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Key Texas M&A Issues

DISCLAIMER:
This is not intended nor should it be used as a substitute for legal advice or opinion, which can be rendered only when related to specific fact situations.

Byron F. Egan is a partner of Jackson Walker in Dallas. He is engaged in a corporate, partnership, securities, mergers and acquisitions ("M&A") and financing practice. He has extensive experience in business entity formation and governance matters, M&A and financing transactions in a wide variety of industries including energy, financial and technology. In addition to handling transactions, he advises boards of directors and their audit, compensation and special committees with respect to fiduciary duty and other corporate governance issues, the Sarbanes-Oxley Act, special investigation and other issues.

Involvement: Byron is Senior Vice Chair and Chair of the Executive Council of the M&A Committee of the American Bar Association and served as Co-Chair of its Asset Acquisition Agreement Task Force, which wrote the ABA Model Asset Purchase Agreement with Commentary. He is immediate Past Chair of the Texas Business Law Foundation; is a former Chair of the Business Law Section of the State Bar of Texas and former Chair of that section's Corporation Law Committee; and on behalf of these groups, has been instrumental in the drafting and enactment of many Texas business entity and other statutes. He is also a member of the American Law Institute.

Publications: Mr. Egan writes and speaks about the areas in which his law practice is focused, and is a frequent author and lecturer regarding M&A, governance of corporations, partnerships and limited liability companies, securities laws, and financing techniques. He is the author of the treatise EGAN ON ENTITIES: Corporations, Partnerships and Limited Liability Companies in Texas (2016) (available on Amazon). Mr. Egan has written or co-authored the following law journal articles: Corporate Governance: Fiduciary Duties of Corporate Directors and Officers in Texas, 43 Texas Journal of Business Law 45 (Spring 2009); Responsibilities of Officers and Directors under Texas and Delaware Law, XXVI Corporate Counsel Review 1 (May 2007); Entity Choice and Formation: Joint Venture Formation, 44 Texas Journal of Business Law 129 (2012); Choice of Entity Decision Tree After Margin Tax and Texas Business Organizations Code, 42 Texas Journal of Business Law 171 (Spring 2007); Choice of Entity Alternatives, 39 Texas Journal of Business Law 379 (Winter 2004); Choice of State of Incorporation – Texas Versus Delaware: Is it Now Time to Rethink Traditional Notions, 54 SMU Law Review 249 (Winter 2001); M&A: Confidentiality Agreements Are Contracts with Long Teeth, 46 Texas Journal of Business Law 1 (Fall 2014); Private Company Acquisitions: A Mock Negotiation, 116 Penn St. L. Rev. 743 (2012); Asset Acquisitions: Assuming and Avoiding Liabilities, 116 Penn St. L. Rev. 913 (2012); Asset Acquisitions: A Colloquy, X U. Miami Business Law Review 145 (Winter/Spring 2002); Securities Law: Major Themes of the Sarbanes-Oxley Act, 42 Texas Journal of Business Law 339 (Winter 2008); Communicating with Auditors After the Sarbanes-Oxley Act, 41 Texas Journal of Business Law 131 (Fall 2005); The Sarbanes-Oxley Act and Its Expanding Reach, 40 Texas Journal of Business Law 305 (Winter 2005); Congress Takes Action: The Sarbanes-Oxley Act, XXII Corporate Counsel Review 1 (May 2003); and Legislation: The Role of the Business Law Section and the Texas Business Law Foundation in the Development of Texas Business Law, 41 Texas Journal of Business Law 41 (Spring 2005).

Education: B.A. and J.D., University of Texas
After law school, Byron served as a law clerk for Judge Irving L. Goldberg on the United States Court of Appeals for the Fifth Circuit.

Honors: For more than 25 years, Byron has been listed in The Best Lawyers in America under Corporate, M&A or Securities Law. He is the 2015 recipient of the Texas Bar Foundation's Dan Rugeley Price Memorial Award, which is presented annually to a lawyer who has an unreserved commitment to clients and to the legal profession. He won the Burton Award for distinguished legal writing four times. Byron has been recognized as one of the top corporate and M&A lawyers in Texas by a number of publications, including *Corporate Counsel Magazine, Texas Lawyer, Texas Monthly, The M&A Journal* (which profiled him in 2005) and *Who's Who Legal*. In 2009, his paper entitled "Director Duties: Process and Proof" was awarded the Franklin Jones Outstanding CLE Article Award and an earlier version of that article was honored by the State Bar Corporate Counsel Section's Award for the Most Requested Article in the Last Five Years.

Agenda

- Letters of Intent
- Best Efforts
- Indemnification
- Sandbagging
- Non-Reliance
- Fiduciary Duties

References

- Treatise by Byron F. Egan entitled **EGAN ON ENTITIES: Corporations, Partnerships and Limited Liability Companies in Texas** (May 2016) ("***EGAN ON ENTITIES***"), which is available on Amazon
- *Acquisition Structure Decision Tree*, TexasBarCLE & Business Law Section of State Bar of Texas Choice, Governance & Acquisition of Entities Course, San Antonio, May 19, 2017 ("***Acquisition Structure paper***"): http://www.jw.com/wp-content/uploads/2017/04/Acquisition-Structure-Decision-Tree-Paper-5-19-2017.pdf
- *Joint Venture Governance and Business Opportunity Issues*, University of Texas School of Law 11th Annual Mergers and Acquisitions Institute, Dallas, October 15, 2015 ("***Joint Venture paper***"): http://www.jw.com/publications/article/2093

Letters of Intent

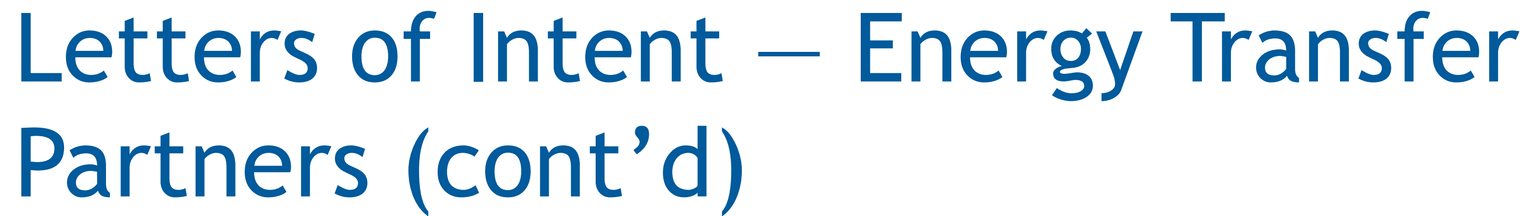
- Buyer may seek letter of intent that is generally not binding on either party (exceptions for expenses, confidentiality, good faith negotiation, etc.).
- The right words are critical in determining extent to which a letter of intent is non-binding. See *Global Asset Capital, LLC v. Rubicon*, C.A. No. 5071-VCL (Del. Ch. 2009) (discussed in note 10 on pp 8-9 of Appendix C to *Acquisition Structure* paper).

Letters of Intent

Even if the letter of intent has unambiguous words to the effect that no binding contract will exist until a definitive agreement is signed, the conduct of the parties (particularly press releases and joint marketing efforts) can lead a trier of fact to find that the parties have entered into a definitive agreement.

Letters of Intent — Energy Transfer Partners

- *Enterprise Product Partners, L.P. ("**Enterprise**") vs. Energy Transfer Partners, L.P. ("**ETP**"),* involved an action over an aborted joint venture.
- ETP claimed it had formed a joint venture with Enterprise to build an oil pipeline, and that Enterprise wrongfully terminated it.
- ETP and Enterprise had signed preliminary agreements which provided that there would be no partnership or joint venture formed unless and until definitive agreements were executed.
- Although no definitive joint venture agreement had been signed, the parties proceeded to spend time and money on the project and, reminiscent of *Texaco v. Pennzoil*, they communicated publicly that a joint venture had been formed and they marketed the pipeline to potential customers as if they had formed a joint venture.
- Notwithstanding the express provisions in preliminary agreements that nobody was bound unless and until definitive agreements were signed, ETP claimed, and the jury found, that the parties' ensuing conduct served to form a Texas law partnership and that Enterprise breached its fiduciary duty of loyalty to ETP by taking the project to a competitor.
- The jury awarded $319 million plus attorneys fees to ETP.



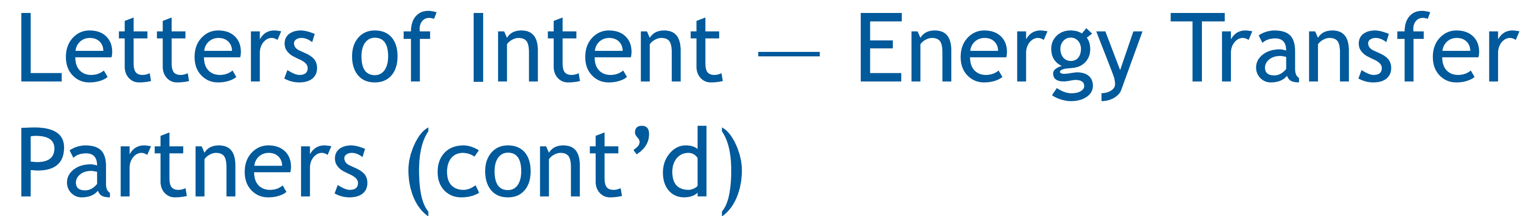
The preliminary agreements between ETP and Enterprise provided that there would be no partnership or joint venture formed unless and until later definitive agreements were executed. The parties' confidentiality agreement (the "***Confidentiality Agreement***") provided that they were not bound to pursue any transaction until a definitive agreement was signed as follows:

> The Parties agree that **unless and until a definitive agreement** between the Parties with respect to the Potential Transaction **has been executed and delivered**, and then only to the extent of the specific terms of such definitive agreement, **no Party hereto will be under any legal obligation of any kind whatsoever with respect to any transaction by virtue of this Agreement or any written or oral expression with respect to such a transaction by any Party or their respective Representatives, except, in the case of this Agreement, for the matters specifically agreed to herein.** A Party shall be entitled to cease disclosure of Confidential Information hereunder and **any Party may depart from negotiations at any time for any reason or no reason without liability to any Party hereto.**

Letters of Intent — Energy Transfer Partners (cont'd)

The parties also signed a letter agreement and term sheet (the "***Letter of Intent***") that provided as follows:

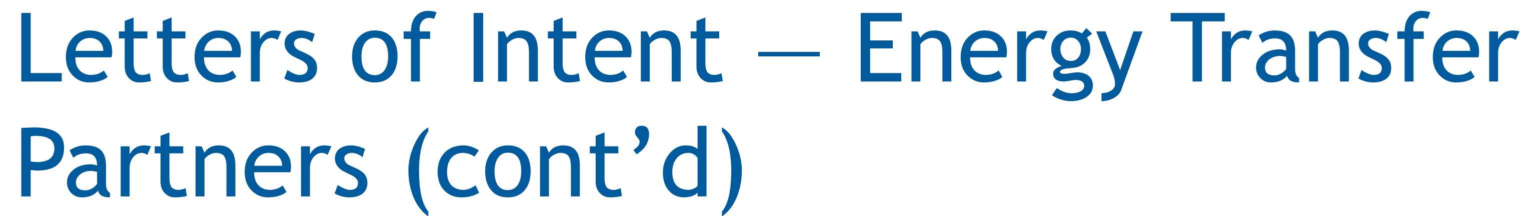
> Neither this letter nor the JV Term Sheet create any binding or enforceable obligations between the Parties and, except for the [ETP] Confidentiality Agreement . . . no binding or enforceable obligations shall exist between the Parties with respect to the Transaction unless and until the Parties have received their respective board approvals and definitive agreements memorializing the terms and conditions of the Transaction have been negotiated, executed and delivered by both of the Parties.
>
> * * *
>
> **Unless and until** such definitive agreements are executed and delivered by both of the Parties, either [Enterprise] or ETP, **for any reason**, may depart from or **terminate the negotiations with respect to the Transaction at any time without any liability or obligation** to the other, whether arising in contract, tort, strict liability or otherwise.



Letters of Intent — Energy Transfer Partners (cont'd)

They also signed a Letter Agreement Regarding Sharing of Engineering Costs for Proposed Cushing to Houston Pipeline (the "***Reimbursement Agreement***") that said that the parties had not completed negotiations of the proposed transaction and nobody was bound until the definitive agreements were signed:

> [Enterprise and ETP] **are in the process of negotiating mutually agreeable definitive agreements** ("the Definitive Agreements") related to the construction and operation of a crude oil pipeline between Cushing, OK and Houston, TX ("The Project"). Although **the negotiation** of the Definitive Agreements **has not been completed**, the Parties desire to begin work to develop a detailed engineering design package for The Project (the "Work") prior to execution of the Definitive Agreements.
>
> * * *
>
> It is understood by each of the Parties that the execution of this Agreement is intended to create and does create legally binding obligations between Enterprise and ETP but only as set forth herein. The obligations of the Parties shall be several and not joint and no Party shall have the right, authority or power to bind the other Party to any agreement without its prior written consent (other than the authority to commit and/or expend funds under Section I of this Agreement). Each Party expressly agrees to indemnify and hold the other Party harmless from liability if it binds or attempts to bind the other Party to any other agreement without such prior written consent. **Nothing herein shall be deemed to create or constitute a joint venture, a partnership, a corporation, or any entity taxable as a corporation, partnership or otherwise.**



Letters of Intent — Energy Transfer Partners (cont'd)

The Court of Appeals reversed the judgment against Enterprise, holding that ETP had failed to prove that the conditions precedent stated in the letter agreement had been satisfied or waived. The Court rejected ETP's argument that the formation of a common law partnership between ETP and Enterprise was controlled solely by the five factor test in TBOC § 152.052. Instead, the Court ruled that the TBOC § 152.052 five factors are non-exclusive. The conditions in the parties' Letter of Intent, which required board of directors approval and execution of definitive agreements, constituted conditions precedent that had to be satisfied before a partnership could be formed. The Court concluded that:

1. The unfulfilled conditions precedent in the parties' written agreements precluded forming the alleged partnership unless ETP obtained a jury finding that the parties waived those conditions precedent;
2. ETP's failure to request such a finding meant that it had to establish waiver of the conditions precedent as a matter of law; and
3. ETP did not prove as a matter of law that the parties waived the conditions precedent.

The Court therefore rendered judgment that ETP recover nothing from Enterprise. It is anticipated that ETP will petition the Texas Supreme Court to review the decision.

Best Efforts Clauses

Texas

- In Texas, a “best efforts” commitment, without any goal or guideline against which to measure the commitment, is not enforceable.
- The goal or guideline does not need to be a black-line metric, but some level of guidance must be provided.
- Best efforts is arguably a higher standard in Texas than reasonable efforts.

New York

- New York cases have held that the terms “reasonable efforts” and “best efforts” are interchangeable.
- New York decisions are split on whether objective criteria are required for enforceability.
- NY courts have said that best efforts requires more than a good faith effort.

Best Efforts Clauses

Delaware

- Surprisingly little case law in Delaware
- Those cases that have addressed the issue have upheld the enforceability of these provisions
- Courts have not required objective criteria but rather have looked at the underlying facts of a party’s efforts.

Takeaways

- Draft with specificity to define what efforts are expected on the part of a party.
- Consider defining exactly what constitutes a party's "best efforts."
- If it is expected that a party will do whatever is necessary to achieve an objective, such as obtaining regulatory approval or a third party consent, use a "hell or high water" provision.

Best Efforts Clauses

Sample Definition

- From the ABA Model Asset Purchase Agreement:

  "Best Efforts"—the efforts that a prudent person desirous of achieving a result would use in similar circumstances to achieve that result as expeditiously as possible; provided, however, that a person required to use Best Efforts under this Agreement will not be required to take actions that would result in a material adverse change in the benefits to such person of this agreement and the transactions contemplated herein or to dispose of or make any change to its business, expend any material funds or incur any other material burden.

Overview

- Indemnification: Promise to protect or hold another party harmless against an existing or future loss or liability
- Considerations:
  - Duty to Indemnify
  - Duty to Defend
  - Exculpation

Strict Construction

General Rule for Contractual Indemnity:

- Intent of the parties to provide indemnification must be clear from the contract
- Courts will generally strictly enforce highly negotiated provisions
- Exceptions: Public policy or statutory limitations

Duty to Defend vs Duty to Indemnify

- Duty to defend is broader
  - Does not depend on the outcome or require the underlying claim to have merit
  - Consider express reimbursement obligation as alternative
- Duty to indemnify does not arise until incurrence of loss
  - Depends on the outcome and requires the underlying claim to be resolved adversely to the indemnified party (e.g., adverse judgment)

Exculpation

- Indemnification for a party’s own negligence is generally limited and courts will not construe indemnity provisions to provide coverage unless the language and/or intent to do so is clear
- Texas: Fair Notice Requirements
  - Express Negligence Doctrine
  - Clear and Conspicuous
- DE & NY:
  - Requirements not as rigid, but the intent must be clear from the express language and/or context

Texas Fair Notice Examples

- Express Negligence Requirements
  - the indemnifying party shall indemnify and hold harmless the indemnified party for all losses arising out of ….. ***regardless of whether attributable to the negligence of the indemnified party***
- Clear and Conspicuous
  - larger than normal type
  - bold face type or different font color
  - all capital letters
  - contrasting it in some distinguishing manner
- The indemnifying party has actual notice and knowledge of the indemnity agreement

Indemnification

Texas Fair Notice Examples

- Be sure the language includes what the parties intend:
  - duties to defend, reimburse and/or indemnify
  - express coverage for negligence
  - direct and third-party claims
  - special indemnities for known matters
  - types of losses that are to be covered (including attorneys’ fees)
  - who is covered
  - duration of obligation
  - process for seeking claims
  - exclusive remedy

Overview

- Purchaser learns of a breach of a representation, warranty or covenant prior to closing and brings a post-closing indemnity claim as recourse for the breach
- M&A Agreement Options:
  - Expressly permit (pro-sandbagging)
  - Expressly prohibit (anti-sandbagging)
  - Remain silent (default to governing law)

Sandbagging
Sample Contract Provisions

- Pro-Sandbagging:
  - An indemnified party’s right to indemnification hereunder will not be affected by any investigation conducted or any knowledge acquired at any time
- Anti-Sandbagging:
  - No Purchaser Indemnified Party shall have any indemnification claim with respect to any Losses arising out of a breach of any representation or warranty on the part of the Company to the extent that, prior to or at Closing, [the Purchaser had knowledge of such breach]
    - [any of the officers of the Purchaser involved in the negotiation, structuring or effectuation of the transactions contemplated by this Agreement had actual knowledge of such breach]

Sandbagging
State Law Nuances

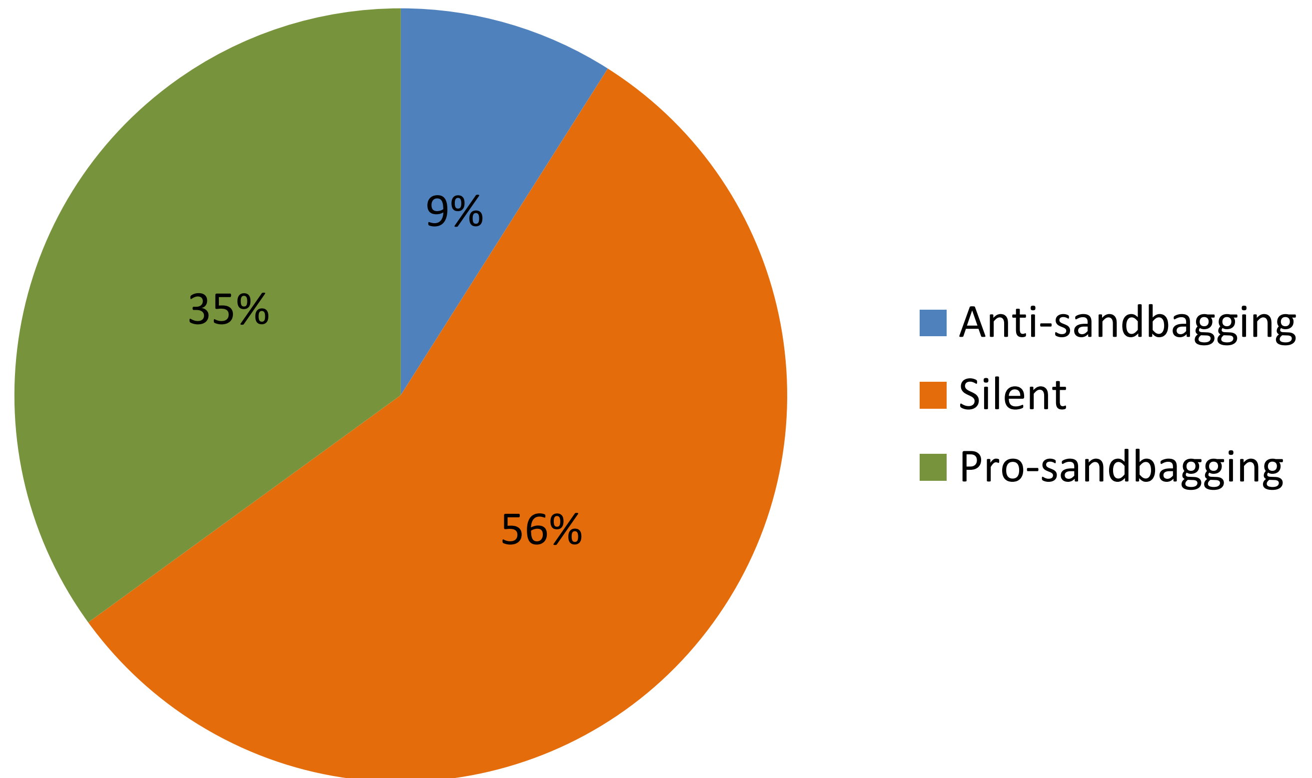
- TX, NY and DE generally all enforce express pro-sandbagging or anti-sandbagging contractual provisions
- When the contract is silent, laws diverge
  - TX: Typically requires reliance on seller's representations in order to bring a claim

When the contract is silent…

- Delaware
  - no reliance on the accuracy of representations is necessary for an indemnity claim for breach
  - Representations are a contractually allocated shifting of the risk of inaccuracy
- New York
  - buyer's reliance on the accuracy of the representations is SOMETIMES required for claim of breach
  - in cases where the buyer learns of breach from sources other than the seller, a breach claim may prevail if buyer negotiated for the reps to insure against this knowledge

Sandbagging

Latest Trends



Source: *Private Targets Mergers & Acquisitions Deal Points Study (including transactions completed in 2014), M&A Market Trends Subcommittee, Mergers & Acquisitions Committee, http://apps.americanbar.org/dch/committee.cfm?com=cl560003*

Non-reliance Provisions

Purpose

- Provisions to the effect that the seller has made no representations other than those specifically set forth in the acquisition agreement are typically requested by sellers to be inserted at the end of the Representations and Warranties section. Such provisions are typically complemented by “entire agreement” or “integration” provisions in the Miscellaneous section that say that the acquisition agreement contains the entire and exclusive agreement of the parties on its subject matter and that there are no other promises or agreements.
- These non-reliance provisions are sought by a seller in an acquisition agreement to prevent the buyer from claiming reliance on allegedly false extra-contractual representations to circumvent negotiated limitations on indemnifications in the agreement. The purpose of the provisions is to eliminate an important element of a fraud claim – that the buyer reasonably relied on the alleged false extracontractual representations.
- The provisions include an acknowledgment by the buyer that no representations or warranties are made which are not set forth in the four corners of the acquisition agreement, that no representation has been made as to the completeness of the information provided by the seller, and that, in entering into the agreement, the buyer is not relying on any representations, warranties or other promises that are not set forth in the four corners of the acquisition agreement.

- Texas, Delaware and New York recognize that non-reliance provisions can be effective, but differ in particular situations.
- Parties have argued that a simple integration clause which states that the acquisition agreement states the entire understanding of the parties should be given the same effect, but courts in Texas, Delaware and New York tend to require express statements of non-reliance in that clause or elsewhere.

Non-reliance Provisions
Texas

- Texas law will give effect to a clear and conspicuous non-reliance clause to preclude a fraudulent inducement claim. However, in contrast to the approach of Delaware and New York courts in this area, the Texas courts look not only to the language of the clause, but also to the circumstances surrounding the formation of the agreement containing the non-reliance clause. A simple integration clause is not sufficient to bar a claim for fraudulent inducement.

Non-reliance Provisions
Texas

- In *Schlumberger Technology Corporation v. Swanson*, 959 S.W.2d 171 (Tex. 1997), a consultant entered into a release in which it sold its interest in an underwater diamond mining project back to one of the project's sponsors. The consultant claimed that it was fraudulently induced to enter into the release by representations made by the sponsor about the project's viability and value. In holding held that the non-reliance clause in the release barred the consultant's claim for fraudulent inducement, Texas Supreme Court considered the following factors: (i) the consultant was represented by highly competent counsel, (ii) the parties were negotiating at arms' length, (iii) the consultant was knowledgeable and sophisticated, (iv) the consultant disagreed with the sponsor about the viability and value of the project during the negotiations, and (v) the language of the release, which disclaimed reliance on any representation or warranty.
- In *Forest Oil Corporation v. McAllen et al*, 268 S.W.3d 51 (Tex. 2008), the Texas Supreme Court reinforced its holding and analysis in *Schlumberger*, and commented that the important factors in *Schlumberger* were that "(1) the terms of the contract were negotiated, rather than boilerplate, and during negotiations the parties specifically discussed the issue which has become the topic of the subsequent dispute; (2) the complaining party was represented by counsel; (3) the parties dealt with each other in an arm's length transaction; (4) the parties were knowledgeable in business matters; and (5) the release language was clear." *Forest Oil* emphasized that there was no per se rule that a disclaimer automatically precludes a fraudulent inducement claim regardless of context.

Non-reliance Provisions
Texas

- An integration clause without an expressed clear and unequivocal intent to disclaim reliance upon extra contractual representations will not bar a claim for fraudulent inducement. *Italian Cowboy Partners, Ltd. v. Prudential Insurance Company of America*, 341 S.W.3d 323 (Tex. 2011).
- *Allen v. Devon Energy Holdings, L.L.C. F/K/A Chief Holdings, L.L.C. and Trevor Rees-Jones*, 367 S.W.3d 355 (Tx. Ct. App. First Dist. March 9, 2012 No. 01-09-00643-CV) (case settled in 2013) (in the context of allegations by seller that CEO and majority owner fraudulently induced seller to sell and citing *Abry* and *Italian Cowboy*, held that disclaimer and release provisions relating to the value of the company did not negate reliance or materiality as a matter of law, as omissions related to seller's decision whether to sell rather than value of company; fact issue existed as to fraud and the existence of a fiduciary relationship).
- *Staton Holdings, Inc. v. Tatum, LLC*, 345 S.W.3d 729 (Tx. App.-Dallas 2011) (express negligence doctrine applies to non-reliance clauses).

Non-reliance Provisions
Delaware

- Delaware courts generally support non-reliance clauses in transactions between sophisticated business parties. They have permitted a non-reliance clause to shield a seller from liability for fraudulent statements made outside of an acquisition agreement.
- However, a traditional non-reliance clause will not bar a fraud claim based on active concealment and a nonreliance clause will not bar a securities fraud claim brought under Section 10(b) of the Securities Exchange Act of 1934).
- Delaware courts have also determined that an integration clause without express non-reliance language is not sufficient to bar a claim for fraudulent inducement.

Non-reliance Provisions

Delaware

- In *RAA Management, LLC v. Savage Sports Holdings, Inc.*, 45 A.3d 107 (Del. 2012), the Delaware Supreme Court determined that a non-reliance clause in a non-disclosure agreement precluded a party from suing the target company for fraud based on alleged knowingly false statements made in due diligence disclosures. The plaintiff in *RAA Management* sought to recover $1.2 million in due diligence and negotiation costs it had incurred before discovering that the statements were false. The non-disclosure agreement contained a non-reliance clause in which the plaintiff acknowledged that no representations were being made with respect to the accuracy or completeness of the due diligence disclosures and that the target would have no liability resulting from the plaintiffs use of those disclosures. It also contained an express waiver of any claims relating to the transaction unless and until the plaintiff entered into a definitive acquisition agreement. The Delaware Supreme Court determined that fraud claims based on representations made outside of an acquisition agreement can be eliminated by a non-reliance clause. The Court determined that New York law applied to that case, but observed that the result would be the same under Delaware law.

Non-reliance Provisions

Delaware

- *ABRY Partners V, L.P. v. F&W Acquisition LLC*, 891 A.3d 1032 (Del. Ch. 2006) (stock purchase agreement non-reliance clause that the buyer was not relying upon any representations and warranties not stated in the contract generally enforceable when the product of give-and-take between commercial parties who had the ability to walk away freely).
- *TransDigm, Inc. v. Alco Global Fasteners, Inc.*, 2013 WL 2326881 (Del.Ch. May 29, 2013), involved the application of a non- reliance clause to a common law fraud claim made by a buyer based on active concealment of material facts. The buyer alleged that seller actively concealed that (1) one of the acquired company's key customers had expressed to the sellers that it intended to buy 50% less from the purchased company; and (2) the sellers had offered, and the key customer agreed to, a 5% price discount effective after the closing date. The court indicated that, unlike a fraud claim based upon a material omission, a fraud claim based upon active concealment does not require a pre-existing duty to speak. The court explained that a party bringing an active concealment claim must instead show some affirmative action intended to prevent, and which did prevent, the discovery of facts giving rise to the fraud claim, some artifice to prevent knowledge of the facts or some representation intended to exclude suspicion and prevent inquiry. The buyer claimed that representatives of the seller were instructed not to discuss the possible loss of business from the acquired company's major customer. The seller asserted that, based on the Delaware Supreme Court's decision in *RAA Management*, *supra*, the non-reliance clause in the acquisition agreement precluded the seller's claim. The court reviewed the specific non-reliance language and determined that while it would bar a fraud claim based on extra-contractual misrepresentations, it was not sufficient to bar a fraud claim based on active concealment. The Vice Chancellor emphasized that the language involved in the *RAA Management* decision was that no representations or warranties were being made with respect to the accuracy *or completeness* of the information provided under the confidentiality agreement involved in that decision and that only representations made in the purchase agreement would have any legal effect, and that there was no similar language in the acquisition agreement and that the purchaser had not disclaimed reliance on extra-contractual *omissions*.

Non-reliance Provisions
New York

- New York courts give effect to non-reliance clauses, but an integration clause without express non-reliance language is not sufficient to bar a claim for fraudulent inducement.

Non-reliance Provisions
New York

- In *Harsco Corporation v. Segui, et al.*, 91 F. 3d 337 (2d Cir. 1996) the Second Circuit Court of Appeals (applying New York law) affirmed the dismissal of a purchaser's claims based on alleged fraudulent representations made outside of the acquisition agreement during purchaser's due diligence. Prior to entering into the acquisition agreement, the seller represented that projections of future earnings contained in an offering memorandum reflected conservative assumptions and accounted for the prospects of certain plants. During the purchaser's subsequent due diligence, it requested some additional information, which was not provided. The Court determined that the non-reliance clause of the acquisition agreement barred a fraud claim based on these extra contractual representations.
- *Dynacorp v. GTE Corporation*, 215 F. Supp.2d 308 (S.D.N.Y 2002) followed *Harsco Corporation v. Segui*. The buyer sought damages based on common law fraud for alleged misrepresentations about the financial condition and operations of the target company and about the projected revenues from a major customer contract. The alleged misrepresentations were made in an offering memorandum and other written materials provided by the seller and by management presentations made prior to the execution of the agreement.
- A general integration clause was found not sufficient under New York law to bar a common law fraud claim based on misrepresentations in *Danann Realty Corp. v. Harris*, 5 N. Y .2d 31 7 (N. Y. 1959), in which the court stated that if it was "dealing solely with a general and vague merger clause, [the] task would be simple" because "a general merger clause is ineffective to exclude parol evidence to show fraud in inducing the contract." However, the court enforced the non-reliance clause, observing that it "destroys the allegations in the plaintiffs complaint that the agreement was executed in reliance upon the contrary representations and warranties."

Sample Provisions

- Acquisition agreements in private M&A transactions increasingly contain an “***exclusive representations clause***” that purports to limit the purchaser’s recourse against the seller for extra-contractual misrepresentations, even if fraudulent, in order to allocate among the parties the risk of potential post-closing losses. Such limitations on liability are generally enforceable under Delaware law when they have been specifically negotiated between sophisticated parties and are clearly set forth in the agreement. They are commonly implemented in combination with a so-called “***entire agreement***” or “***integration***” clause as discussed above and set forth below. In *Prairie Capital III, LP v. Double E Holding Corp*. C.A. No. 10127-VCL (Del. Ch. Nov. 25, 2015), the Delaware Court of Chancery construed and enforced an exclusive representations clause comparable to the foregoing in a stock purchase agreement for the sale of a portfolio company by one private equity firm to another; the clause read as follows:
  - The Buyer acknowledges that it has conducted to its satisfaction an independent investigation of the financial condition, operations, assets, liabilities and properties of the Double E Companies. In making its determination to proceed with the Transaction, the Buyer has relied on (a) the results of its own independent investigation and (b) the representations and warranties of the Double E Parties expressly and specifically set forth in this Agreement, including the Schedules. SUCH REPRESENTATIONS AND WARRANTIES BY THE DOUBLE E PARTIES CONSTITUTE THE SOLE AND EXCLUSIVE REPRESENTATIONS AND WARRANTIES OF THE DOUBLE E PARTIES TO THE BUYER IN CONNECTION WITH THE TRANSACTION, AND THE BUYER UNDERSTANDS, ACKNOWLEDGES, AND AGREES THAT ALL OTHER REPRESENTATIONS AND WARRANTIES OF ANY KIND OR NATURE EXPRESS OR IMPLIED (INCLUDING, BUT NOT LIMITED TO, ANY RELATING TO THE FUTURE OR HISTORICAL FINANCIAL CONDITION, RESULTS OF OPERATIONS, ASSETS OR LIABILITIES OR PROSPECTS OF DOUBLE E AND THE SUBSIDIARIES) ARE SPECIFICALLY DISCLAIMED BY THE DOUBLE E PARTIES.
- In *Prairie Capital* the purchaser was suing for common law fraud based on misrepresentations made outside of the purchase agreement. Since one of the requirements of a *prima facie* claim for fraudulent misrepresentation is reasonable reliance on the misrepresentation in question, the Court’s decision in *Prairie Capital* turned on whether the purchaser could reasonably have relied on any extra-contractual misrepresentation in light of the language in the acquisition agreement quoted above.

Non-reliance Provisions

Sample Provisions

- An Entire Agreement/Contractual Limitation of Extra contractual Liabilities clause that should be effective under Texas, Delaware and New York law could read as follows:

  Section 13.7 Entire Agreement, Non-reliance, Exclusive Remedies and Modification

  (a) This Agreement supersedes all prior agreements, whether written or oral, between the parties with respect to its subject matter (including any letter of intent and any confidentiality agreement between Buyer and Seller) and constitutes (along with the Disclosure Letter, Exhibits and other documents delivered pursuant to this Agreement) a complete and exclusive statement of the terms of the agreement between the parties with respect to its subject matter. This Agreement may not be amended, supplemented or otherwise modified except by a written agreement executed by the party to be charged with the amendment.

  (b) Except for the representations and warranties contained in Article 3 [the representations and warranties section of the Agreement], (i) none of Seller or any Shareholder has made any representation or warranty, expressed or implied, as to Seller or as to the accuracy or completeness of any information regarding Seller furnished or made available to Buyer and its representatives, (ii) Buyer has not relied upon, and will not assert that it has relied upon, any information regarding Seller, or the transactions contemplated by this Agreement, not set forth in Article 3, and (iii) none of Seller or any Shareholder shall have or be subject to any liability to Buyer or any other Person resulting from the furnishing to Buyer, or Buyer's use of or reliance on, any such information or any information, documents or material made available to Buyer in any form in expectation of, or in connection with, the transactions contemplated by this Agreement.

  (c) Following the Closing, the sole and exclusive remedy for any and all claims arising under, out of, or related to this Agreement, or the sale and purchase of the Seller, shall be the rights of indemnification set forth in Article 11 [the indemnification section of the Agreement] only, and no person will have any other entitlement, remedy or recourse, whether in contract, tort or otherwise, it being agreed that all of such other remedies, entitlements and recourse are expressly waived and released by the parties hereto to the fullest extent permitted by law.]

Non-reliance Provisions

Sample Provisions

(d) The provisions of this Section 13.7 and the limited remedies provided in Article 11, were specifically bargained for between Buyer and Sellers and were taken into account by Buyer and the Sellers in arriving at the Purchase Price. The Sellers have specifically relied upon the provisions of this Section 13.7 and the limited remedies provided in Article 11 in agreeing to the Purchase Price and in agreeing to provide the specific representations and warranties set forth herein.

(e) All claims or causes of action (whether in contract or in tort, in law or in equity) that may be based upon, arise out of or relate to this Agreement, or the negotiation, execution or performance of this Agreement (including any representation or warranty, whether written or oral, made in or in connection with this Agreement or as an inducement to enter into this Agreement), may be made only against the entities that are expressly identified as parties hereto. No Person who is not a named party to this Agreement, including without limitation any director, officer, employee, incorporator, member, partner, stockholder, Affiliate, agent, attorney or representative of any named party to this Agreement ("*Non-Party Affiliates*"), shall have any liability (whether in contract or in tort, in law or in equity, or based upon any theory that seeks to impose liability of an entity party against its owners or Affiliates) for any obligations or liabilities arising under, in connection with or related to this Agreement or for any claim based on, in respect of, or by reason of this Agreement or its negotiation or execution; and each party hereto waives and releases all such liabilities, claims and obligations against any such Non-Party Affiliates. Non-Party Affiliates are expressly intended as third party beneficiaries of this provision of this Agreement.

(f) This Agreement may not be amended, supplemented or otherwise modified except by a written agreement executed by the party to be charged with the amendment.

- *See Acquisition Structure* paper pp 303-323. *See also* Glenn D. West and W. Benton Lewis, Jr., *Contracting to Avoid Extra-Contractual Liability—Can Your Contractual Deal Ever Really Be the "Entire" Deal?*, 64 Bus. Law. 999, 1037-38 (Aug. 2009); *see* Byron F. Egan, Patricia O. Vella and Glenn D. West, *Contractual Limitations on Seller Liability in M&A Transactions*, ABA Section of Business Law Spring Meeting Program on "Creating Contractual Limitations on Seller Liability that Work Post-Closing: Avoiding Serious Pitfalls in Domestic and International Deals," Denver, CO, April 22, 2010, at Appendix B, *available at* http://images.jw.com/com/publications/1362.pdf.

Overview

- Texas, Delaware and New York all recognize that directors owe fiduciary duties to the corporation and its shareholders collectively and that those duties include care, obedience and obedience. As to the defense to claims of the breach of duty of care, each state purports to have a business judgment rule under which courts defer to say they do not second guess the business judgment of independent directors. Texas is robust in its application of the business judgment rule, while Delaware is more nuanced in the M&A sphere and more likely to second guess business decisions of independent directors. The business judgment rule is no defense to duty of loyalty claims in Texas, Delaware or New York. Under the internal affairs doctrine followed in Texas, Delaware and New York, the law of the state of organization of an entity governs the fiduciary duties of governing persons of the entity.

- The "***duty of good faith and fair dealing***" is a contractual rather than a fiduciary duty concept and is to be distinguished from the fiduciary duty of good faith which is a subset of the fiduciary duty of loyalty. The duty of good faith and fair dealing is a fundamental, non-waivable component of Delaware law, but is generally not a part of Texas common law except in the partnership context. See EGAN ON ENTITIES p 416 at note 1447; Restatement (Second) of Contracts § 205. The duty of good faith and fair dealing in Delaware allows a court to imply into a contract those terms that the court finds the parties would have included if they had considered the matter at the time they entered into the contract.

Fiduciary Duties

Internal Affairs Doctrine

- "The internal affairs doctrine is a conflict of laws principle which recognizes that only one State should have the authority to regulate a corporation's internal affairs," [*Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982)] and "under the commerce clause a state has no interest in regulating the internal affairs of foreign corporations." [*McDermott, Inc. v. Lewis*, 531 A.2d 206, 217 (Del. 1987)]
- Internal corporate affairs are "those matters which are peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders," and are to be distinguished from matters which are not unique to those relationships.
- Under the internal affairs doctrine followed by Texas, Delaware, New York and most other states, the law of the state of organization of an entity governs its internal affairs, including the liability of an owner or governing person of the entity for actions taken in that capacity. The internal affairs doctrine in Texas mandates that courts apply the law of a corporation's state of incorporation in adjudications regarding director fiduciary duties in M&A transactions. [*Hollis v. Hill*, 232 F.3d 460, 465 (5th Cir. 2000); *Gearhart Indus., Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 719 (5th Cir. 1984); *A. Copeland Enters., Inc. v. Guste*, 706 F. Supp. 1283, 1288 (W.D. Tex. 1989). The internal affairs doctrine is codified in TBOC §§1.101-1.105 (2015). See *EGAN ON ENTITIES* pp 71-72.
- Texas Business & Commerce Code §271.001 et seq allows contractual freedom of choice of law in M&A and other "qualified transactions" involving at least $1 Million, but generally does not trump internal affairs doctrine for fiduciary duties cases.

Source of Fiduciary Duty Law

- Both the Texas Business Organizations Code ("***TBOC***") and the Delaware General Corporation Law (the "***DGCL***") provide that the business and affairs of a corporation are to be managed under the direction of its board of directors ("***Board***"). While the TBOC and the DGCL provide statutory guidance as to matters such as the issuance of securities, the payment of dividends, the notice and voting procedures for meetings of directors and shareholders, and the ability of directors to rely on specified persons and information, the nature of a director's "fiduciary" duty to the corporation and the shareholders has been largely defined by the courts through damage and injunctive actions.
- There is relatively little New York appellate court precedent in M&A context because New York businesses of substance tend to be organized under laws of Delaware or other states because of a New York statute that makes the 10 largest shareholders (determined by fair value of their beneficial interest) jointly and severally personally liability of for wages and benefits of employees of a non-public New York corporation. See *Whitely v. Moravec*, 635 F.3d 308 (7th Cir. 2011).

Fiduciary Duties

Texas Cases

- Texas has its own body of precedent with respect to director, officer and controlling shareholder fiduciary duties.
- In *Gearhart Industries, Inc. v. Smith International*, the Fifth Circuit sharply criticized the parties' arguments based on Delaware cases and failure to cite Texas jurisprudence in their briefing on director fiduciary duties:
    - We are both surprised and inconvenienced by the circumstances that, despite their multitudinous and voluminous briefs and exhibits, neither plaintiffs nor defendants seriously attempt to analyze officers' and directors' fiduciary duties or the business judgment rule under Texas law. This is a particularly so in view of the authorities cited in their discussions of the business judgment rule: Smith and Gearhart argue back and forth over the applicability of the plethora of out-of-state cases they cite, yet they ignore the fact that we are obligated to decide these aspects of this case under Texas law.
- EGAN ON ENTITIES p 74.

Fiduciary Duties

Texas Cases

Formal and Informal Fiduciary Duties

- In Texas there are two types of fiduciary relationships out of which fiduciary duties arise.
    1) a formal fiduciary relationship, which arises as a matter of law (directors and officers owe formal fiduciary duties).
    2) is an informal fiduciary relationship, which may arise from a moral, social, domestic or purely personal relationship of trust and confidence, generally called a confidential relationship.
- Whether undisputed facts give rise to a formal fiduciary relationship is a question of law. Whether an informal fiduciary relationship exists is ordinarily a question of fact because the underlying material facts are disputed. When the underlying facts are undisputed, however, the determination of whether a fiduciary relationship exists is a question of law for the court.
- Fiduciary duties (both formal and informal) are owed to the corporation and all of its shareholders, but generally not to individual shareholders. An officer or director of a closely-held company “may become” a fiduciary to individual shareholders when the corporation repurchases the shareholder’s stock.
- **Controlling shareholders generally do not owe formal fiduciary duties to minority shareholders under Texas law, but may owe informal fiduciary duties to the minority shareholders.**
- EGAN ON ENTITIES pp 75-76

Texas Cases

Ritchie v. Rupe (2014)

- On June 20, 2014, the Texas Supreme Court issued its opinion in Ritchie v. Rupe, 443 S.W.3d 856 (Tex. 2014) [EGAN ON ENTITIES pp 75-82], holding that:
  - For claims of "minority shareholder oppression" – essentially, acts of a majority shareholder group that are harmful to a minority shareholder without necessarily harming the corporation itself – the sole remedy available under Texas law is a statutory receivership.
  - Common law fiduciary duties, as articulated in *Gearhart Indus., Inc. v. Smith Intern., Inc.*, 741 F.2d 707, 723-24 (5th Cir. 1984), are still the appropriate lens through which to evaluate the conduct of directors of Texas corporations.
  - *Gearhart* held that under Texas law "[t]hree broad duties stem from the fiduciary status of corporate directors; namely the duties of obedience, loyalty, and due care," and commented that (i) the duty of obedience requires a director to avoid committing *ultra vires* acts, i.e., acts beyond the scope of the authority of the corporation as defined by its articles of incorporation or the laws of the state of incorporation, (ii) the duty of loyalty dictates that a director must act in good faith and must not allow his personal interests to prevail over the interests of the corporation, and (iii) the duty of due care requires that a director must handle his corporate duties with such care as an ordinarily prudent man would use under similar circumstances.
  - The *Gearhart* decision stated a strong business judgment rule:
    - The business judgment rule is a defense to the duty of care. As such, the Texas business judgment rule precludes judicial interference with the business judgment of directors absent a showing of fraud or an *ultra vires* act. If such a showing is not made, then the good or bad faith of the directors is irrelevant.

Fiduciary Duties
Texas Cases

<u>Sneed v. Webre (2015)</u>

- On May 29, 2015, the Texas Supreme Court in *Sneed v. Webre*, 465 S.W.3d 169, 178 (Tex. 2015), which involved the application of the business judgment rule to a shareholder derivative suit on behalf of a closely held Texas corporation with fewer than 35 shareholders, held:
  - "The business judgment rule in Texas generally protects corporate officers and directors, who owe fiduciary duties to the corporation, from liability for acts that are within the honest exercise of their business judgment and discretion."
- Following *Ritchie v. Rupe* and *Gearhart*, the Texas Supreme Court in *Sneed v. Webre* cited and quoted from the 1889 Supreme Court opinion of *Cates v. Sparkman* as setting the standard for judicial intervention in cases involving duty of care issues:
  - In Texas, the business judgment rule protects corporate officers and directors from being held liable to the corporation for alleged breach of duties based on actions that are negligent, unwise, inexpedient, or imprudent if the actions were "within the exercise of their discretion and judgment in the development or prosecution of the enterprise in which their interests are involved." *Cates*, 11 S.W. at 849. "Directors, or those acting as directors, owe a fiduciary duty to the corporation in their directorial actions, and this duty 'includes the dedication of [their] uncorrupted business judgment for the sole benefit of the corporation.'" *Ritchie*, 443 S.W.3d at 868 (quoting *Int'l Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963)). The business judgment rule also applies to protect the board of directors' decision to pursue or forgo corporate causes of action.

Fiduciary Duties
Texas Cases

Informal Fiduciary Duties

- In *Ritchie v. Rupe*, after reversing a trial court judgment on the ground that minority shareholder oppression is not a cause of action in Texas, the Texas Supreme Court remanded to the Court of Appeals plaintiff's fiduciary duty claim against directors of the corporation that was "not based on the formal fiduciary duties that officers and directors owe to the corporation by virtue of their management action," but on "an informal fiduciary relationship that 'existed between' plaintiff and defendant." The Supreme Court in a footnote explained that "an informal fiduciary duty may arise from 'a moral, social, domestic or purely personal relationship of trust and confidence,' and its existence is generally a question of fact for the jury." On remand, the Court of Appeals held that "there is no evidence of a relationship of trust and confidence to support a finding of an informal fiduciary duty" and thus did not address whether an informal fiduciary duty was breached; the Supreme Court denied the petition for review.

Fiduciary Duties
Director Liabilities and Ways to Limit Them

- In Texas and Delaware directors and officers have personal liability for breach of fiduciary duties.
- In Texas and Delaware statutes provide some ways to limit director fiduciary duty liability:
  - Certificate of formation provisions limiting director (but not officer) liability for breach of the fiduciary duty of care (but not breaches of duty of loyalty or actions not in good faith) [EGAN ON ENTITIES pp 189-191]
  - Renounce individual business opportunities in a charter provision or by Board resolution [EGAN ON ENTITIES p 191]
  - Interested director transactions if (i) approved by disinterested Board or committee after disclosure; (ii) approved by the shareholders after disclosure; or (iii) fair to the corporation. [EGAN ON ENTITIES p 191]

- LLCs and partnerships are “***alternative entities***”.
  - Courts in Texas and Delaware apply “contractarian” approach in measuring fiduciary duties of partners.
  - Fiduciary duties of general partners [EGAN ON ENTITIES pp 370-372; 382-398; 413-438] are highest and include:
    - Care
    - Loyalty
    - Candor
  - Fiduciary duties of managers of LLC analogous to corporate directors absent contractual definition [EGAN ON ENTITIES pp 413-438].
  - Texas LLC and partnership statutes allow modification (but not elimination) of common law fiduciary duties. Delaware allows partnership and LLC agreements to eliminate fiduciary duties, but cannot be “coy” in wording. TBOC only allows restriction and 2013 amendment to TBOC allows limitation of governing person liability to the extent permitted for corporations (eliminate duty of care but not loyalty).

Fiduciary Duties
Delaware Law

- Chancery Court
  - court of equity
  - no jury
  - nuanced precedent
- Standards of Review – EGAN ON ENTITIES pp 234-258
  - Delaware Standards of Review. Under Delaware law, there are generally three standards against which the courts will measure director conduct in the context of considering a business combination transaction:
    - *business judgment rule* – for a decision to remain independent or to approve a transaction not involving a sale of control;
    - *enhanced scrutiny* – for a decision to adopt or employ defensive measures or to approve a transaction involving a sale of control; and
    - *entire fairness* – for a decision to approve a transaction involving management or a principal shareholder or for any transaction in which a plaintiff successfully rebuts the presumptions of the business judgment rule.

Fiduciary Duties

Delaware Law (continued)

- Business Judgment Rule – EGAN ON ENTITIES pp 132-136, 259-304
  - The Delaware business judgment rule "is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company." *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984), *overruled on other grounds by Brehm v. Eisner*, 746 A.2d 244, 253-54 (Del. 2000). "A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be 'attributed to any rational business purpose.'" *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)).
  - The directors' decision must be an informed one: "The determination of whether a business judgment is an informed one turns on whether the directors have informed themselves 'prior to making a business decision, of all material information reasonably available to them.'" *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985). In *Van Gorkom*, notwithstanding a transaction price substantially above the current market, directors were held to have been grossly negligent in, among other things, acting in haste without adequately informing themselves as to the value of the corporation.
  - The business judgment rule is not applicable to duty of loyalty claims. *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009).

Fiduciary Duties

Delaware Law (continued)

- Enhanced Scrutiny. When applicable, enhanced scrutiny places on the directors the burden of proving that they have acted reasonably.
  - The key features of an enhanced scrutiny test are: (a) a judicial determination regarding the adequacy of the decision making process employed by the directors, including the information on which the directors based their decision; and (b) a judicial examination of the reasonableness of the directors' action in light of the circumstances then existing. The directors have the burden of proving that they were adequately informed and acted reasonably.
  - Defensive Measures. In *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 954 (Del. 1985) (quoting *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971)), the Delaware Supreme Court held that when directors authorize takeover defensive measures, there arises "the omnipresent specter that a board may be acting primarily in its own interests, rather than those of the corporation and its shareholders." The Court reviewed such actions with enhanced scrutiny even though a traditional conflict of interest was absent. In refusing to enjoin a selective exchange offer adopted by the Board to respond to a hostile takeover attempt, the *Unocal* Court held that the directors must prove that (i) they had reasonable grounds for believing there was a danger to corporate policy and effectiveness (satisfied by showing good faith and reasonable investigation) and (ii) the responsive action taken was "reasonable in relation to the threat posed" (established by showing that the response to the threat was not "coercive" or "preclusive" and then by demonstrating that the response was within a "range of reasonable responses" to the threat perceived).

Delaware Law (continued)

– Sale of Control. In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, the Delaware Supreme Court imposed an affirmative duty on the Board to seek the highest value reasonably obtainable to the stockholders when a sale of the company becomes inevitable. 506 A.2d 173, 184 n.16 (Del. 1986).

- In *Lyondell Chemical Company v. Ryan*, 970 A.2d 235, 237 (Del. 2009), the Delaware Supreme Court rejected post-merger stockholder class action claims that independent directors failed to act in good faith in selling the company after only a week of negotiations with a single bidder, even accepting plaintiff's allegations that the directors did nothing to prepare for an offer which might be expected from a recent purchaser of an 8% block and did not even consider conducting a market check before entering into a merger agreement (at a "blow-out" premium price) containing a no-shop provision (with a fiduciary out) and a 3% break-up fee.
- The *Lyondell* opinion should also be read as a statement that (i) the Delaware courts will give deference to the decision of disinterested and independent directors when faced with a perceived need to act quickly on a proposal from an unaffiliated, serious bidder that reasonably appears to the directors to be in the best interests of the stockholders, (ii) *Revlon* duties do not arise until the Board starts a negotiation to sell the company and do not arise simply because the Board has facts that give the Board reason to believe that a third party will make an acquisition proposal, and (iii) when the *Revlon* duties become applicable, there is no single blueprint that a Board must follow to satisfy its *Revlon* duties.
- 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 held that the *Revlon* duty requires a Board to design a process with a view to obtaining the best value reasonably available to the stockholders, but does not require the Board to auction the company.

Delaware Law (continued)

- Entire Fairness. Both the business judgment rule and the enhanced scrutiny standard should be contrasted with the "*entire fairness*" standard applied in transactions in which a controlling stockholder (a "controller") stands on both sides of the transaction. In reviewing Board action in transactions involving management, Board members or a principal shareholder, the Delaware Supreme Court has imposed an "***entire fairness***" standard.
  - While a stockholder owning a majority of a corporation's stock will typically be found to be a controller, a stockholder owning less than 50% of the voting stock may be a controller if its stock ownership combined with other factors allows it to dominate the governance of the corporation. *See Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304 (Del. 2015), *affirming In re KKR Financial Holdings LLC Shareholder Litigation*, 101 A.3d 980, 991, 993-94 (Del. Ch. Oct. 14, 2014) (applying the touchstone of "actual control," Delaware Supreme Court held that, although the stockholder which held less than 1% of the corporation's stock exercised total managerial control pursuant to a management agreement between the target and an affiliate of the stockholder, the control was only contractual operating control and ultimate control over the transaction resided with the target company's Board, which the stockholder did not control through the management agreement, and held the merger was not subject to the entire fairness standard of review and the business judgment standard of review was invoked because the merger was approved by a disinterested and informed stockholder majority).
  - In *Kahn v. M&F Worldwide Corp.*, the Delaware Supreme Court held that the business judgment rule review can apply to squeeze-out mergers conditioned up front on both approval by a special committee and a majority-of-the-minority vote.
  - A transaction structured to achieve business judgment rule review under *Kahn v. M&F Worldwide* was subjected to (and failed) entire fairness review in *In re Dole Food Co. Inc. Stockholder Litigation*, CA No. 8703-VCL (August 27, 2015), because the Chancery Court found the transaction complied with *Kahn v. M&F Worldwide* as to form but not substance because of misleading projections and other information furnished to the special committee.

Delaware Law (continued)

- Action Without Bright Lines. Whether the burden will be on the party challenging Board action, under the business judgment rule, or on the Board, under enhanced scrutiny, clearly the care with which the directors acted in a change of control transaction will be subjected to close review. For this review there will be no “bright line” tests, and it may be assumed that the Board may be called upon to show care commensurate with the importance of the decisions made, whatever they may have been in the circumstances.

Fiduciary Duties

Delaware Law (continued)

- <u>Partnership and LLC Agreements Respected in Delaware</u>
  - Unlike TBOC, Delaware statutes governing partnerships and LLCs provide that their policy is to give maximum effect to the principle of freedom of contract and to entity agreements and allow the elimination of fiduciary duties (but not the contractual duty of good faith and fair dealing) [EGAN ON ENTITIES pp 388-398; 419-438].
  - Judicial application of these principles illustrated by six recent Delaware cases discussed in EGAN ON ENTITIES pp 392-398 involving limited partnership reorganizations in which the general partner or an affiliate was the survivor or acquiring party. In four of them, the Delaware Supreme Court affirmed the elimination of common law fiduciary duties and their replacement with a provision authorizing related party transactions if a conflicts committee of independent directors in good faith determines that the transactions are in the best interests of the partnership. The fifth decision applied the implied covenant of good faith and fair dealing (which cannot be eliminated in Delaware) and held that a fairness opinion was inadequate to support a transaction with the GP because it only covered the fairness of the entire transaction rather than to the LPs.
  - In the sixth decision Vice Chancellor Laster in *El Paso Pipeline Partners, L.P. Derivative Litigation* on April 20, 2015 awarded $171 million to the plaintiff limited partners because it found that the conflicts committee of the Board of the general partner did not in fact believe in good faith that the transaction was in the best interests of the partnership because its analysis focused on whether the purchase would enable the partnership to increase its distributions rather than whether it was paying too much for the assets. In a 60 page opinion the Court found that the testimony of the committee members that they had a good faith belief that the transaction was in the best interests of the partnership was not credible because their emails and other objective evidence showed that they were simply going through the motions to approve a transaction they knew general partner wanted and never considered saying no. The Court also focused on the conclusionary nature of the information provided and second guessed the analysis of the committee's financial advisor.

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