; \}

PLUS

(b) \{ [NUMBER]\% of \} Seller’s cost of Seller’s inventories on hand at the closing of the Definitive Agreement;

PLUS

(c) the assumption of the Assumed Liabilities.

3.2 Payment. [ Subject to Section 3.4, ] Buyer would pay the purchase price for the Assets as follows:

USE ONE OR MORE OF THE FOLLOWING SUBSECTIONS, IF APPLICABLE

(a) at the closing of the Definitive Agreement, Buyer would pay Seller $[AMOUNT] \{ ; \} \{ , plus \{ [NUMBER]\% of \} Seller’s cost of Seller’s inventories on hand at the closing of the Definitive Agreement; \}

(b) at the closing of the Definitive Agreement, Buyer would \{ issue to Seller shares of [CLASS] of Buyer \} \{ deliver to Seller shares of [CLASS] of [COMPANY] \} having an aggregate value equal to $[AMOUNT], where each share would have a value equal to [PRICE OR FORMULA];

ALTERNATIVE #1 – EQUAL PAYMENTS OF PRINCIPAL AND INTEREST

(c) beginning [TIME PERIOD] after the closing of the Definitive Agreement, Buyer would pay Seller $[AMOUNT], together with interest on the unpaid balance at an annual rate of [INTEREST RATE]\% from the closing of the Definitive Agreement, in [NUMBER] equal \{ monthly \} \{ quarterly \} \{ annual \} payments of principal and interest; and

ALTERNATIVE #2 – INTEREST ONLY FOR A SPECIFIED NUMBER OF PAYMENTS, AND THEN EQUAL PAYMENTS OF PRINCIPAL AND INTEREST
(d) beginning [TIME PERIOD] after the closing of the Definitive Agreement, Buyer would pay Seller $[AMOUNT], together with interest on the unpaid balance at an annual rate of [INTEREST RATE]% from the closing of the Definitive Agreement, in [NUMBER] equal { monthly } { quarterly } { annual } payments of principal and interest, where:

1. each of the first [NUMBER] payments would consist of interest only; and
2. the final [NUMBER] payments would consist of equal payments of principal and interest;

ALTERNATIVE #3 – INTEREST ONLY FOR A SPECIFIED NUMBER OF PAYMENTS, AND THEN ONE BALLOON PAYMENT

(e) beginning [TIME PERIOD] after the closing of the Definitive Agreement, Buyer would pay Seller $[AMOUNT], together with interest on the unpaid balance at an annual rate of [INTEREST RATE]% from the closing of the Definitive Agreement, in [NUMBER] equal { monthly } { quarterly } { annual } payments of principal and interest, where:

1. each of the first [NUMBER] payments would consist of interest only; and
2. the final payment would consist of principal and interest; and

(f) at the closing of the Definitive Agreement, Buyer would assume the Assumed Liabilities.

3.3 Prorated Expenses. Any utilities, rents, real and personal property taxes, wages, and other similar expenses with respect to the Assets or the Assumed Liabilities would be prorated between Seller and Buyer as of the closing of the Definitive Agreement.

3.4 Adjustment.

(a) The purchase price for the Assets would be:

(1) increased by [ADJUSTMENT]; and
(2) decreased by [ADJUSTMENT].

(b) An adjustment to the purchase price under this Section 3.4 would result in a corresponding adjustment to the payment specified in Section 3.2[REFERENCE].

SECTION 4 ADDITIONAL AGREEMENTS

Contemporaneously with the closing of the Definitive Agreement, the parties would enter into such other agreements as they may agree, including but not limited to the following:
4.1 **Employment Agreement.** Buyer and [SELLER RELATION] would enter into a [alternatively: an employment agreement, in form and substance reasonably satisfactory to Buyer.]; a [alternatively: [TIME PERIOD] employment agreement under which:

(a) [SELLER RELATION] would serve as Buyer’s [POSITION];

(b) Buyer would pay [SELLER RELATION] an annual salary of [$AMOUNT]; and

(c) [SELLER RELATION] would agree to [TIME PERIOD] noncompetition, nonsolicitation, and no-hire provisions in favor of Buyer.

4.2 **Noncompetition Agreement.** Buyer and [SELLER RELATION] would enter into a noncompetition agreement, in form and substance reasonably satisfactory to Buyer. A [alternatively: [TIME PERIOD] noncompetition agreement, which would contain noncompetition, nonsolicitation, and no-hire provisions in favor of Buyer.]

4.3 **Consulting Agreement.** Buyer and [SELLER RELATION] would enter into a consulting agreement under which [SELLER RELATION] would provide consulting services to Buyer as a part-time employee. as an independent contractor.

4.4 **Security Agreement.** The parties would enter into a security agreement under which Buyer would grant Seller a security interest in [COLLATERAL] to secure Buyer’s obligations under the Definitive Agreement and all related agreements.

4.5 **Pledge Agreement.** The parties would enter into a pledge agreement under which Buyer would grant Seller a security interest in [COLLATERAL] to secure Buyer’s obligations under the Definitive Agreement and all related agreements.

4.6 **Guaranty Agreement.** [BUYER RELATION] would enter into a guaranty agreement in favor of Seller under which [BUYER RELATION] would irrevocably and unconditionally guarantee Buyer’s obligations under the Definitive Agreement and all related agreements.

**SECTION 5 ADDITIONAL TERMS AND CONDITIONS**

**ALTERNATIVE #1 – GENERAL**

The Definitive Agreement would contain such representations, warranties, covenants, indemnification provisions, limitation of liability provisions, conditions to closing, and other terms and conditions as the parties may agree.

**ALTERNATIVE #2 – MORE SPECIFIC**

The Definitive Agreement would contain such representations, warranties, covenants, indemnification provisions, limitation of liability provisions, conditions to closing, and other terms and conditions as the parties may agree, including but not limited to the following:

5.1 **Joint and Several Liability.** Each Selling Shareholder would be a party to the Definitive Agreement. Seller and Selling Shareholders would make joint and several representations, warranties, and covenants, and would be jointly and severally liable for all of their indemnification obligations.

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*Business Law—The Life of a Deal*
5.2 **No Materiality Qualifications.** The parties’ representations, warranties, and covenants would not be subject to any “materiality” qualifications, except where such a qualification is inherent in the representation, warranty, or covenant itself, as in a “No Material Adverse Change” representation.

5.3 **Limitation on Seller’s [ ] and Selling Shareholders’ [ ] Liability.**

(a) Subject to Section 5.3(b), Seller [ ] and Selling Shareholders [ ] would have no liability to Buyer for indemnification or otherwise with respect to:

1. any claim that arises out of or results from a breach of any representation, warranty, or covenant in the Definitive Agreement, unless Buyer notifies Seller [ ] and Selling Shareholders [ ] of the claim and specifies in reasonable detail the facts giving rise to the claim within [TIME PERIOD] after the closing of the Definitive Agreement;

2. any claim that arises out of or results from a breach of any representation or warranty in the Definitive Agreement, if the aggregate liability for the claim is less than $[DE MINIMIS AMOUNT];

3. claims that arise out of or result from a breach of any representation or warranty in the Definitive Agreement that are not less than $[DE MINIMIS AMOUNT], unless the aggregate liability for such claims exceeds $[BASKET AMOUNT], and then only to the extent that the aggregate liability for such claims exceeds $[BASKET AMOUNT]; or

4. claims that arise out of or result from a breach of any representation, warranty, or covenant, to the extent that Seller’s [ ] and Selling Shareholders’ [ ] aggregate liability for all claims that arise out of or result from a breach of any representation, warranty, or covenant exceeds $[CAP AMOUNT].

(b) The limitations on Seller’s [ ] and Selling Shareholders’ [ ] liability in this Section 5.3 would not apply with respect to a claim that arises out of or results from:

1. a breach of any “Title to Assets” representation or warranty;

2. a breach of any “Taxes” representation or warranty;

3. a breach of any “Employee Benefits” representation or warranty;

4. a breach of any “Environmental” representation or warranty;

5. a breach of any “Investment” representation or warranty;

6. a breach of any representation or warranty, if Buyer demonstrates by clear and convincing evidence that, as of the date of the Definitive Agreement, Seller [ ] or any Selling Shareholder [ ] had knowledge of the facts giving rise to the breach and that the facts constituted a breach; or
5.4 Limitation on Buyer’s Liability.

(a) Subject to Section 5.4(b), Buyer would have no liability to Seller [ and Selling Shareholders ] for indemnification or otherwise with respect to:

1. any claim that arises out of or results from a breach of any representation, warranty, or covenant in the Definitive Agreement, unless [ Seller notifies Buyer of the claim and specifies in reasonable detail ] [ Seller and Selling Shareholders notify Buyer of the claim and specify in reasonable detail ] the facts giving rise to the claim within [TIME PERIOD] after the closing of the Definitive Agreement;

2. any claim that arises out of or results from a breach of any representation or warranty in the Definitive Agreement, if the aggregate liability for the claim is less than $[DE MINIMIS AMOUNT];

3. claims that arise out of or result from a breach of any representation or warranty in the Definitive Agreement that are not less than $[DE MINIMIS AMOUNT], unless the aggregate liability for such claims exceeds $[BASKET AMOUNT], and then only to the extent that the aggregate liability for such claims exceeds $[BASKET AMOUNT]; or

4. claims that arise out of or result from a breach of any representation, warranty, or covenant, to the extent that Buyer’s aggregate liability for all claims that arise out of or result from a breach of any representation, warranty, or covenant exceeds $[CAP AMOUNT].

(b) The limitations on Buyer’s liability in this Section 5.4 would not apply with respect to a claim that arises out of or results from:

1. a breach of any representation or warranty involving the shares that would be issued to Seller;

2. a breach of any representation or warranty, if [ Seller demonstrates ] [ Seller and Selling Shareholders demonstrate ] by clear and convincing evidence that, as of the date of the Definitive Agreement, Buyer had knowledge of the facts giving rise to the breach and that the facts constituted a breach; or

3. a breach of any covenant, if [ Seller demonstrates ] [ Seller and Selling Shareholders demonstrate ] by clear and convincing evidence that Buyer intentionally breached the covenant.

5.5 Conditions to Buyer’s Closing Obligations. Buyer’s obligation to close the Definitive Agreement would be subject to the satisfaction of such conditions as the parties may agree, including but not limited to the following conditions:
5.6 Conditions to Seller’s [ and Selling Shareholders’ ] Closing Obligations. Seller’s [ and Selling Shareholders’ ] obligation to close the Definitive Agreement would be subject to the satisfaction of such conditions as the parties may agree, including but not limited to the following conditions:

(a) Seller’s [ and Selling Shareholders’ ] satisfactory completion of a due diligence investigation of Buyer;

(b) the consents, authorizations, and approvals set forth on Schedule 5.6 must have been obtained;

(c) the shareholders of Seller must have approved the closing of the Definitive Agreement;

(d) all applicable filings under the HSR Act must have been made, and the termination or expiration of all applicable waiting periods under the HSR Act must have occurred;

(e) [SPECIFIC CONDITION]; and

(f) [SPECIFIC CONDITION].
PART TWO – BINDING PROVISIONS

The binding provisions set forth in this Part Two (collectively, the “Binding Provisions”) are legally binding and enforceable against Buyer and Seller.

SECTION 6 DUE DILIGENCE

ALTERNATIVE #1 — BUYER’S DUE DILIGENCE OF SELLER

Upon Buyer’s request, Seller will provide Buyer and Buyer’s representatives with access to Seller’s properties and personnel, and make available to Buyer and Buyer’s representatives originals or copies of all of Seller’s books, records, agreements, and other documents concerning the Assets.

ALTERNATIVE #2 — RECIPROCAL

6.1 Buyer. Upon Buyer’s request, Seller will provide Buyer and Buyer’s representatives with access to Seller’s properties and personnel, and make available to Buyer and Buyer’s representatives originals or copies of all of Seller’s books, records, agreements, and other documents concerning the Assets.

6.2 Seller. Upon Seller’s request, Buyer will provide Seller and Seller’s representatives with access to Buyer’s properties and personnel, and make available to Seller and Seller’s representatives originals or copies of all of Buyer’s books, records, agreements, and other documents.

SECTION 7 CONDUCT OF BUSINESS

Each party will conduct its business in the ordinary course, and will not enter into any transaction that is not in the ordinary course of its business.

SECTION 8 EXCLUSIVITY

For a period of [NUMBER] days after the date of this Letter of Intent:

8.1 Exclusivity. Seller will negotiate exclusively with Buyer concerning the sale of the Assets. Seller will not, through any representative or otherwise:

(a) provide any information or make any proposal or request to any other person concerning an acquisition of substantially all of the Assets or shares of Seller, whether by sale, merger, consolidation, or otherwise; or

(b) solicit, discuss, consider, or accept any proposal or request from any other person concerning such an acquisition.

8.2 Notification. Seller will promptly notify Buyer if Seller or any shareholder of Seller receives any proposal or request from any other person concerning an acquisition of substantially all of the Assets or shares of Seller, whether by sale, merger, consolidation, or otherwise.
8.3 **Other Negotiations.** Seller will immediately cease any negotiations or discussions that Seller is having with any other person concerning an acquisition of substantially all of the Assets or shares of Seller, whether by sale, merger, consolidation, or otherwise. Seller will immediately revoke any outstanding offer that Seller made to any other person concerning such an acquisition.

SECTION 9  NONDISCLOSURE PROVISIONS

The Nondisclosure Provisions attached as Appendix A are incorporated by reference into this Section 9.

SECTION 10  COSTS AND EXPENSES

Each party will be responsible for its own costs and expenses incurred in connection with this Letter of Intent and the Definitive Agreement, including but not limited to any broker’s fees or finder’s fees, except:

(a) Seller will reimburse Buyer 50% of any filing fee required and paid by Buyer under the HSR Act; and

(b) as otherwise provided in Section 12.

SECTION 11  TERMINATION

11.1 **Termination.** This Letter of Intent will terminate upon the earliest to occur of the following:

(a) upon the written agreement of Buyer and Seller;

(b) upon the signing of the Definitive Agreement; and

ALTERNATIVE #1 – FOR ANY REASON OR NO REASON

(c) upon notice by a party to the other party, for any reason or no reason.

ALTERNATIVE #2 – FOR SPECIFIED REASONS ONLY

(d) upon notice by Buyer to Seller if the satisfaction of any condition in Section 5.5 becomes impossible or commercially impracticable, unless the satisfaction of the condition became impossible or commercially impracticable because Buyer materially breached one or more of the Binding Provisions;

(e) upon notice by Seller to Buyer if the satisfaction of any condition in Section 5.6 becomes impossible or commercially impracticable, unless the satisfaction of the condition became impossible or commercially impracticable because Seller materially breached one or more of the Binding Provisions;

(f) upon notice by Buyer to Seller, if Seller materially breaches one or more of the Binding Provisions;
Upon notice by Seller to Buyer, if Buyer materially breaches one or more of the Binding Provisions;

Upon notice by Buyer to Seller, if the signing of the Definitive Agreement has not occurred on or before [DROP-DEAD DATE], unless the signing has not occurred because Buyer materially breached one or more of the Binding Provisions; and

Upon notice by Seller to Buyer, if the signing of the Definitive Agreement has not occurred on or before [DROP-DEAD DATE], unless the signing has not occurred because Seller materially breached one or more of the Binding Provisions.

11.2 Survival. The provisions of Section 8 through Section 14 will survive the termination of this Letter of Intent.

SECTION 12 BREAK-UP FEE

ALTERNATIVE #1 – SELLER MUST PAY IF SELLER ENTERS INTO ANOTHER AGREEMENT WITH ANOTHER PERSON

12.1 Break-Up Fee. Seller will reimburse Buyer for Buyer’s reasonable costs and expenses incurred in connection with this Letter of Intent and the Definitive Agreement, if:

(a) Seller breaches Section 8; and

(b) Seller or any shareholder of Seller enters into a letter of intent or an agreement with another person concerning an acquisition of substantially all of the Assets or shares of Seller, whether by sale, merger, consolidation, or otherwise, within [TIME PERIOD] after the date of the breach or the delivery of the termination notice.

12.2 Remedies. The break-up fee set forth in Section 12.1 will be the exclusive remedy available to Buyer if Seller breaches Section 8.

ALTERNATIVE #2 – BREACHING PARTY MUST PAY IF THE OTHER PARTY DOES NOT SIGN THE DEFINITIVE AGREEMENT; DO NOT USE THIS ALTERNATIVE IF EITHER PARTY CAN TERMINATE THE LETTER OF INTENT FOR ANY REASON OR NO REASON

12.3 Seller’s Obligation. Seller will reimburse Buyer for Buyer’s reasonable costs and expenses incurred in connection with this Letter of Intent and the Definitive Agreement, if:

(a) Seller materially breaches a Binding Provision;

(b) as a proximate cause of the breach, Buyer does not sign the Definitive Agreement; and

(c) Buyer did not materially breach a Binding Provision.
12.4 **Buyer’s Obligation.** Buyer will reimburse Seller for Seller’s reasonable costs and expenses incurred in connection with this Letter of Intent and the Definitive Agreement and pay to Seller a break-up fee of $[AMOUNT] if:

(a) Buyer materially breaches a Binding Provision;

(b) as a proximate cause of the breach, Seller does not sign the Definitive Agreement; and

(c) Seller did not materially breach a Binding Provision.

12.5 **Remedies.** The break-up fees set forth in this Section 12 will be the exclusive remedy available to a party if the other party breaches a Binding Provision other than a Nondisclosure Provision in Section 9. The break-up fees set forth in this Section 12 will not be the exclusive remedies available to the parties under this Letter of Intent.

**SECTION 13 BINDING EFFECT**

13.1 **Nonbinding Provisions.** The Nonbinding Provisions are not legally binding or enforceable against Buyer or Seller. No binding obligation will exist with respect to the subject matter of the Nonbinding Provisions unless and until the parties sign the Definitive Agreement, and then only to the extent such obligations are set forth in the Definitive Agreement.

13.2 **Binding Provisions.** The Binding Provisions will be binding on the parties and their respective heirs, personal representatives, successors, and permitted assigns, and will inure to their benefit.

**SECTION 14 GENERAL**

14.1 **No Agency Relationship.** This Letter of Intent does not create an agency relationship between the parties and does not establish a joint venture or partnership between the parties. Neither party has the authority to bind the other party or represent to any person that the party is an agent of the other party.

**ALTERNATIVE #1 – NO ASSIGNMENT WITHOUT OTHER PARTY’S CONSENT**

14.2 **No Assignment.** Neither party may assign or delegate any of the party’s rights or obligations under this Letter of Intent to any person without the prior written consent of the other party, which the other party may not withhold unreasonably. If a party is an entity, an assignment includes but is not limited to a transfer of shares or other ownership interests of the party that results in a change in the person owning more than 50% of the shares or other ownership interests of the party, regardless of whether the transfer occurs voluntarily or involuntarily, by operation of law, or because of any act or occurrence.

**ALTERNATIVE #2 – BUYER CAN ASSIGN TO A NEWLY-FORMED ENTITY CONTROLLED BY BUYER**

14.3 **Assignment.**
(a) Buyer may assign this Letter of Intent to a newly-formed entity controlled by Buyer upon [NUMBER] days’ notice to Seller.

(b) Except as otherwise provided in Section 14.3(a), neither party may assign or delegate any of the party’s rights or obligations under this Letter of Intent to any person without the prior written consent of the other party, which the other party may not withhold unreasonably.

(c) If a party is an entity, an assignment includes but is not limited to a transfer of shares or other ownership interests of the party that results in a change in the person owning more than 50% of the shares or other ownership interests of the party, regardless of whether the transfer occurs voluntarily or involuntarily, by operation of law, or because of any act or occurrence.

14.4 Amendment. This Letter of Intent may be amended only by a written document signed by the party against whom enforcement is sought.

14.5 Notices. All notices or other communications required or permitted by this Letter of Intent:

(a) must be in writing;

(b) must be delivered to the parties at the addresses set forth below, or any other address that a party may designate by notice to the other party; and

(c) are considered delivered:

   (1) upon actual receipt if delivered personally, by fax, or by a nationally recognized overnight delivery service; or

   (2) at the end of the third business day after the date of deposit in the United States mail, postage pre-paid, certified, return receipt requested.

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14.6 **Waiver.** No waiver will be binding on a party unless it is in writing and signed by the party making the waiver. A party’s waiver of a breach of a provision of this Letter of Intent will not be a waiver of any other provision or a waiver of a subsequent breach of the same provision.

14.7 **Severability.** If a provision of this Letter of Intent is determined to be unenforceable in any respect, the enforceability of the provision in any other respect and of the remaining provisions of this Letter of Intent will not be impaired if the essential terms and conditions of this Letter of Intent remain, valid, binding, and enforceable.

14.8 **Further Assurances.** The parties will sign other documents and take other actions reasonably necessary to further effect and evidence this Letter of Intent.

14.9 **No Third-Party Beneficiaries.** The parties do not intend to confer any right or remedy on any third party.

14.10 **Termination.** The termination of this Letter of Intent, regardless of how it occurs, will not relieve a party of obligations that have accrued before the termination.

14.11 **Attachments.** Any exhibits, schedules, and other attachments referenced in this Letter of Intent are part of this Letter of Intent.

14.12 **Remedies.** Except as otherwise provided in Section 12, the parties will have all remedies available to them at law or in equity. All available remedies are cumulative and may be exercised singularly or concurrently.

14.13 **Governing Law.** This Letter of Intent is governed by the laws of the State of Washington, without giving effect to any conflict-of-law principle that would result in the laws of any other jurisdiction governing this Letter of Intent.

14.14 **Venue.** Any action, suit, or proceeding arising out of the subject matter of this Letter of Intent will be litigated in courts located in [COUNTY] County, Washington. Each party consents and submits to the jurisdiction of any local, state, or federal court located in [COUNTY] County, Washington.

14.15 **Attorney’s Fees.** If any arbitration, action, suit, or proceeding is instituted to interpret, enforce, or rescind this Letter of Intent, or otherwise in connection with the subject matter of this Letter of Intent, including but not limited to any proceeding brought under the United States Bankruptcy Code, the prevailing party on a claim will be entitled to recover with respect to the claim, in addition to any other relief awarded, the prevailing party’s reasonable attorney’s fees and other fees, costs, and expenses of every kind incurred in connection with the arbitration, action, suit, or proceeding, any appeal or petition for review, the collection of any award, or the enforcement of any order, as determined by the arbitrator or court.

14.16 **Entire Agreement.** This Letter of Intent contains the entire understanding of the parties regarding the subject matter of this Letter of Intent and supersedes all prior and contemporaneous negotiations and agreements, whether written or oral, between the parties with respect to the subject matter of this Letter of Intent.
14.17 Signatures. This Letter of Intent may be signed in counterparts. A fax transmission of a signature page will be considered an original signature page. At the request of a party, the other party will confirm a fax-transmitted signature page by delivering an original signature page to the requesting party.

[signature page follows]
Dated effective: [DATE]

Buyer:

[D] [BUYER]

By: _______________________
Its: _______________________

Seller:

[SELLER]

By: _______________________
Its: _______________________

15 – LETTER OF INTENT
APPENDIX A

Nondisclosure Provisions

ALTERNATIVE #1 – UNILATERAL IN FAVOR OF SELLER

SECTION 1 DEFINITIONS

For purposes of these Nondisclosure Provisions, the following terms have the following meanings:

“Confidential Information” means all information related to Seller or the Assets that Seller discloses to Buyer, including but not limited to business models, customer and supplier lists, marketing plans, financial and technical information, trade secrets, know-how, ideas, designs, drawings, specifications, techniques, programs, systems, processes, and computer software.

“Representatives” means directors, officers, managers, employees, subcontractors, agents, consultants, advisors, and other authorized representatives.

“Restricted Period” means the period beginning on the date of this Letter of Intent and ending on [SPECIFIED DATE].

SECTION 2 OBLIGATIONS OF BUYER

2.1 Use Restrictions and Nondisclosure Obligations. During the Restricted Period:

(a) Buyer will not use Confidential Information for any purpose without Seller’s specific prior written authorization, except Buyer may use Confidential Information to consider and complete the Definitive Agreement.

(b) Buyer will not disclose Confidential Information to any person without Seller’s specific prior written authorization, except Buyer may disclose Confidential Information:

(1) on a need-to-know basis, to Representatives of Buyer who are informed by Buyer of the confidential nature of the Confidential Information and the obligations of Buyer under these Nondisclosure Provisions; or

(2) in accordance with a judicial or other governmental order, but only if Buyer promptly notifies Seller of the order and complies with any applicable protective or similar order.

(c) Buyer will cause Buyer’s Representatives to comply with the provisions of this Section 2.

2.2 Notification and Assistance Obligations. During the Restricted Period, Buyer will:

(a) promptly notify Seller of any unauthorized use or disclosure of Confidential Information, or any other breach of these Nondisclosure Provisions; and
(b) assist Seller in every reasonable way to retrieve any Confidential Information that was used or disclosed by Buyer or Buyer’s Representatives without Seller’s specific prior written authorization and to mitigate the harm caused by the unauthorized use or disclosure.

2.3 **Exceptions.** Buyer will not breach Section 2.1 or Section 2.2 of these Nondisclosure Provisions by using or disclosing Confidential Information if Buyer demonstrates that the information used or disclosed:

(a) is generally available to the public other than as a result of a disclosure by Buyer or a Representative of Buyer;

(b) was received by Buyer from another person without any limitations on use or disclosure, but only if Buyer had no reason to believe that the other person was prohibited from using or disclosing the information by a contractual or fiduciary obligation; or

(c) was independently developed by Buyer without using Confidential Information.

2.4 **Return of Confidential Information.** Upon Seller’s request, Buyer will promptly return to Seller all materials furnished by Seller containing Confidential Information, together with all copies and summaries of Confidential Information in the possession or under the control of Buyer.

**SECTION 3 NO TRANSFER**

These Nondisclosure Provisions do not transfer any ownership rights to any Confidential Information.

**SECTION 4 NO REPRESENTATIONS OR WARRANTIES**

Seller makes no representations or warranties, either express or implied, with respect to the accuracy or completeness of Confidential Information.

**SECTION 5 EQUITABLE RELIEF**

Buyer acknowledges that the remedies available at law for any breach of these Nondisclosure Provisions will, by their nature, be inadequate. Accordingly, Seller may obtain injunctive relief or other equitable relief to restrain a breach or threatened breach of these Nondisclosure Provisions or to specifically enforce these Nondisclosure Provisions, without proving that any monetary damages have been sustained.

**ALTERNATIVE #2 – RECIPROCAL**

**SECTION 6 DEFINITIONS**

For purposes of these Nondisclosure Provisions, the following terms have the following meanings:

“**Confidential Information**” means all information related to Seller, the Assets, or Buyer that the disclosing party discloses to the receiving party, including but not limited to business models, customer and supplier lists, marketing plans, financial and technical information, trade secrets, know-
how, ideas, designs, drawings, specifications, techniques, programs, systems, processes, and computer software.

“Representatives” means directors, officers, managers, employees, subcontractors, agents, consultants, advisors, and other authorized representatives.

“Restricted Period” means the period beginning on the date of this Letter of Intent and ending on [SPECIFIED DATE].

SECTION 7 OBLIGATIONS OF RECEIVING PARTY

7.1 Use Restrictions and Nondisclosure Obligations. During the Restricted Period:

(a) The receiving party will not use Confidential Information for any purpose without the disclosing party’s specific prior written authorization, except the receiving party may use Confidential Information to consider and complete the Definitive Agreement.

(b) The receiving party will not disclose Confidential Information to any person without the disclosing party’s specific prior written authorization, except the receiving party may disclose Confidential Information:

(1) on a need-to-know basis, to Representatives of the receiving party who are informed by the receiving party of the confidential nature of the Confidential Information and the obligations of the receiving party under these Nondisclosure Provisions; or

(2) in accordance with a judicial or other governmental order, but only if the receiving party promptly notifies the disclosing party of the order and complies with any applicable protective or similar order.

(c) Each party will cause the party’s Representatives to comply with the provisions of this Section 7.

7.2 Notification and Assistance Obligations. During the Restricted Period, the receiving party will:

(a) promptly notify the disclosing party of any unauthorized use or disclosure of Confidential Information, or any other breach of these Nondisclosure Provisions; and

(b) assist the disclosing party in every reasonable way to retrieve any Confidential Information that was used or disclosed by the receiving party or the receiving party’s Representatives without the disclosing party’s specific prior written authorization and to mitigate the harm caused by the unauthorized use or disclosure.
7.3 **Exceptions.** The receiving party will not breach Section 7.1 or Section 7.2 of these Nondisclosure Provisions by using or disclosing Confidential Information if the receiving party demonstrates that the information used or disclosed:

(a) is generally available to the public other than as a result of a disclosure by the receiving party or a Representative of the receiving party;

(b) was received by the receiving party from another person without any limitations on use or disclosure, but only if the receiving party had no reason to believe that the other person was prohibited from using or disclosing the information by a contractual or fiduciary obligation; or

(c) was independently developed by the receiving party without using Confidential Information.

7.4 **Return of Confidential Information.** Upon the disclosing party’s request, the receiving party will promptly return to the disclosing party all materials furnished by the disclosing party containing Confidential Information, together with all copies and summaries of Confidential Information in the possession or under the control of the receiving party.

**SECTION 8  NO TRANSFER**

These Nondisclosure Provisions do not transfer any ownership rights to any Confidential Information.

**SECTION 9  NO REPRESENTATIONS OR WARRANTIES**

Neither party makes any representations or warranties, either express or implied, with respect to the accuracy or completeness of Confidential Information.

**SECTION 10  EQUITABLE RELIEF**

The parties acknowledge that the remedies available at law for any breach of these Nondisclosure Provisions will, by their nature, be inadequate. Accordingly, each party may obtain injunctive relief or other equitable relief to restrain a breach or threatened breach of these Nondisclosure Provisions or to specifically enforce these Nondisclosure Provisions, without proving that any monetary damages have been sustained.
## SCHEDULE 1

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**ALTERNATIVE #1 – ALL OF SELLER’S ASSETS, EXCEPT FOR SPECIFIED RETAINED ASSETS**

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**ALTERNATIVE #2 – SPECIFIED ASSETS ONLY**

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**ALTERNATIVE #1 – ALL OF SELLER’S LIABILITIES, EXCEPT FOR SPECIFIED RETAINED LIABILITIES**

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**ALTERNATIVE #2 – SPECIFIED LIABILITIES ONLY**

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SCHEDULE 5.5

Conditions to Buyer’s Closing Obligations

Consents, Authorizations, and Approvals

Key Employees
SCHEDULE 5.6

Conditions to Seller’s [and Selling Shareholders’] Closing Obligations

Consents, Authorizations, and Approvals

[CONSENTS, AUTHORIZATIONS, AND APPROVALS]
NONDISCLOSURE AGREEMENT

This Nondisclosure Agreement ("Agreement") is between [FIRST PARTY] and [SECOND PARTY].

RECITALS

ALTERNATIVE #1 – SALE OF BUSINESS

A. The parties are considering entering into a transaction in which [FIRST PARTY] may buy assets, stock, or other ownership interests of, or merge with, [SECOND PARTY] (the “Potential Transaction”).

ALTERNATIVE #2 – INVESTMENT

B. The parties are considering entering into a transaction in which [FIRST PARTY] may invest in [SECOND PARTY] (the “Potential Transaction”).

ALTERNATIVE #3 – GENERAL BUSINESS TRANSACTION

C. The parties are considering entering into a business transaction (the “Potential Transaction”).

D. In connection with the Potential Transaction, the parties may disclose confidential information to each other.

AGREEMENT

SECTION 1 DEFINITIONS

ALTERNATIVE #1 – MARKED OR DESIGNATED IN WRITING ONLY

“Confidential Information” means information that the disclosing party discloses to the receiving party if the information is marked or designated in writing by the disclosing party as confidential before, at, or promptly after the time of disclosure.

ALTERNATIVE #2 – MARKED OR DESIGNATED ORALLY OR IN WRITING

“Confidential Information” means information that the disclosing party discloses to the receiving party if the information is marked or designated – whether orally or in writing – by the disclosing party as confidential before, at, or promptly after the time of disclosure.

ALTERNATIVE #3 – MARKED OR DESIGNATED ORALLY OR IN WRITING, OR KNOWN BY RECEIVING PARTY AS BEING TREATED CONFIDENTIAL

“Confidential Information” means information that the disclosing party discloses to the receiving party if:

(a) the information is marked or designated – whether orally or in writing – by the disclosing party as confidential before, at, or promptly after the time of disclosure; or
Chapter 2—Before the Deal

Section 2

OBLIGATIONS OF RECEIVING PARTY

2.1 Use Restrictions and Nondisclosure Obligations. During the Restricted Period:

(a) The receiving party will not use Confidential Information for any purpose without the disclosing party’s specific prior written authorization, except the receiving party may use Confidential Information to consider and complete the Potential Transaction.

(b) The receiving party will not disclose Confidential Information to any person without the disclosing party’s specific prior written authorization, except the receiving party may disclose Confidential Information:

Alternative #1 – Receiving Party’s Representatives do not have to sign a separate nondisclosure agreement

(1) on a need-to-know basis, to Representatives of the receiving party who are informed by the receiving party of the confidential nature of the Confidential Information and the obligations of the receiving party under this Agreement; or

Alternative #2 – Receiving Party’s Representatives must sign a separate nondisclosure agreement

(2) on a need-to-know basis, to Representatives of the receiving party who:

(A) are informed by the receiving party of the confidential nature of the Confidential Information and the obligations of the receiving party under this Agreement; and

2 – Nondisclosure Agreement
(B) have signed nondisclosure agreements with or in favor of the receiving party and for the benefit of the disclosing party that are at least as comprehensive as this Agreement; or

(3) in accordance with a judicial or other governmental order, but only if the receiving party promptly notifies the disclosing party of the order and complies with any applicable protective or similar order; and

ALTERNATIVE #1 – RECEIVING PARTY NOT LIABLE FOR A REPRESENTATIVE’S BREACH IF RECEIVING PARTY USED COMMERCIAL REASONABLE EFFORTS TO PREVENT BREACH

(c) Each party will use commercially reasonable efforts to cause the party’s Representatives to comply with the provisions of this Section 2.

ALTERNATIVE #2 – RECEIVING PARTY LIABLE FOR A REPRESENTATIVE’S BREACH

(d) Each party will cause the party’s Representatives to comply with the provisions of this Section 2.

2.2 Notification and Assistance Obligations. During the Restricted Period, the receiving party will:

(a) promptly notify the disclosing party of any unauthorized use or disclosure of Confidential Information, or any other breach of this Agreement; and

(b) assist the disclosing party in every reasonable way to retrieve any Confidential Information that was used or disclosed by the receiving party or a Representative of the receiving party without the disclosing party’s specific prior written authorization and to mitigate the harm caused by the unauthorized use or disclosure.

2.3 Exceptions. The receiving party will not breach Section 2.1 or Section 2.2 by using or disclosing Confidential Information if the receiving party demonstrates that the information used or disclosed:

(a) is generally available to the public other than as a result of a disclosure by the receiving party or a Representative of the receiving party;

(b) was received by the receiving party from another person without any limitations on use or disclosure, but only if the receiving party had no reason to believe that the other person was prohibited from using or disclosing the information by a contractual or fiduciary obligation; or

(c) was independently developed by the receiving party without using Confidential Information.

2.4 Return of Confidential Information. Upon the disclosing party’s request, the receiving party will promptly return to the disclosing party all materials furnished by the disclosing party containing Confidential Information, together with all copies and summaries of Confidential Information in the possession or under the control of the receiving party.
SECTION 3  NO TRANSFER

This Agreement does not transfer any ownership rights to any Confidential Information.

SECTION 4  NO REPRESENTATIONS OR WARRANTIES

Neither party makes any representations or warranties, either express or implied, with respect to the accuracy or completeness of Confidential Information.

SECTION 5  EQUITABLE RELIEF

The parties acknowledge that the remedies available at law for any breach of this Agreement will, by their nature, be inadequate. Accordingly, each party may obtain injunctive relief or other equitable relief to restrain a breach or threatened breach of this Agreement or to specifically enforce this Agreement, without proving that any monetary damages have been sustained.

SECTION 6  GENERAL

6.1 No Agency Relationship. This Agreement does not create an agency relationship between the parties and does not establish a joint venture or partnership between the parties. Neither party has the authority to bind the other party or represent to any person that the party is an agent of the other party.

6.2 No Assignment. Neither party may assign or delegate any of the party’s rights or obligations under this Agreement to any person without the prior written consent of the other party, which the other party may withhold in the other party’s sole discretion. If a party is an entity, an assignment includes but is not limited to a transfer of shares or other ownership interests of the party that results in a change in the person owning more than 50% of the shares or other ownership interests of the party, regardless of whether the transfer occurs voluntarily or involuntarily, by operation of law, or because of any act or occurrence.

6.3 Binding Effect. This Agreement will be binding on the parties and their respective heirs, personal representatives, successors, and permitted assigns, and will inure to their benefit.

6.4 Amendment. This Agreement may be amended only by a written document signed by the party against whom enforcement is sought.

6.5 Notices. All notices or other communications required or permitted by this Agreement:

(a) must be in writing;

(b) must be delivered to the parties at the addresses set forth below, or any other address that a party may designate by notice to the other party; and

(c) are considered delivered:

(1) upon actual receipt if delivered personally, by fax, or by a nationally recognized overnight delivery service; or

(2) at the end of the third business day after the date of deposit in the United States mail, postage pre-paid, certified, return receipt requested.
To [FIRST PARTY]:

______________________________  ______________________________
______________________________  ______________________________
______________________________  ______________________________
______________________________  ______________________________
Fax:  _________________________  Fax:  _________________________
Attn:  _________________________  Attn:  _________________________

With a copy to:

______________________________  ______________________________
______________________________  ______________________________
______________________________  ______________________________
______________________________  ______________________________
Fax:  _________________________  Fax:  _________________________
Attn:  _________________________  Attn:  _________________________

6.6 Waiver. No waiver will be binding on a party unless it is in writing and signed by the party making the waiver. A party’s waiver of a breach of a provision of this Agreement will not be a waiver of any other provision or a waiver of a subsequent breach of the same provision.

6.7 Severability. If a provision of this Agreement is determined to be unenforceable in any respect, the enforceability of the provision in any other respect and of the remaining provisions of this Agreement will not be impaired.

6.8 Further Assurances. The parties will sign other documents and take other actions reasonably necessary to further effect and evidence this Agreement.

6.9 No Third-Party Beneficiaries. The parties do not intend to confer any right or remedy on any third party.

6.10 Remedies. The parties will have all remedies available to them at law or in equity. All available remedies are cumulative and may be exercised singularly or concurrently.

6.11 Governing Law. This Agreement is governed by the laws of the State of Washington, without giving effect to any conflict-of-law principle that would result in the laws of any other jurisdiction governing this Agreement.

6.12 Venue. Any action, suit, or proceeding arising out of the subject matter of this Agreement will be litigated in courts located in [COUNTY] County, Washington. Each party consents and submits to the jurisdiction of any local, state, or federal court located in [COUNTY] County, Washington.

6.13 Attorney’s Fees. If any arbitration, action, suit, or proceeding is instituted to interpret, enforce, or rescind this Agreement, or otherwise in connection with the subject matter of this Agreement, including but not limited to any proceeding brought under the United States Bankruptcy Code, the prevailing party on a claim will be entitled to recover with respect to the claim, in addition to any other relief awarded, the prevailing party’s reasonable attorney’s fees and other fees, costs, and expenses of every kind incurred in connection with the
arbitration, action, suit, or proceeding, any appeal or petition for review, the collection of any award, or the enforcement of any order, as determined by the arbitrator or court.

6.14 Entire Agreement. This Agreement contains the entire understanding of the parties regarding the subject matter of this Agreement and supersedes all prior and contemporaneous negotiations and agreements, whether written or oral, between the parties with respect to the subject matter of this Agreement.

6.15 Signatures. This Agreement may be signed in counterparts. A fax transmission of a signature page will be considered an original signature page. At the request of a party, the other party will confirm a fax-transmitted signature page by delivering an original signature page to the requesting party.

Dated effective: [DATE]

[First Party]
By: ____________________________
Its: ____________________________

[Second Party]
By: ____________________________
Its: ____________________________

6 – NONDISCLOSURE AGREEMENT
Chapter 3


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PART 1
LLC Entity Classification

A. Limited Liability Company

1. Formation.

(a) By 1996, every state had a statute authorizing formation of an LLC within its jurisdiction. Tax filings provide evidence that the number of businesses choosing to operate as an LLC has steadily increased and corporate and limited partnership tax filings have decreased – suggesting that LLCs are gradually replacing corporations and limited partnerships as the business entity of choice.

(b) A limited liability company (LLC) is formed on filing Articles of Organization with the Secretary of State, which must identify, among other things:

(i) The name of the LLC, which must contain the words “Limited Liability Company” or the abbreviation “LLC” or “L.L.C.” ORS 63.094.

(ii) The management of the LLC, which may be managed by the members or by one or more managers. ORS 63.130

(iii) See also ORS 63.007, 63.044, 63.051 and 63.077 regarding formation of LLCs under Oregon law.

2. Limited Liability. Regardless of classification under the federal income tax rules, the member(s) and – if applicable – the manager(s) will generally not be personally liable for the LLC’s debts or obligations unless such personal liability is assumed. The limitation of liability can be meaningful to help individuals protect their personal assets from business creditors. LLCs can be used to isolate high-value business interests (such as real property) from high-risk business operations. Operating agreements, bylaws and partnership agreements can provide clear rules to ensure limited liability is respected in the courts and to avoid conflict among multiple owners (whether related or unrelated).

3. Ownership. Owners of a limited liability company are generally referred to as “members” (or “partners” for tax purposes). Generally, there are no restrictions on the number or type of members an LLC may have. It can be owned by any number of individuals or business entities. There may be different classes of ownership interests in the same LLC. (However, if the LLC elects to be treated as a corporation for federal income tax purposes, ownership may be restricted based on corporate law.)

4. Tax Treatment.

(a) If the LLC has only one owner, it will automatically be treated as a sole proprietorship (referred to as an entity disregarded as separate from its owner for tax purposes), unless an election is made to be treated as a corporation. If the LLC has two or more owners, it will automatically be treated as a partnership, unless an election is made to be taxed as a corporation (see Part 1, B, below).
(b) Treasury Regulation §301.7701-1 provides that “check the box” classifications are for “federal tax purposes.” There appears there is no further law, ruling or guidance that indicates whether the Regulation should be narrowly interpreted to mean federal income tax or broadly applied to include estate and gift taxes – and commentators and practitioners have some disagreement on this point. Therefore, it is important to consider a single-member LLC from an estate planning perspective. Consider ensuring that the LLC is not a single-member LLC. Each spouse (in Oregon) may acquire a 50% membership interest. (This has the additional benefit of potentially helping to equalize the couple’s estates.) Alternatively, the single member may initiate a gift plan or sell some membership interest to another person – even a nominal interest to a child. So long as there is more than one member, the LLC will not be disregarded for federal tax purposes. (However, consider other issues involved – such as whether the single-member LLC holds property that was received pursuant to an exchange under IRC §1031.)

B. **LLC as a Corporation**

1. **Formation.** As people have recognized the flexibility of the LLC entity, it has become more common to form an LLC that elects to be taxed as a corporation rather than to form a corporate entity.

2. **Tax Treatment / Ownership Restrictions.**

   (a) The C corporation calculates and pays tax at the entity level. The owners are taxed at the individual level when cash / assets are distributed (dividends). This form of taxation is often referred to as “double taxation,” because the same income is essentially taxed twice.

   (b) The S corporation is effected on timely filing of a valid “S” election with the Internal Revenue Service. ORS 60.051 / IRC §1362 (Form 2553, “Election by a Small Business Corporation”).

   (i) The S corporation generally must:

      a. be organized in the United States (IRC § 1361(b));

      b. cannot have more than 100 shareholders (although there are special rules relating to spousal share ownership and family share ownership under IRC §1361);

      c. cannot have more than one class of stock (voting and non-voting is permitted as a single class); and

      d. must have “qualified S corporation” owners (as defined under IRC §1361(b)(1)), which generally limits ownership to US citizens or residents, certain trusts, estates and tax-exempt corporations.
(ii) Qualified trusts for S corporations:

a. Grantor trust during the settlor’s lifetime;

b. Grantor trust two years following the settlor’s death;

c. Testamentary trust two years following the owner’s death;

d. Qualified sub-chapter S trusts; and

e. Electing small business trusts. (See IRC § 1361)

(c) Although the S corporation has an individual filing obligation (a separate taxpayer identification is necessary), all incidents of tax are passed through to the shareholders on a pro rata basis, regardless of whether there are any actual distributions. IRC §1366(a)(1); Treas Reg §1.1366-1(a)(1).

PART 2
Membership and Transfer of Membership
[See attached Sample Language]

A. Owning an LLC and Transferring Ownership

1. Acquisition of Member Interest.

(a) Members must make a contribution to purchase their interest in the LLC, which contribution may be cash, property, services rendered or a promissory note or other obligation to pay cash or transfer property.

(b) The Members’ ownership interests may be subject to the provisions of the Securities Act of 1933. If so, the offer and sale of membership interests could be subject to Federal regulation. Whether they are “securities” under the Act generally depends on the level of member participation. If members participate in the business and investment decisions of the LLC, the membership interests probably would not be considered securities. Alternatively, if members are inactive, the membership interests probably would be securities. A membership interest is a security if it is an “investment contract.” Generally, a membership interest is an investment contract if members invest and expect to make a profit from the entrepreneurial and managerial efforts of others.
(c) **Tax Issues.**

(i) Contributions on the formation of the LLC are generally not taxable unless there is a disguised sale or the member is relieved from debts.

(ii) If a Member receives an interest disproportionate to that Member’s contribution, the Member may be taxed on the value of the excess interest received (as compensation).

(iii) Income in an LLC is taxed at the partners’ level if the LLC is properly structured. Distributions are not taxable to the extent of a member’s tax basis in the member interest. Special allocations of tax items are permitted if the entity is a partnership for tax purposes.

(iv) Members may deduct their shares of LLC losses subject to their basis limitations, but the LLC’s debt is included in calculating the basis. The IRS’ "at risk" and "passive activity" limitations apply to an LLC.

(v) The liquidation of an LLC is not taxable to a member to the extent of the tax basis of such member’s ownership interest.

2. **Transfer of Member Interest.** Members may transfer their interests, but there is full substitution of the assignee only if the operating agreement provides for substitution. Until an assignee becomes a member (if ever), such assignee will only have right to receive any allocations of profits and losses distributed by the LLC. See generally ORS 63.249, 63.255 and 63.259.

B. **Restrictions on Transferring Ownership**

1. **General Prohibition on Transfer.** It is common to establish, as a general premise, that no Member may transfer without the consent of the other Members ensures that any proposed transfer of an interest would engage rights as to the other members, which rights are generally referred to as “buy-sell provisions”. It is generally advisable to include buy-sell provisions that contractually bind Members with respect to the transfer of LLC interests. Buy-sell provisions provide the business and its Members with predictability and continuity of ownership, and potentially establish estate and gift tax values for a Member’s interest.

2. **Permitted Transfers (Without Consent of Other Members).**

   (a) It is often beneficial to permit members to make certain transfers without engaging the other members or otherwise triggering buy-sell provisions. For example, Members often want to be able to integrate their estate and business planning without seeking the consent of other Members. Such language may permit a Member to transfer all or any portion of such person’s percentage interest in the Company to:

      (i) the Company;
(ii) any Member;
(iii) a Member’s spouse other than a spouse who is legally separated under a decree of separate maintenance or a spouse who is a party to a pending divorce proceeding;
(iv) a Member’s lineal descendant including lineal descendants by adoption; or
(v) any trust or entity created for the [exclusive] benefit of the parties in
(i), (ii), (iii), or (iv).

(b) When transfers are permitted to trusts or business entities, it is important to consider restrictions that may govern subsequent triggering of buy-sell provisions. For example, it may be important to provide that the death of a natural person triggers the buy-sell provisions even if that Membership Interest is held in that natural person’s revocable grantor trust (for estate planning purposes).

(c) Alternatively, it may be preferable to expand Permitted Transfer language to avoid triggering of buy-sell provisions. For example, in the family business context, you might provide that “a transfer to a Permitted Transferee will not require consent of the non-transferring Members and will not be subject to the buy-sell provisions of this Agreement whether occurring during the life or by reason of the death of a Member.”

3. **Triggering Events (Engaging Buy-Sell Provisions).** Consider the following events that you may wish to trigger buy-sell provisions:

(a) **Attempt to Transfer.** If an owner tries to sell or gift an interest outside the scope of the Permitted Transfers, it is important to consider what rights and recourse will be available to the remaining owners. Sometimes such an action is anticipating a deadlock, a precursor action by a Member seeking to avoid imposition of an irreconcilable differences provision perceived to be unfavorable to the owner seeking transfer. Other times it may just be Member seeking to impose aggressive gift and estate tax planning. It could be used as a way to initiate discussion regarding sale of a business.

(b) **Death.** In most circumstances, the remaining business partners will not want to continue the business with a surviving spouse or surviving children unless those individuals were already involved in the business. Likewise, the surviving spouse or children may rather have cash than a potentially illiquid business interest that may have negative tax implications and require significant attention. Thus, a purchase at death benefits both parties.

(c) **Divorce.** Under Oregon domestic relations law, a family law court has jurisdiction over all assets owned by either of the parties in a suit for divorce, separation or annulment. In fact, upon the filing of the petition, each party becomes a co-owner of all property owned by either party. The property is then subject to division by the court as is just and equitable under the circumstances. When a business interest is the most significant asset of value, a court could order that a non-participating spouse
receive some or all of the business interest. To avoid owning a business with a divorced and disgruntled ex-spouse, the business owners should consider including a provision requiring the sale of any business interest awarded to a non-participating ex-spouse. In all likelihood, the ex-spouse will prefer to be cashed out rather than continue in a business with the ex-husband or ex-wife. In addition, divorce courts, while not bound by buy-sell agreements, will generally respect their terms for purposes of valuing the business. Consideration should be given as to whether the individual would have any right to buy back into the LLC after the divorce is finalized (and at what value?).

(d) **Bankruptcy.** Under 11 USC 541, all property of an individual filing a petition for bankruptcy becomes property of the bankruptcy estate, including any closely-held business interests. If the case is a chapter 7, the trustee will take such property and attempt to sell it for the best price. In all likelihood, the remaining owners do not want to submit their business decisions to a bankruptcy trustee, the bankruptcy court, or an unknown third party purchaser. A buy-sell provision covering bankruptcy may protect the remaining owners. Bankruptcy courts have approved the enforceability of rights of first refusal provisions in bankruptcy. Northrop Grumman Tech. Services v. Shaw Group, Inc. 302 B.R. 483 (D. Del. 2003).

(e) **Disability.** While certainly not as final as death, often a business owner’s disability may adversely affect the business. This is particularly so if active participation by the owners is necessary for the business’ success. Particular care is necessary in defining disability and considering what happens if the disabled business owner recovers. (Can he or she buy back into the LLC?)

(f) **Termination of Employment.** In many circumstances owners must take an active role in the business. An owner’s termination of employment may have an adverse impact on the business. In such cases, a buy-out through a buy-sell provision will best protect the business. In addition, the business can then use the potential for an ownership interest in enticing a replacement.

(g) **Deadlock / Irreconcilable Differences.** Some buy-sell agreements have provisions that allow a buy-out if the owners are deadlocked and cannot agree. While similar provisions are provided under state law, they are cumbersome and require court intervention. Such provisions incorporated into the operating agreement should clearly define the terms under which one or more owners will stay and one or more owner owners will go. Otherwise, the agreement should provide for an orderly liquidation on deadlock. In all circumstances, it is advised to include specific timeframes for notice and resolution (including any rights or restrictions relating to mediation, arbitration or litigation).

4. **Transfer Mechanisms.** Consider the following buy-sell mechanisms:

(a) **Options.** An option gives the right, but not the obligation, to purchase business interests. In defining an option, the period of the option, the manner of exercise, the price and terms should all be considered and well defined. If an option is
not exercised within the defined time period, it will lapse and the current owner will retain the business interest free of the option at issue.

(b) **Rights of First Refusal.** A right of first refusal differs from an option in that, generally, it only comes into effect if an owner intends to transfer his or her business interest. The right of first refusal gives the entity or other business owners the opportunity to “match” the proposed transfer by purchasing the business interest at the same price and terms as the offer. Again, the length of the right, the manner of exercise, the price and terms should be considered and well defined. An additional difficulty with a right of first refusal is if the transferor wants to transfer the interest as a gift. This is often dealt with by allowing certain transfers free of the right of first refusal or by establishing an alternate method of setting the purchase price (i.e. appraisal, book value, etc.).

(c) **Mandatory Purchase Obligations.** These provisions require the LLC or other business partners to purchase the LLC interest under certain circumstances. This may be beneficial to a departing partner, ensuring liquidity of their interest, and provide protection to the remaining partners by establishing the terms under which a departing partner will be paid. It is essential to consider the business’ ability (or individual owner’s ability) to satisfy mandatory purchase obligations and to consider establishing sources for such funding (set-asides / insurance coverage).

(d) **Entity Termination.** The withdrawal, expulsion, death, or an event agreed to in the Operating Agreement (such as retirement of a partner) may trigger an "event of dissociation," which may or may not lead to a winding up (that is, a closing down) of the LLC.

5. **Valuation.**

(a) **Fair Market Value.** The fair market value (FMV) of a business interest is defined as: “the net amount which a willing purchaser, whether an individual or corporation, would pay for the interest to a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts.” 26 CFR 25.2512-3(a), and 20.2031-3(a). Gift and estate taxes are imposed on the fair market value (FMV) of the asset or property transferred. Thus, the application of marketability and minority discounts to LLC interests generally reduces the value of property subject to transfer taxes.

(b) **Valuation Discounts.**

(i) **Lack of Marketability.** Because most interests in closely-held businesses, are not freely transferable, a hypothetical third party purchaser would demand a discount below the Net Asset Value (NAV) of the LLC for any fractional interest in the entity. The marketability discounts are often substantial. In one of the landmark cases in this area, Mandelbaum v. Comr., 69 T.C.M. 2852 (1995), aff’d 91 F.3d 124 (3rd Cir. 1996), Tax Court Judge Davis Laro created
quite a stir when he raised key issues regarding marketability discounts and set forth ten factors to be considered in determining an appropriate discount for lack of marketability:

- Private vs. public sales of stock
- Financial statement analysis
- The Company’s dividend policy
- Nature of the Company, its history, position in the industry and its economic outlook
- Strength of Company management
- Amount of control transferred
- Restrictions on transferability of stock
- Holding period required in the stock
- The Company’s redemption policy
- Costs associated with making a public offering

The Court considered these ten factors and determined – on its own – that a 30% marketability discount was appropriate.

In some instances, the Tax Court has allowed for lack of marketability discounts both for the underlying assets of the entity and the interest in the entity itself. See Maxcy Est. v. Comr., 28 T.C.M. 783 (1969), rev’d on other grounds 441 F.2d 192 (5th Cir. 1971) and Bennett Est. v. Comr., 65 T.C.M. 1816 (1993), each of which valued the entity with a 15 percent discount from NAV due to the unique nature of the underlying assets. Additional marketability discounts were allowed for the interests in the entity. Finally, a marketability discount may be allowed even if the interest at issue is a controlling interest. In Ford Est. v. Comr., 66 T.C.M. 1507 (1993), aff’d 53 F.3d 924 (8th Cir. 1995), the Tax Court’s decision included a 10 percent marketability discount for a controlling interest in a corporation.

(ii) Lack of Control. Further, if the fractional interest represents a minority control interest, the third party purchaser would pay less per unit or share than if purchasing a controlling interest. In general, according to BNA, courts have approved of minority discounts in the range of 20 percent to 30 percent, but discounts as deep as 40 percent have been upheld.

(c) Application of Valuation Discounts. Suppose an individual owns a commercial building worth $1,000,000. If the individual simply holds the building until death, the entire $1,000,000 is subject to tax. Instead, suppose the individual contributes the property to an LLC and then makes a gift to each of his or her two children of a 1/3 interest in the LLC. At first glance, the value of the gift to each child is $333,333. However, because a disinterested third party would want a discount for a minority interest in an entity controlled by strangers with no readily available market for the interest, the discounted value of each 1/3 interest may be $200,000. In addition, the 1/3 interest
retained by the transferor is now a minority interest with no readily available market. Thus, that interest may also be discounted to $200,000. By the use of an LLC and discounts, the individual has just reduced the value of property subject to transfer taxes by $400,000.

(i) **Discounts are Distinct.** Although often discussed in tandem, the lack of control discount (also referred to as a minority discount) and the lack of marketability discounts are actually distinct and separate concepts. Qualification for one discount does not per se result in qualification for the other. As noted by the Tax Court in *Andrews Est. v. Comr.* 79 T.C. 938, 952-953 (1982), the minority discount reflects a lack of control. The marketability discount reflects the lack of a readily available market for interests in the entity, whether minority or controlling. Nonetheless, the court in *Andrews Est.* recognized that a lack of control may affect marketability.

(ii) **Calculation of Discounted Value.** Technically the two discounts should be applied one after the other rather than being summed and applied to the LLC interest.

**Example:** Assume that the total assets in the LLC are $1 million and that the valuation expert is assessing a 1 percent limited LLC interest. The valuation expert determines that for this investment there should be a 25 percent discount for lack of control and a 25 percent discount for lack of marketability. According to Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihis in their book, *Valuing A Business: The Analysis and Appraisal of Closely Held Companies, Third Edition* (Irwin Professional Publishing, 1996), the proper way to value the interest is sequentially, as follows: $10,000 per unit before discount (1% times $1,000,000), Less 25% (lack of control discount) = $7,500, Less 25% (lack of marketability discount) = $5,625 per unit.

(d) **Control Issues.** Prior to 1993, the IRS took the position that family attribution rules applied to the transfer of interests in closely held entities. The IRS position was that no minority discount was available if the family controlled the entity before and after the transfer. The Tax Court and other courts rejected the IRS position as inconsistent with the hypothetical third party purchaser described in the regulations. See generally *Ward v. Comr.* 87 T.C. 78 (1986) and *Bright Est. v. United States*, 658 F.2d 999 (5th Cir. 1981). The IRS abandoned its position in Rev. Rul. 93-12.

(i) The IRS had attempted to aggregate various blocks of ownership interests included in the estate under different code sections. In *Bonner Est. v. Comr.*, 84 F.3d 196 (5th Cir. 1996) and *Mellinger Est. v. Comr.*, 112 T.C. 26 (1999), the IRS argued unsuccessfully that interests held in a QTIP trust of a surviving spouse should be aggregated with interests held by the spouse and included under IRC
§2033. However, the IRS successfully argued for aggregation in Fontana Est. v. Comr., 118 T.C. No. 16 (2002), in which the decedent held a general power of appointment over certain interests and owned other interests outright. The Tax Court reasoned that a power of appointment represented control over the interests whereas, in the QTIP situation, the surviving spouse did not control the interests. Although the QTIP property passed from Bonner for estate tax purposes under IRC § 2044, his QTIP interests did not merge with the interests he held outright for valuation purposes. Because he possessed only a life interest in the QTIP, neither Bonner nor his estate had any control over the ultimate disposition of the QTIP assets.

(ii) The IRS had also successfully asserted the existence of premiums for control in limited circumstances. The IRS takes the position that a premium exists for effective control of an entity based on the theory that a buyer is willing to pay more for an interest in a company if the shares provide opportunities for controlling matters such as salary, dividends, contracts and mergers. See Rev. Rul. 59-60, relating to the stock of closely-held corporations, also apply in determining fair market value “of business interests of any type, including partnerships and proprietorships”.

- In Salisbury Est. v. Comr., 34 T.C.M. 1441 (1975), the Tax Court found a 38 percent control premium for a 51 percent ownership interest in a corporation. A premium for control is generally the percentage by which the amount paid for a controlling block of shares exceeds the amount that would have otherwise been paid for the shares if sold as minority interests.

- In Rodriguez v. Comr., 56 T.C.M. 1039 (1989), the Tax Court declined to apply a control premium when the per share value was determined by dividing the value of the corporation by the number of outstanding shares. The IRS has also attempted to apply control premiums when the interest at issue represents a swing vote which, when aligned with one group or the other, can exert control over the entity. See Winkler v. Comr., 57 T.C.M. 373 (1989), TAM 9436005, TAM 9449001; see also Estate of Augusta Porter Forbes v. Commissioner, 81 T.C.M. 1399 (2001).

- In Estate of Simplot v. Commissioner, 249 F.3d 1191 (9th Cir. 2001), no control premium was applied. The Tax Court found that a control premium was justified.
because hypothetical buyer of the shares would likely be a family member who could potentially control the company because there were only four such blocks of stock in existence. In essence, the buyer "would gain access to the inner circle," the court stated. However, the estate appealed and the 9th Circuit reversed the ruling of the U.S. Tax Court, and held that the value of a company's minority interest voting shares was equal to the value of its non-voting shares.

- The correct approach uses a "purely hypothetical willing buyer and seller," as opposed to "specific individuals or entities." The Tax Court, however, considered "imaginary scenarios," such as combinations the potential purchaser might effect with other shareholders. "In violation of the law, the Tax Court constructed particular possible purchasers," the Appeals Court stated.

- The Tax Court also erred by valuing property not before it — the Class A voting shares that weren't owned by the estate. Under the tax law, property subject to valuation is limited to the property subject to taxation. In this case, that was only the estate's shares.

- Even a controlling block of stock is not to be valued at a premium for estate tax purposes unless the IRS can show that "a purchaser would be able to use the control in such a way to assure an increased economic advantage worth paying a premium for." But the IRS did not make a persuasive case.

(e) Agreement of Value v. Substantiated Value.

(i) Operating Agreements will often allow parties to agree on value — whether such value is agreed to annually (in advance of any specific trigger event) or at the time of a specific trigger event. Generally, agreed value will be respected as FMV, unless the parties are related or there are other factors that may suggest the parties have commonly aligned interests that could generate collusion.

(ii) Operating Agreements may require a qualified appraisal to establish valuation of an interest, and it is generally the best tool to substantiate value for tax reporting purposes. The courts are careful to point out that the question of valuation is a question of fact. See Andrews Est. v. Comr. 79 T.C. 938, 952-953 (1982); see also
Wildman Est., T.C. Memo 1989-667, citing Propstra v. United States 680 F.d 1248 (9th Cir. 1982) and Ahmanson Foundation v. United States, 674 F.2d 761 (9th Cir. 1981). In fact, in at least one case, the court ruled against the taxpayer for relying solely on the average of decided cases rather than presenting evidence or expert opinion. Berg Est. v. Comr., 976 F.2d 1163 (8th Cir. 1992). Thus, it is prudent to obtain an appraisal in support of the position to be taken on the return. Certainly, if litigation is pursued, expert testimony will be essential.

6. **Income Tax v. Transfer Tax.** Under IRC §1014, the assets included in a decedent’s estate for estate tax purposes receive a basis equal to the FMV at date of death (or the alternate valuation date), which means the basis will be stepped-up (or stepped-down) to wipe out any built-in gain (or loss). To the extent assets or interests are discounted in value, the basis will reflect that discounted value. This includes potential step-up in basis of LLC assets, pursuant to an election under IRC §754. Thus, in some instances, it may be advantageous to not claim valuation discounts if there is little to no estate tax liability as to the decedent’s estate. If discounts are desirable, the Operating Agreement should explicitly authorize such discounts in valuing an interest. The valuation provisions need not be the same for valuation in all circumstances.

7. **Valuation Tax Considerations.** Careful consideration should be given to IRC §§ 2701 through 2704, specifically:

(a) **IRC § 2703.** IRC § 2703(a) requires that restrictions on the right to use property be disregarded for valuation purposes. IRC § 2703(b) provides an exception to the general rule set forth in IRC § 2703(a). In order to qualify for the exception, the agreement:

- must be a bona-fide business arrangement,
- must be comprised of terms similar to arrangements entered into in an arm’s length transaction, and
- it must not be a “device” to transfer assets to a family member for less than full and adequate consideration.

In Holman (130 TC No. 12 (2008)), the government won its IRC § 2703 argument. The court relied primarily on traditional buy-sell agreement jurisprudence in holding that the partnership did not pass muster under IRC §2703(b)(1) and flunked the test under IRC §2703(b)(2). This opinion did not cite Church v. United States, 2000-1 USTC ¶ 60,369 (W.D. Tex 2000), aff’d 2001-2 USTC ¶ 60,415 (5th Cir. 2001) or Smith v. United States, 2005 U.S. Dist. LEXIS 24711 (D. Pa. 2005), however, it did cite the Senate Finance Committee Report 3209 (1990) and Treas. Reg. § 25.2703-1(a)(3)) on which those cases were based.

(b) **IRC § 2704(b).** IRC § 2704(b) provides that certain non-commercial restrictions on the ability to dispose of or liquidate family-controlled entities should be
disregarded in determining the fair market value of an interest in that entity for estate and gift tax purposes. See Kerr v. Comr., 113 T.C. 449 (1999), aff’d. 2002-1 USTC ¶ 60,440 (5th Cir. 2002); Harper Est. v. Comr., T.C. Memo 2000-202; Knight v. Comr. 115 T.C. 506 (2000); and Jones Est. Comr., 116 T.C. 121 (2001). The basic issue in each of these cases concerned the right to withdraw from the entity or liquidate the entity. If the restrictions are no more restrictive than applicable state law, they should be respected under IRC § 2704(b).

In §2704(b)(4), Congress provided the IRS with the ability to enact regulations that would address additional abusive transactions. In August 2016, the IRS proposed new Regulations seeking to clamp down on these gift, estate and generation-skipping transfer tax planning techniques. The proposed Regulations would have narrowed long-standing exceptions and dramatically expanded the class of restrictions that are disregarded under IRC § 2704; no exceptions would have been allowed for interests in active or operating businesses.

On October 17, 2017, the IRS withdrew the proposed new Regulations. Treasury and IRS now believe that the proposed Regulations approach to the problem of artificial valuation discounts is unworkable. Commenters had warned that the valuation requirements of the proposed Regulations were unclear and that their effect on traditional valuation discounts was uncertain. In particular, commenters argued that it was not feasible to value an entity interest as if no restrictions on withdrawal or liquidation existed in either the entity's governing documents or under state law. Finally, Commenters argued that the proposed Regulations could have produced unrealistic valuations. For example, the lack of a market for interests in a closely-owned operating businesses is a reality many believed should be taken into account when determining fair market value.
ARTICLE X
RESTRICTIONS ON TRANSFER OF OWNERSHIP INTERESTS

X.1 Generally. Except as otherwise provided in this Article X, no Member may sell, assign, exchange, or otherwise transfer for consideration, or gift or otherwise transfer for no consideration, or pledge or otherwise encumber, all or any part of the Member's Ownership Interest in the LLC without the prior written consent of all the Members.

X.2 First Right of Refusal.

X.2.1 Any Member ("Transferor Member") desiring to transfer all or any portion of an Ownership Interest, whether for consideration or by gift (except as otherwise provided for in Section X.6 of this Agreement), must first give written notice to the other Members of the Transferor Member's intention to transfer an Ownership Interest. The notice ("Transfer Notice") must name the proposed transferee and the percentage of Ownership Interest to be transferred ("Offered Ownership Interest"), and if the transfer is for consideration, the sale price and the terms of payment of the sale price. For thirty (30) days following the Transfer Notice, the other Members may purchase the Offered Ownership Interest at the price and on the same terms and conditions stated in the Transfer Notice; provided, however, if the Transferor Member proposes to transfer the Offered Ownership Interest by gift, subject to the provisions of Section X.6, the other Members may purchase the Offered Ownership Interest at the purchase price determined in accordance with Section X.7 of this Agreement and on the payment terms set forth in X.9 of this Agreement. Within thirty (30) days after the giving of the Transfer Notice, any Member desiring to acquire any part or all of the Offered Ownership Interest must give written notice of the percentage of the Offered Ownership Interest such Member wishes to acquire to the Managers at the principal office of the LLC, the Transferor Member, and each of the other Members. If the total percentage of the Offered Ownership Interest that the other Members collectively offer to purchase exceeds the actual percentage of the Offered Ownership Interest, the offering Members will purchase the Offered Ownership Interest in the proportion that the percentage of Ownership Interest held by each offering Member bears to the total percentage of Ownership Interests held by all offering Members, or in whatever other proportion the offering Members may agree on within fifteen (15) days after the expiration of the thirty (30) day option period. If the offering Members collectively offer to purchase less than all of the Offered Ownership Interest, then the provisions of Section X.2.2 will govern the percentage of the Offered Ownership Interest not purchased by the offering Members.

X.2.2 To the extent the first right of refusal to purchase an Ownership Interest set forth in Section X.2.1 is not exercised by any other Members, the Transferor Member may complete the proposed transfer, but only to the proposed transferee in strict accordance with the terms set forth in the Transfer Notice and only if consummated within ninety (90) days after the giving of the Transfer Notice. Any Offered Ownership Interest not timely purchased by the proposed transferee in strict accordance with the terms set
forth in the Transfer Notice will continue to and once again be subject to the terms and conditions of this Article X.

X.2.3 Unless substituted as a Member as hereinafter provided, a transferee under this Section X.2 will only be entitled to receive the distributions to which the Transferor Member would be entitled with respect to the Ownership Interest transferred. A transferee under this Section X.2 who is not already a Member may be substituted and admitted as a Member only on the vote by the Members of at least eighty percent (80 %) of the Ownership Interests in favor of the substitution and admission, and on the transferee executing a counterpart of this Agreement, as amended, pursuant to which the transferee agrees to be bound by all of the terms and conditions of this Agreement, as amended, with respect to the Ownership Interest transferred. Each Member may vote in favor or against such substitution and admission in the Member's sole discretion. Any transferee under this Section X.2 who is already a Member will be automatically substituted and admitted as a Member with respect to the Ownership Interest transferred on executing a counterpart to this Agreement, as amended, pursuant to which the transferee Member agrees to be bound by all of the terms and conditions of this Agreement, as amended, with respect to the Ownership Interest transferred. The sale of an Ownership Interest pursuant to this Section X.2 must be consummated within ninety (90) days after the giving of the Transfer Notice.

X.3 Death, Divorce or Bankruptcy.

X.3.1 On (a) the death of a Member, (b) the order of a court of competent jurisdiction to transfer an Ownership Interest to a non-Member in connection with a dissolution of a Member's marriage, or (c) the bankruptcy of a Member (as defined below), the remaining Members may purchase the Ownership Interest owned by the effected Member ("Effected Member") pursuant to the terms and conditions of this Section X.3. If the option to purchase pursuant to this Section X.3 is triggered as a result of the death of a Member or the order of a court of competent jurisdiction to transfer an Ownership Interest to a non-Member in connection with a dissolution of a Member's marriage, the purchase price for the Effected Member's Ownership Interest will be determined in accordance with Section X.7 of this Agreement and paid on the payment terms set forth in Section X.9 of this Agreement. If the option to purchase pursuant to this Section X.3 is triggered as a result of the bankruptcy of a Member, the purchase price for the Effected Member's Ownership Interest will be determined in accordance with Section X.8 of this Agreement and paid on the payment terms set forth in Section X.9 of this Agreement. A Member will be considered bankrupt if the Member has filed a voluntary petition for bankruptcy, has an involuntary petition for bankruptcy filed against him or her which is not dismissed within thirty (30) days of the initial filing, makes an assignment for the benefit of creditors, or consents to the appointment of a receiver or trustee with respect to a substantial part of the Member's assets. For purposes of death of a Member, the death of *** will trigger the option to purchase pursuant to this Section X.3. On acquiring knowledge of (a) the death of a Member, (b) the order of a court of competent jurisdiction to transfer an Ownership Interest to a non-Member in connection with a dissolution of a Member's marriage, or (c) the bankruptcy of a Member, the Managers must promptly notify the other Members in
writing of such event. Within thirty (30) days of the giving of notice, any other Member desiring to acquire any part or all of the Effected Member's Ownership Interest must give written notice of the percentage of the Effected Member's Ownership Interest which such Member wishes to acquire to the Managers at the principal office of the LLC, the Effected Member or the legal representative of the Effected Member in the event of the death of a Member, and each of the other Members. If the total percentage of the Effected Member's Ownership Interest that the remaining Members collectively offer to purchase exceeds the actual percentage of the Effected Member's Ownership Interest, the offering Members will purchase the Effected Member's Ownership Interest in the proportion that the percentage of Ownership Interests held by each offering Member bears to the total percentage of Ownership Interests held by all the offering Members, or in whatever other proportion the offering Members may agree on within fifteen (15) days after the expiration of the thirty (30) day option period. If the offering Members collectively offer to purchase less than all of the Effected Member's Ownership Interest, then the percentage of the Effected Member's Ownership Interest not being purchased will pass in accordance with the Effected Member's will, trust, court order, or otherwise.

X.3.2 Unless substituted as a Member as hereinafter provided, a transferee under this Section X.3 will only be entitled to receive the distributions to which the Effected Member would be entitled with respect to the Ownership Interest transferred. A transferee under this Section X.3 who is not already a Member may be substituted and admitted as a Member only on the vote by the Members of at least *** percent (*** %) of the Ownership Interests in favor of the substitution and admission, and on the transferee executing a counterpart of this Agreement, as amended, pursuant to which the transferee agrees to be bound by all of the terms and conditions of this Agreement, as amended, with respect to the Ownership Interest transferred. Each Member may vote in favor or against such substitution and admission in the Member's sole discretion. Any transferee under this Section X.3 who is already a Member will be automatically substituted and admitted as a Member with respect to the Ownership Interest transferred on executing a counterpart to this Agreement, as amended, pursuant to which the transferee Member agrees to be bound by all of the terms and conditions of this Agreement, as amended, with respect to the Ownership Interest transferred. The sale of an Ownership Interest pursuant to this Section X.3 must be consummated within ninety (90) days after the giving of notice of the occurrence of an event described in the first sentence in Section X.3.1 of this Agreement.

X.4 Disability.

X.4.1 On the disability (as defined below) of **** (“Disabled Member”), the remaining Members may purchase the Ownership Interest owned by the Disabled Member at the purchase price determined pursuant to Section X.7 of this Agreement and on the payment terms set forth in Section X.9 of this Agreement. “Disability” as used in this Section X.4 will have the same meaning as set forth in Section Y.2 of this Agreement. On acquiring knowledge of a Disabled Member's disability, the Managers (or if the Disabled Member is a Manager, another Manager or Member) must promptly notify the other Members in writing of such disability. Within thirty (30) days of the giving of notice, any other Member desiring to acquire any part or all of the Disabled Member's Ownership Interest must give written notice of the percentage of the Disabled
Member's Ownership Interest which such Member wishes to acquire to the Managers at the principal office of the LLC, the Disabled Member or the Conservator or other legal representative of the Disabled Member, and each of the other Members. If the total percentage of the Disabled Member's Ownership Interest that the remaining Members collectively offer to purchase exceeds the actual percentage of the Disabled Member's Ownership Interest, the offering Members will purchase the Disabled Member's Ownership Interest in the proportion that the percentage of Ownership Interests held by each offering Member bears to the total percentage of Ownership Interests held by all the offering Members, or in whatever other proportion the offering Members may agree on within fifteen (15) days after the expiration of the thirty (30) day option period. If the offering Members collectively offer to purchase less than all of the Disabled Member's Ownership Interest, then the percentage of the Disabled Member's Ownership Interest not being purchased will continue to be subject to the terms and conditions of this Article X.

X.4.2 The transferee Member or Members under this Section X.4 will be automatically substituted and admitted as a Member with respect to the Ownership Interest transferred on executing a counterpart to this Agreement, as amended, pursuant to which the transferee Member agrees to be bound by all of the terms and conditions of this Agreement, as amended, with respect to the Ownership Interest transferred. The sale of an Ownership Interest pursuant to this Section X.4 must be consummated within ninety (90) days after the Managers' giving of notice of knowledge of a Disabled Member's disability. The Disabled Members each agree that if a Conservator or other legal representative is appointed for his estate, such Conservator or legal representative will be obligated to sell and transfer the Disabled Member's Ownership Interest in accordance with the terms and conditions of this Agreement.

X.5 Irreconcilable Differences.

X.5.1 If there are irreconcilable differences among the Members with respect to the management and business operations of the LLC, a Member (the "Invoking Member") may invoke the provisions of this Section X.5 by giving written notice to the other Members and Managers of the Invoking Member's intent to invoke the provisions of this Section X.5. Such written notice will constitute an offer by the Invoking Member to sell all of his Ownership Interest to the other Members on the terms agreed on in Section X.5.2 hereof. Unless the other Members otherwise agree, the other Members must purchase the Invoking Member's Ownership Interest in the proportion that the percentage of Ownership Interests held by each other Member bears to the total percentage of Ownership Interests held by all the other Members.

X.5.2 Following the receipt of the written notice invoking the provisions of this Section X.5, the Invoking Member and the other Members must in good faith enter into negotiations to determine a reasonable purchase price and reasonable terms of payment for all of the Ownership Interest of the Invoking Member. If the parties agree on a purchase price and terms of payment for all the Ownership Interest of the Invoking Member, the Invoking Member must sell all of its Ownership Interest to the other Members at such purchase price and on such terms.
X.5.3 If the Invoking Member and other Members cannot agree on a purchase price and on terms of payment within a period of sixty (60) days from the date of the other Members receipt of the written notice described in Section X.5.1 hereof, then, immediately on the expiration of such sixty (60) day period, the Invoking Member may submit a new written offer (hereinafter referred to as the "Buy/Sell Offer") to the other Members, which Buy/Sell Offer must set forth the purchase price (including a statement of the purchase price for each 1% of Ownership Interest) and terms of payment for the purchase of the Invoking Member's Ownership Interest. The Buy/Sell Offer will be considered first an offer by the Invoking Member to sell all of its Ownership Interest to the other Members, and then an offer by the other Members to sell all of their Ownership Interests to the Invoking Member. The Buy/Sell Offer must contain a statement of the purchase price for each 1% of Ownership Interest, which will pertain to both the Invoking Member's offer to sell all of its Ownership Interest to the other Members and the offer of the remaining Members to sell all of their Ownership Interests to the Invoking Member. Within a period of thirty (30) days from the receipt by the other Members of the Invoking Member's Buy/Sell Offer, the other Members must elect (by a majority vote of the Ownership Interests held by the other Members), and must notify in writing the Invoking Member and Managers, whether they will purchase all of the Ownership Interest of the Invoking Member or whether they will sell all of their Ownership Interests to the Invoking Member, at the purchase price and on the terms of payment set forth in the Invoking Member's Buy/Sell Offer. If the other Members fail to timely elect and notify, they will be deemed to have elected to purchase all of the Ownership Interest of the Invoking Member. Based on the election of the other Members, the other Members will be obligated to purchase all of the Ownership Interest of the Invoking Member or the Invoking Member will be obligated to purchase all of the Ownership Interests of the other Members. If the other Members elect to purchase all of the Ownership Interest of the Invoking Member, the Invoking Member will be obligated to sell all of its Ownership Interest to the other Members within thirty (30) days following such election of the other Members. If the other Members elect to sell all of their Ownership Interests to the Invoking Member, the Invoking Member will be obligated to purchase all of the other Members' Ownership Interests within thirty (30) days following such election of the other Members.

X.5.4 The transferee Member(s) under this Section X.5 will be automatically substituted and admitted as a Member with respect to the Ownership Interest transferred on executing a counterpart to this Agreement, as amended, pursuant to which the transferee Member(s) agree(s) to be bound by all of the terms and conditions of this Agreement, as amended, with respect to the Ownership Interest transferred.

X.6 Permitted Transfers. Notwithstanding anything to the contrary in Sections X.1, X.2, X.3, X.4 and X.5 of this Agreement, any Member may gift, during his or her lifetime, all or any portion of his or her Ownership Interest to other Members, or to any lineal descendants of such Member, or to a custodian, trustee, conservator, or guardian for such Member or any of such Member's lineal descendants without the consent of any other Member. In addition, notwithstanding anything to the contrary in Sections X.1, X.2, X.3, X.4 and x.5 of this Agreement, any Member may transfer, during his or her lifetime, all or any portion of his or her Ownership Interest to a revocable living trust for the benefit of
such Member and/or such Member’s spouse and/or children without the consent of any other Member. However, unless the substituted Member is already a Member, or is substituted as a Member as hereinafter provided, a transferee under this Section X.6 will only be entitled to receive the distributions to which the transferring Member would be entitled with respect to the Ownership Interest transferred. A transferee under this Section x.6 who is not already a Member may be substituted and admitted as a Member only on the vote by the Members of at least eighty percent (80 %) of the Ownership Interests in favor of such substitution and admission, and the transferee executes a counterpart of this Agreement, as amended, pursuant to which the transferee agrees to be bound by all of the terms and conditions of this Agreement, as amended, with respect to the Ownership Interest transferred. Each Member may vote in favor or against such substitution and admission in the Member’s sole discretion. Any transferee under this Section X.6 who is already a Member will be automatically substituted and admitted as a Member with respect to the Ownership Interest transferred on executing a counterpart to this Agreement, as amended, pursuant to which the transferee Member agrees to be bound by all of the terms and conditions of this Agreement, as amended, with respect to the Ownership Interest transferred.

X.7 Valuation; Purchase Price. The purchase price for Ownership Interests purchased pursuant to Sections X7.2 (in the case of a transfer of an Ownership Interest by gift), X.3 (except in the case of the bankruptcy of a Member) and X.4 of this Agreement will be determined in the following manner:

X.7.1 The aggregate value of all of the Ownership Interests in the LLC may be determined by unanimous agreement of the Members. If for any reason the Members are unable to determine an aggregate value, then the aggregate value of all of the Ownership Interests in the LLC will be determined by an appraisal. The appraiser will be selected and agreed on by the Members. If the Members cannot agree on one appraiser, the Members will each select one appraiser, and the appraisers will in turn select an appraiser whose appraisal will be conclusive and binding on the parties. If the Members agree on one appraiser, the costs and expenses of such appraiser will be borne by the LLC; if multiple appraisers are selected, each Member must pay the costs and expenses of the appraiser selected by him or her, and the costs and expenses of the other appraiser will be paid by the LLC.

X.7.2 On an election by a Member or Members to purchase an Ownership Interest of a Member pursuant to Sections X.2 (in the case of a transfer of an Ownership Interest by gift) and X.3 (except in the case of the bankruptcy of a Member) and X.4 of this Agreement, the purchase price for the Ownership Interest to be purchased will be equal to the aggregate value (as determined pursuant to Section X.6.1) of the Ownership Interests in the LLC on the date of the occurrence of the event giving rise to the right to elect to purchase the Ownership Interest, multiplied by the Ownership Interest percentage to be purchased.
X.8 Book Value; Purchase Price. The purchase price for Ownership Interests purchased pursuant to Sections X.3 (in the case of the bankruptcy of a Member) of this Agreement will be determined in the following manner:

X.8.1 The aggregate value of the Ownership Interests in the LLC will be the book value of the LLC determined as of the close of business on the last day of the calendar month preceding the date of the occurrence of the event giving rise to the right to purchase the Ownership Interest. The book value will be determined from the LLC’s books of account as of that date by the independent certified public accountant regularly engaged by the LLC. “Book value” means the value of the LLC based on the balance sheet prepared by the LLC’s regularly-employed or retained accountant, prepared in accordance with generally accepted accounting principles consistently applied, using the LLC’s standard method of accounting. The book value will be equal to the assets of the LLC, less its liabilities, as adjusted by the following adjustments and/or value determinations:

X.8.1.1 Intangibles - Goodwill. No allowance of any kind will be made for goodwill, patents, trademarks, trade names, trade secrets or any similar intangible assets.

X.8.1.2 Accounts Payable/Receivable. All accounts payable will be taken at face amount less normal discount, and all accounts receivable will be taken at face amount less normal discount and a reasonable reserve for bad debts.

X.8.1.3 Real Property. Real property will be valued at fair market value, such determination to be arrived at by mutual agreement between the purchasing Member or Members and selling Member. If the value cannot be mutually agreed on, the LLC will select and pay the fees of a competent, independent real estate appraiser who will appraise such real property to determine the fair market value thereof and whose determination of such value will be binding on the purchasing Member or Members and selling Member.

X.8.1.4 Inventory. Inventory and supplies will be computed at cost or market value, whichever is lower.

X.8.1.5 Taxes. All accrued and properly accruable taxes and assessments will be deducted as liabilities.

X.8.2 On an election by a Member or Members to purchase an Ownership Interest of a Member pursuant to Sections X.3 (in the case of the bankruptcy of a Member) of this Agreement, the purchase price for the Ownership Interest to be purchased will be equal to the aggregate value (as determined pursuant to Section X.8.1) of the Ownership Interests in the LLC on the date of the occurrence of the event giving rise to the right to elect to purchase the Ownership Interest, multiplied by the Ownership Interest percentage to be purchased.
X.9 Payment of Purchase Price. To the extent that the purchase price for an Ownership Interest is determined in accordance with Sections X.2 (in the case of a transfer of an Ownership Interest by gift), X.3, X.4 and X.5 of this Agreement, such purchase price will be paid to the transferring Member as follows:

X.9.1 *** percent (*** %) of the purchase price will be paid in cash at the closing of the purchase transaction.

X.9.2 The balance of the purchase price will be paid in not more than sixty (60) equal monthly payments of principal and interest (amortized over not more than sixty (60) months), with interest to accrue at the Prime Rate as last published in the Wall Street Journal (in effect on the date of the occurrence of the event giving rise to the election to purchase the Ownership Interest) plus **** percent (****%) per annum, with the first payment to commence not later than thirty (30) days following the closing of the purchase transaction. The obligation to pay the amount owing pursuant to this Section X.9.2 will be evidenced by a promissory note executed by the purchasing Member or Members and delivered to the transferring Member, and will be secured by a pledge of the Ownership Interest being purchased and the personal guaranty of the purchasing Member or Members. The promissory note, personal guaranty and pledge of Ownership Interest instruments must be in form and substance reasonably acceptable to the transferring Member.
Follow the Money

Mark F. LeRoux
mark.leroux@tonkon.com
November 3, 2017

Partnership Tax Basics

- The Deal – Distributions
- Allocations
- The Tax Stuff
Overview

- Partnership itself is not taxed
- The tax results of the partnership – income, gain, loss deduction and credits – are passed through to the partners and reported on their own tax returns
- Flexible—unlike S corporations, these tax results can be varied among partners – within limits, of course

A Few Terms of Art

**Partnership:** general partnerships, limited partnerships, LLCs (except for certain LLCs…)

**Partner:** general partner, limited partner, or member of an LLC taxed as a partnership

**Allocations:** How partnership tax results – income, loss, deduction, credit, etc. are shared among partners.

**Capital Account:** "A sort of economic barometer of the partner's net investment in the partnership." (Bishop and Brooks, 1990)
Distributions – "Follow the Money"

4.2 Net Cash from Operations.

Except as provided in Section 13.2(c), the Company will distribute Net Cash from Operations to the holders of the Preferred Units and Common Units within 90 days after the end of each Fiscal Year in the following order and priority:

(a) First, to the Preferred Units in proportion to and until the cumulative distributions under this Section 4.2(a) and Sections 4.3(a) and 13.2(d)(ii) for the current and all prior Fiscal Years equal the cumulative Preferred Return for the current and all prior Fiscal Years;

(b) Second, to the Preferred Units in proportion to and to the extent of the Preferred Return Base;

(c) Third, the balance, if any to the Common Units.

4.3 Net Cash from Sales or Refinancings.

Except as provided in Section 13.2(c), the Company will distribute Net Cash from Sales or Refinancings to the holders of the Preferred Units and Common Units at such time and in such amounts as the Managers determine in the Managers’ sole discretion, in the following order and priority:

(a) First, to the Preferred Units in proportion to and until the cumulative distributions under this Section 4.3(a) and Sections 4.2(a) and 13.2(d)(ii) for the current and all prior Fiscal Years equal the cumulative Preferred Return for the current and all prior Fiscal Years;

(b) Second, to the Preferred Units in proportion to and the extent of the Preferred Return Base;

(c) Third, to the Preferred Units in an amount equal to the Preferred Residual Percentage of the remainder, if any; and

(d) Fourth, the balance, if any to the Common Units.
Allocating Profits and Losses
"Chasing Distributions"

- Profits and Losses may be ahead of or behind actual distributions. At the end – they should be the same

3.1 Profits and Losses.

(a) Profits. After giving effect to the special allocations set forth on Exhibit B, Profits for each Fiscal Year will be allocated to the holders of the Preferred Units and Common Units in the following order and priority:

(i) First, to offset the most recent allocation of Losses under and in order of Sections 3.1(b)(iv), 3.1(b)(iii) and 3.1(b)(ii) that have not been offset by previous Profit allocations under this Section 3.1(a)(i);

(ii) Second, to the Preferred Units in proportion to and until the cumulative amount allocated to each Preferred Unit under this Section 3.1(a)(ii) that has not been offset by Loss allocations under Section 3.1(b)(i) equals the cumulative Preferred Return;

(iii) Third, to the Preferred Units in an amount equal to Preferred Residual Percentage of the Profits remaining, if any; and

(iv) Fourth, the remainder, if any, to the Common Units.
Allocating Profits and Losses "Chasing Distributions"

(b) **Losses.** After giving effect to the special allocations set forth on Exhibit B, Losses for each Fiscal Year will be allocated to the holders of the Preferred Units and Common Units in the following order and priority:

(i) First, to offset Profits the most recent allocations of Profits under and in order of Sections 3.1(a)(iv), 3.1(a)(iii) and 3.1(a)(ii) that have not been offset by previous Loss allocations under this Section 3.1(b)(i);

(ii) Second, to the Common Units in proportion to and to the extent of the maximum amount that will not result in an Adjusted Deficit;

(iii) Third, to the Preferred Units in proportion and to the extent of the maximum amount that will not result in an Adjusted Deficit; and

(iv) Fourth, to the Preferred Units and Common Units in proportion to the number of Units.

Allocating Profits and Losses "Forced Allocations"

- **Forced allocation provision "punts" the allocation issue to the tax return preparer.**

(A) **Profits and Losses.** After giving effect to the special allocations set forth in Section 2(B), Profits and Losses for any Allocation Year will be allocated among the Members in a manner that will result in the Capital Account balance for each Member (which balance may be positive or negative), after adjusting the Capital Account for all Capital Contributions and distributions and any special allocations required pursuant to this Agreement for the current and all prior Allocation Years, being (as nearly as possible) equal to (x) the amount that would be distributed to the Member if the Company were to sell all of its assets at their current Gross Asset Value, pay all liabilities of the Company (limited, with respect any nonrecourse liabilities, to the value reflected in the Members' Capital Accounts for the assets securing such nonrecourse liabilities), and distribute the proceeds thereof in accordance with Section 6.2, minus (y) the Member's share of Company Minimum Gain and Member Nonrecourse Debt Minimum Gain.
The Tax Stuff
"Substantial Economic Effect"

Allocations will not be respected for tax, unless the allocations have "substantial economic effect" under the Treasury Regulations.

1. The capital account requirement. Capital accounts must be maintained for the partners in accordance with a very precise set of rules.

2. The distribution requirement. Upon liquidation of the partnership, liquidating distributions must be made to partners in accordance with their positive capital account balances.

3. The deficit makeup requirement. Upon liquidation, partners with deficit capital accounts must restore the amounts of their deficits to the partnership.
The Tax Stuff
"Substantial Economic Effect"

- The Capital Account Requirement
  2.8 Maintenance of Capital Accounts.

  The Company will establish and maintain Capital Accounts with respect to each Unit Holder, all in accordance with the capital accounting rules of Regulations Section 1.704-1(b)(2)(iv). The Board of Directors may increase or decrease Capital Accounts to reflect revaluations of Property in accordance with Regulations Section 1.704-1(b)(2)(iv)(f). The Board of Directors may modify the manner in which Capital Accounts are computed to comply with the regulations, provided that such modification is not likely to materially affect the amounts distributed to any Person under Section 13 upon the dissolution of the Company. The Board of Directors will also make any adjustments that are necessary or appropriate to maintain proportionality between the Capital Accounts of the Unit Holders and the amount of capital reflected on the Company’s books, in accordance with Regulations Section 1.704-1(b)(2)(iv)(q).

What Capital Accounts Do....

- Every partner has a capital account
- Simply put, capital accounts keep track of each partner's net investment in the partnership
- Capital accounts are all about an immediate hypothetical dissolution—assets are distributed in accordance with capital accounts not based on some other measure
- Hybrid Accounting System – "Tax Book"
Capital Accounts

Section 2.1
Contributions. As of the date of this Agreement, the members’ Capital Accounts are as set forth on the attached Exhibit B.

Let’s Create Friendly LLC

Capital Accounts

M
50% Interest Each

Property: FMV = $1,000

Friendly LLC

$1,000 cash

L

Bank

$500 Loan
### Friendly LLC's Initial Balance Sheet

<table>
<thead>
<tr>
<th></th>
<th>Assets</th>
<th>Liabilities &amp; Partners' Capital</th>
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<tr>
<td><strong>TOTAL</strong></td>
<td><strong>$2,500</strong></td>
<td><strong>TOTAL $2,500</strong></td>
</tr>
</tbody>
</table>

### Adjustments to Capital Accounts

- **Increased by:**
  - Additional contributions
  - Items of income that are passed through to the partner

- **Decreased by:**
  - Distributions
  - Items of deduction or loss that are passed through to the partner

**Note:** Capital Accounts do not reflect debt—they are the net equity of a partner
Capital Accounts assume book values….usually

- Capital Accounts reflect the value of property contributed at the time of contribution, regardless of later increases or decreases in the value of that property.

- But capital accounts can and should (must?) be restated at specific times during the partnership's lifetime:
  - Admission of a new partner
  - Distribution of property
  - Just before dissolution

Let's assume some simple operating numbers...

Year 1: $500 profit → cash increase
Year 2: $300 profit → cash increase
Year 3: $200 loss → cash decrease
Their Capital Accounts….

- M:
  - $1,000
  - + $250 (Year 1)
  - + $150 (Year 2)
  - - $100 (Year 3)
  - **$1,300** Ending Capital Account

- L:
  - $1,000
  - + $250 (Year 1)
  - + $150 (Year 2)
  - - $100 (Year 3)
  - **$1,300** Ending Capital Account

Friendly LLC's Balance Sheet at end of Year 3

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities &amp; Partners’ Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH</td>
<td>Debt $500</td>
</tr>
<tr>
<td>PROPERTY</td>
<td>M 1,300</td>
</tr>
<tr>
<td></td>
<td>L 1,300</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>TOTAL</strong> $3,100</td>
</tr>
</tbody>
</table>
M and L are at their wits end!

- We need help!
- Who can we get to come in and run this thing?
- F arrives on the scene, and will run it for a 20% membership interest….Great! Sign her up!

Not So Fast!

Remember—when you admit a new partner, you adjust ("book up") capital accounts

- Let's say that the Property that M contributed is now worth $3,100
- We must adjust the capital accounts of M and L before admitting F.
- Property was worth $1,000 at contribution and has increased in value by $2,100
- M and L would each receive a credit to their capital account of $1,050 (their 50% share of the increase in the value of the property)
### Friendly LLC's Balance Sheet After Book-Up

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities &amp; Partners’ Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH $2,100</td>
<td>Debt $500</td>
</tr>
<tr>
<td>PROPERTY 3,100</td>
<td>M 2,350</td>
</tr>
<tr>
<td></td>
<td>L 2,350</td>
</tr>
<tr>
<td><strong>TOTAL $5,200</strong></td>
<td><strong>TOTAL $5,200</strong></td>
</tr>
</tbody>
</table>

### Friendly LLC's Balance Sheet if F Receives a 20% Capital Interest

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities &amp; Partners’ Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH $2,100</td>
<td>Debt $500</td>
</tr>
<tr>
<td>PROPERTY 3,100</td>
<td>M $1,830</td>
</tr>
<tr>
<td></td>
<td>L $1,830</td>
</tr>
<tr>
<td>$520 each</td>
<td>F $1,040</td>
</tr>
<tr>
<td><strong>TOTAL $5,200</strong></td>
<td><strong>TOTAL $5,200</strong></td>
</tr>
</tbody>
</table>
**Friendly LLC's Balance Sheet if F Receives a 20% Profits Interest**

<table>
<thead>
<tr>
<th>Assets</th>
<th>Liabilities &amp; Partners’ Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>CASH $2,100</td>
<td>Debt $500</td>
</tr>
<tr>
<td>PROPERTY 3,100</td>
<td>M 2,350</td>
</tr>
<tr>
<td></td>
<td>L 2,350</td>
</tr>
<tr>
<td></td>
<td>F -0-</td>
</tr>
<tr>
<td><strong>TOTAL $5,200</strong></td>
<td><strong>TOTAL $5,200</strong></td>
</tr>
</tbody>
</table>

**Profits and Losses**

A1.43 “Profits” and “Losses” means, for each Fiscal Year, an amount equal to the Company’s taxable income or loss for such Fiscal Year, determined in accordance with Code Section 703(a) (for this purpose, all items of income, gain, loss or deduction required to be stated separately under Code Section 703(a)(1) will be included in taxable income or loss), with the following adjustments:

(a) Add Company income that is exempt from federal income tax and not otherwise taken into account in computing Profits or Losses;

(b) Subtract any Company expenditures described in Code Section 705(a)(2)(B) or treated as Code Section 705(a)(2)(B) expenditures under Regulations Section 1.704-1(b)(2)(iv)(i), and not otherwise taken into account in computing Profits or Losses;

(c) If any Company asset is revalued under Section 2.7, the amount of such adjustment will be taken into account as gain or loss from the disposition of such asset for purposes of computing Profits or Losses;
Profits and Losses

(c) If any Company asset is revalued under Section 2.7, the amount of such adjustment will be taken into account as gain or loss from the disposition of such asset for purposes of computing Profits or Losses;

(d) Gain or loss resulting from any disposition of Company Property with respect to which gain or loss is recognized for federal income tax purposes will be computed by reference to the value of such Property for Capital Account purposes, notwithstanding that the adjusted tax basis of such Property differs from such value;

(e) In lieu of the depreciation, amortization and other cost recovery deductions taken into account in computing such taxable income or loss, there will be taken into account Depreciation for such Fiscal Year, computed in accordance with Section A1.18;

(f) To the extent an adjustment to the adjusted tax basis of any Company asset under Code Section 734(b) or Code Section 743(b) is required under Regulations Section 1.704-1(b)(2)(iv)(m)(4) to be taken into account in determining Capital Accounts as a result of a distribution other than in complete liquidation of a Member’s Economic Rights, the amount of such adjustment will be treated as an item of gain (if the adjustment increases the basis of the asset) or loss (if the adjustment decreases the basis of the asset) from the disposition of the asset and will be taken into account for purposes of computing Profits or Losses; and

(g) Notwithstanding any other provision of this Section A1.3, any items which are specially allocated under Sections B1.1 or B1.2 of Exhibit B will not be taken into account in computing Profits or Losses.

The amounts of the items of Company income, gain, loss or deduction available to be specially allocated under Sections B1.1 and B1.2 of Exhibit B will be determined by applying rules analogous to those set forth in Sections A1.43(a) through A1.43(g).
The Tax Stuff
"Substantial Economic Effect"

- Liquidate in accordance with positive Capital Accounts

13.2 Winding Up.

Upon the occurrence of a Liquidating Event, *** will cause the Company Property to be liquidated as promptly as is consistent with obtaining its fair value, and will cause the proceeds, to the extent sufficient, to be applied and distributed in the following order:

(a) First, to the payment and discharge of all of the Company’s debts and liabilities to creditors, including Members to the extent permitted by Law;

(b) Second, to the payment and discharge of all of the Company’s remaining debts and liabilities to Members; and

(c) Third, the balance, if any, to the Unit Holders in accordance with their Capital Accounts (determined after giving effect to all allocations and distributions for all periods).

The Tax Stuff
"Substantial Economic Effect"

- Contribute Deficit Capital Accounts – **NOT**

- **Alternate Test** – The "Regulatory Allocations"
The Tax Stuff
"Substantial Economic Effect"

B1. Special Allocations. The following special allocations will be made in the following order:

B1.1. Minimum Gain Chargeback. Notwithstanding any other provision of Section 3 of the Agreement, items of Company income and gain will be specially allocated to one or more Members in the amount and manner required to satisfy the Company Minimum Gain charge back rules of Regulations Section 1.704-2(£) and the Member Minimum Gain charge back rules of Regulations Section 1.704-2(i)(4).

B1.2. Qualified Income Offset. If any Member unexpectedly receives any adjustments, allocations or distributions described in Regulation Sections 1.704-1(b)(2)(ii)(d)(4), (5) or (6) and such Member would have an Adjusted Deficit after all other allocations provided for in the Agreement were made without regard to this Section B1.2, items of Company income and gain will be specially allocated to each such Member in the manner and minimum amount necessary to eliminate the Adjusted Deficit of such Member as quickly as possible.

B1.3. Nonrecourse Deductions. Nonrecourse Deductions for any Fiscal Year will be specially allocated to the Members and the Unit Holders in proportion to the number of Units held by each.

B1.4. Member Nonrecourse Deductions. Any Member Nonrecourse Deductions for any Fiscal Year will be specially allocated to the Unit Holder who bears the economic risk of loss with respect to the Member Nonrecourse Debt to which such Member Nonrecourse Deductions are attributable in accordance with Regulations Section 1.704-2(i)(l).

B1.5. Section 754 Adjustments. To the extent an adjustment to the adjusted tax basis of any Company asset pursuant to Code Sections 734(b) or 743(b) is required, pursuant to Regulations Sections 1.704-1(b)(2)(iv)(m)(2) or (4), to be taken into account in determining Capital Accounts as the result of a distribution to a Unit Holder in complete liquidation of his or her interest in the Company, the amount of such adjustment to Capital Accounts will be treated as an item of gain (if the adjustment increases the basis of the asset) or loss (if the adjustment decreases such basis) and such gain or loss will be specially allocated to the Members and the Unit Holders in accordance with their interests in the Company if Regulations Section 1.704-1(b)(2)(iv)(m)(2) applies, or to the Unit Holder to whom such distribution was made if Regulations Section 1.704-1(b)(2)(iv)(m)(4) applies.
The Tax Stuff
"Substantial Economic Effect"

B1.6  Loss Limitation. Losses allocated under Section 3.1 will not exceed the maximum amount of Losses that may be allocated without causing any Member to have an Adjusted Deficit at the end of any Fiscal Year. If some, but not all, of the Members would have Adjusted Deficits, as a consequence of an allocation of Losses under Section 3.1, the limitation set forth in this Section B1.6 will be applied on a Member-by-Member basis and Losses not allocable to any Member as a result of such limitation will be allocated to the other Members in accordance with the positive balances in such Members’ Capital Accounts so as to allocate the maximum permissible Losses to each Member under Section 1.704-1(b)(2)(ii)(d) of the Regulations.

The Tax Stuff
"Substantial Economic Effect"

B2. Curative Allocations. The allocations set forth in Sections B1.1 through B1.6 of this Exhibit B (the “Regulatory Allocations”) are intended to comply with certain requirements of the Regulations. To the extent possible, all Regulatory Allocations will be offset either with other Regulatory Allocations or with special allocations of other items of Company income, gain, loss or deduction pursuant to this Section B2. Therefore, notwithstanding any allocation provision other than the Regulatory Allocations, the Board of Directors will make such offsetting special allocations of Company income, gain, loss or deduction in whatever manner they determine appropriate so that each Member’s and Unit Holder’s Capital Account balance is, to the extent possible, equal to the Capital Account balance that such party would have had if the Regulatory Allocations were not part of the Agreement and all Company items were allocated pursuant to Section 3.1.
The Tax Stuff
"Substantial Economic Effect"

• Loss allocations that do not satisfy the "substantial economic effect" rule will not be respected and, instead, will be allocated in accordance with the partners' interests in the partnership of the Treasury Regulations.
• = Uncertainty.

The Tax Stuff
"Tax Allocations – IRC Section 704(c)"

3.3 Tax Allocations: Code Section 704(c).

Except as otherwise provided in this Section 3.3, each item of income, gain, loss and deduction of the Company for federal income tax purposes shall be allocated among the Unit Holders in the same manner as such items are allocated for book purposes under this Section 3. In accordance with Code Section 704(c) and the related Regulations, income, gain, loss, and deduction with respect to any Property contributed to the capital of the Company or carried on its books for Capital Account purposes will, solely for tax purposes, be allocated among the Members so as to take account of any variation between the adjusted basis of the Property to the Company for federal income tax purposes and its initial fair market value for Capital Account purposes. If the value of any Company asset is adjusted under Section 2.7, subsequent allocations of income, gain, loss and deduction with respect to the asset will take account of any variation between the adjusted basis of the asset for federal income tax purposes and its value for Capital Account purposes in the same manner as under Code Section 704(c) and the related Regulations. Any elections or other decisions relating to such allocations will be made by the Managers in any manner that reasonably reflects the purpose and intention of this Agreement. Allocations under this Section 3.3 are solely for purposes of federal, state and local taxes and will not affect, or in any way be taken into account in computing, any Person’s Capital Account or share of Profits, Losses, other items or distributions under any provision of this Agreement.
The Tax Stuff
"Tax Allocations – IRC Section 704(c)"

- Reconciles Tax Accounting to Tax Book Accounting
- Three Methods
  - Traditional Methods
  - Traditional Methods with Curative Allocations
  - Remedial Method – **BEWARE OF PHANTOM INCOME**

Profits Interest

- A "profits interest" is partnership interest that has no current capital account, but is entitled to share in future allocations of profits and losses.
- Done right, recipient has no income upon receipt. FMV = initial capital account = 0
- Generally, entitled to capital gain treatment on sale (versus options).
Chapter 6

Updates and Trends in M&A—Presentation Slides

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Perkins Coie LLP
Portland, Oregon
Updates & Trends in M&A

Perkins Coie LLP

PRESENTED BY:
Roy Tucker, Perkins Coie LLP
Kara Tatman, Perkins Coie LLP

Agenda

I. Financial Advisor Conflicts
II. Key Diligence Issues – Cybersecurity and Intellectual Property
III. Representation & Warranty Insurance
IV. Non-Reliance Provisions and Extra-Contractual Fraud Claims
V. Earnouts – Efforts Covenants & Securities
VI. Regulatory Hurdles - HSR and CFIUS Developments
VII. Letters of Transmittal – Life after Cigna
VIII. Post-Closing Adjustments
IX. Controlling Shareholder Transactions
I. Financial Advisor Conflicts

Common elements in *Del Monte, Rural Metro, Zale* cases

- Undisclosed and undiscovered advisor conflicts lead to claims for breach of fiduciary duty by board and risk of injunction for failure to disclose
- Common elements include failure of advisor to inform board of conflict and/or failure to inform stockholders of advisor conflict
- Advisor’s exposure may be greater than board’s

Lessons for advising the board

- Importance of smoking out advisor conflicts at front end
- Engagement letter terms:
  - disclosure of prior relationships
  - ongoing duty to disclose conflicts
  - prohibition of certain conflict roles (e.g., financing the buyer)
  - use of disclosure memo or board book separate from engagement letter
I. Financial Advisor Conflicts

Sample Provisions

• Disclosure of Relationship
  • Except as set forth on Schedule A, the Bank has not, within the past [three years] had [material] investment banking, capital markets or lending engagements with respect to the parties identified thereon (the "Relevant Parties"). Schedule A also sets forth the total fees derived from such engagements by the Bank. The Bank has not within the past year engaged in any discussions with any third party concerning the possibility of affecting, causing, or participating in a Transaction with the Company.

• Disclosure of Holdings:
  • The Bank has previously disclosed to the Board, and hereby represents, that the Bank and its affiliates (including portfolio companies in which the Bank has investments) do not beneficially own any interests in the Company, a Relevant Party, or to the Bank’s knowledge, a portfolio company of a Relevant Party. In addition, the Bank has had discussions with its representatives that the Bank intends to work on this engagement (comprising ___ __________ [the "Team Members"]) and has confirmed that, other than as set forth on Schedule B, no Team Member has any direct holding, as of the date hereof, in the Company, a Relevant Party, or, to the relevant Team Member’s knowledge, a portfolio company of a Relevant Party.

Sample Provisions, continued

• Ongoing Disclosure Obligation
  • If the Board elects to engage in formal discussions with one or more parties other than the Relevant Parties about a Transaction, the Bank will, upon request of the Board, disclose to the Board the information described above concerning such party or parties.

• Direct Conflict Prohibition:
  • Notwithstanding anything herein to the contrary, during the term of this engagement, the Bank shall not provide M&A advisory services, new debt or equity capital markets or new bank financing to any bidder for the Company without the prior written consent of the Board.
II. Key Diligence Issues – Cybersecurity & Intellectual Property

Cybersecurity

• High costs associated with data breaches and increasing value of data – retail, technology, healthcare
• Concerns about correcting existing problems and post-closing integration
• Compliance issues are most common – need knowledgeable personnel and good security governance (not just bells and whistles)

Intellectual Property

• Ownership issues, including employee and contractor rights
• Licensed IP – royalties, scope of use, right to improvements, assignability
• Open source software
• Litigation history – including AIA implications for statutory bar and estoppel
III. Representation & Warranty Insurance

Rep and Warranty Insurance – Increasing in Popularity

- R&W insurance gained traction in private equity deals, auction bids, and large transactions
- Increasingly popular in middle market transactions, and also used for strategic transactions
- Buyer policy (most common) will replace or reduce the need for escrow, while seller policy will compensate for covered losses

Typical Policy Structure

| Premium | Typically 3-5% of the coverage amount, due upfront (often paid by buyer) – plus underwriting fees |
| Deductible | Also called the “retention” – 1-3% of the purchase price (either covered by buyer or split with seller) |
| Survival | Typically longer than standard indemnity – up to 3 years for general reps |
| Exclusions | Known problems, matters listed in disclosure schedule, covenants, purchase price adjustments, certain high-risk reps |
III. Representation & Warranty Insurance

Drafting Considerations

• Despite popularity, no established practice for addressing R&W insurance in transaction documents

<table>
<thead>
<tr>
<th>Closing Condition</th>
<th>Covenants</th>
<th>Indemnification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Limitation on Liability</td>
<td>Source of Recovery</td>
<td>Collection Efforts</td>
</tr>
</tbody>
</table>

• Materiality scrape, definitions of knowledge and losses
• Policy document is highly customized and must be carefully reviewed and negotiated

Sample Provisions

• Closing Condition:
  • Buyer shall have obtained a representation and warranty insurance policy (the “R&W Policy”), [substantially in the form attached hereto,] [in form and substance reasonably acceptable to Buyer,] to become effective at or prior to Closing, that provides coverage for breaches of representations and warranties by Seller of no less than $[NUMBER] with respect to the transactions contemplated hereby and a retention no greater than $[NUMBER].

• Covenant:
  • Buyer shall use [reasonable best / commercially reasonable] efforts to obtain the R&W Policy, solely for the benefit of Buyer, related to Losses arising from breaches of Seller's representations and warranties contained in this Agreement that are in excess of the Escrow Amount. [At Buyer's reasonable request, Seller shall cooperate with Buyer and provide commercially reasonable assistance to obtain and bind the R&W Policy.]
III. Representation & Warranty Insurance

Sample Provisions, continued

• Indemnification:
  • The amount of any recovery by Buyer Indemnitees pursuant to Section [NUMBER] will be reduced by the amounts recovered (or recoverable) by Buyer Indemnitees under any applicable insurance policies (including the R&W Policy), contractual rights or other collateral sources . . . . Each Buyer Indemnitee agrees to [use its reasonable best / commercially reasonable efforts to] make all claims and to diligently pursue collection of any amounts recoverable under applicable insurance policies (including the R&W Policy but excluding self-insurance policies), indemnification agreements, contracts and similar rights and to seek recovery under all applicable insurance policies, indemnification agreements, contracts and similar rights for all Losses to the extent such Losses are covered by any insurance policy, indemnification agreement, contract or similar right of such Buyer Indemnitee. In the event that an insurance or other recovery is made by any Buyer Indemnitee with respect to any Losses for which any such Person has been indemnified hereunder, then a refund equal to the aggregate amount of the recovery will be made promptly to Seller.

• All claims for Losses made by any Buyer Indemnitee under Section [NUMBER] shall be satisfied solely out of funds available in the Escrow Account; provided, however, that claims pursuant to Section [NUMBER] shall be satisfied: (i) first, to the extent such Losses exceed [the Basket,] from the Escrow Account; (ii) second, if the entire retention under the R&W Policy has been exhausted, by submission of claims by Buyer pursuant to the R&W Policy until such time as the policy limit set forth in the R&W Policy has been reached; and (iii) thereafter, by Seller subject to the limits set forth in this Article [NUMBER].

• Notwithstanding anything to the contrary in this Agreement, Buyer, on behalf of itself and each other Buyer Indemnitee, acknowledges and agrees that the sole and exclusive remedy of any Buyer Indemnitee beyond the Escrow Amount for any claim related to or arising under Section [NUMBER] shall be to make a claim against the R&W Policy. Buyer, on behalf of itself and each other Buyer Indemnitee, further acknowledges and agrees that the provisions of this Section [NUMBER] shall apply regardless of whether (i) Buyer obtains at or following Closing or maintains following Closing the R&W Policy, (ii) the R&W Policy is revoked, cancelled or modified in any manner after issuance, or (iii) any Buyer Indemnitee makes a claim under the R&W Policy and such claim is denied by the insurer.
IV. Non-Reliance Provisions and Extra-Contractual Fraud Claims

*Why it's important – fraud exception to exclusivity of contractual indemnity provisions*

**Abry Partners (Del. Ch. 2006)**
- Standard integration clause does not shield seller from fraud claims

**Fd G Logistics (Del. Ch. 2016)**
- Seller's disclaimer of non-contractual representations does not, by itself, bar fraud claims
- Disclaimer must come from the purchaser to be effective as bar

---

Sample Buyer's Representation:

5.7 **Non-Reliance.** (a) In making its decision to enter into this Agreement and to consummate the transactions contemplated hereby, Buyer has relied solely upon its own investigation and the express representation and warranties of the Stakeholders set forth in Article 3 and Article 4 (in each case, including any related Schedules and certificates); and (b) none of the Stakeholders, the Company or any other Person has made any representation or warranty as to the Stakeholders, the Company or this Agreement, except as expressly set forth in Article 3 and Article 4 of this Agreement (including the related portions of the Schedules and related certificates).
V. Earnouts – Efforts Covenants & Securities

Earnout Covenants

• Efforts standards – comparing Lazard Technology Partners (Delaware) with Sanofi (New York)
  • Lazard – buyer prohibited from taking action to divert or defer revenue “with the intent of reducing or limiting” the earnout payment
  • Sanofi – buyer required to use “diligence efforts” to achieve earnout milestones, and referring to industry practices
• Contract provision versus implied covenant of good faith and fair dealing

Earnouts as Securities

• Beware of a hidden security
• Sellers seeking to monetize contingent consideration – royalty streams, and requests to sell rights to third party
• SEC guidance looks at numerous factors to determine whether contingent consideration is more like a contract or more like a security
VI. Regulatory Hurdles - HSR and CFIUS Developments

HSR Process - No major Changes

- Slight drop in deals reviewed through Q3 2017 vs prior 2 years (27 investigations concluded in LTM vs. 33 and 37 in 2016 and 2015, respectively)
- Increase in time to review (where investigation was initiated) - average of 11.6 months 2017 YTD vs. 9.9 months in 2016
- Continued trend (since 2014) of consent orders requiring "up front" divestiture prior to closing of transaction

VI. Regulatory Hurdles - HSR and CFIUS Developments

What the Committee on Foreign Investment in the United States ("CFIUS") Does

- Reviews “covered transactions” …
  - Any transaction which could result in control of a U.S. business by a foreign person
  - Control = ability to determine, direct, or decide specified business actions
  - … to determine whether they pose a threat to U.S. national security
VI. Regulatory Hurdles - HSR and CFIUS Developments

CFIUS Process: Notice & Review

- Voluntary Notice – initiated by part to transaction
  - Public disclosure prohibited by statute
  - Provides for safe harbor
  - President has authority to unwind transaction even after completed
  - CFIUS has 30 days to review a notice
- Recommendations:
  - Submit a thorough, detailed notice
  - Consult with key agencies before filing a notice

CFIUS Process: Investigation

- CFIUS shall conduct an investigation if:
  1. Member believes the transaction poses an unmitigated threat to national security;
  2. Lead agency recommends and CFIUS concurs;
  3. Foreign government controlled transaction; or
  4. Control of critical infrastructure by foreign person.
- CFIUS has 45 days to conduct
- CFIUS reports to President if:
  - Recommend he or she suspend or prohibit the transaction;
  - Unable to reach a decision; or
  - Request that the President decide.
VI. Regulatory Hurdles - HSR and CFIUS Developments (continued)

CFIUS Trends

• More filings (173 cases reviewed in 2016 vs. 35 in 2010)
  • Risk of post-closing review and divestiture
  • Increase in deals withdrawn and abandoned or rejected
  • Higher risk for targeted technologies (e.g. semiconductors) and buyer nationalities (e.g. China)
  • Planar/Leyard - cleared
  • Lattice/Canyon Bridge - blocked by President Trump

CFIUS Trends, cont.

• Deal Implications
  • Get buyer representations regarding government ownership or influence
  • Covenants regarding submission and review process – similar to HSR
  • Consider reverse break fee for failure to obtain clearance
  • Consider impact on timeline – drop-dead termination period
VII. Letters of Transmittal – Life after Cigna

After Cigna – has the practice changed regarding letters of transmittal?

- Refresher – in Cigna, the court (Delaware) found that (1) a release of claims in the letter of transmittal and (2) broad indemnification obligations were unenforceable under the facts of the case
- Practical results:
  - Parties more likely to include release of claims in the merger agreement
  - Benefit to having reasonable limitations on indemnity obligations
  - Buyers requiring signatures, support agreements from shareholders just after signing, and sometimes requiring high percentage of shareholder approval as closing condition

VIII. Post-Closing Adjustments

Typical working capital adjustment

- Difference between target and closing date working capital
- Based on valuation assuming normalized working capital
- Purpose to avoid manipulation and adjust for changes post-signing and pre-closing
VIII. Post-Closing Adjustments

Chicago Bridge (Del. Sup. 2017)

- Transaction with expectation of no consideration at closing
- Typical net working capital adjustment provision
  - Determined in accordance with GAAP
  - Consistently applied by seller in preparation of its financials
- Reps and warranties did not survive closing.
- Westinghouse claimed almost $2 billion as adjustments based on non-compliance with GAAP

---

Court:

- Transaction was viewed as "quitclaim"
- Purchaser had no recourse for problems with historical financial statements
- Westinghouse closed despite known GAAP deficiencies
- Purpose of true up is to address changes in a confined period of time

Drafting Lessons

- Critical to qualify GAAP by reference to seller's historical financials
- "Past practices and accounting methodologies and policies" used by seller
IX. Controlling Shareholder Transactions

Controlling Shareholder Transactions – Lessons from Delaware

• No magic number for “control” – Crimson Exploration, KKR Financial, and Calesa Associates
  • Fact-intensive examination of indicia of actual control beyond ownership
• Standard of review depends on the circumstances
  • Heightened scrutiny of the entire fairness standard
  • More deferential business judgment rule standard

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<tr>
<th>Squeeze-out transaction</th>
<th>Differential consideration</th>
<th>Pro-rata consideration</th>
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<tbody>
<tr>
<td></td>
<td>Continuing stake</td>
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Confidential | 29
Chapter 7
Negotiating Key Terms in M&A Transactions

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  4. Additional Purchase Price Payment ............................ 7–6
  5. Conduct of Company; Accounting Controls ................. 7–9
Summary of Hypothetical Deal:

Target Company is a software-as-a service business that has become an established leader in its business segment over its seven-year history. Target Company has two operating subsidiaries, one of which is a software development company and the other of which focuses on customer support.

Target Company is owned by ten Selling Shareholders. Target Company’s management includes its founder and CEO, as well as a CFO and CTO. The CEO is also a major Selling Shareholder.

Strategic Buyer has agreed to acquire 100% of Target Company’s stock for $25 million. The transaction is to be structured as a merger, with Strategic Buyer forming a wholly owned Merger Sub which will merge with and into Target Company. As a result of the merger, outstanding shares of Target Company stock held by Selling Shareholders will be converted into cash, and shares of Merger Sub held by Strategic Buyer will become shares of Target Company stock.

Other terms include:

- An earn-out based on three years of Target Company’s revenues post-closing. The earn-out will provide up to an additional $15 million in purchase price for the Selling Shareholders.

- An escrow of $2.5 million of the purchase price for 18 months, from which indemnity claims may be satisfied.

- Three-year employment agreements for the CEO, CTO, and CFO.

- Appointment of the CEO to act as Representative of the Selling Shareholders for indemnity claims and other matters involving payment to or by Selling Shareholders.

Matt, representing Strategic Buyer, and Erich, representing Target Company, will negotiate certain terms of the Merger and Sale Agreement that will govern the transaction. In the sample provisions that follow:

- Company refers to Target Company
- Acquired Companies refers to Target Company and its subsidiaries
- Buyer refers to Strategic Buyer
- Sellers refers to Selling Shareholders
Sample Provisions for Discussion:

[Based on terms from the ABA Model Stock Purchase Agreement]

1. **Definitions.**

   For purposes of this Agreement, the following terms have the meanings specified or referred to in this Section 1:

   “Knowledge” -- an individual will be deemed to have “Knowledge” of a particular fact or other matter if:

   (a) such individual is actually aware of such fact or other matter; or

   (b) a prudent individual could be expected to discover or otherwise become aware of such fact or other matter in the course of conducting a reasonably comprehensive investigation concerning the existence of such fact or other matter.

   A Person (other than an individual) will be deemed to have “Knowledge” of a particular fact or other matter if any individual who is serving, or who has at any time served, as a director, officer, partner, executor, or trustee of such Person (or in any similar capacity) has, or at any time had, Knowledge of such fact or other matter.

   “Material Adverse Effect” means a material adverse effect on the business, results of operations, financial position, assets, or prospects of the Company, which will in any event include any adverse effect on the shareholders’ equity, assets, revenue, or net income of the Company; and “Material Adverse Change” means any change that has resulted, will result, or is likely to result in a Material Adverse Effect.

2. **Representations and Warranties of Sellers.**

   Sellers represent and warrant to Buyer as follows:

   2.1 Financial Statements. Sellers have delivered to Buyer: (a) [unaudited] consolidated balance sheets of the Acquired Companies as at ______ in each of the years ____ through ____, and the related [unaudited] consolidated statements of income, changes in stockholders’ equity, and cash flow for each of the fiscal years then ended, [together with the report thereon of __________, independent certified public accountants,] (b) a consolidated balance sheet of the Acquired Companies as at ________, ____ (including the notes thereto, the “Balance Sheet”), and the related consolidated statements of income, changes in stockholders’ equity, and cash flow for the fiscal year then ended, together with the report thereon of __________, independent certified public accountants, and (c) an unaudited consolidated balance sheet of the Acquired Companies as at ________, ____ (the “Interim Balance Sheet”) and the related unaudited consolidated statements of income, changes in stockholders’ equity, and cash flow for the __ months then ended, including in each case the notes thereto. Such financial statements and notes fairly present the financial condition and the results of operations, changes in stockholders’ equity, and cash flow of the Acquired Companies as at the respective dates of and for the periods referred
to in such financial statements, all in accordance with GAAP [, subject, in the case of interim financial statements, to normal recurring year-end adjustments (the effect of which will not, individually or in the aggregate, be materially adverse) and the absence of notes (that, if presented, would not differ materially from those included in the Balance Sheet)]; the financial statements referred to in this Section 2.1 reflect the consistent application of such accounting principles throughout the periods involved [, except as disclosed in the notes to such financial statements]. No financial statements of any Person other than the Acquired Companies are required by GAAP to be included in the consolidated financial statements of the Company.

2.2 **Accounts Receivable.** All accounts receivable of the Acquired Companies that are reflected on the Balance Sheet or the Interim Balance Sheet or on the accounting records of the Acquired Companies as of the Closing Date (collectively, the “Accounts Receivable”) represent or will represent valid obligations arising from sales actually made or services actually performed in the Ordinary Course of Business. Unless paid prior to the Closing Date, the Accounts Receivable are or will be as of the Closing Date current and collectible net of the respective reserves shown on the Balance Sheet or the Interim Balance Sheet or on the accounting records of the Acquired Companies as of the Closing Date (which reserves are adequate and calculated consistent with past practice and, in the case of the reserve as of the Closing Date, will not represent a greater percentage of the Accounts Receivable as of the Closing Date than the reserve reflected in the Interim Balance Sheet represented of the Accounts Receivable reflected therein and will not represent a material adverse change in the composition of such Accounts Receivable in terms of aging). Subject to such reserves, each of the Accounts Receivable either has been or will be collected in full, without any set-off, within ninety days after the day on which it first becomes due and payable. There is no contest, claim, or right of set-off, other than returns in the Ordinary Course of Business, under any Contract with any obligor of an Accounts Receivable relating to the amount or validity of such Accounts Receivable. Part 2.2 of the Disclosure Letter contains a complete and accurate list of all Accounts Receivable as of the date of the Interim Balance Sheet, which list sets forth the aging of such Accounts Receivable.

2.3 **No Undisclosed Liabilities.** Except as set forth in Part 2.3 of the Disclosure Letter, the Acquired Companies have no liabilities or obligations of any nature (whether known or unknown and whether absolute, accrued, contingent, or otherwise) except for liabilities or obligations reflected or reserved against in the Balance Sheet or the Interim Balance Sheet and current liabilities incurred in the Ordinary Course of Business since the respective dates thereof.

2.4 **No Material Adverse Change.** Since the date of the Balance Sheet, there has not been any Material Adverse Change in the business, operations, properties, prospects, assets, or condition of any Acquired Company, and no event has occurred or circumstance exists that may result in such a material adverse change.

2.5 **Disclosure.**

(a) No representation or warranty of Sellers in this Agreement and no statement in the Disclosure Letter omits to state a material fact necessary to make the statements herein or therein, in light of the circumstances in which they were made, not misleading.
(b) There is no fact known to either Seller that has specific application to either Seller or any Acquired Company (other than general economic or industry conditions) and that materially adversely affects [or, as far as either Seller can reasonably foresee, materially threatens] the assets, business, prospects, financial condition, or results of operations of the Acquired Companies (on a consolidated basis) that has not been set forth in this Agreement or the Disclosure Letter.

3. **INDEMNIFICATION; REMEDIES.**

3.1 **Survival; Right to Indemnification Not Affected By Knowledge.** All representations, warranties, covenants, and obligations in this Agreement, the Disclosure Letter, the supplements to the Disclosure Letter, and any other certificate or document delivered pursuant to this Agreement will survive the Closing. The right to indemnification, payment of Damages or other remedy based on such representations, warranties, covenants, and obligations will not be affected by any investigation conducted with respect to, or any Knowledge acquired (or capable of being acquired) at any time, whether before or after the execution and delivery of this Agreement or the Closing Date, with respect to the accuracy or inaccuracy of or compliance with, any such representation, warranty, covenant, or obligation. The waiver of any condition based on the accuracy of any representation or warranty, or on the performance of or compliance with any covenant or obligation, will not affect the right to indemnification, payment of Damages, or other remedy based on such representations, warranties, covenants, and obligations.

3.2 **Indemnification and Payment of Damages by Sellers.** Sellers, jointly and severally, will indemnify and hold harmless Buyer, the Acquired Companies, and their respective Representatives, stockholders, controlling persons, and affiliates (collectively, the “Indemnified Persons”) for, and will pay to the Indemnified Persons the amount of, any loss, liability, claim, damage (including incidental and consequential damages), expense (including costs of investigation and defense and reasonable attorneys’ fees) or diminution of value, whether or not involving a third-party claim (collectively, “Damages”), arising, directly or indirectly, from or in connection with:

(a) any Breach of any representation or warranty made by Sellers in this Agreement (without giving effect to any supplement to the Disclosure Letter), the Disclosure Letter, the supplements to the Disclosure Letter, or any other certificate or document delivered by Sellers pursuant to this Agreement;

(b) any Breach by either Seller of any covenant or obligation of such Seller in this Agreement;

(c) any product shipped or manufactured by, or any services provided by, any Acquired Company prior to the Closing Date;

(d) any matter disclosed in Part _____ of the Disclosure Letter; or

(e) any claim by any Person for brokerage or finder’s fees or commissions or similar payments based upon any agreement or understanding alleged to have been made by any
such Person with either Seller or any Acquired Company (or any Person acting on their behalf) in connection with any of the Contemplated Transactions.

The remedies provided in this Section 3.2 will not be exclusive of or limit any other remedies that may be available to Buyer or the other Indemnified Persons.

3.3 **Time Limitations.** If the Closing occurs, Sellers will have no liability (for indemnification or otherwise) with respect to any representation or warranty, or covenant or obligation to be performed and complied with prior to the Closing Date, other than those in Sections [Authority, Capitalization, Organization, Employee Benefits, Environmental, Taxes, Title to Assets, Brokers] (the “Fundamental Representations”), unless on or before ____________, ____ Buyer notifies Sellers of a claim specifying the factual basis of that claim in reasonable detail to the extent then known by Buyer; a claim with respect to a Fundamental Representation, or a claim for indemnification or reimbursement not based upon any representation or warranty or any covenant or obligation to be performed and complied with prior to the Closing Date, may be made at any time. If the Closing occurs, Buyer will have no liability (for indemnification or otherwise) with respect to any representation or warranty, or covenant or obligation to be performed and complied with prior to the Closing Date, unless on or before ____________, ____ Buyers notify Sellers of a claim specifying the factual basis of that claim in reasonable detail to the extent then known by Sellers.

3.4 **Limitations on Amount -- Sellers.** Sellers will have no liability (for indemnification or otherwise) with respect to the matters described in clause (a), or, to the extent relating to any failure to perform or comply prior to the Closing Date, clause (b) of Section 3.2 until the total of all Damages with respect to such matters exceeds $__________, and then only for the amount by which such Damages exceed $__________. However, this Section 3.4 will not apply to any: (a) Fundamental Representations; (b) Breach of any of Sellers’ representations and warranties of which either Seller had Knowledge at any time prior to the date on which such representation and warranty is made, or (c) any intentional Breach by either Seller of any covenant or obligation.

3.5 **Materiality.** For purposes of (i) determining the breach or inaccuracy of any representations and warranties contained herein and (ii) calculating the amount of any Damages attributable to any such breach or inaccuracy, any “materiality,” “Company Material Adverse Effect,” or similar qualifications in the representations and warranties shall be disregarded.
Sample Earn-Out for Discussion:

4. **ADDITIONAL PURCHASE PRICE PAYMENT.**

   4.1 As additional consideration for the Acquired Shares, the Buyer will pay the Sellers an amount equal to the positive difference, if any, of four and one-half times (4.5x) the Adjusted EBITDA minus the Combined Initial Purchase Price (the “Additional Purchase Price”), subject to the review and dispute procedures set forth in Sections 4.4 and 4.5(a).

   (a) The aggregate Additional Purchase Price paid to the Sellers pursuant to this Agreement shall not exceed Fifteen Million Dollars ($15,000,000.00).

   (b) The Additional Purchase Price shall be payable in two installments: (i) the first installment shall be equal to seventy-five percent (75%) of the Additional Purchase Price calculated in accordance with Section 4.4 (the “Preliminary Earnout Payment”), and shall be payable in accordance with Section 4.6; and (ii) the second and final installment shall be equal to the amount of the Additional Purchase Price calculated in accordance with Section 4.5 minus the Preliminary Earnout Payment, if positive, and shall be payable by the Buyer to the Sellers in accordance with Section 4.6 (the “Final Earnout Payment”). In the event that the Preliminary Earnout Payment exceeds the Additional Purchase Price calculated in accordance with Section 4.5, the Sellers shall reimburse the Buyer for such excess amount, which shall be payable in accordance with Section 4.6 (the “Final Earnout Reimbursement”).

   (c) All amounts due and payable by either Buyer or either Company, as applicable, pursuant to this Section 4 shall be paid in cash by wire transfer to such bank accounts in accordance with written instructions of the corresponding Company or the corresponding Buyer, as applicable, given to such Buyer or such Company, at least two (2) Business Days prior to the date such payment is due.

4.2 The Buyer shall report the amount of Adjusted EBITDA to the Sellers within forty-five (45) days after the end of each calendar quarter during the Earnout Period, subject to year-end adjustment. The Buyer shall also provide unaudited, internal financial statements to the Sellers within twenty-five (25) days of the end of each month during the Earnout Period.

4.3 [Reserved]

4.4 On or prior to [Date], the Buyer shall prepare and deliver to the Sellers an internally-prepared statement which shall set forth in reasonable detail the preliminary determination of Adjusted EBITDA and the preliminary amount, if any, due pursuant to Section 4.1(b)(i) as Additional Purchase Price (a “Preliminary Earnout Statement”). The Sellers shall be entitled to reasonable access to the relevant records and working papers used by the Buyer in preparing the Preliminary Earnout Statement. At the request of the Seller Representative, the Buyer will arrange for the primary accountant that prepared the Preliminary Earnout Statement to be available, by phone or email, to the Seller Representative to review in detail the Preliminary Earnout Statement and the basis therefor, provided that, to the extent resolutions cannot be reached
by phone or email, a meeting with the primary accountant and Seller Representative shall be held at the offices of the Buyer in Portland, Oregon. If the Seller Representative believes that any change is required to be made to the Preliminary Earnout Statement, he shall, within thirty (30) days after receipt, give written notice and a description of, and the basis for, such change. Failure to notify the Buyer as aforesaid shall constitute acceptance and approval of the Earnout Statement. If the proposed change is not accepted by the Buyer, then the Buyer and the Seller Representative shall cooperate in good faith to resolve the dispute prior to the payment of the Preliminary Earnout Payment in accordance with Section 4.6. If any amounts reflected in the Preliminary Earnout Statement remain in dispute on the date of the Preliminary Earnout Payment, the parties agree that such dispute shall be resolved in accordance with Section 4.5(a) with respect to the Final Earnout Statement.

4.5   (a)   After the date of the Preliminary Earnout Payment and on or before [Date], the Buyer shall prepare and deliver to the Sellers an internally-prepared statement, which shall set forth in reasonable detail the Adjusted EBITDA calculated in accordance with Section 4.5(b) and the amount, if any, due to the Sellers or receivable from the Sellers, pursuant to Section 4.1(b) as the Final Earnout Payment or the Final Earnout Reimbursement (the “Final Earnout Statement”). At the request of the Seller Representative, the Buyer will arrange for the primary accountant that prepared the Final Earnout Statement to be available, by phone or email, to the Seller Representative to review in detail the Final Earnout Statement and the basis therefor, provided that, to the extent resolutions cannot be reached by phone or email, a meeting with the primary accountant and the Seller Representative shall be held at the offices of the Buyer in Portland, Oregon. If the Seller Representative believes that any change is required to be made to its Final Earnout Statement, the Seller Representative shall, within thirty (30) days after receipt, give written notice and a description of, and the basis for, such change. Failure to notify the Buyer as aforesaid shall constitute acceptance and approval of the Final Earnout Statement. If the proposed change is not accepted by the Buyer, then the Buyer and the Seller Representative shall cooperate in good faith to resolve the dispute. If, after thirty (30) days, any such proposed change remains in dispute, the Accounting Firm shall be instructed to resolve any such dispute within thirty (30) days after such dispute has been referred to it by selecting with respect to each item subject to dispute whichever amount submitted to the Accounting Firm with respect to such item is more accurate. The decision of the Accounting Firm shall be final and binding. The fees and expenses of the Accounting Firm shall be split equally between the Buyer, on the one hand, and the Sellers, on the other hand.

(b) The amount of the Adjusted EBITDA reflected in the Final Earnout Statement shall be equal to the Adjusted EBITDA reflected in the Preliminary Earnout Statement plus or minus the net impact of the Final Gross Profit Adjustment (as defined below). With respect to each customer contract for which revenue is recognized for [Year] and reflected in Preliminary Earnout Statement but is not completed as of [Year End] (the “Open Contracts”), the Buyer shall determine (i) if such contract is completed prior to [Date], the final gross profit percentage of such contract upon completion thereof, or (ii) if such contract is not completed prior to [Date], the gross profit percentage of such contract calculated based on the most recently available cost to completion estimate prior to the delivery of the Final Earnout Statement (the “Final Contract Gross Profit Percentage”).

Business Law—The Life of a Deal
(c) The Buyer will determine the final gross profit to be included in Adjusted EBITDA for each Open Contract by multiplying the Final Gross Profit Percentage by the adjusted revenue recognized in [Year] (the “Final Contract Revenue”) for each Open Contract (the “Final Open Contract Gross Profit Amounts”). The Final Contract Revenue shall reflect the impact on the percentage of completion resulting from the use of the Final Contract Gross Profit Percentages. The Buyer will then determine the preliminary gross profit for each Open Contract included in the Adjusted EBITDA for the Preliminary Earnout Statement (the “Preliminary Open Contract Gross Profit Amounts”). The final gross profit adjustment to the Adjusted EBITDA for the Preliminary Earnout Statement will equal the sum of the Final Open Contract Gross Profit Amounts minus the sum of the Preliminary Open Contract Gross Profit Amounts (the “Final Gross Profit Adjustment”). If the total of the Final Open Contract Gross Profit Amounts is less than the total of the Preliminary Open Contract Gross Profit Amounts then the Final Gross Profit Adjustment will be a reduction to the Adjusted EBITDA for the applicable Preliminary Earnout Statement and if the total of the Final Open Contract Gross Profit Amounts is greater than the total of the Preliminary Open Contract Gross Profit Amounts then the Final Gross Profit Adjustment will be an increase to the Adjusted EBITDA for the applicable Preliminary Earnout Statement. As used in this Section 4, the terms “complete” or “completion” shall mean with respect to any customer contract the complete performance of the Buyer’s obligation under such contract and receipt of the payment by the Buyer for such performance.

4.6 The Preliminary Earnout Payment to be paid by the Buyer to the Sellers, if any, shall be paid on or prior to [Date]. The Final Earnout Payment, if any, shall be paid by the Buyer to the Sellers on the date that is the later of (i) [Date] and (ii) the fifth (5th) Business Day following resolution of any dispute as to the applicable Final Earnout Statement pursuant to Section 4.5(a). The Final Earnout Reimbursement, if any, shall be paid by the Sellers to the Buyer on the date that is the later of (i) [Date] and (ii) the fifth (5th) Business Day following resolution of any dispute to applicable Final Earnout Statement pursuant to Section 4.5(a).

4.7 In the event the Buyer owes the Sellers any Final Earnout Payment, the Buyer shall pay, together with such Final Earnout Payment, interest thereon at a rate per annum equal to six percent (6%) (computed on the basis of a 360-day year of twelve 30-day months) (the “Interest Rate”), accrued daily from [Date] through the date of such payment. In the event the Sellers owe the Buyer any Final Earnout Reimbursement, the Sellers shall pay, together with such Final Earnout Reimbursement, interest thereon at the Interest Rate accrued daily from [Date] through the date of such payment. To the extent the Buyer believe as of a particular date that there is no material risk that the gross profits of the Open Contracts for the Sellers, taken as a whole, will be significantly different from the amount calculated as of that date, the Buyer shall make a good faith effort to deliver to the Sellers its Final Earnout Statement prior to [Date], in which case the Buyer shall make the Final Earnout Payment on the date that is the later of (i) thirty (30) days after delivery of the Final Earnout Statement and (ii) the fifth (5th) Business Day following resolution of any dispute as to the Final Earnout Statement pursuant to Section 4.5(a).

4.8 Any payment of Additional Purchase Price to the Sellers shall be treated as an adjustment to the Purchase Price paid to the Sellers, and such Additional Purchase Price shall be allocated to the assets of the Sellers in a manner consistent with Section 1060 of the Code and Section 1.8 of the relevant Purchase Agreement.
4.9 In consideration of the benefits to accrue to Buyer Parent as owner of the Buyer in connection with the sale of the Acquired Shares, Buyer Parent unconditionally guarantees that the obligations of the Buyer to pay the Additional Purchase Price, subject to the terms set forth in this Section 4, will be performed and paid in full in cash when due and payable. For purposes of the guarantee obligations set forth in this Section 4.9 only, Buyer Parent hereby waives each of the following:

(a) acceptance, presentment (including notice of dishonor), and demand;

(b) claims and defenses that would require the Sellers to (a) proceed first against the Buyer before the Sellers can proceed against Buyer Parent or (b) provide to Buyer Parent any information in the possession or control of the Sellers relating to the status of the relationship between the Buyer and the Sellers, the financial condition of the Buyer or any action, inaction, or forbearance by the Sellers against the Buyer;

(c) claims and defenses based on discharge of the Buyer through insolvency proceedings or otherwise, election of remedies, or the forbearance by the Sellers with respect to any right or remedy that the Sellers may have against the Buyer; and

(d) claims and defenses based on suretyship, including extension of due dates, material modifications, and impairment of rights of recourse.

The guarantee contained in this Section 4.9 shall continue to be effective, or be reinstated, as the case may be, if at any time payment of the Additional Purchase Price by the Buyer or Buyer Parent is rescinded or must otherwise be restored or returned by the Sellers upon the insolvency, bankruptcy, dissolution, liquidation or reorganization of the Buyer or Buyer Parent as though such payment had not been made. Regardless of the payment or performance of the guaranteed obligations, the liability of Buyer Parent to the Sellers will continue until ten (10) days after the expiration of the longest of any potentially applicable federal or state statute of limitations relating to preferences and fraudulent transfers. Buyer Parent warrants that immediately after execution of this Agreement, Buyer Parent will have sufficient capital to continue to conduct its business, that Buyer Parent will be able to pay its obligations as they become due, and that its liabilities will not exceed the value of its assets.

5. **CONDUCT OF COMPANY; ACCOUNTING CONTROLS.**

5.1 The Buyer acknowledge that a substantial portion of the consideration for the Acquired Shares will be based on the conduct during [YEAR] of the Acquired Businesses. Accordingly, during [YEAR], the Buyer will conduct the Acquired Businesses in good faith and substantially in accordance with past practice by the Sellers, subject to such changes as the Buyer’ respective boards of directors believe in good faith are appropriate and not effected with the sole purpose to have a substantial adverse effect on Adjusted EBITDA (each, an “Adverse Action”); provided that, the Sellers agree that any change to the terms of the contractual arrangements with [Customer] or any sales representatives, or termination thereof, shall not be deemed to be an Adverse Action. In addition, there shall not be allocated to the Buyer during [YEAR] any overhead or other costs incurred by Buyer Parent, in excess of direct costs reasonably incurred by the Buyer for the benefit of the Acquired Businesses. Furthermore, the Buyer agrees not to write up or write
down any amount of reserves during [YEAR] in a manner that is inconsistent with the past practices of the Sellers.

5.2 The Buyer will establish and maintain such accounting procedures and systems as are necessary and appropriate in order to enable them to accurately and fairly calculate the Adjusted EBITDA separately attributable to the Acquired Business. During [YEAR], the Buyer shall maintain one corporate or other legal entity for the business sold by the Sellers, and shall not combine other operations of Buyer Parent or its Affiliates with that entity.
# Chapter 8

## How to Avoid Post-Closing Disputes

**The Honorable David Brewer**  
Eugene, Oregon

**Donald Churnside**  
Gaydos Churnside & Balthrop PC  
Eugene, Oregon

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1. **Introduction.**

Avoiding post-closing disputes should be the goal of the lawyers assisting in the transaction, and the purpose of the documents describing the transaction. A successful transaction is based upon as close to perfect knowledge as the parties can achieve. From a litigator's perspective, the documents are simply Exhibit 1 at the trial. With perfect knowledge and a willing buyer and willing seller, the documents are rarely referred to after signing.

Clearly and articulately capture the parties' intent in each clause of the documents.

Urge the parties to fully and completely disclose as much information as possible, and to thoroughly and completely pursue due diligence on the part of the buyer.

Glossing over an apparent misunderstanding or opportunity to knowingly attempt to take advantage of the other party is a sure path to the courthouse.

It is not a failure by the lawyer if the transaction fails to come together. If a thorough and complete exchange of information confirms the transaction is not in line with all parties' expectations, the transaction is best uncompleted.

2. **The Lawyer's Perspective.**

An important consideration for the lawyer is who the lawyer represents. A seller who receives cash at closing is unlikely to be aggrieved, or have reason to sue after closing. In that instance, the lawyer's perspective is more defensive. The lawyer should anticipate responding to claims or demands asserted by the buyer. That places an emphasis on procedure. Procedure can create a disincentive to sue. A notice period from buyer to seller, with an opportunity for seller to respond and cure, as a condition to mediation, arbitration, or litigation, may be more attractive. A lawyer representing the buyer should have a more protective perspective. That lawyer may negotiate for liquidated damages, penalties, efficient, economical and summary remedies, such as the Czar provision. Once again, relying on forms or previous documents prepared in similar transactions may not provide the best protection for the lawyer's client.

3. **Documentation.**

The lawyers will choose the documents appropriate for the transaction. The number of documents are a continuum based upon the transaction.

In a simple transaction, a simple purchase and sale agreement may be sufficient. It may include all the terms of sale, terms of seller financing, grant of a security interest, personal guaranties, and other provisions that are sometimes the subject of separate documentation executed at closing, after a letter of intent flows into an earnest money agreement, or purchase agreement.
Other documents at closing can include the following:

1. Bill of Sale
2. Closing Instructions
3. Escrow Agreements
4. Assignment Documents
5. Note
6. Security Agreement
7. Trust Deeds
8. Guaranty Agreements
9. Contribution Agreements among shareholders
10. Professional opinion letters
11. Representations and Warranties

In considering the flow of documents evidencing the transaction, the lawyers should be aware of the Doctrine of Merger, and the survival of necessary terms and provisions of prior agreements when they are supplanted and replaced by subsequent agreements. The court has acknowledged and approved the Doctrine of Merger. Frontgate Properties, LLC v. Bennett and Wood River Farms, 261 Or.App. 810, 324 P.3d 483 (Or.App. 2014). In Frontgate, the court acknowledged the Doctrine of Merger, and succinctly stated:

"Any inconsistencies between the terms of a contract of purchase of real estate and the terms of the deed are governed by the latter, into which the former are merged." Winn v. Taylor, 98 Or. 556, 194 P. 857 (1921).

The court in Frontgate acknowledges exceptions to the rule as a result of fraud or relievable mistake.


Each specific provision of the documents can and should be specifically considered and tailored to the transaction. A lawyer should fear the final pages of any document which contain standard and typical provisions. Each deserves careful consideration as to the application and impact any of such provisions might have on the transaction at hand.

A good example is Roberts v. TriQuint Semiconductor, Inc., 358 Or 413 (2015). In that case, it took years of litigation and a huge amount of money to obtain a Supreme Court decision that enforced a Delaware corporation's forum-selection bylaw providing Delaware as the sole and exclusive forum for resolving shareholder derivative suits. That bylaw was adopted unilaterally by the board of directors two days before the corporation announced merger plans. Although this was not a business sale transaction, the issue would be the same with respect to a dispute over a forum-selection provision in a sale transaction. A court would still have to decide whether the provision violated Oregon public policy, and whether litigation in the forum state was seriously inconvenient for the parties. In Roberts, the time and resources in court didn't reach the substance or the merits of the dispute, and was time and money wasted.
The court stated: "Ordinarily, a forum-selection clause will be part of a larger contractual agreement. See, e.g., Reeves, 262 Or. At 96-97, 495 P.2d 729 (considering such an agreement). Often the parties will not dispute the validity of the larger agreement, but instead will dispute whether it would be unreasonable or unfair to enforce the forum-selection clause included in the agreement. See id. at 98, 495 P.2d 729 (stating that standard). In that instance, the law of the forum in which the action was filed governs the decision whether a forum-selection clause will be enforced. See id. At 97, 101, 495 P.2d 729 (applying Oregon law in deciding whether to enforce a forum-selection clause designating Ohio as the exclusive forum, even though the contract also included a choice-of-law provision stating that Ohio law would govern the action); cf. Kevin M. Clermont, Governing Law on Forum-Selection Agreements, 66 Hastings LJ 643, 649-50 (2015) (explaining that most jurisdictions use the law of the forum in determining whether forum-selection clauses should be enforced)."

Each provision in a contract can be a two-edged sword. The goal is to provide a predictable framework and process for resolving disputes surrounding transactions. Each of such provisions can also invite sub-litigation and litigation over procedure instead of substance.

5. **Selected Provisions for Consideration.**

Attached are certain provisions which can assist and add flexibility in completing a transaction. Consider the following specific terms:

1. **Arbitration.** Exhibit 1 is an example of a form of arbitration agreement. Although such provisions are reasonable and offer an efficient and economical opportunity to resolve disputes, consider the situation where the buyer is quickly impairing the seller's collateral and security for deferred balances. A lawyer should make sure that the arbitration and mediation provision does not bar or delay provisional process in such a situation to protect the seller's position.

2. **Mediation.** Exhibit 2 is an example of a form of mediation agreement. Once again, preconditions of commencing litigation may have an adverse effect on the aggrieved party. Generally, a process for demanding mediation is a condition of commencing an arbitration or litigation. An exception should be included for provisional process and immediate and irreparable harm. It may be also be appropriate to exclude from mediation failure to make payments on seller financing and other issues that are more appropriate for summary judgment. Mediation, when both parties are not committed to mediation, may be a waste of resources.

3. **Czar provision.** Exhibit 3 is an example of a form of Czar provision. The Czar provision addresses the time and money concerns involved in litigation. The Czar provision recognizes that no decision or resolution is guaranteed in litigation. Choosing a respected and knowledgeable decision maker, and providing for a more expedient and economical process for reaching a resolution is typically a good business decision.
4. Earn out agreement. Attached as Exhibit 4 is an example of a form of earn out agreement. In a transaction where there is some question as to the value of the business, allowing the performance of the business to dictate a final price in the future can avoid litigation as to value. Its use is limited. An independent third-party buyer may not be motivated to make the company successful until after the earn out period has passed. The earn out agreement is more commonly used when there is some continuity of management after the sale, and the management in place reaps rewards by the business' continued success.

5. Representations survive closing. Exhibit 5 is an example of a clause confirming that representations survive closing. In a transaction with a new wave of closing documents, the Doctrine of Merger may conclude that buyer has waived the representations and warranties of seller by proceeding to closing after the buyer's thorough due diligence. From buyer's perspective, continuing those representations and warranties provides additional protection that the representations and warranties are accurate and complete. In closing documents, it is always appropriate to review and consider representations and warranties in earlier documents. Many of those earlier representations can be eliminated, and perhaps new representations made based upon the results of the buyer's due diligence. In recent years, representations and warranties insurance has been developed and is now a consideration for both parties.

6. Guaranties. Attached hereto as Exhibit 6 is an example of a personal guaranty. Any provision that adds exposure and risk to a party is an additional incentive for that party to perform and comply with the terms of the agreement. Specific terms of a guaranty can be negotiated. The guaranty can be limited to a time period, which is shorter than the obligation being guaranteed. Guaranties can also be limited in dollar amount.

7. Indemnification. Attached hereto as Exhibit 7 is an example of indemnification language. An indemnification agreement is similar to a personal guaranty, and quantifies and codifies risks assumed by one party or the other. Typically a seller will indemnify a buyer from any acts or omissions prior to closing, and a buyer will indemnify a seller from acts post-closing.

8. Contingent price. Another option when the purchase price may be questioned or difficult to ascertain is to acknowledge and agree to conditions or the happening of certain events that will have an impact on the ultimate price. The contingency can be the business' ability to retain business through the assignment of third-party contracts, the happening of certain events in the market, certain legislation, the ability of the buyer to acquire necessary licensing, the ability of the buyer to retain management personnel, the ability of the buyer to retain customers and market share, and any other future event that impacts the company's performance. In many of those circumstances, it is difficult to quantify a reasonable adjustment to the purchase price. Reasonable and open communication between buyer and seller as to the effect of
future events on the business can lead to a more gratifying transaction for both parties.

9. Shareholder Contribution Agreement. Attached as Exhibit 9 is an example of shareholder contribution agreement language. In a shareholder contribution agreement, the shareholders allocate future risk proportionately based upon the shareholder's percentage interest in the company. It avoids joint and several liability, and is similar to limiting or narrowing a guaranty.
1. Arbitration. Any dispute, controversy, or claim arising out of or relating to this Agreement will be settled by arbitration. Unless the parties agree otherwise, the arbitration will be administered by [name of arbitration association]. Judgment on the award rendered by the arbitrator may be entered in the circuit court of the county in which the arbitration occurs, and the resolution of the disputed matter as determined by the arbitrator will be binding on the parties. There will be one arbitrator who will be a [retired federal or state judge with a minimum of _____ years of judicial experience/business lawyer/other] or will have such alternate qualifications that are mutually agreeable to the parties. Any arbitration will be conducted in __________, Oregon, in accordance with the following provisions:

   (a) Except as otherwise provided in this Section ___, the arbitration will be conducted in accordance with [identify arbitration rules].

   (b) Arbitration proceedings under this Agreement may be consolidated with arbitration proceedings pending between other parties if the arbitration proceedings arise out of the same transaction or relate to the same subject matter. Consolidation will be by order of the arbitrator in any of the pending cases or, if the arbitrator fails to make such an order, the parties may apply to any court of competent jurisdiction for such an order.

   (c) A party may, without inconsistency with this Agreement, seek from a court any interim or provisional relief that may be necessary to protect the rights or property of that party pending the establishment of the arbitration (or pending the arbitrator's determination of the merits of the dispute, controversy, or claim).

   (d) The arbitrator will have authority to issue preliminary and other equitable relief.

   (e) Discovery proceedings of the type provided by the Oregon Rules of Civil Procedure will be permitted both in advance of and during recesses of the arbitration hearings. Any dispute relating to such discovery will be resolved by the arbitrator.

   (f) The arbitrator will have the discretion to order a prehearing exchange of information by the parties and an exchange of summaries of testimony of proposed witnesses.

   (g) The arbitrator will have the authority to award any remedy or relief that an Oregon court could order or grant, including specific performance of any obligation created under this Agreement, the issuance of an injunction, or the imposition of sanctions for abuse or frustration of the arbitration process, except that the arbitrator will not have authority to award punitive damages or any other amount for the purpose of imposing a penalty as opposed to compensating for actual damage suffered or loss incurred.

   (h) The award will be in writing, will be signed by the arbitrator, and will include a statement regarding the disposition of any claim. The award will be kept confidential to the fullest extent permitted by law.
Any controversy or claim arising out of or relating to this Agreement, or the transactions contemplated hereby, will be settled in the following manner:

(a) Senior executives representing each party will meet to discuss and attempt to resolve the controversy or claim;

(b) If the controversy or claim is not resolved as contemplated by clause (a), the parties will, by mutual consent, select an independent third party to mediate such controversy or claim, provided that such mediation will not be binding upon any of the parties;

(c) If the parties are unable to select an independent third party, each party will select an independent third party, and such independent third parties for each party shall select a third independent third party, and such mutually chosen independent third party shall mediate the controversy or claim;

(d) If such controversy or claim is not resolved as contemplated by clauses (a), (b), and (c), the parties shall have such rights and remedies as are available under this Agreement and, to the extent not provided for in this Agreement, are otherwise available at law. The costs of such mediator shall be borne equally by the parties.

Notice of a controversy or claim must be delivered in writing by one party to the other party. The party receiving such notice shall have a period of ten (10) days to begin the mediation process. In the event such party fails to begin the mediation process, the party giving notice shall be free to pursue such rights and remedies as are available herein, or to the extent not provided herein, as otherwise available at law.
Exhibit 3
Czar Provision

If any dispute arises in connection with the performance, or the interpretation of the terms and provisions contained herein, the parties agree that any such dispute or issue shall be presented summarily to _____________ as the sole and only decision maker. Upon presentation of such issue to _____________, ___________ shall determine the appropriate process for presenting the issue to _____________. ___________'s decision shall be final, binding, and dispositive of the issue. Either party shall be entitled to present ___________'s decision to the _______ County Circuit Court, and enforce such decision as a final and binding arbitration decision pursuant to ORS Chapter 37.

_______________'s authority agreed upon herein shall extend to provisional process remedies and summary proceedings to avoid immediate harm or damage to either party. Any provisional process decision made by ___________ shall be immediately filed with the court, and enforced as a binding decision on the parties.
Chapter 8—How to Avoid Post-Closing Disputes

Exhibit 4
Earn-Out Payment

Annually, Buyer shall pay to Seller an amount (earn-out payment) equal to the excess, if any, of EBITDA for the acquired business during each of the periods covered hereby in excess of the target amount of EBITDA determined to be _________ multiplied by ___%. The annual earn-out payment shall be cumulative, and shall be adjusted so that if in any prior calculation period the baseline EBITDA exceeded the actual EBITDA for that period, such cumulative annual EBITDA shortfall is to be subtracted from the then cumulative annual EBITDA to determine whether a payment is due to Seller for such current period. The annual earn-out payment will be paid to Seller within 90 days after the net amount of EBITDA has been determined for a particular annual period.

At the end of two (2) years, the cumulative annual EBITDA excesses, net of the cumulative annual EBITDA shortfalls, shall be determined. This net amount shall be multiplied by X% if such computed amount exceeds the cumulative annual earn-out payments that have been made to Seller. Such excess shall be paid by Buyer to Seller within 30 days after the determination has been made. If the cumulative annual payments made to Seller exceed such computed amounts, such excess shall be paid by Seller to Buyer within 30 days after the determination has been made.

EBITDA shall be computed as follows (in accordance with GAAP, as determined by __________, Seller's CPA).

Method for resolving disputes in computation of EBITDA, i.e., Czar provision.
Exhibit 5
Survival of Representations and Warranties

All representations, warranties, covenants and obligations in this Agreement shall survive the closing of this transaction. Buyer’s right to indemnification, reimbursement, or other remedies based upon such representations, warranties, covenants and obligations shall not be affected by the closing, passage of time, or any other circumstance which might have the effect of relieving Seller from any such liability. Any waiver by Buyer of any condition based upon the accuracy of any representation or warranty, or the performance of, or compliance with, any covenant or obligation of Seller will not affect the right of Buyer to indemnification, reimbursement, or other remedies based upon such representations, warranties, covenants, or obligations of Seller.
Exhibit 6
Personal Guaranty

The undersigned, ______________________, unconditionally guarantees the full and complete performance of each and all of the terms, covenants and conditions of that certain _____________, a copy of which is attached hereto as Exhibit __.

The guaranty shall continue, notwithstanding any extension, modification, or alteration of such Agreement, and no extension, modification, alteration or assignment of such Agreement shall in any manner release or discharge the undersigned.

Guarantor agrees to pay ____________’s reasonable attorneys fees and all costs and other expenses incurred in any collection or attempted collection, or in any negotiations relative to the obligations hereby guaranteed, or enforcing this Guaranty against the undersigned.

Guarantor waives any right to require __________ to proceed against __________, proceed against or exhaust any security held by __________, or pursue any other remedy of any nature prior to pursuing Guarantor for the obligations due pursuant to such Agreement. Guarantor waives any defense arising by reason of any disability or other defense. Guarantor waives all presentment, demand for performance, notices of nonperformance, protests, notice of protests, notice of dishonor, and notice of acceptance of this Guaranty.

Additional alternatives:

Guarantor's obligations herein shall expire on __________, and Guarantor shall have no further obligation for any breach or default occurring on or after such date.

In no event shall Guarantor's obligations exceed $________ as a result of Guarantor's guaranty of the total obligations due and owing.
Exhibit 7
Indemnification

1. _________ shall indemnify and hold harmless _________, its Affiliates, and their respective directors, officers, agents and employees (collectively, "Indemnitees") from and against any and all losses, costs, claims, expenses (including, but not limited to, court costs and reasonable legal fees), suits, actions, judgments, fines, penalties, liabilities and damages of every nature and description, irrespective of whether incurred or suffered by Indemnitees on account of third party claims, inter-party claims, or otherwise, and irrespective of whether the possibility of same has been disclosed in advance or could have been reasonably foreseen (collectively, "Losses"), arising out of or resulting from the Agreement or any act or omission in the performance or non-performance thereof by _________ (or its subcontractors, or their respective directors, officers, employees or agents). Notwithstanding the foregoing, _________'s indemnification obligations hereunder shall not apply to the extent (on a proportional basis) that any such Losses are proximately caused by the negligence or willful misconduct of Indemnitees (whether sole, joint, concurrent, contributory or comparative), as determined in the final judgment of a court of competent jurisdiction.

2. Section 1 notwithstanding, _________ shall indemnify and hold harmless Indemnitees from and against any and all Losses arising out of or resulting from any bodily injury to or death of any employee, officer, manager, agent or other representative of _________ or any of its subcontractors suffered or incurred in the course of, or incident to, activities hereunder. Such Losses shall include Losses contributed to by the negligence or willful misconduct of Indemnitees, except for Losses caused by the sole negligence or willful misconduct of Indemnitees.

3. Section 1 notwithstanding, _________ waives any and all claims against Indemnitees arising out of or resulting from, and shall indemnify and hold harmless Indemnitees from and against any and all Losses arising out of or resulting from, the use of any equipment, tools, apparatus or utilities (other than the Equipment as defined herein) owned or leased by _________ (or _________'s other contractors) to perform Services, whether such use is authorized by _________ or not, including but not limited to the manufacture, selection, condition, possession, use and/or operation of same.

4. Section 1 notwithstanding, _________ shall indemnify and hold harmless Indemnitees from and against any and all Losses arising out of or resulting from any actual or alleged infringement, violation or misappropriation of any Intellectual Property of, or any non-disclosure obligation owed to, any third party, based upon the Services, Equipment, Deliverables, and/or _________'s use thereof.

5. _________ shall, at _________'s sole cost and expense, defend Indemnitees against any and all actions, suits or other proceedings, brought by a third party against Indemnitees, with respect to which _________ might have an indemnification obligation under the Agreement (collectively, "Actions") and shall pay or satisfy any
judgment or decree rendered against Indemnitees in any Action. __________ shall give
________ prompt notice of any Action instituted against Indemnitees. The parties agree
that, with respect to any Action as to Indemnitees: (i) __________ shall have the right to
assume exclusive control of the defense and/or settlement of such Action, without
affecting __________'s indemnification obligations hereunder, if (a) criminal liability
of Indemnitees is (or is reasonably expected to be) alleged in such Action or would (or is
reasonably expected to) directly result from such Action; (b) injunctive relief and/or
specific performance is (or is reasonably expected to be) sought from Indemnitees; or (c)
_________ reasonably believes that the interests of __________ and Indemnitees
with respect to such Action are in conflict with one another such that __________
could not adequately represent the interests of Indemnitees in such Action; (ii)
___________ shall have the right to be represented and participate in any proceeding
relating to such defense and/or settlement through __________'s own counsel at
_________’s own expense; (iii) __________ shall not settle or abate any Action in a
manner that constitutes any admission, imposition or statement of any wrongdoing or
liability on the part of Indemnitees, or imposes upon Indemnitees any obligation, or in
any way prejudices the rights of Indemnitees, without __________'s express advance
written consent; and (iv) if __________ fails to actively pursue its defense and/or
settlement obligations as to an Action, then __________ shall have the right to assume
the defense and/or settlement of such Action without affecting __________'s
indemnification obligations hereunder (including, but not limited to, reimbursement of
any and all damages awarded and/or settlements made, and all costs and expenses
incurred by __________ in maintaining such defense). Each party shall provide
reasonable information and assistance to the other with respect to any matter subject to
this Section.

6. It is agreed that, with respect to any legal limitations now or hereafter in effect that affect
the validity or enforceability of the obligations under this Article, such legal limitations
are made a part of such obligations to the minimum extent necessary to bring this Article
into conformity with the requirements of such limitations, and as so modified, such
obligations shall continue in full force and effect. As to any Losses with respect to which
___________ is obligated to indemnify Indemnitees under the Agreement,
___________ further covenants not to bring any suit, action or other proceeding
against Indemnitees to recover such Losses.
The parties acknowledge and agree that Seller is owned by four (4) shareholders. Each of such shareholders own 25% of Seller. The parties acknowledge and agree that in the event of any breach by Seller requiring indemnification and payments to Buyer, Buyer agrees that shareholder responsibility shall be limited to their percentage share of the company, and Buyer agrees that Buyer shall not look to any one (1) shareholder for any amount in excess of such shareholder's 25% of the total amount due and owing Buyer by Seller as a result of any breach or violation by Seller giving rise to the indemnification obligations of Seller contained herein.
Chapter 9

Malpractice and Ethics Considerations for the Transactional Lawyer

Holli Houston
Professional Liability Fund
Tigard, Oregon

Kenneth Landis
Attorneys’ Liability Assurance Society Inc.
Chicago, Illinois

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1 All references in these materials to ALAS refer to Attorneys’ Liability Assurance Society, Inc., A Risk Retention Group. PLF refers to the Professional Liability Fund, a division of the Oregon State Bar. These materials were prepared by ALAS and the PLF to assist the lawyers and law firms the insure/cover in avoiding claims relating to professional, management, and employment practice liability, including meritless claims. The content of these materials does not constitute legal advice and is not intended to suggest or establish standards of care applicable to lawyers in any given situation. Rather, these materials advise lawyers to practice in a manner that is well above the standard of care established by substantive law. The recommendations contained in these materials are not necessarily appropriate for every lawyer or law firm or for every situation referred to or described.
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Where do ALAS claims come from?

- Litigation: 39%
- Real Estate: 7%
- T&E: 7%
- Transactional: 26%
- Other: 21%

Data as of 11/30/2017

Where do PLF claims come from?

2012-2016

- Other: 28%
- Tort Litigation: 16%
- Domestic Relations: 17%
- Debtor-Creditor: 13%
- Securities: 1%
- Real Estate: 9%
- T&E: 9%
- Transactional: 7%
Goal: Avoiding the Top Three

Mistakes
Conflicts of Interest
Unworthy Clients

Non-litigation Mistakes
2011-2016 (ALAS)

<table>
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<tr>
<th>Category</th>
<th>Total</th>
<th>%</th>
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<tr>
<td>Simple Mistakes</td>
<td>$279M</td>
<td>43%</td>
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<td>Bad Results</td>
<td>$247M</td>
<td>38%</td>
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<td>Missed Deadlines</td>
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<td>Other Mistakes</td>
<td>$56M</td>
<td>8%</td>
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<tr>
<td><strong>Five-Year Total:</strong></td>
<td><strong>$656M</strong></td>
<td><strong>100%</strong></td>
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One tiny word can make a BIG difference

- Client to buy smaller company
- Deal includes earn-out provision
  - Founders supposed to get money in Bucket A or Bucket B
  - Final provision says founders get Bucket A plus Bucket B review

Preventing Mistakes

- Slow down and proofread
- Delegation ≠ Abdication
- Docketing systems
- Use checklists and create template documents
- Learn from mistakes
- Document client communications
Document Client Communications

- Engagement or Non-engagement letter
- Client direction to you
- Your advice to client
- Client rejection of advice and/or confirmation of strategy
- Disengagement letter

How to Document

- Email or letter to client
- File memo/handwritten notes
- Billing narrative
Conflicts of interest

It’s about loyalty
### Conflicts of Interest 2011-2016 (ALAS)

<table>
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<tr>
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<th>Total</th>
<th>%</th>
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</thead>
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<tr>
<td>Multi-Representation</td>
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<tr>
<td>Adverse to Former/Current Client</td>
<td>$92M</td>
<td>16%</td>
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<tr>
<td>Doing Business with Client</td>
<td>$91M</td>
<td>16%</td>
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<tr>
<td>Prior Work</td>
<td>$74M</td>
<td>13%</td>
</tr>
<tr>
<td>Other</td>
<td>$48M</td>
<td>8%</td>
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<tr>
<td><strong>Five-Year Total:</strong></td>
<td><strong>$565M</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>

### PLF Exclusions

- 6: Business Interests
- 7: Partner/Employee
- 8: Business Transaction with Client
- 9: Investment Advice
- COMING SOON: Escrow
Conflicts and Communication

- Who is the client?
- What is your role?
- Do the various entities/people understand your role?
- Constantly evaluate and re-evaluate

So... You May Have Made a Mistake

- Potential v. Actual Conflicts
- Waivable v. Unwaivable Conflicts
- What is Informed Consent?
Unworthy clients

“Honesty Impaired” Clients
Chapter 9—Malpractice and Ethics Considerations for the Transactional Lawyer

SURPRISE!

You Are a Securities Lawyer

No Due Diligence!
Know thy client
Section 1  Overview

Claims arising out of the corporate, securities, and real estate practices have resulted in significant incurred loss to ALAS. Measured from the inception of the company through November 2016, these three practice areas have in the aggregate accounted for 37% of all claims asserted against ALAS and 60% of ALAS’s total incurred loss. The cost of claims arising from securities practice tops the list of all practice groups at an average of around $1.4 million per claim. Although not as frequent or costly as claims involving corporate and securities matters, ALAS has seen an increasing number of claims arising from the real estate practice, many of which implicate the same loss prevention concerns as those arising from the corporate practice. Thus, although this tab primarily addresses the corporate and securities practices, the types of claims, their causes, and the loss prevention suggestions apply equally to the real estate practice. For convenience, we sometimes refer collectively to lawyers who focus on these practice areas as “business lawyers.”

Over the past decade, the practice of law for business lawyers has become increasingly complex. Projects often encompass multiple legal specialties, including tax, estate planning, intellectual property, bankruptcy, and environmental law. As a result, a project may be staffed by a team of lawyers from different practice groups (including corporate, real estate, and securities) and perhaps involve multiple law firms, raising staffing, supervision, and project management issues. Work in these areas also often involves multiple parties, more than one of whom may be a firm client and whom may, in fact, be jointly represented by the firm in the specific project. As explained in Section 5 below, this can create conflict of interest concerns that lead to or exacerbate claims against the involved lawyers. The client’s business or the nature of the deal itself may make the representation risky, particularly when the matter involves speculative ventures or raising or borrowing money from third parties. The risks faced by business lawyers increase when they assume other roles in relation to their client’s business.

At the same time, the adoption of new laws and rule changes, including the Sarbanes-Oxley Act of 2002 (SOX), Pub. L. 107-204, 116 Stat. 745 (codified at amended in scattered sections of 15, 18, 28, 29 U.S.C.) (2012) and amendments to Rules 1.6 and 1.13 of the ABA Model Rules of Professional Conduct, has put greater emphasis on the responsibility of business lawyers with respect to the conduct of their clients. Thus, these lawyers need to consider how their daily practice is affected by an expanding view of a lawyer’s role.

Finally, lawyers who primarily engage in transactional work seem particularly vulnerable to potentially significant claims. In our experience, phenomena that contribute to this vulnerability include (1) inordinate time and business pressures to close a deal; (2) lawyers failing to recognize the professional liability risks; and (3) lawyers knowing the risks, but proceeding anyway on the belief that everything works out most of the time. In many cases, problems could have been avoided if the lawyers had been more proactive in addressing the risks and managing the engagement. We explored some of these factors during a program at the 2008 Annual General Meeting (AGM), titled “Perils of Practice for Transactional Lawyers.” The video and written materials for that program, including an article contrasting the differing world views of litigators and transactional lawyers, “How Business Lawyers Get into Trouble,” are available in the Digital Resources Library on the ALAS Web site.

Given these dynamics, work in these practice areas can give rise to significant lawyer liability claims, including claims by third parties. This tab provides an overview of the types of claims often asserted against business lawyers and addresses how these lawyers can manage their practices to help avoid them. In particular, we focus on claims that can be avoided or mitigated with proper attention to important elements of the lawyer-client relationship, including client quality, client identity, scope of engagement, and conflicts of interest.

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Section 2 Client Quality

ALAS has written extensively on the risks to business lawyers posed by unworthy clients. Many of the most costly ALAS claims result from accepting a new client who proves to be dishonest, incompetent, or otherwise undependable, or failing to recognize when an existing client begins to engage in wrongful conduct. Below we describe the types of claims asserted against business lawyers relating to client misconduct and what lawyers and law firms can do to avoid liability. We also discuss lawyers’ ethical and legal responsibilities when confronted with possible client misconduct.

2.1 Common Law Claims

Claims against business lawyers relating to client misconduct are predicated on various theories of liability under state common law. Claimants may allege that the lawyer directly committed wrongdoing, but the more common theory is that the lawyer assisted the client’s wrongdoing while knowing, or recklessly avoiding knowledge, of that wrongdoing. Plaintiffs may be third parties, such as investors or creditors, who have been harmed by the client’s misconduct. They also may be client successors in interest, such as a bankruptcy trustee, or plaintiffs in a shareholder derivative suit. Claims asserted under federal and state securities laws are addressed in Section 11.

2.1.1 Primary Liability

Client Claims. A malpractice claim on behalf of the client entity typically alleges that if the lawyer had exercised reasonable care in performing services, he or she would have recognized that members of management were engaged in wrongdoing and that the lawyer’s services were being used to facilitate the improper conduct. The claim will be that the lawyer either actively assisted in the wrongdoing or failed to report it to a higher authority or take other action to prevent harm to the company (discussed in more detail in Section 2.3 below). See, e.g., Donell v. Nixon Peabody LLP, 2012 U.S. Dist. LEXIS 126146, at *12–16, 2012 WL 3839402, at *5–6 (C.D. Cal. Sept. 5, 2012) (former client’s receiver can sue law firm for failing to prevent fraud by client’s principal).

Common law claims made on behalf of the client entity alleging primary liability typically are based on theories of fraud, conspiracy to commit fraud, malpractice, or breach of fiduciary duty. The fraud claim alleges that the lawyer deceived the company into believing that the transactions at issue were legitimate, thereby exposing it to serious financial and legal risk. A conspiracy allegation asserts that the lawyer and client management agreed to act together to deceive the client or third party, and at least one of them took steps to effectuate the scheme. A claim of negligent misrepresentation alleges that the lawyer failed to exercise reasonable care in providing information to third parties who were entitled to rely on the lawyer for the accuracy of the information. See, e.g., Essex Crane Rental Corp. v. Carter, 371 S.W.3d 366, 382 (Tex. App. 2012) (lawyer may be held liable for conspiracy to defraud by knowingly assisting client in effecting fraudulent transfer).

Third-Party Claims. A third-party common law claim of primary liability alleges fraud, conspiracy to commit fraud, or negligent misrepresentation. The fraud allegation is that the lawyer, with scienter, made untrue statements of material fact or material omissions in statements to third parties. A conspiracy claim alleges that the lawyer and client management agreed to act together to deceive the client or third party, and at least one of them took steps to effectuate the scheme. A claim of negligent misrepresentation alleges that the lawyer failed to exercise reasonable care in providing information to third parties who were entitled to rely on the lawyer for the accuracy of the information. See, e.g., Essex Crane Rental Corp. v. Carter, 371 S.W.3d 366, 382 (Tex. App. 2012) (lawyer may be held liable for conspiracy to defraud by knowingly assisting client in effecting fraudulent transfer).

When the client is accused of wrongdoing, business connections between the firm’s lawyers and the client will render the defense of the case more difficult. This is particularly true when a lawyer has a relationship with the client that goes beyond providing legal services, such as when the lawyer has invested in or serves as a director of the client. For this reason, ALAS discourages these types of entrepreneurial activities by lawyers. See Section 6.1 below.
2.1.2 Secondary Liability

Restatement Second, Torts § 876 (1979), provides that, “[f]or harm resulting to a third person from the tortious conduct of another, one is subject to liability if he,” inter alia, “knows that the other’s conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other.” Typical claims against lawyers that reflect this theory allege that the lawyer aided and abetted the client’s fraud or breach of fiduciary duty. See generally Richard C. Mason, Civil Liability for Aiding and Abetting, 61 Bus. Law. 1135 (2006).

Aiding and Abetting Fraud. To be liable for aiding and abetting fraud, a party must know that the primary actor is engaged in fraud and must provide substantial assistance in perpetrating it. Proof of knowledge “will often be inferential,” Rolf v. Blyth, Eastman Dillon & Co., Inc., 570 F.2d 38, 47 (2d Cir. 1978), and can consist of evidence of: (1) long familiarity with the conduct that effectuates a scheme of wrongdoing, Jaguar Cars, Inc. v. Royal Oaks Motor Car Co., Inc., 46 F.3d 258, 270–71 (3d Cir. 1995); (2) the use of atypical procedures to provide services, Aetna Cas. & Sur. Co. v. Leahey Constr. Co., Inc., 219 F.3d 519, 536 (6th Cir. 2000); and (3) a motive to gain from the primary actor’s conduct, Neilson v. Union Bank of Cal., N.A., 290 F. Supp. 2d 1101, 1121–22 (C.D. Cal. 2003). Significantly, courts have found that the knowledge requirement can be satisfied by evidence of reckless disregard that is short of actual knowledge. See Oster v. Kirschner, 905 N.Y.S.2d 69, 73 (App. Div. 2010) (in finding that plaintiffs had adequately pled claim for aiding and abetting Ponzi scheme based on allegations that lawyer had actual knowledge of company’s intent to commit fraud because he knew of principals’ extensive criminal background, court rejected lawyer’s “see no evil, hear no evil” defense); Am. Auto. Accessories, Inc. v. Fishman, 175 F.3d 534, 543 (7th Cir. 1999); Levine v. Diamanthuset, Inc., 950 F.2d 1478, 1483 (9th Cir. 1991); see also Comment [3] to Model Rule 1.13 (“knowledge can be inferred from circumstances, and a lawyer cannot ignore the obvious”).

Comment d to Restatement Second, Torts § 876, indicates that “[a]dvice or encouragement to act” can constitute substantial assistance. It further states that in determining if assistance is substantial, relevant considerations are: (1) the nature of the act that is assisted; (2) the amount of assistance the defendant provides; (3) the presence or absence of the defendant at the time of the tort; (4) the defendant’s relation to the primary actor; and (5) the defendant’s state of mind. If the defendant has rendered substantial assistance, he or she is liable for any foreseeable acts by the primary actor that are done in connection with the tortious act. Thus, for instance, banks that helped design transactions with Enron in which the banks themselves participated were deemed to have rendered substantial assistance to Enron in enabling it to “distort its public financial statements.” UniCredito Italiano SPA v. JPMorgan Chase Bank, 288 F. Supp. 2d 485, 502 (S.D.N.Y. 2003).

Finally, some courts have used a sliding scale approach in which the amount of evidence that is necessary to establish substantial assistance varies with the strength of the evidence of knowledge and vice versa. See, e.g., In re Temporomandibular Joint (TMJ) Implants Prods. Liab. Litig., 113 F.3d 1484, 1495 (8th Cir. 1997); McDaniel v. Bear Stearns & Co., Inc., 196 F. Supp. 2d 343, 352–53 (S.D.N.Y. 2002).

Aiding and Abetting Breach of Fiduciary Duty. Another frequent common law claim against lawyers as secondary actors is aiding and abetting a breach of fiduciary duty. This claim requires that: (1) the primary actor is a fiduciary, such as a director or officer; (2) the primary actor breaches the fiduciary duty; (3) the lawyer is aware of the breach; and (4) the lawyer substantially assists in or encourages the breach. See, e.g., AmeriFirst Bank v. Bomar, 757 F. Supp. 1365, 1380 (S.D. Fla. 1991). The lawyer need not have a fiduciary duty to the plaintiff as long as the primary actor does. The plaintiffs in these cases tend to be parties suing on behalf of a company, such as a successor in interest, trustee, or shareholder in a derivative suit, or minority shareholders who allege that the lawyer helped the majority shareholder squeeze them out of the company or inflict some other harm.
Section 51(4) of Restatement Third, The Law Governing Lawyers (2000) (Restatement) provides for liability in the narrower circumstance where the client is a fiduciary, such as a trustee, guardian, or executor. In that case, a lawyer may be liable to a nonclient where the lawyer’s client has fiduciary duties to the nonclient, the lawyer knows that appropriate action is necessary to prevent or rectify a breach of the fiduciary duty owed by the client to the nonclient, and the breach is a crime or fraud or the lawyer has assisted in the breach. Comment h makes clear that Subsection 4 applies to a fiduciary duty based on “strict duties to protect specific property for the benefit of specific, designated persons,” and, therefore, does not apply when the client is a “partner in a business partnership, a corporate officer or director, or a controlling stockholder.” But see Granewich v. Harding, 985 P.2d 788, 797 (Or. 1999) (discussed below).

As with aiding and abetting fraud, knowledge of the breach of fiduciary duty may be satisfied by proof of recklessness. See Andreo v. Friedlander, Gaines, Cohen, Rosenthal & Rosenberg, 660 F. Supp. 1362, 1367 (D. Conn. 1987). One court has gone so far as to suggest that “[c]onstructive knowledge is adequate when the aider and abettor has maintained a long-term or in-depth relationship with the fiduciary.” Chem-Age Indus., Inc. v. Glover, 652 N.W.2d 756, 775 (S.D. 2002). See also Witzman v. Lehrman, Lehrman & Flom, 601 N.W.2d 179, 188 (Minn. 1999) (long-term relationship between accountant and client may permit finding of constructive knowledge).

Whether providing legal services alone can constitute substantial assistance has been a point of some uncertainty in recent years, but the trend seems to be that it cannot. The Oregon Supreme Court said that a lawyer acting “within the scope of the lawyer-client relationship … is not liable for assisting the client in conduct that breaches the client’s fiduciary duty to a third party.” Reynolds v. Schroek, 142 P.3d 1062, 1069 (Or. 2006) (en banc). In Reynolds, the lawyer had advised the client that he could sell property despite the possibility that a security interest in favor of the plaintiff might attach to it; had asked the escrow officer to treat the pending sale of the property as confidential; had assisted the client in revoking his consent to sell property under a prior agreement with the plaintiff; and had accepted “substantial fees” for legal work. The court found that all these activities fell within the scope of “the assistance that a lawyer properly provides for a client.” Id. at 1071. To hold otherwise, the court indicated, would inhibit lawyers in providing candid advice and rendering assistance to clients because of the fear of liability. The court distinguished Granewich (cited above), emphasizing that the lawyer in that case was acting outside the scope of his duties as lawyer for the corporation when he took steps on behalf of majority shareholders to squeeze out a minority shareholder. Id. at 1065. Other courts have reached the same conclusion, holding that a lawyer does not render substantial assistance by providing legal advice. See Alpert v. Crain, Caton & James, P.C., 178 S.W.3d 398, 407 (Tex. Ct. App. 2005); Spinner v. Nutt, 631 N.E.2d 542, 546 (Mass. 1994). See also Cunningham v. Tarski, 365 S.W.3d 179, 188--89 (Tex. Ct. App. 2012) (lawyer cannot be held liable for mere transmission of client’s allegedly fraudulent document).

On the other hand, a district court denied two motions to dismiss in a case brought by trust beneficiaries, holding that lawyers can be liable for aiding and abetting a client trustee’s breach of fiduciary duty where the lawyers assisted the trustee in various loan and stock purchase transactions. See generally Scanlan v. Eisenberg, 913 F. Supp. 2d 591 (N.D. Ill. 2012); Scanlan v. Eisenberg, 2011 U.S. Dist. LEXIS 24681, 2011 WL 862748 (N.D. Ill. Mar. 9, 2011), rev’d on other grounds, 669 F.3d 838 (7th Cir. 2012). The court relied heavily on Thornwood, Inc. v. Jenner & Block, 799 N.E.2d 756 (Ill. App. Ct. 2003). In Thornwood, a partner who had sold his interest in a real estate venture to the other partner sued the purchaser’s lawyers. The selling partner alleged that, at the same time the lawyers were involved in the negotiation and documentation of the sale transaction, they were also assisting their client in negotiating another transaction that would dramatically increase the value of the partnership’s assets. The purchasing partner allegedly breached a fiduciary duty by not disclosing the other transaction. The court denied the lawyers’ motion to dismiss for failure to state a claim, holding that nothing in Illinois law prohibits an aiding and abetting claim against lawyers. 799 N.E.2d at 768.

Thornwood and Scanlan demonstrate how difficult it can be to predict when a lawyer will be deemed to have properly provided legal services and when the lawyer will be deemed as having gone
beyond that. Lawyers engage in a wide range of activities in the course of representing clients. Whether they have acted outside the proper scope of providing legal services may depend on the extent to which they are aware of the client’s breach of duty. For example, in most circumstances, lawyers have no duty to disclose material information to nonclients (to the contrary, they are obliged to maintain client confidences). But if the lawyer knows that information he has provided to the nonclient is misleading or that the sale involves a breach of fiduciary duty, then one could argue that the lawyer knows that his or her work is substantially assisting the breach. The risk also may be heightened in the case of a longtime firm client. A lawyer may be less skeptical about unusual conduct, and a fact finder may be more willing to infer scienter. See Section 2.3 below. As a practical matter, therefore, firms should focus attention on knowledge as a critical element of aiding and abetting liability.

2.2 Client Due Diligence

The first line of defense against high-risk clients is a sound business intake system. This is especially important when considering representation of a client with which the firm has no prior experience. Too often, lawyers undertake representation of new clients in transactional matters without sufficient due diligence. Firms must perform a quality check on all new clients, although the type and intensity of the investigation may vary depending on the client and the nature and scope of the proposed representation. In conducting due diligence, ALAS suggests that firms be alert to the warning signs for risky representations. If one or more risk factors are present, the firm should perform a more in-depth quality review of the potential new client and its principals. At a minimum, firms should require more extensive quality checks in any situation involving: (1) clients starting a new business or raising or managing third-party funds; (2) clients changing law firms, auditors, or other professional advisers, especially in the middle of a transaction; (3) clients acting as fiduciaries; and (4) clients about whom little is known.

2.3 Quality Concerns Regarding Existing Clients

Firms should also be mindful of the danger that an existing client, perhaps struggling to remain afloat, or eager to expand into unchartered waters, may cross the line into the kind of conduct that can lead to claims against the lawyer for aiding and abetting the client’s wrongdoing. The longer a firm has represented a client, and the more familiar it is with the client’s operations, the more likely a court may find that lawyers knew of the client’s wrongful activity. Normal human tendencies may heighten this risk. A lawyer who has worked with a client’s managers for a lengthy period or on several projects naturally will develop trust in those people, and will operate on the presumption that they are engaged in legitimate activity. The lawyer, therefore, may be slower to recognize warning signs than someone less familiar with the client. This is one of the reasons ALAS counsels firms to encourage their lawyers at all levels to consult with their loss prevention partner when presented with a questionable situation. The same facts may not seem as alarming to the lawyer familiar with the client as they might to the loss prevention partner.

2.4 Responding to Client Misconduct

The spate of high-profile financial failures in 2000 and 2001 led both Congress, through the enactment of SOX and the ABA, through the 2003 amendments to Model Rules 1.6 and 1.13, to address more directly the problem of misconduct by corporate managers. As a result, lawyers may have affirmative obligations to act when they encounter client wrongdoing. This section discusses lawyers’ duties under the Model Rules, while Section 11.3.1 below discusses duties imposed by SOX.

Model Rules 1.6 and 1.13 delineate certain responsibilities of lawyers who discover client wrongdoing. Under revised Model Rule 1.6, lawyers are permitted, but not required, to disclose confidential information to prevent, mitigate, or rectify the consequences of client crimes or frauds that threaten substantial financial harm to others and in which the lawyer’s services were used.
Revised Model Rule 1.13 requires a lawyer who knows of actual or intended conduct by a constituent of an organization that is a violation of the organization’s legal obligations or a violation of law that is likely to substantially harm the organization, to report such misconduct up the line, to the board of directors if necessary, unless the lawyer believes it is “not necessary in the best interest of the organization” to do so. Formerly, such up-the-line reporting was merely an option that the lawyer should consider. Amended Rule 1.13 also provides that when a lawyer has reported misconduct that is “clearly a violation of law” to the organization’s highest authority and the organization fails to take timely remedial action, the lawyer may reveal client confidences outside the organization to the extent necessary to prevent substantial injury to the organizational client, even if Model Rule 1.6 would not otherwise permit such disclosure. The rule provides that a lawyer who reasonably believes that he or she has been discharged because of reporting up the line or making an outside report, or who withdraws under circumstances that would permit such reporting, must inform the organization’s board of the discharge or withdrawal and what the lawyer reasonably believes to be the basis for the discharge or withdrawal.

As of early 2014, 35 states had adopted amended Model Rule 1.13 or a variation of it. Determining whether a lawyer may or must reveal information regarding a client’s fraudulent or illegal conduct requires detailed analysis of the applicable jurisdiction’s versions of Rule 1.6 and Rule 1.13, as well as applicable state and federal law.

The up-the-line reporting obligations of Model Rule 1.13 are similar to those imposed under SOX but apply to all organizational clients, not just the public companies covered by SOX. Firms should be aware that in any given situation, the Model Rules and the SEC rules for lawyer conduct might impose different obligations on them. Lawyers may have less discretion in responding to possible client wrongdoing under the SEC rules than under their jurisdiction’s version of Model Rules 1.6 and 1.13.

Lawyers should keep in mind that other ethical obligations may affect how they respond to possible client misconduct. Under Model Rule 1.2(d), a lawyer cannot counsel or assist a client in conduct that the lawyer knows is criminal or fraudulent, although the lawyer can discuss the legal consequences of a proposed course of conduct. If, despite the firm’s advice, a client continues on a course of fraudulent or illegal conduct, the firm should consider whether it must or may withdraw from the engagement under Model Rule 1.16. In addition, a lawyer who has unwittingly communicated false or misleading information in connection with a representation may have ethical duties under Model Rule 4.1 (Truthfulness In Statements To Others).

How a firm reacts to possible client misconduct can sometimes determine whether the firm and its lawyers are implicated in the client’s problems. Given the significant liability and reputational risks, firms are well advised to adopt a policy that requires lawyers and other firm personnel to report internally any suspicious or problematic client behavior, including complaints received about the client, such as a whistleblower letter, so that the firm can investigate and take action as appropriate.

### Section 3 Client Identity

Claims can arise from misunderstandings regarding who the firm does and does not represent. In the corporate, securities, and real estate practices, claims often result from failing to clarify and respect client identity when representing entities, and from failing to maintain boundaries when dealing with nonclients.

#### 3.1 Client Identity at Intake

A critical first step to avoiding client identity claims is to understand who you represent at the beginning of the engagement. Representation of corporations, general or limited partnerships, and limited liability companies inherently raise questions about client identity. Briefly, Model Rule 1.13 and Restatement § 96 recognize the “entity” theory whereby a lawyer retained by an organization represents the organization acting through its authorized constituents and not the constituents themselves. Nevertheless, failure to expressly limit the representation to the organizational client can lead to
problems. Under the Restatement § 14, Cmt. f, “whether the lawyer represents an organization, a person or entity associated with it, or more than one such persons or entities is a question of fact to be determined based on reasonable expectations in the circumstances.” And because questions of fact are decided with the benefit of hindsight, taking care to properly identify the client takes on added significance.

There are numerous cases where third parties to an entity representation, such as shareholders or limited partners, claim that the lawyers should have protected their interests. But such a claim should not be predicated upon the lawyer’s failure to properly identify the client at the start of the engagement. Consider how a poorly drafted engagement letter can create an opportunity for misunderstanding, whether actual or alleged. For example, if an engagement letter is addressed to a company’s chief executive and refers to the client as “you,” does the firm represent the company, the executive, or both? In one case, that ambiguity, together with the lawyers’ lack of precision when speaking about their client, prevented the lawyers from obtaining dismissal of an action brought by the company’s executive. See Bayit Care Corp. v Einbinder, 2013 N.Y. Misc. LEXIS 4226, at *9–11, 2013 WL 5339967, at *4 (N.Y. Sup. Ct. Sept. 24, 2013) (court denied motion to dismiss claim asserted by client’s president and 50% shareholder where engagement letters were ambiguous and lawyers referred to president as their client during hearing in underlying litigation). At a minimum, a firm’s engagement letter should expressly state the name of the client in the body of the letter. In entity representations, the letter should also disavow representation of affiliates and constituents unless such representation is expressly undertaken.

It is not just clients and nonclients who need to maintain clarity about client identification. Sometimes the lawyers themselves need to keep in mind whose interests they have been retained to serve. Two recent cases are instructive. In Kirschner v. K&L Gates, 46 A.3d 737 (Pa. Super. Ct. 2012), the firm was engaged by an independent committee of a corporation’s board of directors to investigate possible financial misconduct. After the company went bankrupt, the bankruptcy trustee sued the firm for malpractice. In reversing and remanding the trial court’s ruling in favor of the firm, the appellate court rejected the firm’s argument that it represented the committee and not the company. See id. at 748. Although the firm’s engagement letter specifically stated that the committee and not the company was the firm’s client, the court found an implied attorney-client relationship with the company because the committee had been created to undertake an investigation on behalf of the company and its recommendations were to be presented to the company’s board. Further, the court concluded that certain actions taken by the firm, such as giving the company’s president a copy of the preliminary report, indicated that the firm knew its duties extended beyond the special committee. See id. at 750. Thus, lawyers must understand that unless the purpose of the engagement is to advise the members of a board or special committee on their personal, fiduciary responsibilities vis-à-vis the corporation, representation of a board or special committee may be deemed to be a representation of the corporation as a whole.

Ky. Bar Ass’n v. Hines, 399 S.W.3d 750 (Ky. 2013), illustrates the danger when a lawyer loses sight of who he represents in an intracorporate dispute. In Hines, a power struggle erupted among the shareholders of a family-owned business. After a corporate election kept the existing faction in power, the company terminated the services of its lawyer in all matters except one piece of litigation. The lawyer, however, insisted that the election was invalid and refused to comply with the company’s requests. After the company’s president terminated the lawyer in all matters, he continued to hold himself out as the company’s counsel and ultimately filed suit, allegedly on behalf of the corporation, seeking to oust the governing faction. See id. at 770. When that suit was converted to a shareholder’s derivative suit on behalf of the minority shareholders, the lawyer delivered the company’s files to new counsel representing the minority shareholders rather than to the company. Not surprisingly, bar complaints were filed against the lawyer, who ultimately received a 120-day suspension for numerous violations of the rules of professional conduct. See id. at 773. The Kentucky Supreme Court rejected the lawyer’s argument that he was acting in the best interests of the corporation. The then-serving directors and officers, who would have remained in office even if the elections were invalid, were the client’s duly authorized agents to whom he owed ethical and fiduciary duties, including the duty to respond to questions and to return files.
Although it may seem obvious in hindsight, lawyers who find themselves in the midst of a shareholder dispute must carefully consider their relationship and responsibilities to all of the parties before acting on behalf of one side or the other.

### 3.2 Unintended Clients

In many situations, the nonclient who might later claim to also have been represented will not be privy to the engagement letter. Any time there is a possibility that a nonclient might think that the firm is also protecting its interests, such as when a party to a transaction is not known to be represented by other counsel in the matter, the firm should advise the nonclient in writing to the contrary. This can be accomplished through an “I’m not your lawyer” letter stating that the firm does not represent the nonclient, that it may not rely on the firm to protect its interests in preparing transaction documents, and that it may want to obtain independent counsel. In addition, consider inserting a “representation paragraph” into transaction documents explaining whom the firm represents and disclaiming representation of nonclients. In *Rosenbaum v. White*, 692 F.3d 593, 601–03 (7th Cir. 2012), such a disclaimer protected a lawyer who prepared the offering documents for a failed investment from claims by investors that the lawyer represented their interests in the venture, as well as the promoter’s.

If during the engagement any party appears to misunderstand the lawyer’s role, the lawyer needs to remind the party, preferably in writing. See *Restatement* §14, Comment f (“a lawyer’s failure to clarify whom the lawyer represents in circumstances calling for such a result might lead a lawyer to have entered into client-lawyer representations not intended by the lawyer. Hence, the lawyer must clarify whom the lawyer intends to represent when the lawyer knows or reasonably should know that, contrary to the lawyer’s own intention, a person, individually, or agents of an entity, on behalf of the entity, reasonably rely on the lawyer to provide legal services to that person or entity”); *see also* Model Rule 4.3 and *Restatement* § 103, Comment b (regarding lawyer’s duty to warn unrepresented persons as to lawyer’s role); Meredith Hobbs, *Holland & Knight’s Lesson? Get a Disclaimer*, Daily Rep. (May 21, 2012), available at www.dailyreportonline.com/PubArticleFriendlyDRO.jsp?id=1202555431438 (last visited Feb. 5, 2014) (“I’m not your lawyer” disclaimer might have prevented $34.5 million jury verdict against firm).

Of course, actions speak louder than words. Once the identities of clients and nonclients are established, a lawyer must not act in ways that are contrary to the intended representation. Thus, a lawyer representing a company in a sale transaction should refrain from advising the business executive with whom the lawyer is dealing regarding the agreements the executive is being asked to sign in connection with the sale. Similarly, if a lawyer is asked to assist a nonclient in connection with a matter, the lawyer should do so only after clarifying in writing what the lawyer is doing and for whom. Examples abound: A lawyer for a buyer in a sale transaction may, in an effort to move the deal along, be asked to help the seller (whether or not represented by other counsel) prepare government filings or contract schedules; a client may need its lawyer to provide a third-party legal opinion relating to a nonclient participant, such as a shareholder who is guaranteeing corporate indebtedness; or a lender may “require” that the borrower’s counsel “share” their due diligence report with the lender’s counsel. Unless properly documented, these types of scenarios raise the potential for the nonclient to later allege that the lawyer, in fact, was representing it and either provided negligent advice or had a conflict of interest.

### 3.3 Client Identity in Follow-On Engagements

Even intended “engagement creep” can have unintended consequences if client identities are not documented and carefully observed. A firm that initially represents a company may later be asked to provide estate planning services for one of its executives. Or a firm engaged to organize a venture capital fund might then seek to represent the fund in raising and investing capital and then to represent the portfolio company acquired by the fund. These follow-on engagements should present no problems so long as the lawyers are scrupulous in following the firm’s new business intake procedures, particularly opening a new matter and checking conflicts for each new assignment. Doing so will allow the firm to
evaluate whether the assignment is for a new client, i.e., an affiliate whose name should be added to the firm’s conflict database, involves a joint or concurrent representation with a preexisting client, or creates or has the potential to create a conflict of interest with the existing client. If so, the firm may need to obtain a current or advance conflict consent and to appropriately limit the scope and term of the engagement to avoid the type of ongoing, general representations that can lead to conflicts. See Section 5.3 below.

3.4 “Zone of Insolvency” Situations

Although the general rule is that a lawyer retained by a company represents the interests of the company and not its constituents or affiliates, one circumstance where the lawyer needs to consider the interests of third parties is when the entity is arguably within a zone of insolvency. There have been a number of cases where claimants have asserted claims for “deepening insolvency,” i.e., that the lawyer wrongfully assisted the client in conduct designed to prolong the life of the enterprise, thereby increasing its debt and exposure to creditors. Because these claims are often asserted in the context of bankruptcy proceedings involving the lawyer’s former client, we discuss them in the Bankruptcy Practice tab.

Section 4 Scope of Engagement Issues

4.1 Documenting Scope of Engagements

ALAS stresses the importance of documenting the scope of engagement in all matters, regardless of practice area. It is particularly important in business representations, where the natural tendency may be to describe the engagement broadly, either to cover potential future engagements or because the required work has not been sufficiently fleshed out at the time the engagement letter is prepared. Unfortunately, lack of specificity regarding what the client expects the firm to do can lead to claims that the lawyers dropped the ball when, in reality, the work was not contemplated to be part of the assignment. Model Rule 1.2(c) recognizes that a lawyer, with client consent, can reasonably limit the scope of the engagement. In many cases, it is the client that places restrictions on the work performed by a law firm on a particular matter, either because it retains some of the work in-house or uses different law firms for different tasks.

The ABA Commission on Ethics 20/20 recognized the potential for misunderstanding in the face of increasing disaggregation of legal services among law firms and other legal service providers. Revised Comment [7] to Model Rule 1.1 now provides that “[w]hen lawyers from more than one law firm are providing legal services to the client on a particular matter, the lawyers ordinarily should consult with each other and the client about the scope of their respective representations and the allocation of responsibility.” Comment [4] to Model Rule 5.3 similarly states that “[w]here the client directs the selection of a particular nonlawyer service provider outside the firm, the lawyer ordinarily should agree with the client concerning the allocation of responsibility for monitoring as between the client and the lawyer.” Lawyers would do well to have these conversations with their clients early and often, and to reduce their understandings regarding the allocation of responsibilities to writing.

4.2 Practice Area Competency

It is axiomatic that lawyers must provide competent representation. See Model Rule 1.1. Perhaps more so than in other practice areas, business lawyers regularly contend with issues that implicate other legal specialties, including tax, intellectual property, environmental, and employment and benefits law. Corporate transactions frequently involve real estate matters and vice versa. There may be securities law implications in both corporate and real estate transactions. Transactional lawyers may consider themselves “jacks-of-all trades,” who can handle all of these issues on their own, but those who do so are acting at their own peril. ALAS has seen numerous claims resulting from lawyers who dabbled in areas in which they lacked sufficient expertise, ranging from improper tax advice on deal structure to failures to adequately address the securities aspects of complex real estate financings. Lawyers should not hesitate to seek assistance from colleagues in other practice areas when necessary. See Section 7 below. Two areas.
where dabbling can lead to trouble deserve special mention: internal investigations and global corporate
practice.

4.2.1 Internal Investigations

As a primary contact of many firm clients, business lawyers may be asked to conduct or become
involved in a corporate internal investigation. These investigations require special expertise and
precautions. See Tab III.J, Section 3. Whenever a firm is asked to undertake an internal investigation for a
current client, the firm should consider whether doing so involves an examination of the firm’s own prior
work or advice to the client. If so, the firm should carefully consider whether undertaking the requested
investigation would create a conflict of interest.

4.2.2 Global Practice

The reach of many ALAS firms has become increasingly global, either because the firms have
opened offices outside the United States or because their clients’ interests have expanded internationally.
Not surprisingly, in recent years ALAS firms have reported significant claims arising out of international
matters. Although some of these claims arise from familiar causes, such as dishonest or incompetent
clients or conflicts of interest, international practice presents its own special areas of concern. First among
these is that often U.S. lawyers are dealing with unfamiliar laws and legal systems. International
transactions involve a maze of laws and regulations that can be unlike any typically encountered by a U.S.
lawyer. Also significant are the cultural differences between U.S. and foreign nationals, especially in the
perception of the role of lawyers. Finally, there are important differences in the professional conduct rules
and the law governing lawyers, especially the law of attorney-client privilege as observed in the United
States and other countries. The same problems exist in reverse for ALAS firm lawyers based abroad who
are exposed to U.S. laws, customs, clients, perceptions, and rules of professional conduct.

Section 5 Conflicts of Interest

Conflicts of interest frequently arise in corporate and real estate matters and are a continuing
source of claims against lawyers. Conflicts in nonlitigation matters can be particularly troublesome
because, with no forum in which to raise the issue during the engagement, the client often does not claim
a conflict existed until after the work has concluded and the client is dissatisfied with the result. Thus, the
claimed loss has already occurred and the alleged conflict plays out with the benefit of hindsight.

In some jurisdictions, violation of a conflicts rule can constitute a breach of fiduciary duty owed
by a lawyer to a client. See, e.g., Griva v. Davison, 637 A.2d 830, 846 (D.C. 1994). Conversely, an
adverse representation that does not violate the ethics rules can still support a breach of fiduciary duty
not require the plaintiff to plead or prove actual malpractice. See Klemme v. Best, 941 S.W.2d 493,
496–97 (Mo. 1997) (en banc). Moreover, in some states a client claiming a breach of fiduciary duty based
on a conflict of interest need not prove causation or damages to obtain disgorgement of legal fees. See,
e.g., Huber v. Taylor, 469 F.3d 67, 77 (3d Cir. 2006); Hendry v. Pelland, 73 F.3d 397 (D.C. Cir. 1996).
And a breach of fiduciary duty that rises to the level of fraud or willful disregard of the client’s rights can
also support a request for punitive damages. See id. at 400. When a plaintiff can allege both negligence
and a conflict of interest, the conflict allegation “colors the entire case against the lawyer, casting doubt
with jurors as to the lawyer’s motives and loyalty to the client.”

5.1 Representations Adverse to Firm Clients in Unrelated Matters

As noted in Comment [7] to Model Rule 1.7, a direct adversity conflict will arise under the rule
“if a lawyer is asked to represent the seller of a business in negotiations with a buyer represented by the
lawyer, not in the same transaction but in another, unrelated matter.” Under Model Rule 1.10, imputing
conflicts among lawyers within a firm, a conflict exists when any lawyer in the firm is representing the
adverse party on an unrelated matter. The difficulty is that adverse parties in transactions may not be identified until well after the representation begins. For example, a lawyer assisting a client in the sale of a business may not know at intake whether the lawyer will need to negotiate with the client’s (or the other side’s) lenders, landlords, tenants, or other business relations. Similarly, a lawyer who serves as a client’s corporate counsel on many matters may not think to check for a conflict whenever the client asks the lawyer to review a contract or provide general advice involving a third party. Sometimes, there is a tendency not to view such matters as adversarial, despite the real possibility that the lawyer’s advice may prove to be detrimental to another firm client. To avoid these types of conflicts, business lawyers should run a conflicts check for every new matter that involves a third party and whenever a new party becomes involved in an ongoing matter.

5.2 Joint Representations of Clients in Single Matter

Even when there is no direct adversity, a conflict can arise under Rule 1.7(a)(2) when a lawyer’s representation of one client may be materially limited by the lawyer’s responsibilities to another client. This type of conflict often occurs in the transaction practice when a lawyer is asked to jointly represent two or more clients in a single matter where their interests are generally but not fully aligned. For example, a lawyer may be asked to jointly represent individuals organizing a new venture or multiple shareholders selling a business. Comment [26] to Rule 1.7 indicates that “[r]elevant factors in determining whether there is significant potential for material limitation include the duration and intimacy of the lawyer’s relationship with the client or clients involved, the functions being performed by the lawyer, the likelihood that disagreements will arise and the likely prejudice to the client from the conflict.” As more fully described in Tab II, Sections 2.2.4 and 2.3.6, joint representations require careful evaluation of the nature of the matter, the relative positions and sophistication of the clients, and the relationship of the clients to the firm. The initial inquiry should be whether the conflict is consentable under Rule 1.7(b) because the lawyer reasonably believes that he or she will be able to provide competent and diligent representation to each affected client. See Comment [28] to Model Rule 1.7 (whether a conflict is consentable “depends on the circumstances. For example, a lawyer may not represent multiple parties to a negotiation whose interests are fundamentally antagonistic to each other, but common representation is permissible where the clients are generally aligned in interest even though there is some difference in interest among them.”)

Lawyers are sometimes asked if the firm can represent both sides of a transaction with consent from each client. Although some authorities would permit this in limited circumstances, see, e.g., Vermont Opinion 2011-02 (undated) (dual representation of lender and borrower in real estate transaction is not inherently improper), it is a risky course of action. It is difficult to be just a “scrivener” under contemporary conflicts of interest law. See Layton v. Pendleton, 864 S.W.2d 937, 942 (Mo. Ct. App. 1993). Even full disclosure and consent may not protect a lawyer representing both sides of a negotiated transaction. In Baldasarre v. Butler, 625 A.2d 458, 467 (N.J. 1993), the New Jersey Supreme Court held that representing two clients having adverse interests in the same commercial real estate deal was a per se violation of the professional conduct rules, subjecting the lawyer to malpractice liability even though both clients had consented to the dual representation. The court found the conflict of interest was nonconsentable.

Even if the conflict is consentable, lawyers should also consider whether it is advisable to proceed with the joint representation. For example, if the work involves organizing a joint venture between a sophisticated, long-standing firm client and a person without extensive business or legal experience, and the terms of the proposed venture are not well defined, it may be difficult for the firm to remain neutral. If a conflict is likely to develop that would require the firm to withdraw, none of the parties would be well served by the joint representation.

If the conflict is consentable and the firm and clients determine to proceed with the joint representation, each client must give informed consent, confirmed in writing, preferably signed by each
client. The consent should make clear that if a conflict develops between the clients as the representation unfolds that they are unable to resolve, the firm will have to withdraw from representing all of them unless they agree to the firm’s continued representation of some of them. If the firm wants to preserve the right to represent one of them in the event of a conflict, the issue should be addressed in the initial engagement letter or conflict consent. Jointly represented clients should also understand that all information material to the matter will be shared with all of them and that communications with the lawyer probably will not be privileged in a dispute among them. The consent also should state that the clients have had the opportunity to consult independent counsel before signing.

As noted in more detail in Tab II, Section 2.2.4, before the 2002 amendments to the Model Rules, 1983 Model Rule 2.2 (Intermediary), addressed multiple representations. Some states, including Hawaii, Tennessee, Texas, and West Virginia, have retained Model Rule 2.2. Lawyers in those states need to recognize that acting as “lawyer for the deal” may be more restricted under Model Rule 2.2 than under Model Rule 1.7(b).

5.3 Concurrent Representation of Constituents and Affiliates

Lawyers who concurrently (not jointly) represent constituents or affiliates of other clients must take extra precautions to avoid conflicts of interest. Although the interests of a parent company and its subsidiaries generally are aligned, conflicts can also arise if a subsidiary is spun-off, sold, or becomes insolvent. Similarly, representing a company executive or shareholder, even in matters unrelated to the representation, can create a conflict of interest if the lawyers are then asked to take action on behalf of the company that is adverse to the shareholder or executive. See, e.g., D’Andrea, 2013 Tex. App. LEXIS 14961, at *15–16, 2013 WL 6698215, at *4–5 (lawyer who represented owner of business in unrelated bankruptcy litigation could be liable for breach of fiduciary duty for concurrently preparing memo for business alleging owner’s misconduct). Transactions between affiliates without identical ownership can create a conflict of interest. For example, a firm will likely have a conflict representing both a parent company and a non-wholly owned subsidiary in a squeeze-out of public shareholders. Firms representing private equity funds may not be able to represent both the fund manager and a portfolio company in a transaction that could benefit the manager to the detriment of the fund’s investors. Leveraged buy-out transactions can give rise to conflicts if the firm tries to represent too many interested parties. In these types of situations, the lawyers may need to obtain conflict waivers and in many cases advise one of the clients to obtain separate counsel.

5.4 Avoiding Conflict of Interest Claims

The following summarizes our advice on how business lawyers can avoid conflict claims:

1. Know who your client is in each engagement, particularly when the firm concurrently represents affiliates and constituents of entity clients.

2. Be thoughtful in running conflicts checks, making sure to identify the clients, their affiliates, and other involved parties. Remember to run a new conflict check any time a new party becomes involved in a matter.

3. Clearly identify the client(s) in a written engagement letter. It also may be helpful to specifically identify other individuals or entities that will not be clients in the engagement.

4. If there is any possibility for misunderstanding, advise nonclients, particularly those who are not known to be represented by other counsel, in writing, that the firm does not represent them.

5. Before undertaking the work, carefully consider the likelihood that an actual conflict of interest may develop in a joint representation of multiple clients and be alert for signs that the clients’ interests are diverging as the representation proceeds.
6. Informed consent to conflicts of interest requires adequate disclosure regarding the nature of the conflict, the material risks, and the reasonably available alternatives. Consult the firm’s loss prevention partner as to the substance and form of the disclosure and consent.

7. Once you tell parties that they are not your clients, do not treat them like they are. Remind those who may misunderstand your role. Do not give legal advice to nonclients.

Communications regarding client identity and conflicts of interest should be in writing. Otherwise, there may be factual disputes that preclude summary judgment in a subsequent malpractice action. Ultimately, lawyers need to be attuned to the possibility of conflicts in their practice, to follow the firm’s business intake and conflicts checking and resolution procedures, and to promptly bring any conflict issues to the attention of the firm’s general counsel or loss prevention partner.

Section 6 Mixing Law and Business

6.1 Investing in Clients and Serving on Client Boards

Business lawyers often have opportunities to make investments in or serve as directors of their clients. We strongly discourage these practices. When lawyers take these opportunities, the fact of their investment or board service may be used against them by plaintiffs who claim injury from involvement with or other conduct by the clients. A plaintiff may claim that the lawyer’s stake in the client’s business inclined the lawyer to look the other way in the face of client wrongdoing, or even gave the lawyer an incentive to assist the client in engaging in misconduct or “pushing the envelope.” A lawyer serving on a client’s board will find it harder to defend against allegations that the lawyer knew or should have known about the client’s wrongful conduct. When a trial comes down to a contest about the lawyer’s knowledge, the jury’s perception of the lawyer’s credibility is important, and the lawyer’s involvement in the client’s business can be a negative factor. That involvement also may be considered by a court, such as on a motion for summary judgment, in deciding whether adequate evidence of scienter exists for a plaintiff to proceed to trial. See, e.g., Renovitch v. Kaufman, 905 F.2d 1040, 1046 (7th Cir. 1990).

6.2 Business Decisions and Advice

Business lawyers are frequently the target of a disappointed client’s wrath when a transaction or business venture fails. Without attempting to describe every possible scenario, ALAS has seen claims alleging that the lawyers should have warned the client of the business risks in the transaction; performed due diligence on the business aspects of or the other participants in the deal; obtained more favorable contract terms than the parties ultimately agreed upon; or otherwise protected the client from the adverse consequences of its business dealings. When disputes over advice given or decisions made in negotiations result in litigation, it usually means that there was no documentation to support the lawyer’s version of the events. In some cases, what is alleged to be negligence may actually be the result of limitations the client had placed on the lawyer as to budget, schedule, staffing, or scope of work. Again, when those client-imposed restrictions are not documented, the lawyer often winds up in a swearing contest with potentially huge amounts of money hanging in the balance.

Whether a lawyer’s failure to protect a client from its own bad business decisions can constitute professional negligence was addressed in Abrams v. DLA Piper (US) LLP, 2013 U.S. Dist. LEXIS 82484, 2013 WL 2634767 (N.D. Ind. June 12, 2013). There, a bankruptcy debtor alleged that its law firm committed malpractice by providing substantial legal assistance in connection with several questionable transactions when the firm knew or should have known of the debtor’s precarious financial condition. In granting the firm’s motion to dismiss, the district court noted that the debtor did not allege any deficiency in the legal services provided by the firm but argued that the firm should not have provided the legal services at all because the transactions were disadvantageous to the client. See id. at *16–18, at *6. The court concluded that the complaint sought to hold the firm liable for failing to provide business rather than legal advice and, therefore, did not state a claim for legal malpractice. The court distinguished In re JTS Corp., 305 B.R. 529, 554–55 (Bankr. N.D. Cal. 2003), which held that a lawyer could be liable for
failing to advise her client that its sale of real estate for less than its appraised value could have adverse legal consequences because it involved a failure to give legal rather than business advice.

Although cases brought by clients disappointed with a business outcome often are weak, they can be expensive to defend. Lawyers may not be able to avoid these types of claims completely, but there are things they can do to minimize their exposure. First, to avoid misunderstandings, have a written record of any limitations placed on the representation and of other specific client instructions. Document significant concessions made by the client in the negotiation process. Ideally, the information should be reflected in a contemporaneous writing to the client, such as an e-mail or memo to the client. Another effective method of creating a contemporaneous record is to send cover letters or e-mails with revised draft documents that call the client’s attention to the change or concession. Finally, the comment fields in “track changes” within a word processing program can be used to the same effect. Regardless of the method used, the goal is to create a contemporaneous, written record.

Business lawyers also can be tripped up when they try to be business (as well as legal) advisors to their clients. Following are three important points. First, lawyers should avoid giving advice that is not truly within their area of knowledge. Second, lawyers who tout their business expertise may find themselves held to an elevated standard of care when the client is dissatisfied with the results. Third, lawyers who turn a blind eye when the client seems to be pursuing a foolish course place themselves at risk of a claim by the client or by a third party. Our advice to practitioners is to avoid giving explicit business advice in most cases, but not to check your business (or common) sense at the door when you represent a client. When a client is pursuing a foolish course, say so. If the client nevertheless proceeds, make a record of your advice, or consider withdrawing from the matter.

Section 7 Mistakes

Lawyers in high-caliber law firms working on corporate, securities, and real estate matters are not immune from simple drafting errors or other types of mistakes. In the last several years, ALAS has seen a substantial increase in the number of claims where a provable legal blunder is the centerpiece of the complaint. The cost of these mistakes can be significant, and significantly disproportionate to the fees generated by the engagement. ALAS encourages firms to instill and maintain a firm culture that emphasizes the importance of quality, teamwork, and openness in admitting and learning from mistakes.

When mistakes occur, the plaintiff must establish not only that the lawyer was negligent, but also that “but for” the alleged malpractice, it is more likely than not that the plaintiff would have obtained a more favorable result.” Viner v. Sweet, 70 P.3d 1046, 1054 (Cal. 2003) (emphasis in original). See also Hazel & Thomas, P.C. v. Yavari, 465 S.E.2d 812, 815 (Va. 1996). The client will need to show, for instance, that without the lawyer’s mistake the client would have achieved better terms or would have been better off by not entering into the transaction. To claim an actual loss, the client must establish that “the lawyer’s negligence actually caused the specific loss in question.” See Michael L. Shakman et al., There but for the Grace of God Go I: A Look at the Modern Transactional Legal Malpractice Case, 18 C.B.A. Record 32 (Apr. 2004). Moreover, even if a plaintiff can prove cause-in-fact, to recover for malpractice in a transaction matter the plaintiff may also have to prove that the lawyer’s conduct was the legal cause of the loss, i.e., that the loss was a reasonably foreseeable consequence of the allegedly negligent conduct. See Elmo v. Callahan, 2012 U.S. Dist. LEXIS 120142, at *19–22, 2012 WL 3669010, at *6–7 (D.N.H. Aug. 24, 2012) (although plaintiffs could show that “but for” their lawyer’s malpractice they would not have sold their business to buyer, they proferred no evidence that lawyer’s conduct caused buyer’s business to collapse shortly after closing, rendering the noncash portion of the consideration worthless).

Mistakes come in all varieties. Two that frequently give rise to claims are government filing errors and drafting errors. Filing errors involve failures to timely or properly file tax returns or real estate or financing documents. In some cases, the claim results from a misunderstanding regarding who was
responsible for making the filing as between the lawyer, another professional, such as an accountant, or the client. See, e.g., Barnes v. Turner, 606 S.E.2d 849, 850–51 (Ga. 2004) (malpractice action could be based on lawyer’s failure to advise client in writing that client would be responsible for filing UCC continuation statements after the closing). One way to avoid such claims is to clarify in writing who has responsibility for completing tasks, both before and after the consummation of the transaction.

Recently, relatively simple mistakes in real estate transactions, such as including a faulty legal description or attaching the wrong deed in a filing, have resulted in claims. When good lawyers produce flawed documents, the reason usually involves inattention at some level. Perhaps the drafting was delegated to a less experienced lawyer or paralegal, and the supervising lawyer failed to provide the appropriate level of review. Perhaps the lawyers involved merely failed to take the necessary time to check for drafting errors or to consider whether the written documents accurately reflected the terms of the transaction. In transactions with several operative documents, the lawyers may have neglected to conform all the documents to the final deal terms.

In other cases, the form document may not accurately reflect the reality (or the client’s understanding) of the deal. Many law firms maintain precedent files of standard transactional documents so that lawyers need not reinvent the wheel for every matter. Word processing and document management software have increased the utility of precedent files. These tools, however, can turn against the lawyer who fails to focus on the differences between the precedent and the transaction at hand.

A drafting error occasionally reflects the failure to grasp a significant legal point. This can occur when the missed point was outside the drafter’s area of competence. A common example is the delegation of responsibility for drafting a complex document to an inexperienced associate working with insufficient supervision. Another is when lawyers dabble in specialized areas beyond their expertise, such as tax, ERISA, environmental, or land use law, or fail to bring in specialty counsel when warranted. In either case, if the work results in unforeseen consequences that could have been avoided if a specialist had been consulted, the inevitable lawyer liability claim will be difficult to defend. No single lawyer can be an expert on everything. One advantage of large firm practice is the availability of lawyers knowledgeable in other areas of law. Making full use of the firm’s resources when handling complex, multifaceted matters reduces the firm’s professional liability risk.

It is much easier to explain the causes of mistakes than it is to advise lawyers on how to avoid them. After all, everyone makes mistakes. Unfortunately, if a claim is asserted, a veritable legion of litigators (possibly supported by their transactional colleagues) will, outside of the time exigencies and business pressures of the matter, review the documents in great detail. The best advice, though it may seem obvious, is to proofread, review, and then proofread again, right up to the last possible moment. Additional review is the most potent weapon in the arsenal against claims caused by mistakes. In particular, we suggest:

1. Proofread the hard copy, not the version on a computer screen. Experience and ALAS claims history teach that lawyers, young and old, are more prone to proofreading errors if they are looking at a computer screen. Moreover, headers, footers, and formatting snafus sometimes only become apparent in a printout.
2. Read the boilerplate. Even if it is from your firm’s form, review the contract language that is not subject to a lot of negotiation, and consider it in the context of your deal.
3. If multiple lawyers have been involved in various parts of the transaction, someone who is familiar with all the aspects of the deal should review all of the documents in order to catch inconsistencies that might otherwise go unnoticed.
4. Make time before execution of the documents, even if it is just an hour, to give particular attention to the changes made early in the negotiation process that may not have been reviewed since, and to the last-minute changes in the documents.
Additionally, as projects become increasingly complex, project management has become a useful skill for many business lawyers. In particular, using checklists may help avoid something “slipping through the cracks.” A detailed checklist can list all the steps that need to be taken to complete a project, identify the persons responsible for each task (which may be the client or a nonclient participant), and set a timetable for completing each task.

Section 8 Legal Opinions and Other Representations to Third Parties

8.1 Third-Party Legal Opinions

Corporate and real estate lawyers routinely provide legal opinions to third parties in closing transactions. The frequency and severity of claims arising from legal opinions continue to be a concern. Although some claims arise from faulty legal analysis, many involve either an unworthy client, leading to an allegation that the lawyer aided and abetted the client’s fraud, or an erroneous factual assumption, leading to an allegation (by either the client or a third party) that the lawyer failed to do a sufficient factual investigation. Causes of actions relating to opinions given in securities matters are discussed in Section 11.1 below.

8.2 Other Representations to Third Parties

Beyond formal legal opinions, corporate, securities, and real estate work often involves factual representations made by or on behalf of clients to third parties. Typical scenarios examined below include discussing a client’s operations with a nonclient in the course of a negotiation, assisting a client in making written disclosures in a transaction, allowing a third party to rely on the firm’s due diligence work product, and responding to an audit inquiry.

8.2.1 Informal Communications

Lawyers working on transactions may make various written or oral factual statements to nonclients about the client or its operations, particularly in negotiating contracts or responding to due diligence requests. For instance, the lawyer may advise the prospective purchaser of a client company that the lawyer is delivering all the company’s material contracts or that there are no related party transactions other than those that have been disclosed.

In some cases, a lawyer will make representations to a third party based on the lawyer’s own knowledge. In other cases, however, the lawyer may only be relaying information from the client. As long as there is no reason to doubt the accuracy of the information or the veracity of the client, and the lawyer does not explicitly vouch for the truthfulness of the information, the lawyer should not be held responsible if the information turns out to be false or misleading. But see Kirkland Constr. Co. v. James, 658 N.E.2d 699, 701–02 (Mass. App. Ct. 1995) (firm could be liable for associate’s written assurance to contractor that client had financial ability to pay for contract work). Nevertheless, it may be prudent when acting as a conduit for client information to make it clear that the lawyer is relying on the client to ensure the truthfulness of the information, and that the lawyer has not conducted any independent investigation to confirm that the information is, in fact, true.

8.2.2 Written Representations

Business lawyers frequently draft documents in which the client makes various representations and warranties relating to a company’s property, operations, financial condition, claims history, and legal compliance. (Disclosure under the securities laws is discussed in Sections 11.1 and 11.2 below.) If a representation turns out to be false or misleading, often because the client has misled the lawyer, the nonclient that relied on it may sue the lawyer who drafted the document. The causes of action are similar to those described in Section 2.1.1 above, including fraud, conspiracy to commit fraud, aiding and abetting fraud, and aiding and abetting a breach of fiduciary duty by corporate actors.
Lawyers who prepare documents that include client representations should be clear with the client about the division of responsibility between the client, the lawyer, and any other advisors for drafting the representations and related disclosure schedules and about what due diligence, if any, the firm will be expected to do to verify their accuracy or sufficiency. If the client will be primarily responsible for due diligence, the lawyer may want to provide guidance to the client on its internal procedures. The lawyer should also document his or her reliance on information provided by the client or others. A lawyer who suspects that a client’s disclosure is false or misleading should advise the client regarding the client’s disclosure obligations. If the client refuses to follow the lawyer’s advice about disclosure even though the lawyer believes that failure to make changes will result in a violation of the company’s fiduciary obligations, the lawyer should make a written record of the advice and the client’s decision not to follow it, and should discuss with the firm’s loss prevention partner what additional action may be required under applicable law and rules of professional conduct.

8.2.3 Agreed Reliance by Third Parties

Clients sometimes ask lawyers to provide their work product to nonclients that want to rely on it in connection with their participation in the transaction. For instance, a firm may conduct due diligence for a client as part of its work for the client’s acquisition of another company. The lender financing the acquisition may want a copy of the firm’s conclusions for use in fulfilling its own due diligence obligation on the transaction, conducting independent investigation only on matters not covered by the firm’s work. If problems with the acquisition arise after the closing, the lender may bring claims against the law firm for misrepresentations or omissions in the information that it provided to the lender. In any circumstance where a third party will rely on a firm’s due diligence report, the report and any limitations on reliance should be subject to the same second partner review as the firm requires for legal opinions. Because the work is being given to a nonclient, the firm should also consider limiting its liability with respect to the nonclient’s reliance.

8.2.4 Audit Response Letters

Lawyers communicate with nonclients when they respond to an outside auditor’s request for a lawyer’s assessment of the risks to the company from pending or overtly threatened litigation, or from contractually assumed obligations or unasserted possible claims upon which the client has specifically requested comment to the auditor, which the auditor will use in determining whether the company has sufficient reserves for loss contingencies. If any information from the lawyer is inaccurate, the lawyer could face liability for misleading an auditor in violation of SEC Rule 13b2-2(b), 17 C.F.R. § 240.13b2-2(b). See Section 11.3.2 below. Business lawyers need to have a clear understanding of the requirements and protocols associated with responses to auditors request for information.

Section 9 Attorney-Client Privilege

All lawyers should be generally familiar with the basic tenets of the attorney-client privilege. Because the privilege is an evidentiary rule that plays out in litigation, however, many nonlitigators have only a cursory understanding of its nuances and may fail to appreciate how it applies, and can be lost, in commercial and transactional settings. Although an in-depth discussion of the privilege is beyond the scope of this tab, we will offer some insights that may be helpful to business lawyers. Attorney-client privilege is also discussed in Section 10 below with respect to change of control transactions. Edna Selan Eptstein, The Attorney-Client Privilege and the Work-Product Doctrine (5th ed. 2007, with 2012 supplement), is a good treatise on the attorney-client privilege.

Although one might not realize it based on the number of documents and e-mails that bear a privilege legend, simply labeling a document or e-mail as privileged does not make it so. Broadly speaking, the privilege applies to communications between a lawyer and a client made in confidence for the purpose of seeking or giving legal advice. It is the client’s to assert or waive. See, e.g., Restatement § 68. What does this mean for business lawyers?
1. The privilege protects against disclosure of communications, including documents embodying them, not of underlying factual matters. Thus, information that may be confidential under Model Rule 1.6, such as the identity of a client, may not be privileged. See United States v. Jenkens & Gilchrist, 2004 U.S. Dist. LEXIS 6919, at *1–2, 2004 WL 870824, at *1 (N.D. Ill. Apr. 20, 2004) (law firm compelled to reveal identity of clients who participated in tax avoidance schemes). Further, although a communication containing facts may be privileged, the facts themselves are not privileged if discoverable by other means.

2. The communication must be between the lawyer, or his or her agent, and the client. Who constitutes “the client” in an organizational setting varies by jurisdiction. Federal law and many states apply a subject matter test that generally protects communications with a company’s employees at any level if made at the direction of a superior for the purpose of securing legal advice for the company and within the scope of the employee’s responsibilities. See Upjohn Co. v. United States, 449 U.S. 383, 394–95 (1981). Some states follow the more restrictive “control group” test that limits the privilege to communications with employees who control the company or can act on the requested legal advice. See, e.g., Consol. Coal Co. v. Bucyrus-Erie, 432 N.E.2d 250, 254–55 (Ill. 1982). Although it is not always possible to know in advance what jurisdiction’s law will apply, lawyers should be careful, and should warn their clients, about communications with employees who may not be covered by the privilege.


4. The communications must be made to or by the lawyer acting in his or her capacity as a lawyer, making it imperative that a lawyer-director clarify his or her role in any communications with the client.

5. A significant concern in business representations is maintaining the confidentiality of privileged communications. As noted above, even if a communication is intended to be confidential, it will not be protected if “outsiders” are included in the conversation. For example, some courts have held that providing privileged information to a public relations professional for purposes of obtaining media advice on a legal matter can vitiate the privilege even if the public relations firm was hired by the lawyer. See Calvin Klein Trademark Trust v. Wachner, 198 F.R.D. 53, 54–55 (S.D.N.Y. 2000). In a sale or investment transaction, allowing a third party to review privileged materials as part of due diligence may constitute a waiver unless the parties can show that the common interest doctrine applies, which may require that there be a common legal, as opposed to business, interest in sharing the information. Compare Santella v. Grizzly Indus., Inc., 2012 U.S. Dist. LEXIS 158348, at *6–7, 2012 WL 5399918, at *2 (D. Or. Nov. 5, 2012) (inclusion of privileged information in offering materials distributed to multiple potential investors waived privilege) with Tenneco Packaging Specialty and Consumer Prods., Inc. v. S.C. Johnson & Son, Inc., 1999 U.S. Dist. LEXIS 15433, at *7–8, 1999 WL 754748, at *2 (N.D. Ill. Sept. 14, 1999) (limited disclosure of patent opinion to purchaser in final stage of asset acquisition did not constitute waiver). See also OXY Res. LLC v. Superior Court, 115 Cal. App. 4th 874, 899–900 (2004) (discussing common interest doctrine among transaction participants when litigation is anticipated).

6. In joint representations, communications relating to the representation may not privileged as between co-clients, although they remain so against outsiders to the representation. Because the
state of the law on control of the privilege in joint representations is unsettled, in situations where it could be an issue (such as joint representation of a corporation and an employee), it is best to specifically address the issue in the joint engagement agreement.

7. As discussed in Section 10 below, a merger or sale transaction can affect who controls the privilege with respect to preclosing communications. Lawyers must be aware of the possible consequences when representing buyers and sellers in these transactions.

8. Separate from the attorney-client privilege (and except in California), the work product doctrine only protects materials and mental impressions created in anticipation of litigation. See Fed. R. Civ. P. 26(b)(3). It will not protect documents prepared in connection with commercial transactions unless they relate to anticipated litigation.

The above discussion only scratches the surface of the ways in which the attorney-client privilege can impact business lawyers and their clients. Lawyers representing clients in business matters must have a sufficient understanding of these principles to adequately protect clients in securing and maintaining the privilege. When a question arises, lawyers should seek advice from colleagues, including their loss prevention partner, who are more familiar with the intricacies of the privilege.

Section 10 Change of Control Transactions

A sale or other change of control transaction involving a client raises a host of potential liability issues for business lawyers. A sale transaction implicates three critical facets of the attorney-client relationship: (1) privilege and confidentiality, if the right to assert the attorney-client privilege or access lawyer work product relating to presale matters is at issue; (2) conflicts of interest, if the seller’s lawyer wants to represent either the buyer or the seller after the sale; and (3) malpractice, if the buyer sues the seller’s lawyer with respect to legal services rendered preclosing. Lawyers need to understand the effect of a sale on privilege, confidentiality, and conflicts to protect the interests of their clients during the negotiation and documentation of the transaction.

10.1 Changes in Management

Because a lawyer engaged by an entity represents the entity acting through its duly authorized constituents (usually its senior management), a change in management does not, in and of itself, change the attorney-client relationship. This holds true regardless of whether the change in management occurs as a result of the entity’s bankruptcy or other involuntary change in control. See Commodity Futures Trading Comm’n v. Weintraub, 471 U.S. 343, 351 (1985) (bankruptcy trustee, rather than debtor’s directors, controlled debtor’s attorney-client privilege with respect to prefiling communications).

10.2 Stock Sales

When a company is sold, courts have grappled with whether the form of the transaction, i.e., a stock sale, a merger or an asset sale, should affect the result. There is little doubt that the Weintraub articulation of the effect on the attorney-client relationship applies in the context of a stock sale. See, e.g., Goodrich v. Goodrich, 960 A.2d 1275, 1281–83 (N.H. 2008). As illustrated by Bronco Hazelton Co. v. Bryce Downey & Lenkov LLC, 2011 U.S. Dist. LEXIS 100832, 2011 WL 3924167 (S.D. Ind. Sept. 7, 2011), however, the issue can become muddled when a lawyer represents both the selling shareholders and the company being sold. In that case, a law firm represented the sellers in the sale but did certain things to suggest that it was also representing the target companies, including issuing a legal opinion as corporate counsel to the companies and billing one of the targets for its work. When the targets subsequently failed, the buyer and the targets sued the law firm, claiming that it breached its fiduciary duty by refusing to turn over its files on the acquisition and by favoring the interests of the sellers over the interests of the targets in the joint representation. The law firm contended that it had only represented the interests of the sellers in the transaction. The court disagreed and allowed the plaintiffs to proceed with their suit for return of legal fees paid by the targets and damages occasioned by the firm’s refusal to turn
over its files. To make matters worse, in a subsequent decision, the court held that the plaintiffs could assert a claim for common law deceit based on the firm’s statement in the legal opinion that it was acting as corporate counsel to the targets in the acquisition. See Bronco Hazelton Co. v. Bryce Downey & Lenkov LLC, 2011 U.S. Dist. LEXIS 146261, at *12–14, 2011 WL 6399511, at *4–5 (S.D. Ind. Dec. 20, 2011). This result might have been avoided if the firm had thoughtfully considered and documented who it was representing at the outset of the engagement, and had confirmed its actions accordingly.

10.3 Mergers

The leading case in the merger context is Tekni-Plex, Inc. v. Meyner & Landis, 674 N.E.2d 663 (N.Y. 1996), where the law firm that jointly represented a company (old Tekni-Plex) and its selling shareholder in the transaction had previously represented the company in its business operations and the shareholder in personal matters. In the transaction, old Tekni-Plex was merged into a new company formed by the buyer (new Tekni-Plex) that continued the business of old Tekni-Plex. New Tekni-Plex subsequently asserted a claim against the seller under the merger agreement. When the seller retained the law firm to represent him, new Tekni-Plex moved for disqualification, asserting that it was a former client that the firm had represented in a substantially related matter. The court agreed, holding that: “When ownership of a corporation changes hands, whether the attorney-client relationship transfers as well to the new owners turns on the practical consequences rather than the formalities of the particular transaction.” 674 N.E.2d at 668.

In addition, the court ruled that new Tekni-Plex controlled the attorney-client privilege relating to the firm’s communications with old Tekni-Plex regarding presale operations and ordered the firm to turn over its presale files to new Tekni-Plex. The court did conclude, however, that confidential information relating to the sale transaction itself should not be provided to the buyer because the firm had jointly represented the company and the seller in the transaction. Id. at 672. See also Girl Scouts-W. Okla., Inc. v. Barringer-Thomson, 252 P.3d 844, 847–48 (Okla. 2011) (lawyer who represented merged entity in premerger matters must transfer files to surviving entity in merger); Venture Law Grp. v. Superior Court, 118 Cal. App. 4th 96, 103–105 (2004) (attorney-client privilege of merged corporation belongs to successor corporation). But cf. In re Cap Rock Elec. Coop., Inc., 35 S.W.3d 222, 228–30 (Tex. Ct. App. 2000) (events subsequent to merger indicated that former client had ceased operating as business and there was no continuing attorney-client relationship deserving of protection).

As illustrated by Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP, 80 A.3d 155, 158–60 (Del. Ch. 2013), Tekni-Plex is consistent with the law regarding the effect of a merger on the merged entity’s assets, liabilities, rights, and privileges generally. In Great Hill, the court held that the attorney-client privilege passes to the surviving corporation in the merger as a matter of statutory law, including preclosing communications between the sellers and counsel relating to the transaction itself. The court suggested that the parties could have, but did not, negotiate special contractual agreements to prevent certain aspects of the privilege from transferring to the surviving corporation.

10.4 Asset Sales

Courts have reached disparate results when a sale is structured as an asset transfer. Although Tekni-Plex recognized that a “mere transfer of assets” does not affect ownership of the attorney-client privilege, a number of courts have relied on the “practical consequences” test of Tekni-Plex to find that the attorney-client relationship can transfer from a seller to a buyer in an asset sale, at least when the transaction involves the sale of an ongoing business. See Tekni-Plex, 674 N.E.2d at 133; Graco Children’s Prods., Inc. v. Regalo Int’l LLC, 1999 U.S. Dist. LEXIS 11392, at *25–26, 1999 WL 553478, at *8 (E.D. Pa. July 29, 1999) (defendant’s lawyer disqualified after plaintiff acquired relevant assets of company that lawyer had previously defended in substantially related matter despite seemingly compelling argument that lawyer had not, in fact, switched sides because in both cases he represented defendant in an infringement action brought by plaintiff); Soverain Software LLC v. Gap, Inc., 340 F.

The court in Postorivo v. AG Paintball Holdings, Inc., 2008 Del. Ch. LEXIS 17, 2008 WL 343856 (Feb. 7, 2008), went even further in divvying up the right to control the attorney-client privilege. There, a company sold substantially all of its assets to the buyer but retained a specified asset and its associated rights and privileges. In subsequent litigation, the buyer and seller agreed, with the concurrence of the court, that: (1) the buyer controlled the attorney-client privilege with respect to communications relating to pre-closing business operations; and (2) the seller controlled the privilege with respect to communications relating to the acquisition transaction itself. The court, applying New York law, held that under the “practical consequences” test the seller also controlled the privilege for communications relating to the retained asset, a result consistent with the parties’ intent as expressed in the sale agreement. Compare In re I Successor Corp., 321 B.R. 640, 654–58 (Bankr. S.D.N.Y. 2005), with Am. Int’l Specialty Lines Ins. Co. v. NWT-I, Inc., 240 F.R.D. 401, 406–09 (N.D. Ill. 2007), on whether multiple successors to a bankrupt company can control the privilege with respect to different assets of the debtor.

Not every court has been willing to find a transfer of the attorney-client privilege in connection with a sale of assets, or to give effect to the parties’ expressed intent. In Zenith Elecs. Corp. v. WH-TV Broad. Corp., 2003 U.S. Dist. LEXIS 13816, at *5–7, 2003 WL 21911066, at *1–2 (N.D. Ill. Aug. 7, 2003), the court held that the transfer of assets constituting an operating division did not transfer the attorney-client privilege even though the seller had delivered all of the documents relating to the division to the buyer and the agreement stated that all rights and privileges transferred to the buyer. The court concluded that the attorney-client privilege is not a property right that can be sold.

Conflicts of interest can also arise when a lawyer who represents a company before its sale continues to represent it after the sale. If the lawyer jointly represented the company and its owner in the sale, the lawyer likely will not be able to represent either the buyer or the seller in a later dispute relating to the sale. But see Russell-Stanley Holdings, Inc. v. Buonanno, 210 F. Supp. 2d 395, 398 (S.D.N.Y. 2002) (court denied buyer’s motion to disqualify seller’s lawyer where seller continued to supervise lawyer’s ongoing work on behalf of sold company and was privy to any confidential information lawyer obtained in postsale representation). But a lawyer who represented the acquired company, not the seller, both before and after the sale, may be able to represent the company in an action against the former owner. Cf. Lane v. Chowning, 610 F.2d 1385, 1389 (8th Cir. 1979) (lawyer for entity can participate in majority shareholders’ efforts to oust chairman). Nevertheless, there is little authority on the issue, so it is not free from doubt.

The question of whether a buyer can sue the selling company’s former lawyer for malpractice is complicated by the fact that many jurisdictions do not permit the assignment of malpractice claims on public policy grounds. For example, in Revolutionary Concepts Inc. v. Clements Walker PLLC, 744 S.E.2d 130, 138 (N.C. Ct. App. 2013), North Carolina joined the majority of courts holding that legal malpractice claims are unassignable. Thus, a patent owner’s attempt to assign his malpractice claim in connection with the assignment of the underlying patent was invalid. See also Gen. Sec. Ins. Co. v. Jordan, Coyne & Savits, LLP, 357 F. Supp. 2d 951, 959–60 (E.D. Va. 2005) (company that assumed affiliate’s operations could not bring suit against affiliate’s counsel because Virginia prohibits assignment of malpractice claims); Greene’s Pressure Treating & Rentals, Inc. v. Fulbright & Jaworski, L.L.P., 178 S.W.3d 40, 44–45 (Tex. Ct. App. 2005) (buyer of patent could not assert malpractice claim against firm that issued noninfringement opinion to prior owner of patent and then represented competing patent owner in infringement action against buyer).
Several courts have reached the opposite conclusion, however, when the assignment occurs in the context of a commercial transaction. In *St. Luke’s Magic Valley Reg’l Med. Ctr. v. Luciani*, 293 P.3d 661, 664–65 (Idaho 2013), the Idaho Supreme Court, in responding to a certified question from the federal district court, examined whether a purchaser of a hospital could assert a malpractice claim against a lawyer who had represented the hospital in litigation that was ongoing at the time of the acquisition and for which the purchaser assumed liability. After surveying the law in other states, the court held that “while malpractice claims are generally not assignable, where the legal malpractice claim is transferred to an assignee in a commercial transaction, along with other business assets and liabilities, such a claim is assignable.” *Id.* at 667. The district court subsequently ruled that a provision in the sales contract transferring all of the hospital’s property and interests to the purchaser was sufficient to transfer the malpractice claim. *St. Luke’s Magic Valley Reg’l Med. Ctr. v. Luciani*, 2013 U.S. Dist. LEXIS 143020, at *14–20, 2013 WL 5486863, at *5–6 (D. Idaho Sept. 30, 2013).


### 10.5 Loss Prevention Suggestions

What lessons should a business lawyer take away from these cases? First, when representing an entity, even a closely held company, a lawyer should render services with an awareness that someone other than current management may control the entity in the future and, as such, may have the rights of a current or former client in relation to the lawyer. A lawyer should not assume that a close relationship with the owner or senior management of a client will protect him or her against a malpractice claim by a less friendly successor.

Second, when a lawyer represents a party to a sale transaction, the lawyer must consider the effect of the transaction on the existing attorney-client relationship, including the effect on the lawyer’s duties of confidentiality and loyalty to the client and the client’s right to assert the attorney-client privilege following the transaction. This is important for the protection of the client, as well as the lawyer. Questions that a lawyer may want to consider:

1. In a sale transaction, who should the lawyer represent—the entity being sold, its owners, or both? Potential conflict and postclosing issues should be evaluated at the outset of the engagement and the identity of the client(s) clearly established.

2. What jurisdiction’s law will likely apply, recognizing that the decisional law on these issues is not uniform?

3. What rights of the client need to be protected? For example, if the client is the seller, it will want to protect the confidentiality of its attorney-client communications regarding the transaction. The client may also want to maintain the confidentiality of documents with respect to retained assets or liabilities or protect its right to engage the lawyer in a postclosing dispute with the buyer. Conversely, if the client is the buyer, it may want to be able to assert those rights with respect to preclosing matters that affect the ongoing operations of the business.

4. If a lawyer represents the selling entity in business matters, will the buyer want the lawyer to continue as counsel to the business? If so, will that representation create a conflict of interest between duties owed to the seller and to the buyer? The answers to these questions may impact
whom the lawyer should represent in the transaction (for example, whether the lawyer should represent both the company and a selling shareholder or just one of them).

As evidenced by the cases noted above, although some courts have refused to permit the parties to a transaction to agree upon which of them should control the attorney-client privilege going forward, or to “slice and dice” the privilege, others have been more receptive to such agreements. Further, apart from assigning the attorney-client privilege, there is no reason the parties should not be able to agree on matters, such as access to documents, confidentiality, and the right to future legal representation. Business lawyers should discuss these issues with their clients and address them in the transaction documents, being mindful of any boilerplate language that a party may look to after the fact to bolster an argument that is not consistent with the parties’ intent.

Section 11 Securities Practice

Several of the largest claims ever experienced by ALAS firms have arisen from the securities practice. We see the same primary drivers of claims against securities lawyers as we do in other practices: unworthy clients, conflicts, and mistakes. Yet, more than in any other practice, securities lawyers face claims by third parties seeking to recover money they invested with the lawyer’s clients. This characteristic of the practice can expose securities lawyers to the risk of substantial liability.

11.1 Lawyer Liability under Federal Securities Laws

Several provisions of the federal securities law theoretically provide a basis for claims against securities lawyers. We focus on Section 10(b) of the Securities Exchange Act of 1934, codified as amended at 15 U.S.C. § 78j(b) (2012), because until a series of Supreme Court decisions dramatically curtailed its reach, Section 10(b) provided the most commonly used basis for large, third-party claims against securities lawyers. Even after those decisions, however, some risk remains under Section 10(b) and other provisions of the federal securities laws.

11.1.1 Section 10(b) of Securities Exchange Act

In pertinent part, Section 10(b) makes it unlawful to “use or employ any deceptive device or contrivance in contravention of” certain rules and regulations prescribed by the SEC. Promulgated pursuant to Section 10(b), SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (2012), makes it unlawful for anyone, directly or indirectly, in connection with the purchase or sale of a security:

(a) to employ any device, scheme, or artifice to defraud,

(b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Thus, provided that the other elements are satisfied, Section 10(b) and Rule 10b-5 prohibit fraudulent schemes, false or misleading statements, and deceptive conduct.

Before the Supreme Court decided Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994), claims against securities lawyers typically alleged that by drafting periodic SEC filings or other documents containing false or misleading statements, the lawyer aided and abetted a client’s primary violation of Section 10(b). Central Bank put an end to this tactic by holding that Section 10(b) does not authorize private litigants to bring aiding and abetting claims. Id. at 177.

After Central Bank, plaintiffs tried to hold lawyers liable as primary violators by alleging that they engaged in deceptive conduct or participated in a scheme to defraud investors. Known as “scheme liability,” this theory often targeted lawyers who structured and documented transactions that turned out
to be fraudulent. In Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148, 159–64 (2008), the Supreme Court severely restricted “scheme liability.” In that case, plaintiffs sought to hold two companies liable for participating in sham transactions that enabled an issuer to overstate its revenues. Although the Court found that defendants’ conduct was deceptive, it rejected the claims. The Court reasoned that because “[n]o member of the investing public had knowledge, either actual or presumed, of [defendants'] deceptive acts during the relevant times,” plaintiffs could not establish the element of reliance. Id. at 158–59.

Applying Stoneridge, the Third Circuit barred class certification of securities fraud claims against a law firm where the allegedly fraudulent conduct was not publicly attributed to the firm. See In re DVI, Inc. Sec. Litig., 639 F.3d 623, 649 (3rd Cir. 2011). There, the shareholders of a bankrupt company sued the company’s law firm, among other defendants, alleging that the firm assisted the company’s officers and directors in drafting fraudulent SEC filings. The complaint alleged that although the company had provided the law firm with a draft Form 10-Q disclosing material weaknesses in the company’s internal controls, a firm lawyer devised a scheme to avoid disclosing the weaknesses. The court held that to invoke the presumption of reliance against a secondary actor in a scheme liability case, a plaintiff “must show the deceptive conduct was publicly attributed to that secondary actor.” 639 F.3d at 648. Because plaintiffs did not assert that the firm’s alleged role in masterminding the fraudulent 10-Q was disclosed to the public, they could not invoke the presumption. Subsequently, the trial court granted the firm’s motion for summary judgment in light of plaintiffs’ failure to offer any evidence that the allegedly false statements were publicly attributed to the law firm. In re DVI, Inc. Sec. Litig., 2013 U.S. Dist. LEXIS 1259, at *36–37, 2013 WL 56073, at *8 (E.D. Pa. Jan. 4, 2013).

After Stoneridge, plaintiffs returned to challenging the role lawyers and other advisors sometimes play in preparing false and misleading statements. Barred from bringing an aiding and abetting claim by Central Bank, plaintiffs alleged that advisors should be held liable as primary violators when they are significantly involved in creating misstatements. The Supreme Court rejected that argument in Janus Capital Group., Inc. v. First Derivative Traders, 131 S. Ct. 2296 (2011). There, shareholders of a mutual fund alleged that the fund’s investment advisor caused the fund to make false statements in its prospectuses. In a five-to-four decision, the Court held that under Rule 10b-5, primary liability for misstatements is restricted to those who “make” the challenged statement, and that “making” a statement requires having ultimate authority over its content and whether and how to communicate it. Id. at 2302. The Court reasoned that although the investment adviser may have been significantly involved in preparing the prospectuses, it did not itself “make” the statements at issue for Rule 10b-5 purposes, as the content and dissemination of the statements remained subject to the fund’s ultimate control. As the same usually can be said when lawyers prepare documents for their clients, Janus Capital makes it significantly more difficult, if not impossible, to hold lawyers primarily liable under Rule 10b-5 for their role in preparing disclosure documents.

Although Central Bank, Stoneridge, and Janus Capital preclude many Section 10(b) claims against lawyers, some risk remains. Perhaps most significantly, Central Bank’s ban on aiding and abetting claims applies only to private litigants. The SEC remains free to pursue that theory. See, e.g., SEC v. Greenstone Holdings, Inc., 2013 U.S. Dist. LEXIS 97107, at *1, 2013 WL 3481551, at *1 (S.D.N.Y. July 10, 2013) (noting that during prior oral argument, court granted SEC’s motion for summary judgment against lawyer for aiding and abetting Section 10(b) violation). In addition, Janus Capital does not preclude claims against lawyers for false or misleading statements explicitly authored by them, such as opinion letters. Moreover, even after Stoneridge, lawyers still may be sued for deceptive conduct that is publicly attributed to them. See DVI, 639 F.3d at 648.

11.1.2 Other Provisions of Federal Securities Laws

Depending on the circumstances, lawyers may face claims by private litigants or the SEC under numerous additional provisions of the federal securities laws. The most frequently encountered claims

In general, Section 11 prohibits false or misleading statements in any portion of a registration statement. In contrast to Section 10(b), which applies to “anyone,” Section 11 provides a cause of action against certain specified types of persons. Ordinarily, lawyers face Section 11 claims in only two situations: (1) when they “expertise” a statement within the meaning of the statute, which for lawyers typically means rendering a legal opinion contained in or used in connection with a registration statement; or (2) when they serve as a director of the issuer. 15 U.S.C. § 77k(a)(4).

Section 12 creates certain causes of action against the “seller” of securities. Lawyers do not qualify as “sellers” just by providing typical legal services. See, e.g., Wilson v. Santine Exploration and Drilling Corp., 872 F.2d 1124, 1127 (2d Cir. 1989). Soliciting purchases of securities may prompt a Section 12 claim, however. See Pinter v. Dahl, 486 U.S. 622, 647 (1988) (Section 12 liability extends to one who solicits purchases for personal benefit or to serve the owner’s financial interests). Accordingly, lawyers should take great care when communicating with prospective purchasers. At a minimum, lawyers should refrain from promoting or encouraging the transaction. Some authorities even counsel against merely “passing along” offering documents to potential investors. See Mark Steinberg, Corporate and Securities Malpractice, p. 56 (1992) (characterizing such communications as “an unnecessary risk for counsel to incur”).

Section 14(a) prohibits material misrepresentations and omissions in proxy statements and other communications soliciting consent or authorization from shareholders. Typically, Section 14(a) claims against lawyers involve a legal opinion rendered by the lawyer that is contained in a proxy statement. Lawyers should note that Section 14(a) sweeps broadly, however, and can apply in merger transactions and routine matters such as uncontested elections of directors. See, e.g., Weisberg v. Coastal States Gas Corp., 609 F.2d 650, 652–54 (2d Cir. 1979).

11.2 Lawyer Liability under State Securities Laws

Securities lawyers may face claims under state securities law in addition to or instead of claims under federal securities laws. As state securities laws vary widely, a comprehensive review of them is beyond the scope of this publication. Instead, this section highlights key issues involving state securities laws.

At the outset, lawyers should not presume that state securities claims are preempted by federal law. Although the Securities Litigation Uniform Standards Act of 1998 (SLUSA), Pub. L. No. 105-353, 112 Stat. 3227 (codified at amended in scattered sections of 15 U.S.C.) (2012), preempts most state law securities class actions relating to nationally traded securities, not all such actions fall within SLUSA. See, e.g., Chadbourne & Parke LLP v. Troice, 2014 U.S. LEXIS 1644, 2014 WL 714697 (Feb. 26, 2014) (Supreme Court holding that SLUSA did not bar claims against law firm for allegedly aiding client’s fraudulent sale of certificates of deposit (CDs) because CDs are not “covered” securities under SLUSA). Moreover, institutional investors and other shareholders still may bring individual actions under state law, as may investors in private placements.

In addition, some states continue to allow aiding and abetting claims, including claims alleging that lawyers aided and abetted their clients’ primary violations of state securities law. For example, in Houston v. Seward & Kissel, LLP, 2008 U.S. Dist. LEXIS 23914, 2008 WL 818745 (S.D.N.Y. Mar. 27, 2008), a New York law firm drafted offering materials for a hedge fund. After the fund was placed into receivership, an Oregon resident sued the firm under Oregon law, alleging that the firm aided and abetted the fund’s securities fraud. Although Stoneridge and Central Bank would bar such claims under federal securities laws, the district court denied the motion to dismiss it. See id. at *38, *10.
Although several states allow aiding and abetting claims, suits under Oregon and Oklahoma securities laws can be particularly treacherous. The Oregon statute makes a secondary actor jointly and severally liable with the seller if she “participates or materially aids” in the sale of the subject security unless she “sustains the burden of proof that [she] did not know, and, in the exercise of reasonable care, could not have known, of the existence of facts on which the liability is based.” Or. Rev. Stat. § 59.115(3) (2013). Oklahoma’s securities law contains an almost identical provision. See Okla. Stat. tit. 71, § 1-509G(5) (2012). The ALAS claims experience with the Oregon and Oklahoma statutes indicates that, with the benefit of hindsight, it can be difficult to establish that a lawyer in the exercise of reasonable care could not have known of her client’s securities law violation. Therefore, claims brought under these statutes can be extremely dangerous.

Moreover, several states impose liability based on a defendant’s status as a partner, officer, or director, without requiring defendant’s participation in the sale of the subject security. See, e.g., Kirchoff v. Selby, 703 N.E.2d 644, 651 (Ind. 1998) (interpreting Indiana Securities Act). In many of these states, liability is strict unless the defendant meets the burden of proving lack of knowledge of the facts giving rise to the claim. See, e.g., Taylor v. Perdition Minerals Group, Ltd., 766 P.2d 805, 809 (Kan. 1988). This risk provides an additional reason for firms to be cautious about allowing their lawyers to serve on boards.

11.3 SOX and Related Issues

SOX covers a broad spectrum of subjects relating to the governance, finances, and disclosure obligations of public companies. As discussed below, SOX contains three provisions of particular relevance to lawyers.

11.3.1 Reporting Obligations under SEC Rule 205

Pursuant to Section 307 of SOX, 15 U.S.C. § 7245, the SEC adopted SEC Rule 205, 17 C.F.R. pt. 205. See also Securities Exchange Act Release No. 47276, available at www.sec.gov/rules/final/33-8185.htm (last visited Jan. 13, 2014) (adopting SEC Rule 205). In very brief summary, Rule 205 requires a lawyer “appearing and practicing before the Commission” who becomes aware of “evidence of a material violation” of the securities laws, of a breach of fiduciary duty, or of a similar violation by an issuer-client or any of its agents, to report that evidence to the issuer’s chief legal officer or to both the chief legal officer and the CEO. If the reporting lawyer “reasonably believes” that the client has not made “an appropriate response within a reasonable time,” the lawyer must report further up the line to the issuer’s audit committee, an independent board committee, or the issuer’s board. Rule 205 contains provisions regarding the duties of subordinate and supervising lawyers, as well as reporting exceptions for lawyers retained by an issuer to conduct an internal corporate investigation about evidence of a material violation. Rule 205 does not require either mandatory withdrawal or “reporting out” obligations. Lawyers who are considering reporting misconduct pursuant to Rule 205 also should consider the rules of professional conduct in the relevant jurisdictions.

The SEC has made clear that it expects law firms “to put in place procedures to comply with [Rule 205’s] requirements.” See SEC Adopts Attorney Conduct Rule Under Sarbanes-Oxley Act, SEC News Release 03-13, 2003 WL 164827 (Jan. 23, 2003). As a result, ALAS encourages firms to adopt a policy regarding compliance with Rule 205 and other provisions of SOX applicable to lawyers. The firm should provide training for all firm lawyers on their obligations under SOX. Given the complexity of interpreting and applying the rules, firms may find it desirable to appoint a committee of lawyers with experience in the areas of internal investigations and securities compliance to advise the firm and individual lawyers on SOX compliance.

11.3.2 Communicating with Auditors

Section 303(a) of SOX, 15 U.S.C. § 7242, and related SEC Rule 13b2-2(b), 17 C.F.R. § 240.13b2-2(b), also have important implications for lawyers. Section 303(a) makes it unlawful “for any officer or director of an issuer, or any other person acting under the direction thereof, to take any action to
fraudulently influence, coerce, manipulate, or mislead” any accountant auditing the issuer’s financial statements “for the purpose of rendering such financial statements materially misleading.” Rule 13b2-2(b) implements Section 303(a). The Commission’s Release adopting Rule 13b2-(b), Improper Influence on Conduct of Audits, SEC Release No. 34-47890, 68 Fed. Reg. 31820-01 (May 28, 2003), includes important commentary on its interpretation of Section 303(a). The SEC interprets the statutory phrase “under the direction” to encompass a broader category of behavior than “supervision,” and points out that persons acting “under the direction” of an issuer’s officer or director could include partners or employees of the issuer’s law firm or accounting firm, as well as other “securities professionals.” Release No. 34-47890 at 31822. Rule 13b2-2(b) also provides that fraudulent intent need be shown only in the case of attempts to “influence” auditors, but not in the case of efforts to “coerce, manipulate, or mislead” them. Id. at 31820. Finally, the Commission’s rule specifies that the “purpose” requirement of Section 303(a) is satisfied if the actor “knew or should have known” that his or her conduct could render the issuer’s financials materially misleading. The commentary acknowledges that this formulation “historically has indicated the existence of a negligence standard.” Id. at 31826

The SEC’s commentary contains a number of examples of conduct that could violate SEC Rule 13b2-2(b) if the actor knew, or should have known, that the conduct could render an issuer’s financial statements materially misleading. Of most interest to lawyers is the example of “[p]roviding an auditor with an inaccurate or misleading legal analysis.” Neither the rule nor the commentary appears to require that the lawyer have known that the analysis was inaccurate or misleading.

Section 303(a) and SEC Rule 13b2-2(b) increase the risks that can arise from a lawyer’s discussions or written communications with auditors outside of the formal response to the auditors’ request letter, and firms should be sensitive to these increased risks.

11.3.3 Whistleblowing

In 2010, Congress enacted The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (codified as amended in scattered sections 12, 15 U.S.C.) (2012) (Dodd-Frank). Among many other things, Dodd-Frank amended SOX’s whistleblower provisions. On May 25, 2011, the SEC adopted final rules implementing these provisions. See Securities Whistleblower Incentives and Protections, SEC Release No. 34-64545, 76 Fed. Reg. 34300 (June 17, 2011) [hereinafter Adopting Release]. The rules require the SEC to pay substantial bounties to those who provide information about violations of the securities laws. Lawyers should be aware, however, that the rules preclude whistleblowers from receiving a reward for disclosing information obtained through a privileged communication or in connection with the legal representation of a client by the whistleblower or the whistleblower’s firm. SEC Rule 21F-4(b)(4)(i), (ii). These exclusions apply unless disclosure would otherwise be permitted pursuant to the following exceptions:

1. SEC Rule 205.3(d)(2), which allows certain disclosures by a lawyer “appearing and practicing before” the SEC in the representation of an issuer;
2. State professional conduct rules; or
3. “Otherwise,” a term not defined in either the rules or the Adopting Release.

Although the rules are written in the disjunctive, the Adopting Release states that the SEC “will not reward attorneys or others for providing us with information that could not otherwise be provided to us consistent with an attorney’s ethical obligations and Rule 205.3.” Adopting Release at 34315 (emphasis added). The Release also states that “there will be no prospect of financial benefit for submitting information in violation of an attorney’s ethical obligations.” Id.

The temptation to reveal confidential client information in exchange for a potential financial bonanza raises significant risks for lawyers and their firms. New York County Opinion 746 (Oct. 7, 2013) concluded that a lawyer may not collect a bounty for blowing the whistle on a client pursuant to the
The opinion reasoned that such bounties pose an inherent conflict of interest. Cf. United States v. Quest Diagnostics Inc., 734 F.3d 154, 165 (2d Cir. 2013) (lawyer violated applicable New York professional conduct rules when he brought qui tam suit against his former employer with respect to matters substantially related to his prior representation of employer). In addition to violating professional conduct rules, disclosing confidential client information potentially could lead to a breach of fiduciary duty claim. See Fremont Reorg. Corp. v. Faigin, 198 Cal. App. 4th 1153, 1175–76 (2011) (former in-house counsel who told insurance authorities about his former employer’s allegedly illegal conduct could be held liable for breach of fiduciary duty and duty of confidentiality). A lawsuit against a whistleblowing lawyer might name the lawyer’s firm as an additional defendant.

11.3.4 New Exchange Issues

In the wake of SOX, some public companies delisted from the major exchanges to avoid SEC scrutiny and the expense of regulatory compliance. Some of those companies have moved to a listing service (OTCQX) organized by Pink OTC Markets, Inc., a provider of pricing and financing information on over-the-counter (OTC) securities markets. The OTCQX is self-described as “the highest tier for companies listed on a non-U.S. exchange that want a cross-listing in the U.S. on a credible market tier, and the highest primary market tier for U.S. companies that trade over-the-counter.” Pink OTC Markets, Overview Brochure, available at https://www.otcquote.com/content/doc/pinkote-overview.pdf (last visited Feb. 6, 2014).

Each OTCQX-listed company must assign a Designated Advisor for Disclosure (DAD) or a Principal American Liaison (PAL) (for companies on International OTCQX). The DAD must be a “reputable” securities lawyer or a “FINRA member investment banking firm.” A PAL must be a FINRA member investment banking firm or ADR bank. Several ALAS firms have been asked to be a DAD for their clients. Acting as a DAD poses significant risks for a law firm. Firms should require management approval before a lawyer agrees to act as a DAD.

11.4 Certifying Accredited Investors under Rule 506(c) of Regulation D

Some lawyers have received requests to verify a client’s status as an “accredited investor” following recent changes to Rule 506 of Regulation D and Rule 144A under the Securities Act of 1933. On July 10, 2013, the SEC amended Rule 506 to allow general solicitation in certain securities offerings. See Eliminating the Prohibition against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, SEC Release No. 33-9415, No. 34-69959, No. IA-3624, 78 Fed. Reg. 44771-01 (July 24, 2013). Under new Rule 506(c), issuers may offer securities through general solicitation provided that all purchasers are “accredited investors,” the issuer takes reasonable steps to verify their accredited investor status, and certain other conditions are satisfied. Banks and certain other entities automatically qualify as “accredited investors” under the Rule, while trusts, other entities, and natural persons must meet the requirements specified in the Rule. For example, a natural person qualifies as an “accredited investor” if she has earned income exceeding $200,000 (or $300,000 together with a spouse) in each of the prior two years and reasonably expects the same for the current year or has a net worth over $1 million, either alone or together with a spouse (excluding the value of her primary residence). Among other methods, Rule 506(c) permits verification through written confirmation from a licensed lawyer stating that he “has taken reasonable steps to verify that the purchaser is an accredited investor within the last three months and has determined that such purchaser is an accredited investor.”

Providing confirmation of “accredited investor” status presents numerous loss prevention issues. For example, determining whether the client meets the definition may require financial analysis beyond the firm’s expertise, particularly when using the net worth method for a client with contingent liabilities. And regardless of the method used, a confirmation that turns out to be inaccurate could expose the firm to claims by the client, the issuer, or both. In addition, a client might argue that by providing the confirmation, the lawyer is agreeing that the proposed investment is suitable for the client from a financial perspective or otherwise placing a stamp of approval on the transaction.
The safer course of action is for firms to decline to provide confirmations. Should the firm decide to provide the service, it should take precautions including: following the guidance provided by the SEC in the release cited above and elsewhere; conducting due diligence on the relevant factual issues, rather than relying on the client’s representations; following the firm’s conflicts and other business intake policies; and carefully delineating the scope of the firm’s work in the engagement letter and disclaiming any obligation to assess the desirability or suitability of the proposed purchase.

Section 12 Conclusion

Corporate, securities, and real estate practices present three major risk areas. First, lawyers may provide various services for clients who turn out to be engaged in wrongdoing. The first line of defense is an effective business intake system that identifies prospective clients and matters that pose significant risks. Once the firm has accepted an engagement, it can minimize risk by clarifying and documenting the responsibilities of the firm and of other parties, explicitly indicating when the firm is relying on representations made or information provided by the client or a third party, and seeking the perspective of other lawyers in the firm not working on the matter when concerns arise. And a firm may periodically want to scrutinize the risks that may be posed by new or ongoing matters for an existing client.

The second area of concern, liability for alleged conflicts, is a particular problem for business lawyers. The potential for claims arising out of joint representation of clients, whether intentional or unintentional, tends to occur more in the corporate and real estate practices than in other areas. Firms need effective systems to address conflicts of interest, both at the outset of a matter and as it develops.

A third risk in these practice areas is the opportunity for mistakes. In large projects, the potential for serious economic harm from such errors is significant. The time-tested methods of double-checking documents, supervising associates and paralegals, and involving lawyers with appropriate expertise in applicable disciplines are as important as ever.
November 2, 2012

Re: Engagement of Services

Dear

You have asked us to represent you and Inc. regarding This letter will replace the letter we previously signed as it contains some language that we need to change.

As we discussed, the primary initial goal of our representation was to obtain a set-over of the trial date of Now that we have accomplished that, we will continue to work on preparing this case. That work has been going on and will continue as time for preparation is short even with the extension.

As you are aware, our initial review of the file materials you provided demonstrates that this case has not been adequately prepared for a trial. There is considerable discovery left to be done, there may need to be experts retained and prepared and we will be starting from next to zero in terms of our preparation. Additionally, I want to be clear that our agreement to help you get this case set over and properly prepared for trial was not and is not an endorsement of your case. I do not yet know enough about your claims and evidence to know whether your claims are likely to succeed even under the best of circumstances. I will commit, however, to advise you as we go concerning my view of the strengths and weaknesses of your case as I get a better grasp on the controlling facts and law.

Our goal is to work collaboratively with you to deliver superior legal services and to make your experience with our firm a positive one. To that end, it is important to clarify both of our responsibilities at the start of this engagement. This engagement letter sets forth the terms and conditions of our representation. If the scope of our engagement changes, this agreement shall continue to govern the relationship between you and our firm.
Enclosed is a copy of the firm’s brochure that sets out in detail our Fee and Billing Policy. Unless otherwise indicated in this engagement letter, the terms and conditions in the Fee and Billing Policy are part of the agreement between you and our firm. Please read this brochure carefully. We are happy to answer any questions about the information it contains.

Our fees will be based upon the standard hourly rates charged by attorneys in the firm during the course of this matter. My current standard rate is [rate] per hour. Where appropriate, other attorneys and paralegals in the office, some of whose rates are lower, also may work on your legal matter. If our rates change, we will provide at least 30 days’ prior written notice before charging the new rates.

In addition to attorney fees, you are responsible for out-of-pocket costs, expenses, and disbursements, as described in the enclosed Fee and Billing Policy brochure. In the event the firm pays for any of these, they will be considered an advance on your behalf which you agree to re-pay to the firm immediately.

If we provide an estimate of your expenses for the handling of this matter, understand that it is only an estimate and not a promise or a cap on your fees and other costs. The final expenses of this engagement are dependent on many factors and developments, not all of which can be foreseen at the time of the estimate. Therefore, although we do our best to help you understand the probable expenses of representation, no estimate we provide can be regarded as binding. We will attempt to revise any estimate we provide as additional developments in the matter warrant.

We will send an itemized statement each month for fees and expenses, which is due and payable on receipt. We understand that there are times when an explanation or clarification on a statement may be needed. If, at any time, there are questions or concerns about your account, please contact me immediately. There is no charge for discussions about your account.

We require that you pay an advance deposit of [amount] before we undertake any work on this matter on your behalf. The advance deposit will be placed in the firm’s lawyers’ trust account. You agree that if the firm’s monthly invoices are not paid when due, the firm may, at its discretion, apply part or all of this advance deposit to the balance due on the account. If that happens and the amount in the account falls under [amount], you will immediately replenish that deposit in the amount so applied in order to keep the deposit at no less than [amount] at all times. We will apply the deposit to the final bill, and any portion of the deposit remaining after that will be returned.

Now that the Court has granted a set-over of the current trial date, and we both agree that we will represent you at trial, we will need an additional deposit at that time to cover the costs associated with trial.
All matters of policy regarding this engagement will be decided jointly, and neither you nor the firm will act without advice to the other. We view each of our relationships with clients as a partnership, and good communication is essential to any effective partnership. In particular, you are responsible for fully and accurately providing the firm and its attorneys with all of the facts and information necessary to the handling and resolution of this matter. You also agree to keep us informed of your current address and telephone number at all times, and to appear at depositions, hearings, trials, or examinations when notified by us. In the event of your failure to appear at any court hearing or trial, however, we are authorized to exercise our discretion to proceed in any manner we see fit, including withdrawing as your attorneys.

Unless otherwise agreed or instructed by you, we routinely communicate with, and sometimes transmit documents to, you and third parties by unencrypted email.

Except under limited circumstances, documents in our files prepared in furtherance of our representation of you are your property. (One exception is if there are unpaid fees or costs at the time our relationship ends, we may retain all documents and other items in your file until we have received full payment for our services, unless the Rules of Professional Conduct require us to take a different course of action.) Under the firm’s document retention and destruction policy, when a file is closed, the original documents provided by you will be returned. We will retain the other documents for a period of ten years, unless you are otherwise notified. At the end of the ten-year period, the file, including all duplicates saved in electronic format, will be destroyed. At your request, we will provide copies of documents in your file at any time until they are destroyed. You will be billed for these copying expenses.

You may discharge us as your attorneys at any time. If you do so, you agree to immediately reimburse us for all costs advanced and fees incurred as of the date you discharge us. In addition, you agree to compensate us for our time and expenses incurred after our discharge for responding to requests for information, and providing copies of any records or materials in connection with our representation.

The law firm may also withdraw as your attorney at any time, so long as in doing so we comply with applicable Rules of Professional Conduct. If we elect to withdraw, we agree to give you reasonable written notice of our intention to withdraw.

The law firm will use its best efforts in representing you. However, we cannot guarantee the outcome of this legal matter, and nothing in this letter or in any conversations with me or any other of the firm’s lawyers is intended, or should be understood, to assure you of a particular outcome.

If you wish to retain us as counsel in this matter, please sign the extra copy of this letter and return it to me in the envelope provided. The original of this letter is for your file. However,
even if you do not sign this letter, if you indicate that we should proceed with this engagement, it will be on the terms and conditions set out in this letter.

Since you have asked us to represent both you and Inc. in this matter, there are a few other items about which you should be informed. The Oregon Rules of Professional Conduct forbid any attorney from representing a client if the representation involves a conflict of interest, except in limited circumstances when a waiver is determined to be appropriate and is given by each affected client. A conflict of interest exists where the representation of one client is “directly adverse” to another or where there is a significant risk that the representation of one or more clients will be “materially limited” by the lawyer’s responsibilities to serve a different client.

Based on the facts known to me to date, you and Inc. are aligned in the same cause and the engagement does not involve any such conflict, that is, any interests by one or the other differs from any interest of the others. If it ever should occur that in order to adequately represent one of you, we would be required to consider interests that one has which different from the other, a conflict of interest as described above might then arise. In such a case, we would be required to withdraw from representing both of you, absent your valid waiver of the conflict, with the result that you may incur attorney fees related to changing your counsel at that time. The process of considering whether any such conflict of interest may or should be waived, questions on which we would ordinarily require you to engage separate counsel to resolve, would moreover itself result in additional legal expense. You have agreed with us that these risks are outweighed by the benefits of joint representation, given that the possibility of their occurrence appears low.

Thank you again for this opportunity to represent you. To help familiarize you with all the legal services we provide, we are enclosing our firm brochure. We take immense pride in the legal services we provide by working collaboratively with our clients. Our goal is to deliver superior legal services to you.
I am taking your requests seriously. Let me try to clarify.

First, my original optimism about the case was based only on your representations about what evidence you had. As you know, the evidence is different in some significant respects than you originally told me. I was unaware of the credibility issues, of the issues related to corporate ownership, of some contradictory statements or positions. I did not understand that there would be gaps in the evidence we would need for ownership and conversion or that there would be evidence that you were repeatedly given access to the warehouse, etc. That does not mean I now believe all the evidence against you, just that I believe some or all of it will be used and could be persuasive against you in trial.

Second, let me go through the categories

Category 1 provides our strongest claim with regard to ownership as that fact has been admitted. You have not identified for us which pictures relate to those items, but for the moment I am going to assume that you could. The problem with this part of the claim are as follows. I understand your evidence which contradicts or explains these problems, so please do not feel it necessary to spell that out again.

1. There is evidence from which a jury could
   in this area is unsettled, but could provide the judge grounds to dismiss the claims before they reach the jury or more likely allow the jury to hold these items were not converted. There are cases
   which are unfavorable to us holding that could also claim that you affirmatively abandoned the
   property which is a slightly different argument and a much harder one for them to make given both the law and the facts.

2. I expect that your credibility will be low for the reasons we have discussed in detail below and both for
   be in question.

3. The total for this category might be capped close to the value based on your representations, if you are
   able to overcome the things above.

4. will argue that you cannot prove that the items in the pictures you can provide are the same items on
   the list as opposed to items which may have been acquired by you or someone else working on behalf of

Category 4 and 5

I’m going out of order because the problems with category 1 apply to these as well. Additionally, if you go item by item, there are problems with the evidence for many of these items.

And, we have not valuation evidence for the majority of items so it is impossible for me to evaluate that other than to say, it will be impacted by the credibility issues discussed above.
Of course, the stronger category are those for which we have evidence of

have that kind of evidence and that is the strongest in the group which is why I used that evidence to try to demonstrate to that we have the evidence we need. The problem is that even if we win on that item, the value would not cover even half of the likely fees moving forward and there is not guaranty even for this item.

All of the factors above work together, but the critical point for these items (assuming you can get us the evidence we have requested) is your credibility problems combined with the issue of access to the warehouse. That combination leads me to believe that you are unlikely to recover the cost of trial moving forward from any of these categories even viewed in combination.

Category 2

I will try not to repeat all I have said about this issue. The primary problem, in addition to the global problems discussed above is that it will be difficult or impossible to show that even when we can prove that money came to the company that should have gone to , you had access to the accounts. Even if you did not, we can not prove what happened to that money, in that we cannot show that it was not taken by someone else or the extent to which . Then there are the issues related to and whether a reasonable person would have believed the company representing itself as . There is also a possibility that the court would find that any that appears to be concern. My primary concern is that I believe you, at the most, had a claim against deal, but cannot prove a conversion claim against . We cannot prove that the money ended up in their accounts or that it was taken from you, at least before you got locked out. Given that, I believe you will lose this claim entirely. The best case scenario is the possible recovery of payments made after you were kicked out that were clearly to go to , but I have not seen that evidence.

Category 3

The positives are that all of the invoices and negotiations were between you and . There appears to be none between . The downside is that paid and we cannot prove the agreement between you and about how to handle those machines. This is a very brief summary of the concerns I have voiced in detail many times. I do not believe you will recover the value of those machines. Your description of what happened has not been consistent and the documents work against you, other than those between you and . I really do not believe I can add anything further to what I have said in the past on this subject. I also note that you are still claiming the , but given your email saying this was a sale taken for along with everything else I have seen, I believe that is the weakest claim of all. So, at a minimum, this category should be reduced by that amount and I would not advise even making that claim at trial as I believe it hurts our credibility.

The meeting document is not, by itself, a reason to drop the case. It is, however, a very bad document for us when taken with the other documents in the case. Remember, that is not the only time you suggested that low value of the inventory. I do believe there is a very real chance that those documents, taken together with the other issues, will cap your damages claim at just over.

I also talked to today briefly. He expressed some concern that an award against could reduce any award you might get in your other cases. I cannot evaluate those other cases for you, but if they are stronger than this one, I would advise you spend your resources there, rather than here.

I am not trying to “scare” you away from court. I am trying to give you my honest assessment that I believe pursuing these claims at trial will result in a net loss to you. I understand the arguments you want to make and we can make
them. Weighing them against the other side’s evidence, I think it more likely than not that you will not prevail or will not get a large enough verdict to justify the expense.

My comments in my earlier emails stand. I need clear direction from you to continue preparation or I will be forced to withdraw. I hope this helps.
Checklist—Potential Malpractice Claim Against Attorney

[To Be Used in Conjunction With Sample Letter to Client with Potential Malpractice Claim Against Attorney]

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
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<tbody>
<tr>
<td>1. Has lawyer taken an action, or failed to take an action, that could have an adverse impact on the matter? In other words, has the lawyer committed potential legal malpractice.</td>
<td></td>
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<tr>
<td>2. Contact the Professional Liability Fund (or other professional liability insurance carrier) and speak to a Claims Attorney regarding the matter.</td>
<td></td>
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<tr>
<td>3. Consider whether to: a) consult with in-house counsel or risk management partner at your firm; b) retain outside ethics counsel; or c) contact OSB General Counsel for guidance.</td>
<td></td>
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</tr>
<tr>
<td>4. Does a personal conflict of interest exist under Oregon RPC 1.7(a)(2)? Is there a significant risk that the lawyer’s representation of one or more clients will be materially limited by the lawyer’s personal interest in the matter due to the alleged conduct. <em>See, e.g.</em>, OSB Formal Ethics Op. No. 2009-182; The Ethical Oregon Lawyer § 9.2 (OSB Legal Pubs 2015) (Economic and Personal Conflicts).</td>
<td></td>
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<tr>
<td>5. If the answer to 4 is yes, does the lawyer reasonably believe that she or he will be able to provide competent and diligent representation to each affected client?</td>
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<tr>
<td>6. If the answer to 5 is no, prepare a complete copy of client file for production to client, take appropriate measures to withdraw, send a disengagement letter, and provide an accounting to the client of any funds in trust (and return any unearned fees). <em>See also</em>, “Production of Client File or Documents” practice aid.</td>
<td></td>
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<tr>
<td>7. Consider carefully whether facts or circumstances exist that would make it preferable for the client to obtain new counsel even if the conflict arguably can be waived.</td>
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<tr>
<td>8. If the answers to 4 and 5 are yes and 7 has been analyzed, lawyer should contact client to discuss conflict and determine if client will provide informed consent to continue the representation. Lawyer may want to prepare a draft letter to client before meeting or call in order to frame discussion. <em>See</em>, Sample Letter to Client with Potential Malpractice Claim Against Attorney.</td>
<td></td>
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<tr>
<td>9. After client call, revise Sample Letter to Client with Potential Malpractice Claim Against Attorney and provide to PLF (or other carrier) Claims Attorney (or your own ethics counsel) for review and comments.</td>
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<tr>
<td>10. Retain signed copy of informed consent letter for lawyer’s records.</td>
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</table>
Do Not Use This Form If Non-Waivable Conflict Exists

Determination of whether continuing as counsel or withdrawing in this situation is very dependent upon the unique facts of each situation. Before using this form as the basis for a letter to the client, the lawyer should analyze the particular facts giving rise to the conflict and is strongly encouraged to consult with a Claims Attorney at the Professional Liability Fund and/or private ethics counsel. In addition, while this form is a template intended to cover the basics, it essential the letter be customized to fit the facts and circumstances giving rise to the need for the letter.

**DISCLAIMER:** Every situation is different and there is no one form that is applicable in every situation. This form is designed only as an instructive guide but it does not, and cannot, replace consultation with a private ethics lawyer and/or a Claims Attorney at the Professional Liability Fund.

************

<Name>
<Address>
<Email>

Re: Personal Conflict of Interest Disclosure
Withdrawal from Representation
<Case Caption/Case No.> [or other identifying matter information]

Dear <Name>:

As you know, I currently represent you in <describe action taken on client's behalf or scope of representation, e.g., bringing an action for breach of contract>. I am writing now to confirm our recent discussion wherein I advised you of the following facts relevant to your legal matter: <provide brief description of relevant facts that may give rise to an alleged error, e.g., the running of the applicable statute of limitations>. In addition, I advised you that you may have a claim against me for <describe alleged act or omission that may have been faulty, e.g. failing to timely file the complaint>.

The purpose of this letter is to explain the personal interest conflict of interest that has now arisen for me and to seek your consent to my continuing to represent you in this matter despite the allegation that I may have made an error. I am not, however, asking you to waive any claim you may have against me <or my firm>.
The Oregon Rules of Professional Conduct (RPCs) prohibit an attorney from representing a client when the attorney’s personal interests conflict with those of the client’s, unless the client consents after being informed of the nature of the conflict, the risks involved and possible alternatives to providing consent. Consequently, I can continue to act as your lawyer in this matter only if you give your informed consent, confirmed in writing.

Clients that are asked to waive or consent to personal conflicts typically should consider whether their attorney’s professional judgment will be materially limited by their own personal interest in the matter due to the potential claim against them. For example, in your matter you might be concerned that I will pursue or avoid certain strategies in order to protect my own interests, or that my continued representation of you could or might affect the “zealousness” or eagerness with which I and my firm continue to represent you. Finally, you should consider whether or not my ability to protect your confidential client communications will be impaired in any way by my desire to protect my own interests. Although I believe these risks are minimal, you must necessarily decide this for yourself.

Alternatives to consenting to my continued representation include, but are not limited to, seeking replacement counsel or representing yourself. [Consider if there are other obvious alternatives in a given matter, such as retaining counsel on a limited scope to monitor and advise the client.]

When you and I spoke, you made it clear that you want me to continue as the attorney acting on your behalf. Nevertheless, the RPCs require me to recommend that you consult independent counsel to determine whether consent should be given, and I encourage you to do so. You are not obligated to consult such counsel if you do not wish to do so, however. The choice is yours.

I am happy to discuss this matter further with you or an attorney of your choosing. If you decide to consent to my continuing representation of you, please sign the enclosed copy of this letter and return it to me for your file. Thank you.

Very truly yours,

<Attorney>

I hereby consent to the representation set forth above:

________________________________________________________

<Client>

Dated: _________________________________
Sample Letter to Client with
Potential Malpractice Claim Against Attorney
Where Attorney Seeks Leave to Withdraw
(See Checklist)

(Rev. 01-2017)

This form may be appropriate when a lawyer has concluded he/she may have committed an error in the representation, the client may have a claim against the lawyer as a result of the error, and/or the lawyer intends to withdraw from the representation either because the error has created a nonwaiveable conflict of interest under RPC 1.7(b), the conflict is waivable under RPC 1.7(b) but the lawyer chooses not to seek a waiver from the client to continue the representation, or because the client may be better served with alternate counsel going forward.

Determination of whether continuing as counsel or withdrawing in this situation is very dependent upon the unique facts of each situation. Before using this form as the basis for a letter to the client, the lawyer should analyze the particular facts giving rise to the conflict and is strongly encouraged to consult with a Claims Attorney at the Professional Liability Fund and/or private ethics counsel. In addition, while this form is a template intended to cover the basics, it essential the letter be customized to fit the facts and circumstances giving rise to the need for the letter.

DISCLAIMER: Every situation is different and there is no one form that is applicable in every situation. This form is designed only as an instructive guide but it does not, and cannot, replace consultation with a private ethics lawyer and/or a Claims Attorney at the Professional Liability Fund.

************

<Name>
<Address>
<Email>

Re: Personal Conflict of Interest Disclosure
Withdrawal from Representation
<Case Caption/Case No.> [or other identifying matter information]

Dear <Name>:

As you know, I currently represent you in <describe action taken on client’s behalf or scope of representation, e.g., bringing an action for breach of contract>.

I am writing now to confirm our recent discussion wherein I advised you of the following facts relevant to your legal matter: <provide brief description of relevant facts that may give rise to an alleged error, e.g., the running of the applicable statute of>
limitations. In addition, I advised you that you may have a claim against me for <describe alleged act or omission that may have been faulty, e.g. failing to timely file the complaint>. As a result, and as we discussed, a personal interest conflict of interest has now arisen because you may have a claim against me.

Due to the conflict of interest identified above, I do not believe I should continue as your attorney in this matter. There are two ways to accomplish my withdrawal from your representation:

1. You can retain new counsel to take over and substitute as counsel for me; or
2. I can file a motion to withdraw for the court to consider. If the court grants the motion, you will be without representation until you retain new counsel.

In general, the transition is smoother for the client (you) if the client (you) first retains counsel and there is an orderly substitution. Unless required by the court, no will generally motion need be filed and there is no gap in your representation. If you would like to proceed in this fashion, we need to have the substitution of counsel completed by <enter date>. If it is not completed by then, I will file the enclosed motion and order to withdraw as counsel. I will forward to you a copy of the order granting our withdrawal when I receive it.

Explain the status of the matter, whether there is a relevant statute of limitation, and/or any pending motions, deadlines, trial dates, or other significant events that could affect the litigation going forward.

If client has confirmed retention of new counsel:

This will confirm you have retained <Attorney> to represent you going forward in this matter and that you <do/do not> consent to my speaking with <him/her> about your matter. We will cooperate with successor counsel to effect a substitution of counsel and to ensure an orderly transfer of files. Please have your new attorney contact me to accomplish the substitution. I have informed opposing counsel and indicated that <he/she> should contact your new lawyer directly.

If client has not retained counsel:

We encourage you to seek alternate counsel as soon as possible who can protect your interests in this matter. If you have not located counsel, you can contact the Oregon State Bar Lawyer Referral Service for options. They can be reached online at https://www.osbar.org/public/ris/lrsform.html, by phone locally at 503-684-3763, or toll-free in Oregon at 800-452-7636. I have instructed opposing counsel you will represent yourself going forward and that <he/she> can contact you directly. Please let me know right away if you retain new counsel so I can let opposing counsel know to contact your
lawyer instead. Also, if you do retain new counsel before <enter date>, have him/her contact me to arrange for substitution.

**When there is an outstanding trust balance:**

Please find enclosed an accounting on your matter, reflecting a trust account balance of <$$$.> I have enclosed a check for the remaining trust balance.

**When there is an outstanding balance due on the account, the lawyer may choose to not seek payment given the circumstances of the conflict. If the lawyer, however, chooses to seek payment:**

Please find enclosed a final invoice on your matter, reflecting a total amount of fees and costs due of <$$$.>. This amount is now due and payable and request that you make a prompt payment for the services rendered.  

Please contact me if you have any questions.

Very truly yours,

<Attorney>

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1 A lawyer may write off a balance due, or resolve a dispute as to remaining trust funds, by requesting the client release the lawyer from any potential claims of liability. In doing so, the lawyer should be mindful of RPC 1.8(h)(2), which provides that a lawyer shall not “settle a claim or potential claim for [liability to a client for malpractice] with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith.” Nonetheless, a lawyer should consider consulting private ethics counsel or a Claims Attorney at the Professional Liability Fund before requesting payment in such a situation.
RULE 1.0 TERMINOLOGY

(a) "Belief" or "believes" denotes that the person involved actually supposes the fact in question to be true. A person's belief may be inferred from circumstances.

(b) "Confirmed in writing," when used in reference to the informed consent of a person, denotes informed consent that is given in writing by the person or a writing that a lawyer promptly transmits to the person confirming an oral informed consent. See paragraph (g) for the definition of "informed consent." If it is not feasible to obtain or transmit the writing at the time the person gives informed consent, then the lawyer must obtain or transmit it within a reasonable time thereafter.

(c) "Electronic communication" includes but is not limited to messages sent to newsgroups, listservs and bulletin boards; messages sent via electronic mail; and real time interactive communications such as conversations in internet chat groups and conference areas and video conferencing.

(d) "Firm" or "law firm" denotes a lawyer or lawyers, including "Of Counsel" lawyers, in a law partnership, professional corporation, sole proprietorship or other association authorized to practice law; or lawyers employed in a private or public legal aid or public defender organization, a legal services organization or the legal department of a corporation or other public or private organization. Any other lawyer, including an office sharer or a lawyer working for or with a firm on a limited basis, is not a member of a firm absent indicia sufficient to establish a de facto law firm among the lawyers involved.

(e) "Fraud" or "fraudulent" denotes conduct that is fraudulent under the substantive or procedural law of the applicable jurisdiction and has a purpose to deceive.

(f) "Information relating to the representation of a client" denotes both information protected by the attorney-client privilege under applicable law, and other information gained in a current or former professional relationship that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client.

(g) "Informed consent" denotes the agreement by a person to a proposed course of conduct after the lawyer has communicated adequate information and explanation about the material risks of and reasonably available alternatives to the proposed course of conduct. When informed consent is required by these Rules to be confirmed in writing or to be given in a writing signed by the client, the lawyer shall give and the writing shall reflect a recommendation that the client seek independent legal advice to determine if consent should be given.

(h) "Knowingly," "known," or "knows" denotes actual knowledge of the fact in question, except that for purposes of determining a lawyer's knowledge of the existence of a conflict of interest, all facts which the lawyer knew, or by the exercise of reasonable care should have known, will be attributed to the lawyer. A person's knowledge may be inferred from circumstances.

(i) "Matter" includes any judicial or other proceeding, application, request for a ruling or other determination, contract, claim, controversy, investigation, charge, accusation, arrest or other particular matter involving a specific party or parties; and any other matter covered by the conflict of interest rules of a government agency.

(j) "Partner" denotes a member of a partnership, a shareholder in a law firm organized as a professional corporation, or a member of an association authorized to practice law.

(k) "Reasonable" or "reasonably" when used in relation to conduct by a lawyer denotes the conduct of a reasonably prudent and competent lawyer.

(l) "Reasonable belief" or "reasonably believes" when used in reference to a lawyer denotes that the lawyer believes the matter in question and that the circumstances are such that the belief is reasonable.

(m) "Reasonably should know" when used in reference to a lawyer denotes that a lawyer of reasonable prudence and competence would ascertain the matter in question.

(n) "Screened" denotes the isolation of a lawyer from any participation in a matter through the timely imposition of procedures within a firm that are reasonably adequate under the circumstances to protect information that the isolated lawyer is obligated to protect under these Rules or other law.

(o) "Substantial" when used in reference to degree or extent denotes a material matter of clear and weighty importance.

(p) "Tribunal" denotes a court, an arbitrator in a binding arbitration proceeding or a legislative body, administrative agency or other body acting in an adjudicative capacity. A legislative body, administrative agency or other body acts in an adjudicative capacity when a neutral official, after the presentation of evidence or legal argument by a party or parties, will render a binding legal judgment directly affecting a party's interests in a particular matter.
"Writing" or "written" denotes a tangible or electronic record of a communication or representation, including handwriting, typewriting, printing, photostatting, photography, audio or videorecording and electronic communications. A "signed" writing includes an electronic sound, symbol or process attached to or logically associated with a writing and executed or adopted by a person with the intent to sign the writing.

**RULE 1.7 CONFLICT OF INTEREST: CURRENT CLIENTS**

(a) Except as provided in paragraph (b), a lawyer shall not represent a client if the representation involves a current conflict of interest. A current conflict of interest exists if:

1. The representation of one client will be directly adverse to another client;
2. There is a significant risk that the representation of one or more clients will be materially limited by the lawyer's responsibilities to another client, a former client or a third person or by a personal interest of the lawyer; or
3. The lawyer is related to another lawyer, as parent, child, sibling, spouse or domestic partner, in a matter adverse to a person whom the lawyer knows is represented by the other lawyer in the same matter.

(b) Notwithstanding the existence of a current conflict of interest under paragraph (a), a lawyer may represent a client if:

1. The lawyer reasonably believes that the lawyer will be able to provide competent and diligent representation to each affected client;
2. The representation is not prohibited by law;
3. The representation does not obligate the lawyer to contend for something on behalf of one client that the lawyer has a duty to oppose on behalf of another client; and
4. Each affected client gives informed consent, confirmed in writing.
RULE 1.8 CONFLICT OF INTEREST: CURRENT CLIENTS: SPECIFIC RULES

(a) A lawyer shall not enter into a business transaction with a client or knowingly acquire an ownership, possessory, security or other pecuniary interest adverse to a client unless:

1. the transaction and terms on which the lawyer acquires the interest are fair and reasonable to the client and are fully disclosed and transmitted in writing in a manner that can be reasonably understood by the client;
2. the client is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel on the transaction; and
3. the client gives informed consent, in a writing signed by the client, to the essential terms of the transaction and the lawyer’s role in the transaction, including whether the lawyer is representing the client in the transaction.

(b) A lawyer shall not use information relating to representation of a client to the disadvantage of the client unless the client gives informed consent, confirmed in writing, except as permitted or required under these Rules.

(c) A lawyer shall not solicit any substantial gift from a client, including a testamentary gift, or prepare on behalf of a client an instrument giving the lawyer or a person related to the lawyer any substantial gift, unless the lawyer or other recipient of the gift is related to the client. For purposes of this paragraph, related persons include a spouse, domestic partner, child, grandchild, parent, grandparent, or other relative or individual with whom the lawyer or the client maintains a close familial relationship.

(d) Prior to the conclusion of representation of a client, a lawyer shall not make or negotiate an agreement giving the lawyer literary or media rights to a portrayal or account based in substantial part on information relating to the representation.

(e) A lawyer shall not provide financial assistance to a client in connection with pending or contemplated litigation, except that:

1. a lawyer may advance court costs and expenses of litigation, the repayment of which may be contingent on the outcome of the matter; and
2. a lawyer representing an indigent client may pay court costs and expenses of litigation on behalf of the client.

(f) A lawyer shall not accept compensation for representing a client from one other than the client unless:

1. the client gives informed consent;
2. there is no interference with the lawyer’s independence of professional judgment or with the client-lawyer relationship; and
3. information related to the representation of a client is protected as required by Rule 1.6.

(g) A lawyer who represents two or more clients shall not participate in making an aggregate settlement of the claims of or against the clients, or in a criminal case an agreement as to guilty or nolo contendere please, unless each client gives informed consent, in a writing signed by the client. The lawyer’s disclosure shall include the existence and nature of all the claims or please involved and of the participation of each person in the settlement.

(h) A lawyer shall not:

1. make an agreement prospectively limiting the lawyer’s liability to a client for malpractice unless the client is independently represented in making the agreement;
2. settle a claim or potential claim for such liability with an unrepresented client or former client unless that person is advised in writing of the desirability of seeking and is given a reasonable opportunity to seek the advice of independent legal counsel in connection therewith;
3. enter into any agreement with a client regarding arbitration of malpractice claims without informed consent, in a writing signed by the client; or
4. enter into an agreement with a client or former client limiting or purporting to limit the right of the client or former client to file or to pursue any complaint before the Oregon State Bar.

(i) A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for a client, except that the lawyer may:

1. acquire a lien authorized by law to secure the lawyer’s fee or expenses; and
2. contract with a client for a reasonable contingent fee in a civil case.

(j) A lawyer shall not have sexual relations with a current client of the lawyer unless a consensual sexual relationship existed between them before the client-lawyer relationship commenced; or have sexual relations with a representative of a current
client of the lawyer if the sexual relations would, or
would likely, damage or prejudice the client in the
representation. For purposes of this rule:

(1) “sexual relations” means sexual intercourse or
any touching of the sexual or other intimate parts of a
person or causing such person to touch the sexual or
other intimate parts of the lawyer for the purpose of
arousing or gratifying the sexual desire of either party;
and

(2) “lawyer” means any lawyer who assists in the
representation of the client, but does not include other
firm members who provide no such assistance.

(k) While lawyers are associated in a firm, a prohibition
in the foregoing paragraphs (a) through (i) that applies
to any one of them shall apply to all of them.

RULE 1.9 DUTIES TO FORMER CLIENTS

(a) A lawyer who has formerly represented a client in a
matter shall not thereafter represent another person in
the same or a substantially related matter in which that
person's interests are materially adverse to the
interests of the former client unless each affected client
gives informed consent, confirmed in writing.

(b) A lawyer shall not knowingly represent a person in
the same or a substantially related matter in which a
firm with which the lawyer formerly was associated had
previously represented a client:

(1) whose interests are materially adverse to that
person; and

(2) about whom the lawyer had acquired
information protected by Rules 1.6 and 1.9(c) that
is material to the matter, unless each affected
client gives informed consent, confirmed in writing.

(c) A lawyer who has formerly represented a client in a
matter or whose present or former firm has formerly
represented a client in a matter shall not thereafter:

(1) use information relating to the representation
to the disadvantage of the former client except as
these Rules would permit or require with respect to
a client, or when the information has become
generally known; or

(2) reveal information relating to the
representation except as these Rules would permit
or require with respect to a client.

(d) For purposes of this rule, matters are “substantially
related” if (1) the lawyer’s representation of the current
client will injure or damage the former client in
connection with the same transaction or legal dispute in
which the lawyer previously represented the former
client; or (2) there is a substantial risk that confidential
factual information as would normally have been
obtained in the prior representation of the former client
would materially advance the current client’s position
in the subsequent matter.
RULE 1.10 IMPUTATION OF CONFLICTS OF INTEREST; SCREENING

(a) While lawyers are associated in a firm, none of them shall knowingly represent a client when any one of them practicing alone would be prohibited from doing so by Rules 1.7 or 1.9, unless the prohibition is based on a personal interest of the prohibited lawyer or on Rule 1.7(a)(3) and does not present a significant risk of materially limiting the representation of the client by the remaining lawyers in the firm.

(b) When a lawyer has terminated an association with a firm, the firm is not prohibited from thereafter representing a person with interests materially adverse to those of a client represented by the formerly associated lawyer and not currently represented by the firm, unless:

(1) the matter is the same or substantially related to that in which the formerly associated lawyer represented the client; and

(2) any lawyer remaining in the firm has information protected by Rules 1.6 and 1.9(c) that is material to the matter.

(c) When a lawyer becomes associated with a firm, no lawyer associated in the firm shall knowingly represent a person in a matter in which that lawyer is disqualified under Rule 1.9, unless the personally disqualified lawyer is promptly screened from any form of participation or representation in the matter and written notice of the screening procedures employed is promptly given to any affected former client.

(d) A disqualification prescribed by this rule may be waived by the affected clients under the conditions stated in Rule 1.7.

(e) The disqualification of lawyers associated in a firm with former or current government lawyers is governed by Rule 1.11.
misrepresentation on the part of the **Covered Party**, or on the part of anyone for whose conduct a **Covered Party** is legally liable; or

c. Any attorney fees or costs owed as a result of any statute making any attorney liable or responsible for fees or costs owed by a client.

5. **Failure to Pay Lien.** This Plan does not apply to any **Claim** based on or arising out of the non-payment of a valid and enforceable lien if actual notice of such lien was provided to any **Covered Party** or to anyone for whose conduct a **Covered Party** is legally liable, prior to the payment of the funds to a client or any person or entity other than the rightful lien-holder.

6. **Business Interests.** This Plan does not apply to any **Claim** relating to or arising out of any business enterprise:

a. In which **You** are a general partner, managing member, or employee, or in which **You** were a general partner, managing member, or employee at the time of the alleged acts, errors, or omissions on which the **Claim** is based;

b. That is controlled, operated, or managed by **You**, either individually or in a fiduciary capacity, including the ownership, maintenance, or use of any property in connection therewith, or was so controlled, operated, or managed by **You** at the time of the alleged acts, errors, or omissions on which the **Claim** is based; or

c. In which **You** either have an ownership interest, or had an ownership interest at the time of the alleged acts, errors, or omissions on which the **Claim** is based unless: (i) such interest is solely a passive investment; and (ii) **You**, those controlled by **You**, **Your** spouse, parent, stepparent, child, sibling, or any member of **Your** household, and those with whom **You** are regularly engaged in the practice of law, collectively own, or previously owned, an interest in the business enterprise of less than ten percent.

7. **Partner and Employee Exclusion.** This Plan does not apply to any **Claim** made by:

a. A present, former, or prospective law partner, employer, or employee of a **Covered Party**, or of anyone for whose conduct a **Covered Party** is legally liable; or

b. A present, former, or prospective officer, director, or employee of a professional corporation in which a **Covered Party**, or in which any attorney for whose conduct a **Covered Party** is legally liable, is or was a shareholder.

This Exclusion 7 does not apply if the **Claim** arises solely out of conduct in an attorney-client capacity for a person or entity listed in subsections a and b.

8. **Business Transaction with Client.** This Plan does not apply to any **Claim** based on or arising out of any business transaction in which any **Covered Party**, or in which anyone for whose conduct a **Covered Party** is legally liable, participated with a client unless any written disclosure required by ORPC 1.8(a), or its equivalent, was properly executed prior to the transaction.
9. **Investment Advice.** This Plan does not apply to any of the following **Claims** or excluded activities, whether or not they are the sole cause, or a contributing cause, of any resulting loss or damage:

   a. **Any Claim** for investment losses, or for any damages arising from or relating to such losses, as a result of any **Covered Party**, or any person for whose conduct any **Covered Party** is legally liable: advising any person or entity respecting the value of a particular investment; recommending investing in, purchasing, or selling a particular investment; providing any economic analysis of any investment; inducing any person or entity to make any particular investment; making any warranty or guarantee regarding any investment; or making a financial decision or investment choice on behalf of any other person or entity regarding the purchase or selection of any particular investment.

   This subsection (a) does not apply, however, to **Claims** made by a purchaser of securities for losses that arise only from **Professional Legal Services** provided to a seller of securities, provided no **Covered Party**, nor any attorney for whose conduct a **Covered Party** is legally liable, provided any advice or services, or made any representations, falling within this exclusion, directly to such purchaser.

   b. **Any Claim** arising from any **Covered Party**, or any person for whose conduct any **Covered Party** is legally liable: advising or failing to advise any person in connection with the borrowing of any funds or property by any **Covered Party** for the **Covered Party** or for another; acting as a broker for a borrower or a lender; or giving advice of any nature when the compensation for such advice is, in whole or in part, contingent or dependent on the success or failure of a particular investment.

   c. Managing an investment, or buying or selling an investment for another, except to the limited extent such activities fall within the common and ordinary scope of **Special Capacity Services**.

10. **Law Practice Business Activities or Benefits Exclusion.** This Plan does not apply to any **Claim**:

   a. For any amounts paid, incurred, or charged by any **Covered Party** as fees, costs or disbursements, (or by any **Law Entity** with which any **Covered Party** was associated at the time the fees, costs, or expenses were paid, incurred or charged), including but not limited to fees, costs, and disbursements alleged to be excessive, not earned, or negligently incurred, whether claimed as restitution of specific funds, forfeiture, financial loss, set-off, or otherwise.

   b. Arising from or relating to the negotiation, securing, or collection of fees, costs, or disbursements owed or claimed to be owed to any **Covered Party**, or any **Law Entity** with which any **Covered Party** is now associated, or was associated at the time of the conduct giving rise to the **Claim**; or

   c. For damages or the recovery of funds or property that have or will directly or indirectly benefit any **Covered Party**.

In the event the PLF defends any **Claim** or **Suit** that includes any claim within the scope of this exclusion, the **Covered Party** is required to consent to and cooperate with the PLF’s attempt to settle or dismiss any other claim(s) not falling within this exclusion. The PLF will have the right to withdraw from the defense following the settlement or dismissal of any such claim(s).
So You Think You Don’t Practice “Securities Law?”

Securities Liability for Transactional Lawyers under the *draconian* provisions of ORS 59.115

Daniel L. Keppler
Garvey Schubert Barer

I. Why should I care as a transactional lawyer?

Oregon courts hold that a lawyer preparing documents in a transaction with investors may be liable for participating in or material aiding the unlawful sale of securities to those investors. *Prince v. Brydon*, 307 Or. 146, 764 P.2d 1370 (1988).

➢ Here’s the kicker: the investors do not need to prove the lawyer knew about the unlawful conduct:

“ORS 59.115(3) makes one who is not himself the seller of a security liable for an unlawful sale if he ‘participates or materially aids in the sale.’ * * * Whether one’s assistance in the sale is ‘material’ does not depend on one’s knowledge of the facts that make it unlawful; it depends on the importance of one’s personal contribution to the transaction.” *Prince*, 307 Or. at 149 (emphasis added).

➢ One consolation is that the lawyer can avoid liability by proving that the lawyer “did not know, and, in the exercise of reasonable care, could not have known, of the existence of facts on which the liability is based.” ORS 59.115(3) (emphasis added).

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1 All commentary, suggestions and snarky quips contained in these materials constitute the opinions solely of the author and are not intended to create a standard of care, insurmountable defense, or safe harbor from securities claims.
But proving this “negative” is difficult. And maybe has never happened in an Oregon trial court.

So it’s better to avoid the risk of securities liability altogether . . . .

II. Does my client’s deal involve the sale of a security in Oregon?

A. What is a security?
   - All-encompassing definition in ORS 59.015 (19).
   - The usual stuff: stocks, bonds, debentures, notes.
     - Beware: stock sale of a small business is a sale of securities.
     - Asset sales of a business may avoid securities problems.

   ❖ Wait . . . did you say notes?
     - Promissory notes are often securities.
     - May also meet the definition of investment contracts.

   ❖ Catchall: “investment contracts” are defined as securities.
     - Four-part test for investment contracts:
       - (1) investment of money (or money’s worth)
       - (2) in a common enterprise,
       - (3) with the expectations of a profit,
       - (4) to be made through the management and control of others.
         - Pratt v. Kross, 276 Or. 483, 497, 555 P.2d 765 (1976) (holding that limited partnership interest was a security); see also Computer Concepts, Inc. v. Brandt,
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- **Common investment contracts**
  - **Limited Liability Company** membership interests — especially in a manager-managed LLC, but can be any LLC that meets the test.
  - **Limited Partnerships** — or any partnership that meets the test.
  - **Tenant-in-Common** or other joint ownership interests in real estate. See *Bergquist v. Int'l Realty, Ltd.*, 272 Or. 416, 427, 537 P.2d 553 (1975) (undivided fractional interests in a sale and leaseback transaction was investment contract).
  - **Other jointly-owned assets**, e.g., a *racehorse!* *Marshall v. Harris*, 276 Or. 447, 455, 555 P.2d 756 (1976) (sale of a fractional interest in a racehorse is an investment contract).

B. **What is a “sale” of a security?**
   - Includes virtually any “disposition” of a security for value.
   - See definition in ORS 59.015 (17)(a).

C. **When does Oregon Securities law apply to a sale?**
   - An offer to sell is made in or directed to Oregon.
   - An offer to buy is made and accepted in Oregon.
   - The offer to sell or buy originates in Oregon.
   - The offer to buy or sell is communicated in Oregon.
   - See ORS 59.335 and 59.345.
     - Practically any Oregon connection is enough!
III. What makes the sale of a security unlawful and actionable?

A. Untrue statements and misleading omissions
   • The most common seller liability allegation in Oregon securities litigation.
   • Security sold “by means of” untrue statement of material fact.
   • Or “by means of” omission to state a material fact necessary to make statements made not misleading (i.e. half-truths).
   • Purchaser does not know the truth.
   • Seller has burden to prove affirmative defense that the person did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.
   • ORS 59.115 (1)(b).

B. Securities Fraud
   • To employ any devise, scheme or artifice to defraud.
   • To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.
   • ORS 59.115 (1)(b) and ORS 59.135 (1) and (3).
   • Note: Fraud claims may also be asserted under ORS 59.137, which can be more difficult to prove. See State ex rel. Oregon State Treasurer v. Marsh & McLennan Companies, Inc., 269 Or. App. 31, 50, 346 P.3d 504 (2015).

C. Technical violation of the Oregon Securities Law
   • Failure to register or to qualify for registration exemption
     o Registration unrealistic in many small business deals.
     o Commonly-used exemptions:
       ➢ Accredited investors —
         o individual or joint net worth with spouse, exceeds $1,000,000, excluding the value of the natural investor's primary residence, or
         o individual income in excess of $200,000 in each of the two most recent years or joint income with spouse in excess of $300,000 in
each of those years and has a reasonable expectation of reaching the same income level in the current year.

- No public advertising/solicitation.
- See ORS 59.035 (5); OAR 441-035-0010.
- See also 15 USC § 77b (15).

- **Under 10 Purchasers of securities**
  - For last 12 months.
  - No commissions or remuneration for sale.
  - No public advertising.
  - ORS 59.035 (12).

- **Exemption analysis is complicated!** — Get help from experienced securities counsel.
  - Other technical violations, e.g., unlicensed brokers.

### IV. Statutory Damages for Seller Liability

- Amount investor paid for security minus amount received on security — sometimes called a rescissionary remedy.
  
  Bottom line: a $5 million investment deal = $5 million base damages. ORS 59.115(2).

- Plus interest at 9% or at the rate stated in the security — whichever is higher.

- Plus discretionary court-awarded attorney fees. ORS 59.115 (10).
V. Nonseller Liability — *The Scary Part.*

These nonsellers are **jointly and severally liable with and to same extent as the seller** of securities under ORS 59.115(3):

- Any person who directly or indirectly controlled the seller.
- Every partner, LLC manager, officer, director, manager, or person who occupied a similar role.
- **Any Person who participated or materially aided** in the sale — including professionals just doing their jobs such as:
  - **Attorneys**
    - Especially if prepared prospectus, private placement memorandum, offering circular or similar offering documents. *See* *Prince*, 307 Or. at 148 (preparing partnership agreement and offering circular sufficient to give rise to liability for materially aiding).

❖ **Don’t like it? Move north of the Columbia River:**

- *Compare* Washington vs. Oregon securities law:

- Doubtful whether mere business formation and basic entity documentation is material aid in the sale — but there are no safe harbors.
- It’s going to be a case-by-case analysis of the importance of the attorney’s work to the transaction. *Prince*, 307 Or. at 149 (“it is a drafter’s knowledge, judgment, and assertions reflected in the contents of the documents that are ‘material’ to the sale.”).
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- Accountants
  - Doubtful whether audits or tax work materially aids sale of securities, but there are no safe harbors.
  - Preparation of financial projections or pro formas provided to investors might increase risk of liability for material aiding.

- Brokers / Finders
  - Recommending or promoting investment.
  - Bringing in investors is probably enough, but depends on circumstances.

- Financial Advisors
  - Recommending or promoting investment.
  - Bringing in investors is probably enough, but depends on circumstances.

- Banks / Financial Institutions
  - Bridge loans to facilitate investor financing.
  - Unclear whether merely acting as a lender or custodian materially aids in security.
  - Recommending investments to customers is probably risky.

➢ Note: Nonsellers can also be liable in securities fraud claims brought under ORS 59.137. But in contrast with ORS 59.115(3) to prove material aiding liability, the investor must prove that the person materially aided in the violation of the anti-fraud provisions of ORS 59.135 (i.e. not merely materially aid in the sale of securities).

VI. Affirmative Defenses

A. “Due diligence” defense to nonseller liability:

“[E]very person who participates or materially aids in the sale is also liable jointly and severally with and to the same extent as the seller, unless the nonseller sustains the burden of proof that the nonseller did not know, and, in the exercise of reasonable care, could not have known, of the existence of facts on which the liability is based.” ORS 59.115(3). This means:
The nonsellers must prove they could not have known about bad facts giving rise to investor liability.

For lawyers, this can be difficult if the lawyer has a close relationship with the client.

Also requires the nonseller to prove a negative “could not have known.”

This must be evaluated on a case-by-case basis.

B. Statutes of Limitation Defense

For claims alleging untrue statements, material omissions or securities fraud under ORS 59.115(1)(b) (or under ORS 59.137): three years from the sale of securities or two years from discovery of the facts giving rise to liability. ORS 59.115(6). See also Anderson v. Carden, 146 Or. App. 675, 934 P.2d 562 (1997) (construing earlier version of the statute of limitation).

For registration or other technical violations, the statute of limitations for private rights of action is three years from the sale. ORS 59.115(6).

VII. What can I do as a transactional lawyer to manage these risks?

- Unfortunately, there are no safe harbors — and no established best practices and no clear standards.
- Here are some general suggestions, but they are not “litigation tested” or supported by specific legal authorities:
  - Even if your legal work is perfect, you can still be sued and taken to trial under ORS 59.115 (3).
  - Securities law is not for beginners — get securities law advice if you have a deal involving investors.
  - Don’t assume you will be protected from claims by the accredited investor exemption.
  - If the deal loses money, disgruntled investors and their lawyers may take advantage of any minor problem they can find with the deal or with the offering documents and allege a misrepresentation or material omission.
Choose your transactions carefully:
- Avoid deals involving passive investors if possible.
- Ideally, all people putting in money should have a role in management of the business.
- Refer out cases involving passive investors to securities counsel.
- Stay away from the financing part of a transaction — try to limit your role to non-financing aspects of the transaction, e.g., just the transfer of real estate.
- Avoid deals that seem unlikely to succeed or are poorly conceived.
- Beware of deals that depend heavily on existing market conditions, market bubbles, or overly optimistic views of reality.
- Consider having a business or investment consultant or similar professional conduct an analysis of the deal.
- Avoid deals involving investors using self-directed IRAs or that rely heavily on tax avoidance strategies.
- Be skeptical of businesses lacking in financial controls.

Choose your clients carefully:
- Good business clients should have a solid business plan and financial controls in place.
- Avoid clients who will oversell or puff about their project.
- Emphasize the need for transparency with investors.
- Beware of clients who intend to solicit investors from their religious congregation or social organization in which trust among members is unquestioned.

Try to persuade your client to choose investors carefully:
- Ideally, investors should be wealthy, accredited, experienced, cognizant of risks and maybe even represented by their own counsel before investing.
- Avoid investors who plan to invest their retirement savings, are inexperienced, uneducated or vulnerable.
- Avoid investors who will place unearned trust in promoters regardless of the merits of the business idea, business strategy or business risks.
Tips for preparing offering documents and disclosures:

- Reminder: These are not safe harbors, standards of care or best practices — they are only suggestions that are untested in litigation. Every situation requires judgment and a fact-specific approach.
  - Don’t do securities offering documents unless you know what you are doing. Bring in an experienced securities lawyer.
  - Assume your documents will be scrutinized for accuracy and completeness in litigation by counsel representing the investors as plaintiffs.
  - Avoid having the offering circular or private placement memo that reads like a marketing brochure — it should be a risk disclosure document.
  - Try to identify all obvious and nonobvious investment and business risk factors. Consider adding risk factors that are specific to this particular deal.
  - Beware of forms and boilerplate.
  - Consider using a detailed questionnaire or other method to discover and disclose potentially “bad facts” including any black marks against your clients.
  - Consider using management (client) representation letters or similar documents for having your clients “sign off” on all disclosures and certify that they cannot think of any other risks or material matters to disclose.
  - Consider having a business financial or investment professional analyze the deal and potential risks.
  - Recommend that your client use financial projections or pro formas that are conservative, realistic, and based on the most reliable information available.
  - If possible, try to make sure at least two registration exemptions apply.
  - Make sure you are adequately insured.
About the Presenter:
Dan Keppler is an attorney in the Portland office of Garvey Schubert Barer. He focuses on helping lawyers, accountants and other professionals mitigate risks and resolve complex disputes, often involving securities and business-related litigation.

His practice includes complex business litigation, securities litigation, professional malpractice, class action litigation, appeals and alternative dispute resolution. Dan has experience negotiating and implementing complicated settlement transactions involving numerous claims and parties. He also counsels professional and institutional clients on risk management issues.
Lessons from Securities Litigation

Choose your clients carefully. That is the golden rule when it comes to representing clients who are doing securities offerings. The risks faced by attorneys who represent clients doing securities offerings were evidenced by the recent $6.2 million settlement paid by a Reno law firm that represented a Bend-based real estate investment operation.

The securities laws present unique challenges and risks for attorneys practicing in Oregon. First, the term “security” is broadly defined; hence, the securities laws cover a wide range of investments. Second, attorneys who “materially aid” in their client’s securities offerings can be held jointly and severally liable for their client’s violation of the securities laws. Due to a combination of these factors, well-intentioned attorneys can find themselves subject to claims brought on behalf of investors who invested in their client’s failed business transactions.

To protect yourself from liability, you must be able to identify what constitutes a security. This is not an easy task given that the term “security” is broadly defined. Most attorneys readily identify stock as a security. However, the definition of a security includes many other forms of investment, including promissory notes and “investment contracts.” The courts have defined certain rules for determining when a promissory note constitutes a security, but those rules start with the presumption that the promissory note is a security. Transactional attorneys should also evaluate whether their client’s deals may constitute an “investment contract” and thus a security. In general, an “investment contract” is formed when there is an investment of money in a common enterprise with the expectation of profits derived from the efforts of others. A wide variety of transactions have been classified as “investment contracts,” including the sale of fractional interests in race horses – Marshall v. Harris, 276 Or 447 (1976); undivided interests in real property – State of Oregon v. Jacobs, 55 Or App 406 (1981); and interests in master music recordings – Cleveland v. Jerden Industries, Inc., 1985 US Dist LEXIS 23747 (Or Dist Ct 1985). In recent years, the structures used to finance real estate transactions have become increasingly elaborate and creative. You should review these types of transactions carefully to determine whether a security may have been created. A number of good summaries explain what constitutes a security, including those found in Chapter 15 of Advising Oregon Businesses (Oregon CLE 2001, Supp 2007) and Chapter 6 of Fundamentals of Real Estate Transactions (Oregon CLE 1992, Supp 2001). However, even with careful research, you may still be uncertain whether or not a particular transaction involves a security. In these situations, it is prudent to take the safe path and assume the transaction involves a security.

Being able to identify a security is critical. If a security is sold in violation of the Oregon securities laws, the investor has a right of rescission against the seller of that security. Essentially, this right allows the investor to recover the amount of the investment, statutory interest, and potentially attorney fees. ORS 59.115(3) provides that every person who materially aids in the sale of a security is jointly and severally liable with, and to the same extent as, the seller. The Supreme Court of Oregon, in Prince v. Brydon, 307 Or 146 (1988), held that an attorney who had advised his client concerning the requirements for private placements of limited partnership interests, drafted the limited partnership agreement, and prepared

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portions of the offering circular had “materially aided” in the sale of a security as contemplated in ORS 59.115(3). The reasoning is that an attorney “materially aids” in the sale of the security by having his or her “knowledge, judgment and assertions” reflected in the offering documents. Id. at 149.

If you materially aided in the sale of a security, you can avoid liability by sustaining the burden of proof that you did not know and, in the exercise of reasonable care, could not have known of the existence of facts on which the liability is based. This “due diligence” defense provides a measure of protection. However, it is important to consider that securities claims arise after an investment has failed. Against the backdrop of a failed deal and with the benefit of hindsight running in favor of the investor, you can face a difficult challenge proving that your actions were, in fact, reasonable.

What can you do? First, accept that ignorance is not an excuse. Ignoring the requirements of the securities laws places you at great peril. This is true whether you consider yourself a “securities lawyer” or not. If the deal involves a security and you do not feel sufficiently competent to handle the matter, refer the securities work to another attorney.

Second, insist that your client structure the offering in a manner that complies with the securities laws and fully cooperate in disclosing the risks associated with the proposed securities transaction. This can become an issue when a client is desperate for capital or otherwise unwilling to pay the legal fees necessary to comply with the applicable securities laws. It can also become an issue when a client is under time constraints to close a transaction. In these situations, you cannot escape liability by merely advising your client of the risks associated with not complying with the securities laws. If your client refuses to structure the offering in a manner that complies with the securities laws, you should walk away from the deal.

Third, keep in mind that although certain elements of the securities laws provide very clear guidance on what is required, many of the rules involve inherently subjective determinations. For example, a person may not sell a security by means of an untrue statement of material fact or omit a material fact necessary in order to make the other statements made, in light of the circumstances under which they are made, not misleading. ORS 59.115. What is “material” is a subjective determination. Due to these subjective determinations, it is not possible for you to completely insulate yourself from a claim. This is especially true when the investor can look back with the benefit of hindsight and question why certain disclosures were or were not made. While experience and careful research can help mitigate a large portion of these risks, such risks cannot be eliminated either for you or your client. Given that securities work will always involve some inherent level of risk, the golden rule is to choose your clients carefully. If you do not feel confident about the offering or have reservations about the client, you should strongly consider passing on the work.

Similarly, encourage your clients to select their investors carefully. Both you and your client should feel confident that the investor is sufficiently sophisticated and knowledgeable to understand the risks involved with the particular investment. In addition, both you and your client should consider whether the investor can afford to lose the investment and how the investor might react to such loss.

To summarize, keep the following rules in mind to help minimize your potential exposure to liability under the securities laws:

- Know how to spot a security.
- Do not ignore the securities laws.
- Insist that clients comply with the securities laws.
- Encourage your clients to select their investors carefully.
- Choose your clients carefully.

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