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Forum Selection Bylaws: Where We Are and Where We Go from Here

A significant number of Delaware corporations have adopted forum selection bylaws that identify Delaware as the exclusive forum for litigating intra-corporate disputes. In an important decision, the Delaware Court of Chancery recently held that such bylaws are facially valid under the Delaware General Corporation Law and traditional contract law principles.

By Frederick H. Alexander, James D. Honaker, and Daniel D. Matthews

On June 25, 2013, in *Boilermakers Local 154 Retirement Fund v. Chevron Corp. and IClub Investment Partnership v. FedEx Corp. (Boilermakers)*, the Court of Chancery of the State of Delaware upheld the facial validity of two public company bylaws that selected Delaware as the exclusive forum for litigating intra-corporate disputes.[1] In recent years, a significant number of publicly traded entities have adopted exclusive forum selection provisions following a suggestion by Vice Chancellor Laster of the Delaware Court of Chancery that a forum selection provision in a corporation's certificate of incorporation would be valid.[2] For the most part, these provisions have taken the form of board-adopted bylaws, such as those at issue in the *Boilermakers* decision.

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While other trial court judges or the Delaware Supreme Court could reach a different view as to the validity of such bylaws, this well-reasoned decision should make it far less likely that plaintiff stockholders will bring claims asserting the facial invalidity of forum selection bylaws. Accordingly, a board that has not adopted a forum selection bylaw may wish to reconsider whether it is prudent to do so. Of course, potential downside risks still need to be considered, including any investor criticism that may be associated with adopting these provisions.

The Court of Chancery Upholds Forum Selection Bylaws as Facially Valid

In September 2010 and March 2011, respectively, the board of directors of each of Chevron Corporation (Chevron) and FedEx Corporation (FedEx) adopted a forum selection bylaw. Each of these bylaws provided that unless the corporation consented to an alternative forum, the Delaware Court of Chancery would be the sole and exclusive forum for litigating (1) derivative actions or other actions brought on behalf of the corporation, (2) actions bringing a claim against any corporate director, officer, or employee for breach of fiduciary duty, (3) actions asserting any claims arising pursuant to the Delaware General Corporation Law (DGCL), and (4) any other claims governed by the internal affairs doctrine. Both bylaws also provided that any person buying stock in the corporation was "deemed to have notice of and consented to" the terms of the forum selection bylaw.

In February 2012, plaintiffs filed lawsuits in the Court of Chancery challenging the validity of the Chevron and FedEx bylaws, as well as similar bylaws at 10 other Delaware corporations. Ten of the 12 corporations deleted the forum selection provisions from their bylaws and the lawsuits against them were dismissed. Chevron and FedEx chose not to repeal their bylaws and filed answers to plaintiffs' complaints. After plaintiffs filed their lawsuit, the Chevron board of directors amended its forum selection bylaw to provide that suit could be filed in any state or federal court in the State of Delaware, subject to that court having personal jurisdiction over all "indispensible" parties to the proceeding. The FedEx board of directors did not make a similar change to the FedEx bylaw. Plaintiffs' complaints challenged the forum selection bylaws on a number of grounds. Defendants moved for judgment on the pleadings on two counts: (1) whether the forum selection bylaws were facially invalid under the DGCL and (2) whether the board-adopted forum selection bylaws were facially invalid as a matter of contract law.

Forum Selection Bylaws Are Facially Valid Under the DGCL

Plaintiffs argued, among other things, that the bylaws at issue were facially invalid under the DGCL. In order to make such a showing, plaintiffs were required to show that the bylaws "cannot operate lawfully or equitably *under any circumstances*."[3] Chancellor Leo E. Strine, Jr. emphasized that in order to meet this standard plaintiffs would need to show that the bylaws do not deal with a proper subject as defined by the DGCL and "can never operate consistently with law."[4] Merely positing hypothetical scenarios that might make the bylaw operate inequitably in the future would not be sufficient to meet this burden.[5] The Court held that plaintiffs failed to meet this burden and that the bylaws in question were facially valid under the DGCL.

As the Court explained, a valid bylaw must pertain to one of the enumerated topics in Section 109(b) of the DGCL: "The bylaws may contain any provision, not inconsistent with law or with the certificate of incorporation, 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."[6] The Court found that "[a]s a matter of easy linguistics," a forum selection bylaw addresses the "rights" of a corporation's stockholders because such a bylaw regulates *where* a stockholder can bring claims relating to the corporation's internal affairs.[7] In addition, such a bylaw relates to the "conduct of [a corporation's] affairs by "channeling internal affairs cases into the courts of the state of incorporation."[8] Furthermore, a forum selection bylaw is a valid "process-oriented" bylaw because it regulates "*where* stockholders may file suit, not *whether* the

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stockholder may file suit or the kind of remedy that the stockholder may obtain."[9] Chancellor Strine emphasized that the bylaws at issue only addressed the type of claims that are "most central" to the relationship between a corporation, its directors and officers, and its stockholders.[10]

Finally, the *Boilermakers* Court noted that it is not novel or unheard of for a bylaw to regulate how stockholders can exercise rights *qua* stockholders. Advance notice bylaws have a similar effect and impose a mandatory process that stockholders must comply with in order to make nominations of director candidates or business proposals at a stockholder meeting.[11] Similarly, a bylaw is not invalid simply because it speaks to a new topic.[12] Rather, as Chancellor Strine noted, in *Moran v. Household International, Inc.*, the seminal decision upholding a rights plan as a valid use of statutory authority, the Delaware Supreme Court rejected such an argument: "our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs. Merely because the [DGCL] is silent as to a specific matter does not mean that it is prohibited."[13]

Forum Selection Bylaws Are Facially Valid as a Matter of Contract Law

In addition to their statutory arguments, plaintiffs argued that forum selection bylaws are facially invalid as a matter of contract law because, in the case of a board-adopted bylaw like those of Chevron and FedEx, the stockholders do not approve the forum selection bylaw in advance of adoption.[14] The Court rejected this argument and held that the FedEx and Chevron bylaws were facially valid as a matter of contract law.

The certificate of incorporation of both Chevron and FedEx authorized the board of directors to unilaterally adopt and amend the bylaws under Section 109(a) of the DGCL.[15] Plaintiffs argued, essentially, that a board-adopted bylaw was not effective to bind stockholders as a matter of contract law, because, even though the board may have validly adopted the bylaw under corporate law principles, the stockholders had not assented to the bylaw's provisions.[16] The Court rejected this argument explaining that plaintiffs' argument was inconsistent with Delaware's long-standing rejection of the "vested rights" doctrine.[17] Where, as in the case of Chevron and FedEx, the certificate of incorporation expressly authorizes a board to unilaterally amend the bylaws, all stockholders are "'on notice that the bylaws may be amended at any time, [and] no vested rights can arise that would contractually prohibit an amendment.'"[18] Furthermore, the Court explained, "an unbroken line of decisions dating back several generations" makes it clear that bylaws are part of a binding contract between a Delaware corporation and its stockholders and that stockholders are "on notice" that the board has the unilateral power to amend the bylaws to address the subjects enumerated by Section 109(b).[19] There is no requirement that the stockholders must consent to a board-adopted bylaw in order for stockholders to be bound by it.[20]

The Court also reasoned that, although the established framework of the DGCL and Delaware corporate law requires stockholders to comply with board-adopted bylaws, this same framework also provides stockholders with an indefeasible right to repeal a board-adopted bylaw: "Section 109(a) vests in the shareholders a power to adopt, amend or repeal bylaws that is legally sacrosanct."[21] Accordingly, the statute provides the stockholders the power to repeal a board-adopted forum selection bylaw if they chose.[22] Furthermore, the stockholders always retain the authority to express their dissatisfaction with a board that adopts a forum selection bylaw at the annual election of directors.[23]

In addition to these corporate law protections, because forum selection bylaws are part of the *contract* between a corporation and its stockholders, the application of a forum selection bylaw will be reviewed under the traditional principles used to evaluate forum selection provisions established by the United States Supreme Court in *The Bremen v. Zapata Off-Shore Co.*[24] As the *Boilermakers* Court noted, the Delaware Supreme Court has expressly adopted the standards articulated by *Bremen* and its progeny.[25] Under this line of authority, forum selection bylaws will "be construed like any other contractual forum selection clause and are considered presumptively, but not necessarily, situationally enforceable."[26]

Finally, in resolving this motion involving facial challenges, the Court refused to consider the "parade of horribles" that plaintiffs advanced as "not appropriately posed" because Delaware courts "do not render advisory opinions about hypothetical situations that may not occur."[27] Instead, the appropriate time for a plaintiff to make an "as applied" challenge is when a plaintiff actually files a lawsuit outside of the forum specified by the forum selection bylaw. Then a court can consider, under the specific facts present, whether enforcement of the forum selection bylaw would not be appropriate under a traditional contract law analysis or whether the directors' use of the bylaws is a breach of fiduciary duty under the *Schnell v. Chris-Craft Indus., Inc.*, line of cases.[28] It was apparent to the Court that in the majority of cases the forum selection bylaws "will work without any problem" because the bylaws at issue only attempted to regulate where claims relating to a corporation's internal affairs could be brought.[29] Furthermore, the Court found that the provision in the bylaws permitting the corporations to consent to jurisdiction in another forum weighed against any need to address plaintiffs' hypothetical scenarios because through that mechanism a stockholder could request that the board waive application of the bylaw in a particular case.[30]

The *Boilermakers* Case: Where Does It Go from Here?

The *Boilermakers* opinion addressed plaintiffs' two claims challenging the facial validity of the bylaws. Plaintiffs, however, also brought a range of other challenges to the bylaws as well, which claims have yet to be resolved and as to which ongoing discovery continues. These claims include allegations that the boards of directors of Chevron and FedEx breached their fiduciary duties in adopting the forum selection bylaws. In this claim, plaintiffs allege that the boards' decisions to adopt forum selection bylaws were self-interested decisions that are subject to review under the onerous entire fairness standard because, among other reasons, the bylaws "(i) enable[] [the directors] to cause litigation against them to be confined to the forum where they believe they are least likely to be held liable, (ii) enable[] [the directors] to avoid a jury trial and (iii) may make it difficult or impossible for certain claims to be brought against [the directors]."[31]

Prior to the final disposition of all remaining claims in the case, an interim appeal to the Delaware Supreme Court is possible with the consent of the Court of Chancery. Following final disposition of all remaining claims, plaintiffs will have the right to appeal Chancellor Strine's decision with respect to the claims addressed by the June 25, 2013, opinion. Accordingly, it is difficult to predict if and when the Delaware Supreme Court will address the forum selection bylaws.

Future Challenges to Forum Selection Bylaws

The *Boilermakers* Court upheld the forum selection bylaws against facial challenges as a matter of both statutory and contractual law. The enforceability of a forum selection provision generally is governed by the procedural law of the jurisdiction in which suit is filed.[32] Chancellor Strine made clear that, in Delaware, future enforcement of such bylaws will be subject to review both under traditional contract law principles as articulated in *Bremen*, and as adopted by the Delaware Supreme Court, and with respect to fiduciary principles.[33] Where, however, stockholder suits are filed outside of Delaware, those non-Delaware courts will likely apply the law of their own jurisdiction, which may or may not differ from the procedural law of Delaware, to determine whether a forum selection bylaw should be enforced.

Like Delaware, many other states have adopted the standards expressed in the *Bremen* decision, an admiralty case that addressed a dispute over the enforceability of a forum selection clause in an actively negotiated commercial contract. In *Bremen*, the United States Supreme Court, rejecting what it characterized as the "provincial attitude" of American courts that had previously disfavored forum selection clauses, held that a choice of forum clause should be enforced unless enforcement would be "unreasonable or unjust."[34] In its reasoning, the Court highlighted three situations where enforcement might be found unreasonable: (1) the forum selection clause was itself the product of "fraud or overreaching"; (2) the party seeking to avoid enforcement of the forum selection clause could show that enforcement would "for all practical purposes, depriv[] [that party] of his day in court"; and (3) enforcement would violate an important public policy of the forum in which the suit had been brought.[35]

The United States Supreme Court's analysis in *Bremen* indicates that inconvenience of the selected forum generally will not be a sufficient basis for a court to refuse to enforce a forum selection provision.[36] This is especially the case where the inconvenience was foreseeable at the time of contracting and the contract does not concern an attempt to agree by contract to resolve "essentially local disputes in a remote alien forum."[37] The *Bremen* Court also makes clear that the party seeking to enforce a forum selection clause does not bear the burden of proof "to show that the balance of convenience [i]s strongly in its favor."[38] Rather, the party opposing enforcement "bear[s] a heavy burden of proof" to show that the forum selection provision should not be enforced under the factors identified by the *Bremen* Court.[39] Subsequent decisions have identified additional factors that a court might look to in deciding whether to enforce a forum selection provision, including:

> (1) the law governing the construction of the contract; (2) the jurisdiction in which the contract was executed; (3) the jurisdictions in which the transactions have been or are to be performed; (4) [t]he availability of remedies in the designated forum; (5) [t]he public policy of the initial forum state; (6) the location of the parties, the convenience of prospective witnesses, and the accessibility of evidence; (7) [t]he relative bargaining power of the parties and the circumstances surrounding their dealings; (8) the presence or absence of fraud, undue influence or other extenuating (or exacerbating) circumstances; and (9) [t]he conduct of the parties.[40]

As Chancellor Strine aptly noted, in a subsequent decision, *Carnival Cruise Lines, Inc. v. Shute*,[41] the United States Supreme Court applied the reasoning of *Bremen* to enforce a forum selection clause set forth in boilerplate language on a cruise ship ticket that the passenger seeking to avoid enforcement had paid for prior to receiving the ticket. The United States Supreme Court held that the forum selection clause in a contract of adhesion such as the cruise ship ticket was not *per se* unenforceable.[42] As the *Boilermakers* Court emphasized, this was so even though the passenger did not receive the ticket until after she had paid for it. The *Carnival Cruise* Court reasoned, much like commentators have argued with respect to forum selection bylaws, that forum selection clauses on cruise line tickets offer a significant benefit because they establish *ex ante* the forum for dispute resolution in a context where disputes might otherwise be subject to suit in several different fora.[43] This in turn has the potential to improve judicial efficiency and may lead to reduced fares due to the cost savings that cruise lines may recognize.[44] Similarly, well-regarded commentators have argued that forum selection bylaws may benefit stockholders by reducing the costs of multi-jurisdictional litigation which are ultimately born by the stockholders.[45]

In addition to challenges to the enforcement of a forum selection bylaw under the standards set forth by *Bremen*, enforcement of such bylaws also may be subject to challenge on fiduciary principles. Although Chancellor Strine cited the provisions in the forum selection bylaws expressly permitting the board to consent to litigation in another forum as a factor weighing against the Court addressing hypothetical scenarios on motion practice, he also noted that a board's decision whether or not to consent to a lawsuit proceeding elsewhere will be subject to review for breach of fiduciary duty. In resolving the facial validity challenges presented in *Boilermakers*, the Court did not explore in what circumstances a board's fiduciary duties might require it to consent to litigation outside of Delaware. The Court was, of course, not presented with a concrete factual scenario that would have provided the Court with an appropriate basis to engage in such a determination. However, in rejecting plaintiffs' challenges to the facial validity of the forum selection bylaws, the Court indicated its view that "in most internal affairs cases the bylaws will not operate in an unreasonable matter."[46]

It is not apparent under what circumstances a court would refuse to enforce a forum selection bylaw, or order a board to consent to a different forum, on fiduciary principles. A board of directors' decision not to consent to litigation in another forum is not a self-dealing transaction in a classical sense, *i.e.*, it is not a situation where the directors "stand on both sides" of the transaction.[47] Furthermore, and potentially significantly, the traditional *Bremen* contract law based analysis already includes consideration of whether enforcement of the provision would deprive a plaintiff of his or her day in court or would violate public policy of the jurisdiction in which suit has been brought. Accordingly, it is unclear in what additional situations the fiduciary overlay would cause a court to refuse to enforce a forum selection bylaw. It will be future cases, presenting a court with concrete factual situations, that will resolve this question.

The *Boilermakers* Case: Where Does It Leave Us?

In light of the *Boilermakers* decision upholding forum selection bylaws against facial challenges, a Delaware corporation should give serious consideration to adopting such a provision. These provisions have become popular in recent years as stockholder lawsuits have continued to proliferate and corporations frequently struggle with the challenges of multi-jurisdictional litigation, *i.e.*, defending the same conduct simultaneously in different jurisdictions. As the Delaware Court of Chancery has repeatedly noted in recent years, multi-jurisdictional litigation is troubling because it (1) forces corporate defendants to litigate the same claims simultaneously in multiple jurisdictions, (2) wastes judicial resources, and (3) creates the potential that two judges might apply the same law differently to the same facts.[48] It is challenges such as these that forum selection bylaws seek to ameliorate.

In the case of a Delaware corporation, in addition to the advantage of avoiding the complications presented by multi-jurisdictional litigation, selecting the Delaware Court of Chancery as the exclusive forum for litigating intra-corporate disputes offers the additional advantage of having a court that is highly experienced and expert at handling corporate litigation hear intra-corporate disputes.[49] This is especially the case with respect to expedited M&A litigation, with which all of the judges sitting on the Delaware Court of Chancery develop significant, repeat experience.[50]

The Chevron and FedEx boards opted to place forum selection provisions in the corporate bylaws, which, as noted above, the board of a Delaware corporation can do if its certificate of incorporation expressly grants the board that authority.[51] As the *Boilermakers* Court noted, the stockholders always retain the unilateral right to repeal such a bylaw. The majority of publicly traded corporations have opted for the bylaw approach taken by Chevron and FedEx, but, as an alternative, a board may wish to consider whether to propose that its stockholders amend the certificate of incorporation to add a forum selection provision. Including a forum selection provision in a corporation's certificate of incorporation has at least two advantages. First, amending the certificate of incorporation of a Delaware corporation requires both board and stockholder action.[52] Thus, such a provision cannot be repealed without board approval. Second, when faced with challenges to the enforceability of a forum selection clause, courts may be more willing to enforce such a clause if it appears in the certificate of incorporation.[53]

Proposing such an amendment to a certificate of incorporation is uncommon, but a handful of publicly traded corporations have taken this route, including prominent S&P 500 corporations such as DIRECTV, Life Technologies Corporation, and Altera Corporation.[54] The voting results on these proposals have varied. For example, one study found that five of six such proposals in 2011 passed, but two did so by a narrow margin, two were passed at corporations where corporate insiders held significant blocks of stock and the fifth was bundled with a proposal to declassify the board.[55] An internal review of public filings identified an additional five companies from 2012–2013 that sought stockholder approval of proposals to add a forum selection provision to the certificate of incorporation. Each of these corporations obtained stockholder approval, but several of them also had significant insider ownership. This limited data makes forecasting how such proposals will fair in the future a challenging proposition. More commonly, when forum selection provisions are included in a corporation's certificate of incorporation, they are added pre-IPO or in connection with the corporation's emergence from bankruptcy.[56] Examples include some of the biggest IPOs of recent years, such as Facebook, Inc., ING U.S., Inc., Groupon Corporation, and LinkedIn, Inc.[57]

When evaluating whether to adopt a forum selection provision, either in the bylaws or certificate of incorporation, a board also should consider the views of proxy advisory firms and investors regarding these provisions. In evaluating proposals submitted by companies to their stockholders to adopt a forum selection provision in the certificate of incorporation, Institutional Shareholder Services considers other governance factors such as whether the corporation has an annually elected board, has a majority vote standard in uncontested director elections and the absence of a poison pill, unless that pill was approved by the stockholders.[58] ISS also will take into account whether the corporation has been previously harmed by stockholder litigation outside of the corporation's state of incorporation (*i.e.*, multi-jurisdictional litigation).[59] Despite this case-by-case policy, ISS has almost always recommended a vote against proposals to adopt a forum selection provision as part of the certificate of incorporation. The only instance that we are aware of in which ISS recommended a vote in favor amending a certificate of incorporation to add a forum selection provision is Life Technologies Corporation. ISS indicated that it did so only because approval of the forum selection provision was bundled with an amendment to declassify the board of directors.[60]

Glass Lewis generally recommends a vote against proposals to adopt a forum selection provision.[61] Glass Lewis may, however, recommend a vote in favor of such a proposal in limited cases where a company (1) can show a compelling argument as to why a forum selection provision would directly benefit stockholders, (2) can provide evidence of abuse of legal process in other jurisdictions, and (3) maintains a strong record on "good corporate governance practices."[62] Glass Lewis also recommends a vote against the chair of the governance committee if the board has adopted a forum selection provision without stockholder approval within the past year or if the corporation is currently seeking stockholder approval of such a provision as part of a bundled proposal.[63]

In addition to taking into account the views of proxy advisory firms, a board considering whether to adopt a forum selection provision also should consider the views of its stockholders. If a board unilaterally adopts a forum selection bylaw, in the future the corporation may receive a stockholder proposal to eliminate such a provision. This type of stockholder proposal may bring unwanted attention to a subject that may be misunderstood by the corporation's stockholders.[64] As such, even if the corporation defeats such a proposal, the corporation may receive negative publicity as well as incur additional costs to explain to stockholders why maintaining such a provision is advisable.

Conclusion

The *Boilermakers* decision is an important development in the ongoing debate regarding corporate forum selection provisions. Putting aside lingering litigation concerns regarding (1) allegations that the boards breached their fiduciary duties in adopting the provisions and (2) how courts will resolve future enforceability questions on as applied challenges, *Boilermakers* addresses questions concerning the facial validity of such bylaws. Following this decision, a corporation should consider whether to adopt such a provision and where to place it. Pre-IPO, the corporation should consider putting a forum selection provision in its certificate of incorporation. A publicly-traded company should consider adopting a forum selection bylaw and may wish to consider seeking stockholder approval to add a forum selection provision to its certificate of incorporation.

When deciding how to proceed, a board should evaluate the potential litigation risks associated with such provisions, as well as the somewhat negative perception that proxy advisory firms and certain investors have of such provisions. These downsides should be balanced against the advantages that a forum selection provision offers, including (1) ameliorating the challenges presented by multi-jurisdictional litigation and (2) attempting to ensure that intra-corporate disputes will be resolved by judges highly-experienced in corporate litigation. Boards also will need to make a judgment call on whether now is the time to adopt a forum selection provision. On the one hand, the Chancellor's decision should mitigate the risk that a stockholder will challenge the provision as *per se* invalid, so that a board might have more confidence in adopting a provision now. On the other hand, a board could wait to see if there is an appeal and subsequent decision of the Delaware Supreme Court on these provisions. If the provision takes the form of a board-adopted bylaw, the board could decide to adopt a provision now and amend the provision in the future to account for any pronouncement from the Delaware Supreme Court.

Notes

1. *Boilermakers Local 154 Retirement Fund v. Chevron Corp. and IClub Investment Partnership v. FedEx Corp.*, --- A.3d ---, C.A. Nos. 7220-CS & 7238-CS, 2013 WL 3191981 (Del. Ch. June 25, 2013).
2. *In re Revlon, Inc. S'holders Litig.*, 990 A.2d 940, 960 (Del. Ch. 2010) ("If boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intraentity disputes.").
3. *Boilermakers*, 2013 WL 3191981, at *9.
4. *Id.*
5. *Id.*
6. 8 *Del. C.* § 109(b).
7. *Boilermakers*, 2013 WL 3191981, at *10.
8. *Id.*
9. *Id.* at *11; *see generally CA, Inc. v. AFSCME Emps. Pension Plan*, 953 A.2d 227, 236-37 (Del. 2008) (explaining that to be valid, a bylaw

of a Delaware corporation should have a “procedural, process-oriented nature”).

10. *Boilermakers*, 2013 WL 3191981, at *11.

11. *Id*. at *12.

12. *Id*.

13. *Id*. (*quoting Moran v. Household Int’l, Inc.*, 500 A.2d 1346, 1351 (Del. 1985) (*quoting Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 957 (Del. 1985))).

14. *Id*. at *13.

15. 8 *Del. C*. § 109(a) (“[A]ny corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal bylaws upon the directors….”).

16. *Boilermakers*, 2013 WL 3191981, at *13.

17. *Id*. (citing *Federal United Corp. v. Havender*, 11 A.2d 331, 335 (Del. 1940)).

18. *Id*. at *14 (*quoting Kidsco Inc. v. Dinsmore*, 674 A.2d 483, 492 (Del. Ch. 1995)).

19. *Id*.

20. *Id*.

21. *Id*. (*quoting CA, Inc. v. AFSCME Employees Pension Plan*, 953 A.2d 227, 323 (Del. 2008)); *see* 8 *Del. C*. § 109(a) (“The fact that such power [*i.e.*, to adopt, amend or repeal bylaws] has been so conferred upon the directors…shall not divest the stockholders…of the power, nor limit their power to adopt, amend or repeal bylaws.”).

22. *Boilermakers*, 2013 WL 3191981, at *14.

23. *Id*.

24. 407 U.S. 1 (1972).

25. *Ingres Corp. v. CA, Inc.*, 8 A.3d 1143, 1146 (Del. 2010).

26. *Boilermakers*, 2013 WL 3191981, at *16.

27. *Id*. at *16–18.

28. *Id*. at *16–17; *see Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del.1971).

29. *Boilermakers*, 2013 WL 3191981, at *17.

30. *Id*. at *19.

31. *See Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, C.A. No. 7220-CS, Complaint at ¶¶ 103–108 (Feb. 6, 2012).

32. Joseph A. Grundfest & Kristen A. Savelle, The Brouhaha Over Intra-Corporate Forum Selection Provisions: A Legal, Economic, and Political Analysis, 68 Bus. Law. 325, 381 (2013).

33. *Boilermakers*, 2013 WL 3191981, at *16, 19.

34. *Bremen*, 407 U.S. at 9, 12, 15; *see also* Restatement (Second) Conflict of Laws § 80 (“The parties’ agreement as to the place of the action cannot oust the state of judicial jurisdiction, but such an agreement will be given effect unless it is unfair or unreasonable.”).

35. *Bremen*, 407 U.S. at 12–17.

36. *Id*. at 17–18.

37. *Id*.

38. *Id*. at 18.

39. *Id*. at 17.

40. *Grundfest & Savelle*, 68 Bus. Law. at 384 n.259 (*quoting D’Antuono v. CCH Computax Sys., Inc.*, 570 F. Supp. 708, 712 (D.R.I. 1983) (internal quotation marks omitted)).

41. 499 U.S. 585 (1991).

42. *Id.* at 593–95.

43. *Id*. at 594–95.

44. *Id*.

45. *See, e.g.*, *Grundfest & Savelle*, 68 Bus. Law. at 328-29 (“These foreign-forum filings [*i.e.*, multi-jurisdictional litigation] increase litigation costs, create opportunity for opportunistic settlements, generate the prospect of inter-jurisdictional inconsistencies, and often reflect a battle among plaintiffs’ counsel for a ‘seat at the table’ in the test to collect a share of the attorney’s fees that might be awarded in any litigation. This battle for control of fees further imposes costs on stockholders and corporations without generating commensurate benefits.”).

46. *Boilermakers*, 2013 WL 3191981, at *3.

47. *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 362 (Del. 1993) (“Classic examples of director self-interest in a business transaction involve either a director appearing on both sides of a transaction or a director receiving a personal benefit from a transaction not received by the shareholders generally.”).

48. *See, e.g., In re Allion Healthcare S’holder Litig.*, 2011 WL 1135016, at *4 (Del. Ch. Mar. 29, 2011).

49. *In re Compellent Techs., Inc. S’holder Litig.*, C.A. No. 6084-VCL, at *15 (Del. Ch. Jan. 13, 2011) (transcript).

50. *Id*.

51. 8 *Del. C*. § 109(a).

52. 8 *Del. C*. § 242(b).

53. *See Galaviz v. Berg*, 763 F. Supp. 2d 1170, 1175 (N.D. Cal. 2011) (“Certainly were a majority of shareholders to approve such [an exclusive forum] charter amendment, the arguments for treating the venue provision like those in commercial contracts would be much stronger, even in the case of a plaintiff shareholder who had personally voted against the amendment.”).

54. *See* Claudia H. Allen, Study of Delaware Forum Selection Clauses in Charters and Bylaws, at 5 (Jan. 25, 2012).

55. *Id*.

56. *Id*. at 1.

57. *Facebook, Inc.*, Exhibit 3.3 to Form S-1/A (filed Apr. 23, 2012); *ING U.S., Inc.*, Exhibit 3.2 to Form S-1/A (filed Apr. 16, 2012); *Groupon, Inc.*, Exhibit 3.2 to Form S-1/A (filed Nov. 1, 2011); *LinkedIn Corporation*, Exhibit 3.2 to Form S-1/A (filed Mar. 11, 2011).

58. *See* Institutional Shareholder Services, *ISS Benchmark Policy*, *Exclusive Venue* (Feb. 1, 2013).

59. *Id*.

60. ISS Report for Life Technologies Corporation 2011 Annual Meeting, at 11–12 (April 11, 2011).

61. Glass Lewis & Co., Proxy Paper Guidelines 2013 Proxy Season, at 34.

62. *Id*.

63. *Id*. at 13.

64. *See Grundfest & Savelle*, 68 BUS. LAW. at 329-30. ("The potential benefits of [forum selection provisions] might, however, be unfamiliar to many stockholders because these provisions were rare in the extreme until recent years. They might also provoke a reflexive negative response from constituencies that systematically (and here incorrectly) oppose measures that increase management or board discretion on the theory that directorial discretion can be expanded only at stockholders' expense.").

DIRECTOR LIABILITY

Current Issues in Director and Officer Indemnification and Insurance

In light of increasing litigation and government investigations, the stakes have never been higher for directors and officers. Accordingly, careful attention to their protection under director and officer liability insurance and company indemnification provisions is essential.

By John F. Olson, Jonathan C. Dickey, Amy L. Goodman, and Gillian McPhee

More than four years after the financial crisis, exposure to investigations and lawsuits remains real for individuals serving as directors and officers of public companies. Fortunately, the general rule still holds true that directors and officers rarely contribute to settlements and judgments out of their personal assets. However, the last four years have brought a steady wave of litigation and an increased enforcement focus from regulators. In addition to ongoing litigation stemming from the financial crisis, public companies have faced an uptick in shareholder litigation involving M&A transactions, claims brought in foreign jurisdictions, lawsuits challenging their executive compensation practices and proxy disclosures, and record levels of enforcement activity under the Foreign Corrupt Practices Act. The FCPA is just one of several areas where the Securities and Exchange Commission (SEC or Commission) and the Department of Justice have been active in their enforcement efforts, and these efforts are likely to continue. Indeed, the SEC recently announced that under its new leadership, the Commission intends to begin to target more individual directors and officers in future enforcement actions, and in appropriate cases to compel directors and officers to admit liability even when settling these enforcement actions. Clearly, the stakes for directors and officers have been raised significantly, and the need has increased for enhanced protections under their companies' D&O insurance policies.

Additionally, a new decision from the U.S. Court of Appeals for the Second Circuit serves as a reminder of the potential exposures facing public company directors and officers concerning their insurance coverage for major claims. In *Mehdi Ali v. Federal Insurance Co.*,[1] the Second Circuit affirmed a lower court holding that the former directors and officers of Commodore International Limited had no coverage under several of the company's excess D&O insurance policies based on the appellate court's reading of the policies. The circumstances that led to this result are somewhat unusual: after Commodore filed for bankruptcy in 1994, two of the insurers in its D&O insurance program became insolvent. However, the Second Circuit's decision illustrates the importance of a careful review and consideration of D&O policy wording, and evaluating whether better terms and conditions can be achieved. Indeed, in recent years a number of new forms of coverage have been introduced that strengthen protections for directors and officers when faced with catastrophic situations such as a bankruptcy.

Public companies and their boards also are well advised to revisit the indemnification provisions in their charter documents (certificate of incorporation and bylaws), consider the need for

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indemnification agreements if they don't already have them, and insure that there are no significant gaps between the protections afforded directors and officers from their statutory or contractual indemnification rights on the one hand, and their D&O insurance rights on the other hand.

Look at the Whole Package of Protections

Most companies rely on a combination of three liability protections for their directors and officers: (1) so-called "exculpatory" charter provisions that limit or eliminate directors' personal monetary liability to the corporation and its stockholders; (2) indemnification, both in charter documents and contractual agreements; and (3) insurance. In evaluating these liability protections, public companies should consider the protections as a package and understand the benefits and limits of each. In discussing the first two, this article focuses on Delaware law due to the number of public companies incorporated there.

"Exculpatory" charter provisions adopted under Section 102(b)(7) of the Delaware General Corporation Law (DGCL) and equivalent statutes in other jurisdictions generally insulate directors from liability for monetary damages for breaches of the duty of care, but not breach of the duty of loyalty or actions found to be in bad faith.[2] If a complaint alleges only a breach of the duty of care, a 102(b)(7) exculpatory provision adopted by a Delaware corporation (or analogous exculpatory provisions under the corporations laws of other states) provides the basis for dismissing the complaint at the outset of the litigation, while a complaint alleging a breach of the duty of loyalty or conduct in bad faith would proceed to trial.

This distinction was readily apparent in two recent decisions from Vice Chancellor Noble of the Delaware Court of Chancery involving the acquisitions of Novell, Inc. and BJ's Wholesale Club, Inc. Both cases involved similar allegations—that the companies' directors breached their fiduciary duties by according favorable treatment to the successful bidders during the acquisition process—but resulted in different outcomes. In the *Novell* case, the Chancery Court held that the plaintiffs stated a bad faith claim based on the directors' "unexplained, extremely favorable treatment" of the buyer.[3] As a result, the Chancery Court refused to dismiss the claim based on the company's 102(b)(7) provision. In the *BJ's* case, by contrast, the Chancery Court granted dismissal in reliance on the company's 102(b)(7) provision. After observing that an "extreme set of facts" would be necessary to sustain a bad faith claim, the Chancery Court concluded the plaintiffs' allegations of bad faith were "not reasonable in light of the rational explanations for the Board's conduct."

Where directors and officers do face legal expenses or liability, indemnification is, in some respects, the first line of defense. Indemnification is broader than insurance in some respects, so it can provide protection in situations where insurance coverage may be more limited, such as the costs in the early stages of investigations borne by an individual director, officer, or employee. However, indemnification is only as good as a company's ability to pay, so indemnification may be unavailable if the company is financially troubled, insolvent or otherwise prevented by law from indemnifying a director, officer or employee. Likewise, a claim in which a company official is found to have obtained an improper personal benefit subject to restitution or disgorgement remedies may not be indemnified—by definition, this conduct is deemed not to be in good faith and in the best interests of the corporation.

A key purpose of D&O insurance is to "fill gaps" where indemnification may be unavailable. One situation where indemnification is not available is in derivative suits, where settlements and judgments in some circumstances may not be indemnifiable under state law because companies would end up paying out amounts recovered by or on behalf of the corporation, but actually paid by the same corporation—in effect, a circular transfer of funds that violates public policy. In April, in what is reportedly the largest-ever cash settlement of a derivative lawsuit, News Corporation's directors and officers settled a series of consolidated derivative actions arising out of the acquisition of a company owned by Rupert Murdoch's daughter and phone-hacking allegations involving reporters and editors at newspapers run by the company. The company's D&O insurance will fund the entire amount of the $139 million settlement, which will be paid over to News Corporation. Others situations where indemnification is not available, and where the company's D&O insurance may "fill gaps," include instances where an individual has not met the standard of conduct (typically good faith) that is a prerequisite to receiving indemnification under state law and claims under the Securities Act of 1933, which the SEC views as against public policy.

Consider in Advance What Rights to Grant

Companies should consider carefully the nature and extent of the indemnification and advancement protections they intend to provide to their directors and officers and make sure their documents reflect those rights. While indemnification represents after-the-fact payment at the conclusion of a legal proceeding, advancement provides for the payment of legal fees while a proceeding is ongoing. In many instances, the costs of defending a lawsuit are more daunting, as well as more immediate, than the ultimate threat of liability. Advancement fills a critical and significant need for directors and officers by enabling them to defend themselves vigorously.

In recent years, the message from the Delaware courts has been clear: courts generally will enforce indemnification and advancement provisions as written. Delaware courts will construe provisions mandating indemnification and advancement "to the full extent permitted by law" to mean just that. It remains the norm for companies to provide indemnification and advancement "to the full extent permitted by law." However, depending on how a provision is written, the company's advancement obligations may continue even when one of its executives has pled guilty to a crime, until the final resolution of the "proceeding" in question, including all appeals or other post-conviction proceedings. This can result (and has resulted) in situations where companies must continue advancing expenses to "bad actors," despite the seeming incongruity of such a result.[4]

If both the certificate and bylaws address indemnification, the two documents should be consistent. Otherwise, if there are limitations in one document that do not appear in the other, individuals can simply seek coverage under the broader document. Language in the certificate of incorporation will not necessarily control, as reflected in a 2010 case in which the Delaware Court of Chancery upheld limitations on advancement contained in the company's bylaws, even though the certificate provided directors with a right to mandatory advancement to the fullest extent permitted by law.[5] Additionally, indemnification provisions typically contain "non-exclusivity" language stating that rights granted to an individual are not exclusive of indemnification rights granted elsewhere, whether by charter documents, agreement or otherwise.

A similar principle applies to indemnification agreements. An agreement can provide greater specificity, or more expansive rights, than the certificate and bylaws, but the agreement must be consistent with those documents. If the agreement limits rights that directors and officers have under the certificate or bylaws, individuals can simply seek to enforce their rights under those documents. Likewise, indemnification provisions should exclude indemnification and advancement for claims *initiated by* a director or officer, so it is explicit that there is no coverage in those situations. A broadly drafted provision that grants protection "to the full extent permitted by law" may be viewed as extending to situations where a director or officer sues the company. One important exception to this carve-out is for "fees-on-fees," which are fees incurred in enforcing rights to indemnification and advancement. Modern indemnification provisions typically contain express language stating that directors and officers are entitled to fees-on-fees where they successfully enforce their rights.

It is particularly important for companies to review the indemnification provisions in their charter documents if they do not have indemnification agreements with their directors or officers. As discussed below, companies that do not have indemnification agreements should consider whether to add them. However, in the absence of agreements, more detailed provisions in the bylaws are advisable. These provisions would cover matters like the process and time frames for obtaining indemnification and advancement, "appeal" rights in the event the company denies a request for indemnification or advancement, and the right to fees-on-fees. Because the board can amend the bylaws on its own (while shareholder approval is necessary to amend the certificate of incorporation), including these provisions in the bylaws allows the board to review them periodically and update them as appropriate. Additionally, in Delaware, even in the absence of a written indemnification obligation, the DGCL provides for mandatory indemnification in circumstances where a director or officer successfully defends a proceeding or claim.

Consider Who Gets Mandatory Rights

A policy question that each corporation must address as a threshold matter is which groups of individuals should receive mandatory indemnification and advancement rights under the corporation's certificate and/or bylaws. Most companies grant mandatory indemnification and advancement rights only to directors and officers and "permissive" rights to employees and agents—that is, the certificate and bylaws permit, but do not require, indemnification and advancement for employees and agents. Broad, mandatory rights can be an important tool in attracting and retaining qualified directors and officers, but extending these rights to employees can result in significant financial obligations for a company, particularly in the event of a major lawsuit or investigation. Permissive rights also preserve flexibility for a company to decide whether, and to what extent, to provide indemnification and advancement based on specific facts and circumstances, including circumstances where an individual's conduct appears to have violated a law, but the claim will require expensive litigation to resolve that question, the costs of which might have to be borne by the corporation. A minority of companies (particularly, older companies and companies in certain industries like manufacturing and consumer products) provide mandatory indemnification and advancement rights to all employees. For these companies, there may be cultural and optical issues associated with limiting or eliminating these rights once they are in place.

Companies also should consider who qualifies as an "officer" for purposes of the indemnification provisions in their charter documents. This is critical at companies that follow the predominant approach of providing mandatory rights only to directors and officers, because officer status entitles an individual to mandatory (rather than permissive) indemnification and advancement. There is limited Delaware case law on the question of who is an "officer" for indemnification purposes, although, at a minimum, this term is likely to encompass positions described in the officer provisions of a company's bylaws. Accordingly, companies should consider which of their "officers" should have mandatory indemnification and advancement rights, particularly at companies that have a large number of officers or positions with officer-like titles. If a company wishes to cover a narrower (or broader) group of individuals than those who are designated as officers by or in accordance with the bylaws, it should consider a definition of "officer" that is specific to the indemnification provisions. Further, whether an individual is deemed an "officer" may have implications for the company's D&O insurance, which will cover officers but not necessarily employees for certain types of claims.

Consider Whether to Provide Indemnification Agreements

In recent years, there has been a trend among larger public companies toward adding indemnification agreements. Other public companies continue to rely on provisions in their charter documents and many have updated their bylaws to make them more detailed.

Indemnification agreements have a number of advantages over relying exclusively on indemnification provisions in charter documents. Among other things, agreements enable companies to address rights in more detail. An indemnification agreement typically includes definitions of key terms, which offers clarity on the types of proceedings and expenses that are covered. Agreements often outline procedures and time frames for obtaining payment and specify who will authorize indemnification payments, including in specific scenarios like a change of control, although these matters can be addressed in the bylaws. Additionally, the indemnification agreement can include presumptions in favor of indemnification, provisions to empower directors and officers to select among several dispute resolution alternatives, and provisions that permit an award of legal fees, including "fees-on-fees" where an individual is successful in suing to enforce rights under the agreement. The corporation also can contractually agree that indemnification rights are not subject to unilateral amendment or rescission by the company and indemnification agreements may raise fewer enforceability issues because they are bilateral contracts. Finally, indemnification agreements are individual to directors and officers, which may provide a degree of comfort that is not present with a generally applicable certificate or bylaw provision. From the company's perspective, an agreement may limit flexibility because changes, or the adoption of a new agreement, will require the consent of both parties.

For public companies, provisions in the certificate of incorporation also result in limited flexibility because changes to the certificate require shareholder approval. The board can amend the bylaws on its own, but this creates a risk for individuals because their indemnification rights are subject to change without their consent. However, these changes would be prospective only, and would not apply to acts occurring prior to the amendment, unless explicitly authorized in the bylaws.

Companies also should consider who should receive indemnification agreements. Among companies that have agreements, most provide them to both their directors and senior officers, but practices differ. Companies with large numbers of officers often limit indemnification agreements to a group consisting of the most senior executives.

Consider "Priority" Issues

Priority issues—that is, who is responsible for paying first—arise in situations where there are multiple sources of indemnification. Following the 2007 *Levy* case in Delaware,[6] which addressed the relative indemnification obligations of a private equity fund and one of its portfolio companies, this issue drew significant attention in the private equity context. Priority provisions and agreements emerged to clarify that portfolio companies would be primarily liable for the indemnification and advancement of expenses to private equity fund representatives serving on portfolio company boards. These types of provisions articulated what had been the widespread expectation prior to *Levy*: that individuals typically would look to the entity where they are serving as a director or officer as the first source of payment.

Priority issues come up in a number of situations outside the private equity context that are relevant—and even commonplace—for public companies. Directors and officers may serve at any number of outside entities, ranging from subsidiaries and employee benefit plans to joint ventures, industry groups and non-profit organizations. Broad, mandatory indemnification provisions typically state that a corporation will indemnify and advance expenses not only for service at the corporation itself, but also where an individual "is or was serving at the request of the corporation" at "another corporation, partnership, joint venture, trust or other enterprise." However, outside organizations often will have their own indemnification arrangements. Companies should address the possibility of competing indemnification obligations in advance by considering priority issues and taking steps to document the obligations of the respective parties.

The question of responsibility for indemnification also arises in the parent/subsidiary context. Under Delaware law, directors of first-tier subsidiaries are deemed to be serving "at the request of" the parent corporation.[7] Therefore, directors of first-tier subsidiaries would be entitled to indemnification by the parent corporation under a broad, mandatory indemnification provision stating that the parent corporation will indemnify and advance expenses to individuals serving "at the request of the corporation" at another enterprise. Outside this context, indemnification for subsidiary directors and officers is not automatic. Subsidiaries may have their own indemnification provisions in their certificates and bylaws. Unless a parent company explicitly grants indemnification rights to directors and officers of subsidiaries, it is unlikely that these individuals would be entitled to indemnification from the parent company.

Similar priority considerations apply with respect to insurance. D&O policies typically extend coverage to the subsidiary level, but companies should understand how that coverage works together with indemnification obligations. Additionally, it is important to review the policy language on coverage for outside entity service and understand the effect of insurance provided by outside entities.

Pay Attention to the Specifics of D&O Insurance

D&O insurance plays an important role by "filling gaps" where indemnification is not otherwise available to a director or officer. In those situations, D&O insurance is the last line of defense, so it is critical that a company's D&O insurance respond to protect directors and officers when it is most needed. This means that companies should pay attention to their D&O insurance, understand what it does and does not cover, and seek to obtain the most favorable terms available in the market at a reasonable price.

D&O insurance is not an "off the shelf" product. The particular insurance carrier's policy form is just the starting point for a D&O insurance policy. Many of the substantive coverage terms appear in "endorsements" that add to or otherwise modify the form. Endorsements can impact coverage in significant ways, so companies should understand the endorsements, and the endorsements should integrate well with the policy form.

Policy language ordinarily is negotiable, with certain coverage enhancements having direct correlation to the premium charged by the carrier. Language matters, and it differs from one policy to the next, and sometimes from one type of industry to the next—depending on the carrier's perception of litigation risks associated with certain industries. Minor wording changes can mean the difference between having and not having coverage, or having significantly more limited coverage. "The devil is in the details," and knowledge of "state of the art" coverage terms available in the insurance market is critical.

Understand the Structure of D&O Insurance

A typical public company D&O insurance program consists of multiple policies: a primary policy and one or more excess layer policies issued by different insurers. This structure allows public companies to obtain appropriate levels of coverage and enables insurers to spread risk.

The D&O insurance program typically provides three types of coverage: (1) "Side A" coverage for directors and officers for "non-indemnifiable" losses—that is, losses for which the company does not indemnify them, either because applicable law prohibits it, or because the company refuses or is financially unable to do so; (2) "Side B" coverage that reimburses the company for indemnification paid to directors and officers; and (3) "Side C," or "entity," coverage that protects the company for securities-related claims brought against it. In some cases, insurance carriers also offer coverage for internal investigations in response to a shareholder derivative claim, subject to a "sub-limit" of insurance amounting to several hundreds of thousands of dollars (often not enough to cover the true legal costs of these investigations).

Directors share D&O coverage with other parties.

Additionally, D&O policies often include coverage for non-officer employees. This may be limited to certain types of claims (such as employment and securities), or it may take the form of broader, "co-defendant" coverage that protects employees for any claims where a director or officer also is a party. Finally, D&O policies cover defense costs, which means that substantial legal fees could deplete a policy well before settlement or trial.

One fundamental feature of a D&O insurance program that may come as a surprise to some companies and their directors is that directors share D&O coverage with other parties. This means that claims involving other parties can "erode" or dilute the amount of insurance available for directors, creating the risk that D&O insurance may not be there for the very individuals it was designed to protect—the directors and officers. This reality is inherent in the structure of modern D&O policies, but there are steps that companies can take to maximize the coverage available for their directors. Addressing this issue should be top of mind for companies in evaluating their D&O insurance programs, and it should be a key consideration in determining both the amount and structure of coverage. As an initial matter, it is important to look at whether the overall amount of D&O insurance is likely to be adequate. Although there is no way to predict with certainty how much insurance is enough, factors including company size and industry, potential litigation exposure, and peer group coverage levels are relevant. "Dedicated" Side A coverage, which protects directors and officers only and is not shared with the company, has also become popular in recent years. Among public companies participating in Towers Watson's *2012 Directors and Officers Liability Survey*, 83 percent had some form of additional Side A coverage in 2012.[8] The Towers Watson data also indicate that, for larger companies (those with $1 billion or more in market capitalization), the average amount of additional Side A coverage represented between 32 percent and 40 percent of total coverage.

A specialized and increasingly common form of Side A coverage—known as "Side A DIC" (difference-in-conditions) coverage—provides even broader protection for individuals and is designed to protect them from catastrophic losses, such as where the company refuses to indemnify them or cannot do so because of bankruptcy, or where an underlying insurer rescinds coverage or becomes insolvent. Not one, but two, of these situations arose in the *Commodore* case in the Second Circuit discussed at the beginning of this article—a company bankruptcy followed by insurer insolvency. In that respect, the *Commodore* case provides a compelling illustration of why Side A DIC coverage is so important. Another circumstance that aggravated the outcome in the *Commodore* case was that the company had obtained multiple insurance policies from the same insurers. Commodore's D&O

insurance program consisted of a total of nine policies. Four were issued by the insolvent insurers, and two were issued by the insurer that successfully contested coverage in the Second Circuit. Thus, between the insurer insolvencies and the Second Circuit holding, Commodore's former directors and officers ultimately had no coverage under six of the company's nine D&O policies. Although this is an unusual outcome, it illustrates the importance of placing coverage with different insurers to spread risk and minimize the impact of an insurer's insolvency or refusal to pay.

Excess policies may contain different or more restrictive terms that can impact the scope of coverage.

As with traditional Side A/B/C D&O insurance, directors and officers share in a Side A-only policy, so the coverage available to any one director or officer may be diluted by the coverage for other individuals. "Independent director liability" (or IDL) coverage is reserved for outside directors and is intended to address this risk, but it has not become widespread since its introduction several years ago. Accordingly, securing an adequate amount of D&O insurance that includes some Side-A only coverage remains the most common solution for public companies. While specifics will vary from one company to the next, the ultimate goal of the D&O insurance program should be to ensure that there will be a pool of funds available to protect directors and officers.

Review Excess Policy Terms

As noted above, a typical public company D&O insurance program consists of multiple policies, which means that the majority of the coverage will come from the excess policies. Accordingly, once a claim exhausts the primary policy, the excess policies will provide the remaining coverage. Most excess policies "follow form" of the primary policy, meaning that they generally provide coverage on the same terms as the primary policy. However, excess policies may, and frequently do, contain different or more restrictive terms that can impact the scope of coverage. These considerations underscore the need for careful scrutiny of excess policies. It should not automatically be assumed that excess policies simply follow all the terms of the underlying insurance. It is important to understand the terms of the excess policies and how those policies work together with the underlying insurance.

The most critical aspect of excess policies is the "trigger" language, which establishes when coverage becomes available under those policies. An excess policy might state, for example, that coverage "attaches" (that is, coverage under that excess policy is triggered) only after the underlying insurance has been exhausted by the actual payment of losses by the insurers. This language can be problematic where an underlying insurer does not pay, whether due to a coverage dispute, insolvency of the insurer, or for other reasons. For example, if a company has a $10 million primary policy, settles a claim with the primary insurer for $8 million, "fills the gap" by paying the remaining $2 million itself, and seeks coverage from its excess insurers for amounts in excess of the $10 million limit, coverage may not be available because the policy language stipulates that the *insurers* must pay up to the underlying policy limits.

Similarly, in the *Commodore* case, where two of the company's insurers were insolvent, the Second Circuit held that two of the remaining, solvent insurers had no payment obligations under their policies based on the policy language, which stated that coverage was triggered only if the insolvent insurers' policies had been exhausted by the payment of claims. With the insolvent insurers unable to pay, the Court held that the limits of their policies had not been exhausted and thus, the other insurers' policies had not been triggered. The Court rejected the argument from the former directors and officers that coverage was triggered because their liability (not the amount of claims paid) exceeded the limits of the insolvent insurers' policies.

Unfortunate outcomes like these have occurred with increasing frequency in recent years. Trigger language in excess policies has become a recurring subject of coverage disputes, with a growing number of cases permitting excess insurers to deny coverage where the insured company settled with an underlying insurer for less than the full policy limits.[9] The results in these disputes demonstrate that courts will enforce policy language as written.

In the wake of these cases, some insurers have responded to market demand by modifying policy language so that it explicitly recognizes payments from sources other than the underlying insurers. Well-drafted trigger language should recognize payments from any source, including a "gap filling" payment by the company in order to fully exhaust the dollar amount of the limits of a particular underlying policy in order to access the excess layers of insurance above that policy. Accordingly, trigger language should state that an excess policy attaches after payment of the underlying policy limits, regardless of whether payment is made by the underlying insurers, the company or any other entity, such as a Side A DIC (difference-in-conditions) insurer. Likewise, well-drafted trigger language should not include a "limits shaving" provision. These provisions state that, if an underlying insurer (as opposed to some other party) pays only a portion of its liability limits (such as 75 percent), then the excess insurer is only responsible for paying the same percentage (75 percent) of its limits.

As a result of recent litigation involving trigger language in excess policies, today's market generally offers access to better, more comprehensive language. Nevertheless, companies should review the language carefully in evaluating their excess policies.

Consider the Coverage for Cyber Liability

The recent spotlight on cyber security issues has led public companies and their boards to consider what role the board should have in overseeing cyber security matters. This, in turn, has prompted questions about liabilities directors may face for cyber breaches and whether D&O insurance covers those liabilities.

As part of the board's risk oversight function, the board should have an understanding of the cyber risks the company faces in operating its business and should be comfortable that the company has systems in place to identify and manage cyber risks, prevent cyber breaches, and respond to cyber incidents when they occur. This should include an understanding of the extent to which a company's insurance may provide protection in the event of a major cyber incident. When the SEC staff issued its October 2011 guidance on disclosures about cyber security risks and cyber incidents,[10] the staff specifically mentioned that, where material, one component of appropriate disclosure may be a description of any relevant insurance coverage.

A company's D&O coverage should respond in the event of litigation alleging traditional claims for breach of fiduciary duties related to cyber issues. Accordingly, a claim for oversight liability—alleging, for example, that directors failed to see that the company implemented appropriate systems to manage cyber risks and to oversee those systems effectively—would fall squarely within the D&O policy. For other types of cyber losses—involving both the company and third parties—a number of traditional insurance products (general liability, crime, errors, and omissions) may provide some coverage, but this will depend on the policy terms. With the growing focus on this area, insurers have begun offering policies that specifically are designed to address cyber losses. While cyber insurance is evolving, it typically provides coverage for losses that the company incurs in responding to a cyber incident, such as the cost of notifying customers of a data breach, and claims brought by third parties, such as customers alleging unauthorized disclosure of their data.

Review D&O Insurance Coverage Annually

D&O insurance should be reviewed annually with the assistance of qualified professionals. Changes in both the external environment and the D&O insurance market may warrant changes in coverage. In the current environment, litigation defense costs and pre-litigation investigation costs continue to rise and litigation from M&A transactions has increased to the point where post-deal lawsuits are a virtual certainty. For the first time in several years, companies renewing their D&O insurance can expect higher premiums and the possibility of restrictions in coverage terms. Investigations remain a significant exposure for companies, so investigations coverage has become an area of particular focus and has begun evolving to meet the demand for insurance to respond at earlier stages in the investigative process. Companies with significant international operations increasingly are evaluating whether their D&O policies will respond to claims brought in foreign jurisdictions and considering the need for some form of "local" D&O coverage issued by in-country insurers. The laws of some countries require the purchase of local policies while there is uncertainty about the status of traditional D&O policies under the laws of other countries. All of these developments illustrate the importance of reviewing D&O coverage annually.

Due to the complexity of policy language and the issues involved, expert advice from qualified professionals is important in obtaining a thorough understanding of the coverage available under a company's D&O insurance program. These professionals should include both insurance and legal advisors, as each group brings different skills and experience to the table. Many boards of directors seek comprehensive analyses of their companies' D&O insurance programs, undertaken with the assistance of experts, at the time of initial purchase or renewal of D&O insurance coverage.

Notes

1. *Mehdi Ali v. Federal Ins. Co.*, 2013 U.S. App. LEXIS 11157 (2d Cir. 2013).
2. Note that some states, such as Maryland and Virginia, permit broader protection than Delaware.
3. *In re Novell, Inc. Shareholder Litigation*, 2013 Del. Ch. LEXIS 1 (Jan. 3, 2013); *In re BJ's Wholesale Club Shareholders Litigation*, 2013 Del. Ch. LEXIS 28 (Jan. 31, 2013).
4. *See, e.g.*, *Bergonzi v. Rite Aid Corp*., 2003 Del. Ch. LEXIS 117 (Nov. 3, 2003), *appeal denied, Rite Aid Corp. v. Bergonzi*, 836 A.2d 514 (Del. 2003).
5. *See Xu v. Heckmann Corp.*, 2010 Del. Ch. LEXIS 3 (Jan. 8, 2010).
6. *See Levy v. HLI Operating Co., Inc.*, 924 A.2d 210 (Del. Ch. 2007).
7. *See VonFeldt v. Stifel Financial Corp.*, 714 A.2d 79 (Del. 1998).
8. Towers Watson, Directors and Officers Liability Survey: 2012 Summary of Results 15.
9. *See, e.g.*, *Goodyear Tire and Rubber Co. v. National Union Fire Ins. Co. of Pittsburgh, PA*, 694 F.3d 781 (6th Cir. 2012); *Citigroup Inc. v. Federal Ins. Co.*, 649 F.3d 367 (5th Cir. 2011); *Great American Ins. Co. v. Bally Total Fitness Holding Corp.*, 2010 U.S. Dist. LEXIS 61553 (N.D. Ill. June 22, 2010); *Qualcomm, Inc. v. Certain Underwriters at Lloyds, London*, 161 Cal. App. 4th 184 (2008); *Comerica Inc. v. Zurich American Ins. Co.*, 498 F. Supp. 2d 1019 (E.D. Mich. 2007); *J.P. Morgan Chase & Co. v. Indian Harbor Ins. Co.*, 98 A.D.3d 18 (N.Y. App. Div. 2012); *Forest Laboratories, Inc. v. Arch Ins. Co.*, 38 Misc. 3d 260 (N.Y. Sup. Ct. N.Y. County 2012).
10. Division of Corporation Finance, Securities and Exchange Commission, *CF Disclosure Guidance: Topic No. 2, Cybersecurity* (Oct. 13, 2011), available at *http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm*.

What's the Deal with Regulation M?

Those with a financial interest in a securities offering are subject to SEC Regulation M, which is intended to prevent actions that might manipulate the market for the securities being offered. The reach of the regulation is broad, and the article below provides answers to some of the most frequently asked questions.

By Alexander F. Cohen, Kirk A. Davenport II, Dana G. Fleischman, and Joel H. Trotter

Regulation M addresses certain activities that could be viewed as artificially impacting the price of an offered security. It is intended to protect the integrity of the securities offering process by preventing persons with a financial interest in a securities offering from taking particular actions that might manipulate the market for the securities being offered.[1] This article examines the ins and outs of Regulation M, which was adopted in 1996 by the US Securities and Exchange Commission under the Securities Exchange Act of 1934 (the Exchange Act), and provides answers to some of the most frequently asked questions regarding Regulation M.

General Framework

Regulation M consists of six rules:

- Rule 100 sets forth the definitions of certain terms used in Regulation M.
- Rules 101 and 102 regulate bids for and purchases of the offered securities and certain other covered securities. More specifically:
- Rule 101 regulates bids and purchases by distribution participants (including underwriters and selling group members) and their affiliated purchasers; and
- Rule 102 regulates bids and purchases by issuers, selling securityholders and their affiliated purchasers.
- Rule 103 governs the extent to which distribution participants that are also NASDAQ market makers can continue to engage in certain passive market making activities.
- Rule 104 addresses permissible stabilization arrangements that may be used to facilitate an offering.
- Rule 105 restricts short selling activities that may take place in connection with certain types of offerings.

Key Terms

Distribution. An offering of securities, whether or not registered under the Securities Act of 1933 (Securities Act), that is distinguished from ordinary trading transactions by the magnitude of the offering (*i.e.,* the amount of securities to be sold and the percentage of outstanding securities, public float and trading volume those securities represent) and the presence of special selling efforts and methods (*e.g.,* payment of greater than normal sales commissions and/or the use of a roadshow, prospectus or sales memorandum). Note that in the case of shelf offerings, each takedown must be individually examined to determine whether it

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constitutes a "distribution." In addition, a private placement of securities can be a "distribution" for purposes of Regulation M if the offering satisfies the "magnitude" and "special selling efforts and selling methods" criteria. The issuance of securities in a merger can also be a Regulation M "distribution."

Distribution participant. Any underwriter, prospective underwriter, broker, dealer or other person that has agreed to participate or is participating in the distribution. For purposes of Regulation M, a "prospective underwriter" is one who has submitted a bid to the issuer or selling securityholder and knows or is "reasonably certain" that such bid will be accepted or who has reached or is "reasonably certain" to reach an understanding with the issuer, selling securityholder or managing underwriter that it will become an underwriter. Absent unusual circumstances, investment banks that attend the organizational meeting for an offering will typically be considered "distribution participants" for the offering.

Covered security. The security being distributed in the offering (the subject security), and any security (a reference security) into which the subject security may be converted, exchanged, or exercised,[2] or which, under the terms of the subject security, may in whole or significant part determine the value of the subject security.[3] So, for example, in a distribution of notes that are convertible into shares of common stock, the convertible notes are the "subject security," the common stock into which the notes can be converted is the "reference security" and both the convertible notes and the common stock are "covered securities" for purposes of Regulation M.

Affiliated purchaser. Any person (including non-US persons) acting in concert with a distribution participant, issuer, or selling securityholder in connection with the acquisition or distribution of a covered security, or an affiliate whose purchases of a covered security are controlled by or under common control with a distribution participant, issuer, or selling securityholder. In addition, subject to certain limited exceptions for specialist activity, any affiliate that acts as a market maker or engages as a broker or dealer in solicited transactions or proprietary trading activities in covered securities will be an affiliated purchaser. Other affiliates (including investment advisers and investment companies) that regularly purchase securities for their own account or for others, or that recommend or exercise investment discretion with respect to the purchase or sale of securities, may be able to avoid affiliated purchaser status if they can satisfy certain conditions intended to demonstrate their separateness from the affiliated distribution participant, issuer, or selling securityholder (including through the use of independently assessed information barriers and the absence of overlapping officers or employees that direct, effect, or recommend securities transactions).

Restricted period. The period during which the trading prohibitions established by Regulation M apply. The length of this period depends on the size of the issuer's public equity float (*i.e.*, the amount of the issuer's common equity securities held by non-affiliates), the worldwide reported average daily trading volume (or ADTV) of the security and the type of transaction.

ADTV. The worldwide average daily trading volume during a specified period prior to the filing of the registration statement or, if there is no registration statement or the distribution involves the sale of securities off of a shelf registration statement pursuant to Securities Act Rule 415, the pricing of the offering (such point in time, the Applicable Test Date). For the specified period, distribution participants may choose either the two full calendar months immediately preceding the Applicable Test Date or any 60 consecutive calendar days ending within the 10 calendar days preceding the Applicable Test Date.[4]

Overview of Rule 101

General Prohibition

In the context of distributions of securities, Rule 101 restricts distribution participants and their affiliated purchasers from bidding for, purchasing, or attempting to induce others to bid for or purchase, covered securities during the applicable restricted period. Rule 101 will *not* apply, however, if the offering does not rise to the level of a "distribution."

Restricted Period

Ordinary offerings. For ordinary offerings (*i.e.*, offerings other than those occurring in the context of a merger, acquisition, or exchange offer), the restricted period begins (i) on the first business day prior to the pricing of the offering if the security has ADTV of at least US$100,000 and the issuer of the security has a public float of at least US$25 million or (ii) on the fifth business day prior to the pricing of the offering for all other securities.[5]

The restricted period ends when the distribution participant has completed its participation in the distribution. For an underwriter, this occurs when the securities underwritten by it have been distributed (including through placement, under appropriate circumstances, into an investment account of the underwriter) and all stabilization arrangements and syndicate trading restrictions in connection with the distribution have been terminated. For an issuer or selling security holder, Regulation M takes a somewhat circular approach by providing that their restricted period ends when "the distribution is completed." This is generally understood in the case of underwritten distributions to mean the same time as the restricted period ends for the underwriters as described above.

Although the mere existence of an unexercised syndicate overallotment option will not in and of itself prolong the restricted period, it is important to note that if the overallotment option is exercised in an amount that exceeds the net syndicate short position at the time of exercise the distribution will not be deemed complete as of the pricing date. In such case, any bids or purchases of covered securities made prior to the exercise of the option could, absent another exemption, constitute a violation of Regulation M.

Mergers, acquisitions, and exchange offers. In the context of mergers, acquisitions, and exchange offers, the restricted period begins on the day proxy solicitation or offering materials are distributed to securityholders and ends at the time of the securityholder vote or the expiration of the offer. In addition, a separate restricted period will also apply with respect to any period during which the market price of the subject security will be used to determine the consideration to be paid to securityholders in connection with the merger, acquisition, or exchange offer. Such additional restricted period will begin one or five business days prior to the commencement of the valuation period and will end at the termination of the valuation period.[6]

At-the-market offerings. The restricted period for a person participating in an at-the-market offering (which is defined as any offering other than a fixed price offering) begins one or five business days before the pricing of each sale and ends when the person's participation in the distribution has ended.

Important Exceptions

Excepted Securities

- Securities with ADTV of at least US$1.0 million whose issuer has common equity securities with a public float of at least US$150 million (such securities are commonly referred to as "actively-traded securities").
- Nonconvertible debt, nonconvertible preferred, and asset-backed securities that are, in each case, rated by at least one nationally

recognized statistical rating organization as "investment grade."[7]

- Securities that are "exempted securities" as defined in Section 3(a)(12) of the Exchange Act or that are face-amount certificates or securities issued by an open-end management investment company or unit investment trust.

Excepted Transactions

Distributions of securities eligible for resale under Rule 144A of the Securities Act solely to persons that are or are reasonably believed to be "qualified institutional buyers" or "QIBs" (as defined in Rule 144A), in transactions exempt from registration under Securities Act Section 4(a)(2), Rule 144A, or Regulation D,[8] and to persons not deemed to be "US persons" for purposes of Regulation S under the Securities Act (Rule 144A/ Reg S transactions).[9]

- Transactions in connection with the distribution or complying with Rule 103 (passive market making) or Rule 104 (stabilization).

- Unsolicited brokerage transactions and unsolicited principal purchases that are not effected through a broker or dealer, on a securities exchange, or through an inter-dealer quotation system or electronic communications network. (Note that unlike predecessor Rule 10b-6 there is no requirement that unsolicited principal purchases be of "block" size.)

- Certain basket transactions and odd-lot and odd-lot related transactions.

- Exercises of any option, warrant, right, or conversion privilege set forth in the instrument governing the security.

- Inadvertent violations that in the aggregate total less than 2 percent of a security's ADTV, if written procedures to achieve compliance with Rule 101 are maintained and enforced (the *de minimis* exception). Note that this exception can only be relied on up to the time the violations are discovered (*i.e.*, once the inadvertent violations are discovered, subsequent transactions would not be covered by this exception).

Issuer and Selling Securityholder Prohibitions Under Rule 102

General Prohibition

Rule 102 prohibits issuers and selling securityholders, and their respective affiliated purchasers, from bidding for, purchasing, or attempting to induce others to bid for or purchase, any covered security during the applicable restricted period.

Although Rule 102 repeats many of the same provisions set forth in Rule 101 and uses many of the same definitions, certain of the exemptions included in Rule 101 are omitted from Rule 102, primarily based on the SEC's view that issuers and selling securityholders have more of a direct stake in the proceeds of the offering and therefore may have a greater incentive to manipulate the price of covered securities.

Restricted Period

The commencement and duration of the restricted period applicable to issuers, selling securityholders and their affiliated purchasers is the same for purposes of Rule 102 as it is for purposes of Rule 101.

Unlike Rule 101, however, Rule 102 does *not* contain an exception for "actively-traded securities" issued by the issuer that is the subject of the distribution or an affiliate of such issuer.[10]

Important Exceptions

Excepted Securities

- Like Rule 101, Rule 102 excepts investment grade non-convertible debt, non-convertible preferred and asset-backed securities, as well as securities that are "exempted securities" as defined in Section 3(a)(12) of the Exchange Act or that are face-amount certificates or securities issued by an open-end management investment company or unit investment trust.[11]

Excepted Transactions

- Like Rule 101, Rule 102 contains exceptions for (i) certain odd-lot and odd-lot related transactions, (ii) the exercise in accordance with their terms of options, warrants, rights, and convertible securities, (iii) unsolicited purchases, (iv) transactions in connection with the distribution, and (v) Rule 144A/Reg S transactions.

- Rule 102 also contains exceptions for certain (i) repurchase transactions by closed-end investment companies, (ii) redemptions by commodity pools and limited partnerships, and (iii) transactions in connection with qualifying issuer stock option, dividend reinvestment, and other "plans."

- Unlike Rule 101, however, Rule 102 contains no "*de minimis* exception," nor an exception for basket transactions.

NASDAQ Passive Market Making Activities Under Rule 103

Rule 103 provides an exemption for the continuance of certain passive market making activities in a NASDAQ security by a distribution participant during the Rule 101 restricted period if the distribution participant is a registered market maker on NASDAQ. However, this exemption does not apply (i) if a stabilizing bid is in effect, (ii) during an at-the-market offering, or (iii) during a best efforts offering.

The exemption sets forth explicit criteria that must be followed including with respect to pricing limitations, purchasing capacity, displayed size, designation of bids, regulatory notification, and prospectus disclosure. NASDAQ market makers seeking to rely on this exemption will have well-developed policies and procedures designed to comply with the intricacies of Rule 103.

Stabilization Activities Under Rule 104

Coverage

Rule 104 provides that it is "unlawful for any person, directly or indirectly, to stabilize,[12] to effect any syndicate covering transaction,[13] or to impose a penalty bid,[14] in connection with an offering of any security" except in accordance with the provisions of Rule 104. Rule 104 further states that "[n]o stabilizing shall be effected at a price that the person stabilizing knows or has reason to know is in contravention of [the provisions of Rule 104] or is the result of activity that is fraudulent, manipulative, or deceptive under the securities laws, or any rule or regulation thereunder."

Rule 104 sets forth detailed and rather complex criteria (including with respect to stabilizing levels and initiating, maintaining, increasing or reducing stabilizing bids) in accordance with which stabilization and certain other activities used by distribution participants to facilitate an offering may proceed even if such activity takes place during a Rule 101 or 102 restricted period. It is important to note that Rule 104 applies to all "offerings"—not only to those that constitute "distributions" under Regulation M.

General Limitations

- Stabilizing is prohibited except for the purpose of preventing or retarding a decline in the market price of a security.

- Priority must be given to independent bids at the same price.

- No more than one stabilizing bid at the same price may be maintained in any one market.

- Stabilization is not permitted in connection with at-the-market offerings.

Significant Exceptions (and Missing Exceptions)

- Rule 144A/Reg S transactions
- Distributions of "exempted securities," as such term is defined in Section 3(a)(12) of the Exchange Act.
- Non-US Stabilization—stabilizing may be conducted outside the United States during an offering in the United States without compliance with the requirements of Rule 104 if: (i) no stabilization is conducted in the US, (ii) the stabilization price is not above the US offering price, and (iii) stabilization is conducted only in jurisdictions with stabilization regulations that the SEC has recognized as comparable to those in Rule 104 (so far, only the U.K. has been recognized by the SEC as having comparable regulations).[15]
- Unlike Rule 101, Rule 104 contains *no* exception for actively-traded securities.
- Unlike Rules 101 and 102, Rule 104 contains *no* exception for nonconvertible debt, nonconvertible preferred, or asset-backed securities.

Disclosure and Recordkeeping Requirements

- Any person subject to Rule 104 that conducts a transaction in securities where the price may be or has been stabilized is required to notify the purchaser of such fact. Such notification is commonly made in the prospectus relating to the offering and in the confirmation statement sent to the purchaser upon completion of the transaction.
- Any person displaying or transmitting a bid that such person knows is for the purpose of stabilizing must provide prior notice to the market on which such stabilizing is being effected and must disclose the purpose of the bid to the person with whom it is entered.

Rule 104 also imposes certain disclosure requirements with respect to post-offering (or aftermarket) syndicate activities. In particular, pursuant to Rule 104, any person that effects a "syndicate covering transaction" or imposes a "penalty bid" must provide prior notice thereof to the self-regulatory organization with direct authority over the principal market in the United States for the subject security.[16]

Short Sale Restrictions Under Rule 105

General Rule

In general, Rule 105 prohibits any person that has sold short a security that is the subject of a registered offering from purchasing securities in the offering from an underwriter, broker, or dealer participating in the offering if the short sale took place during a specified period prior to the pricing of the offered securities (the pre-pricing period).[17] For purposes of the Rule, the pre-pricing period <u>begins</u> on the later of (i) the fifth business day before pricing or (ii) the initial filing of the registration statement, and <u>ends</u> with the pricing of the securities.

Scope

Rule 105 applies to registered offerings of equity securities for cash that are conducted on a firm commitment basis. Accordingly, Rule 105 is not applicable to (i) offerings of nonconvertible debt securities, (ii) offerings that are not registered under the Securities Act, or (iii) best efforts offerings.

In addition, the Rule 105 Release clarifies that the Rule's reference to the security that is the "subject" of the offering is intended to be synonymous with the definition of "subject security" in

Rule 100 of Regulation M. Thus, Rule 105 does not prohibit a person that shorted common stock in the pre-pricing period from purchasing securities that are convertible into or exchangeable for such common stock (*i.e.*, the prohibition does not extend to reference securities).[18]

Exceptions

Bona Fide Pre-Pricing Purchases

- Rule 105 permits a person that established a short position in the offered securities during the pre-pricing period to purchase securities in the offering if such person entered into a *bona fide* transaction that closed out that short position prior to the pricing of the offering.

- In order to qualify for the exception, the pre-pricing covering purchase must be (i) in an amount at least equal to the amount of the pre-pricing period short sale, (ii) effected during regular trading hours, (iii) reported pursuant to an effective transaction reporting plan, and (iv) effected at least one business day prior to the pricing of the offering.[19]

- However, the exception is not available to a person that has effected a pre-pricing period short sale within the 30 minutes prior to the close of regular trading on the business day prior to the pricing date of the offering.

Purchases by Separate Accounts

- Rule 105 provides an exception for certain accounts that may be affiliated with each other or otherwise "related," but for which the decisions regarding securities transactions are made separately and without coordination or cooperation between the accounts (separate accounts).[20]

- This exception permits broker-dealers, investment advisers, individual investors, and other persons to purchase securities in an offering even if a short sale was effected during the pre-pricing period on behalf of a related account, so long as the trading decisions for each account are "made separately and without coordination of trading or cooperation among or between the accounts."[21]

Purchases by Investment Companies

Rule 105 also contains an exception specifically applicable to investment companies registered under Section 8 of the US Investment Company Act of 1940. This exception allows a registered investment company to purchase securities in the offering even if an affiliated investment company (or another fund in the same fund family or fund series) sold the offered security short during the pre-pricing period.

Frequently Asked Questions

1. Are all private placements exempt from trading restrictions under Regulation M?

No. Unless a private placement satisfies the criteria for Rule 144A/Reg S transactions, it will be subject to Regulation M trading restrictions unless another exception is available. It is possible that a particular private placement would not meet the magnitude and special selling efforts criteria necessary to constitute a "distribution" for purposes of Rules 101 and 102, but such determination would need to be made on a case-by-case basis after considering all the relevant facts.

2. Do the trading prohibitions of Rules 101 and 102 apply to transactions in derivatives?

Generally, no. "Rights to purchase" the security in distribution (which were restricted under predecessor Rule 10b-6) are not subject to trading restrictions under Rules 101 or 102. As a result, so long as the price of the derivative security is not used to determine the price of the security in distribution under the terms of the distributed security, options, warrants, rights, and convertible securities are not subject to Rule 101 or Rule 102 restrictions during a distribution of the underlying security. Trading restrictions, however, generally will be applicable to the underlying security in connection with a distribution of the derivative security itself.

Because "rights to purchase" a subject security are not subject to the trading restrictions of Regulation M, a distribution participant (for purposes of Rule 101) or an issuer or selling securityholder (for purposes of Rule 102) may write (or sell) a put option or maintain a "short put" position with respect to the subject security during the restricted period for the subject security. Moreover, the Reg M Adopting Release clarifies that maintaining a short put position is *not* deemed to be a continuing bid for the underlying security for purposes of Regulation M.

Nonetheless, general manipulation concerns may still be raised if an issuer writes such a derivative security during a Regulation M restricted period with respect to the underlying security and knows or has reason to believe that the counterparty will effect purchases of the underlying security to hedge its position in connection with that derivative.

3. Do Regulation M trading restrictions apply to securities in the "same class and series" as the subject security?

No. Regulation M eliminated predecessor Rule 10b-6's restriction on securities of the "same class and series" as the security in distribution. Thus, for example, a distribution of an issuer's debt securities will not subject other debt securities of that issuer to trading restrictions under Regulation M, unless such other debt securities are identical in all respects (including, among other terms, the coupon rate and maturity date) to the security in distribution. On the other hand, because of the elimination of the "same class and series" concept, most debt offerings (other than reopenings) will be subject to a five-day minimum restricted period because the offering will involve the issuance of a new security with no prior trading history.

Note, however, that an equity security that differs only in voting rights from the security in distribution is deemed to be the same security as the security in distribution and, therefore, will be a "covered security."

4. How is an issuer's public float calculated for purposes of determining a security's ADTV?

The Reg M Adopting Release provides that, for reporting issuers, the public float value should be taken from the issuer's most recent annual report on Form 10-K or be based upon more recent information made available by the issuer. For foreign private issuers (since the annual report on Form 20-F does not require disclosure of public float information), the Reg M Adopting Release states that the public float value should be determined in the same manner as provided in Form 10-K.[22]

5. For purposes of the exclusion from affiliated purchaser status for securities industry affiliates of distribution participants, issuers, and selling securityholders, can an internal audit group of the distribution participant, issuer, or selling securityholder perform the required annual independent review of such entity's information barrier policies and procedures?

Yes, under certain conditions. For an affiliated entity to qualify for the securities industry exclusion from "affiliated purchaser" status, the affiliated distribution participant, issuer or selling securityholder must (in addition to certain other requirements) maintain and enforce written policies and procedures reasonably designed to prevent the flow of information to or from the affiliate that might result in a violation of Rules 101, 102, and 104 of Regulation M and obtain an annual, independent assessment of the operation of such policies and procedures. The Reg M Adopting Release confirms that an internal audit group may be viewed as "independent" and perform this review if such group is independent of the corporate financing, trading and advisory departments of the distribution participant, issuer or selling security holder.[23]

6. Does Regulation M restrict the publication of research?

Yes. Rule 101 allows distribution participants and their affiliated purchasers to publish research reports (which, in general, have been thought to constitute inducements to purchase) during the applicable restricted period for a distribution *only* if such reports satisfy the requirements of Rule 138 or 139 under the Securities Act.[24]

Nonetheless, although Rules 138 and 139 qualifying research may be distributed throughout the applicable restricted period, some broker-dealers have elected, as a matter of internal risk-management policy (*i.e.,* to mitigate potential claims regarding the misuse of material nonpublic information or appearance of impropriety), to restrict, in connection with any distribution in which it is a distribution participant, (i) any publication of research regarding the issuer in distribution except in the ordinary course of its business and consistent with past practice and (ii) the inclusion in such research reports of increased estimates regarding the issuer's earnings and/or upgraded recommendations with respect to the issuer's securities, unless, in each case, such action is taken in response to an event involving or affecting the issuer that has been previously disclosed to or is already known by the public.

Note that the SEC has not yet indicated how Regulation M restrictions on research during the restricted period apply to reports on emerging growth companies (or EGCs) that do not satisfy either the Rule 138 or 139 safe harbor, but that would satisfy the definition of research set forth in Section 2(a)(3) as modified by the Jumpstart Our Business Startups Act of 2012 (the JOBS Act). Under the JOBS Act, the SEC is prohibited from maintaining or adopting any rule that restricts a broker-dealer from publishing or distributing any research report or making any public appearance with respect to the securities of an EGC within any prescribed period of time following the effective date of the EGC's IPO. Although the JOBS Act prohibition does not address the period of time *before* the EGC's IPO—and thus appears not to be inconsistent with the pre-effective date portion of the Regulation M restricted period for an EGC IPO—it potentially raises an issue for "sticky offerings" (see below) and other offerings in which the "completion of the distribution" is not the same date as the pricing date for the offering.[25] It also raises an issue for a follow-on or secondary offering of securities that are not "actively-traded." In such case, Regulation M would prohibit distribution participants from publishing non-qualifying research during the applicable one- or five-day period prior to the pricing date for such offering.

7. How does the existence and exercise of an overallotment option affect the determination of when an underwritten distribution is deemed to be complete for purposes of ending the Regulation M restricted period?

An underwritten distribution is ordinarily deemed complete when all underwriters have distributed their allocations (*i.e.*, after all investors have confirmed their intent to purchase the securities allocated to them) and all syndicate restrictions have been lifted, even if the overallotment option (sometimes referred to as the "Green Shoe") granted to the underwriters in connection with the offering will be exercised in whole or in part at a later date (or not at all, due to covering purchases in the market). Successful distributions are typically completed on the pricing date and the possible exercise of the overallotment option at a later date should not normally prevent the distribution from being deemed completed as of the pricing or other "putative completion" date because the overalloted securities are sold and distributed at the same time as the firm commitment securities. However, if the overallotment option is exercised in an amount that exceeds the net syndicate short position (taking into account securities purchased in stabilizing or syndicate covering transactions), the distribution will not be deemed to have been complete as of the putative completion date and bids and purchases made prior to the exercise of the option could constitute a violation of Regulation M, unless an applicable exemption is available.

In certain offerings, underwriters may engage in a practice known as "refreshing the shoe." In such case, the syndicate short position may be reduced by purchases of the subject security made in the open market, and then reestablished in whole or in part by subsequent sales of the securities back into the market, after which time the syndicate short position is covered by the overallotment option. Because it is not clear whether such activity might extend the distribution period of the offering past the pricing date, underwriters will typically only "refresh the shoe" in connection with offerings in which they can take advantage of the actively-traded securities exception for their post-pricing activities. As a practical matter, this means that underwriters will not "refresh the shoe" in IPOs since the securities in distribution will not qualify for the actively-traded securities exception. In addition, because issuers and selling securityholders do not have an actively-traded securities exception under Rule 102, it will be important for the underwriters to inform the issuer and/or selling securityholders (and their affiliated purchasers), that such activity is or may be taking place so that inadvertent Regulation M violations are avoided.

8. If an underwriter is an affiliate of the issuer or a selling securityholder, can the underwriter rely on the exceptions available under Rule 101 rather than the more limited exceptions available under Rule 102?

Yes, other than the actively-traded securities exception. Regulation M provides that an underwriter or other distribution participant that is also an affiliate of the issuer or selling securityholder will be subject to Rule 101 rather than Rule 102, but an affiliated distribution participant (even one acting as an underwriter) cannot rely on the exception for actively-traded securities.[26] If, however, an underwriter is itself the issuer of the security or a selling securityholder, the underwriter will be subject to the prohibitions (and limited to the exceptions) set forth in Rule 102.

9. Is an issuer subject to Regulation M trading restrictions if it is not an affiliated purchaser of a selling securityholder and is not otherwise involved in the offering?

No. The Reg M Adopting Release notes that an issuer will *not* be subject to Rule 102 in connection with a distribution of the issuer's securities effected solely by or on behalf of a selling securityholder that is not affiliated with the issuer. If, however, the issuer is an affiliated purchaser of the selling securityholder, the issuer will be subject to Rule 102 trading restrictions.

10. Can affiliates of the issuer or a selling securityholder buy securities in the offering?

Yes. The Reg M Adopting Release clarifies that Regulation M does not preclude affiliates of an issuer or selling securityholder (such as, for example, officers and directors) from purchasing securities in the offering itself.

More specifically, the Reg M Adopting Release states that securities acquired in the distribution by anyone participating in the distribution (or any affiliated purchaser) for "investment purposes" are considered to be distributed for purposes of determining the end of the applicable restricted period for the offering.[27] The phrase "for investment purposes" is not defined in this context, but most market participants believe it is sufficient for the purchasers in these cases to represent or otherwise acknowledge that they are purchasing with investment intent and not with a view to distribution or immediate resale. Although Regulation M does not mandate the imposition of resale restrictions on these purchasers, in many cases they will be subject to general offering-related lock-up agreements with the underwriters, which should also help support the investment purpose characterization.

Disclosure of these types of purchases is not required by Regulation M but is often included as a matter of practice, particularly when the purchases are of a significant size or if the purchaser is a member of company management.

11. When is a Regulation M distribution deemed to be complete in the case of a "sticky offering"?

If an underwriter is unable to sell all of its allotted securities to the public on or promptly after the pricing date (a so-called "sticky offering"), the underwriter may determine to place the unsold securities into an investment account of the firm (sometimes referred to as the "freezer"). The definition of "completion of the distribution" in Regulation M states that securities acquired in a distribution "for investment" by a distribution participant or an affiliated purchaser of a distribution participant are deemed to be distributed. To our knowledge, however, the SEC has never issued any formal guidance as to how long such securities should be held "in the freezer" to demonstrate the requisite investment intent. Accordingly, each underwriter will typically have its own policies and procedures with respect to the minimum period the securities must be held in the freezer before they may be sold into the market and deviations from the set minimum generally are allowed only upon a showing of changed circumstances that could not have been reasonably anticipated at the time the securities were put into the freezer.[28]

12. If a shelf registration statement includes a broad description of the various means by which securities may be sold off the shelf (including through an underwritten offering), will each shelf takedown be considered a distribution?

No. The SEC confirmed in the Reg M Adopting Release that each takedown off a shelf should be individually assessed to determine whether the takedown constitutes a distribution for purposes of Regulation M. Further, the Reg M Adopting Release notes that an "issuer's description in a shelf registration statement of a variety of potential selling methods will not cause, by itself, any sales off the shelf to be treated as a distribution, unless the broker-dealer in fact uses special selling efforts or selling methods in connection with particular sales off the shelf, and the sales are of a magnitude sufficient to demonstrate the existence of a distribution."[29]

The SEC went on to note that "a broker-dealer likely would be subject to Rule 101, however, if it enters into a sales agency agreement that provides for unusual transaction-based compensation for the sales, even if the securities are sold in ordinary trading transactions."[30]

13. Can issuers continue to effect repurchases of securities under Rule 10b-18 during a Regulation M distribution?

No. In connection with the adoption of Regulation M, the SEC adopted an amendment to Exchange Act Rule 10b-18 (which provides a safe harbor under certain circumstances for repurchases by an issuer of its own common stock) that precludes reliance on the Rule 10b-18 safe harbor during the Rule 102 restricted period in distributions in which the common stock is (or is a reference security for) the security in distribution.

14. While participating in a distribution, can underwriters (i) solicit customers to purchase additional shares of the offered securities after the distribution has ended and secondary market trading in the securities begins or (ii) require customers to commit to purchase additional shares in the aftermarket as a condition to being allocated shares in the distribution?

No. The SEC staff issued Staff Legal Bulletin No. 10 on August 25, 2000, to remind underwriters and other distribution participants that such solicitations and "tie-in" arrangements are prohibited by the provisions of Regulation M (as improper inducements) and also may violate other antifraud and antimanipulation provisions of the federal securities laws.[31]

15. If an affiliated purchaser of an issuer or selling securityholder has in place a Rule 10b5-1 trading plan, can purchases under such plan continue during the restricted period for an offering?

No. Although Exchange Act Rule 10b5-1 provides a narrow safe harbor from insider trading liability, it does not provide a safe harbor from market manipulation claims, nor is purchasing activity pursuant to a Rule 10b5-1 trading plan an excepted or permitted activity under Rule 102 of Regulation M.

16. After the execution of a merger agreement, does the target company become an "affiliated purchaser" of the acquiring company?

Yes. Staff Legal Bulletin No. 9 clarifies that the target company will be subject to the restrictions of Rule 102 with respect to purchases of the acquiror's securities. Regulation M, however, generally does not apply to purchases of the target company's securities by either the target or acquiror during a merger or exchange offer (unless the acquiror's securities have a feature or term that directly ties its value to the price of the target's securities).[32]

17. In an exchange offer, are the target's securities considered reference securities for the acquiror's securities if the market price of the target's securities will be used as a factor in determining the exchange ratio for the offer?

No. SLB No. 9 states that the target's securities would only be reference securities if the relationship between the target's and acquiror's securities was a feature of the acquiror's securities themselves.

18. If the security being distributed is convertible into common stock that satisfies the criteria for the actively-traded securities exception, does the exception also apply to the security being distributed?

No. The SEC takes the view that the security in distribution is a separate security from the security into which it may be converted or for which it may be exchanged. Accordingly, a convertible security does not get the benefit of the exception for actively-traded securities that is available to the underlying common stock. The same result applies to mandatory convertible or exchangeable securities and to securities that are immediately convertible into or exchangeable for the underlying securities.

19. If an actively-traded subject security is convertible into or exchangeable for a reference security that does not satisfy the actively-traded securities exception, is the reference security subject to a restricted period under Rule 101?

No. SLB No. 9 provides that the "restricted period for a reference security is never greater than that of the subject security."

20. Do FINRA member firms need to notify FINRA when they are involved in a Regulation M distribution?

Yes. FINRA Rule 5190 requires member firms to notify and provide FINRA with certain specified information with respect to activities conducted by it in connection with a distribution subject to Regulation M (this notification requirement is typically fulfilled by the lead or managing underwriter on behalf of all the members of the underwriting syndicate). The Rule 5190 notice with respect to the determination of the restricted period generally must be filed no later than the business day prior to the first complete trading session of the applicable restricted period, unless later notification is necessary under specific circumstances.[33] Firms also must submit a notification to FINRA under Rule 5190 that details pricing information with respect to the distribution. Such notification generally is required to be filed no later than the close of business on the next business day following the pricing of the securities. Finally, firms immediately must notify FINRA in writing if a distribution for which they have previously filed the restricted period notification subsequently has been canceled or indefinitely postponed.

Note that the FINRA Rule 5190 notification must be filed in respect of both listed and unlisted securities if a restricted period is applicable to the offering under either Rule 101 or Rule 102. Accordingly, FINRA notification is required even if the securities meet the actively-traded securities exception under Rule 101. In addition, FINRA Rule 5190 notification is required even if the offering qualifies for an exemption from filing under FINRA Rule 5110 (the Corporate Financing Rule).[34]

Notes

1. Regulation M, which became effective on March 4, 1997, replaced former Exchange Act Rules 10b-6, 10b-6A, 10b-7, and 10b-21 and eliminated in its entirety the regulation of rights offerings formerly contained in Exchange Act Rule 10b-8. In adopting Regulation M, the SEC expressly rejected requests from some commenters that the rules be designed as safe harbors, determining instead that a prophylactic approach was a more effective means to protect the integrity of the offering process. *See* SEC Release No. 34-38067 (Dec. 20, 1996) (the Reg M Adopting Release).
2. Note that characterization as a "reference security" does *not* depend on whether the subject security is immediately convertible, exchangeable, or exercisable for such security, or whether the conversion, exchange, or exercise may take place only after a certain contingency or condition has been met.
3. Unlike predecessor Rule 10b-6, this definition encompasses a security underlying an equity-linked security or similar instrument that does not give the holder the right to acquire the underlying security but whose value is or may be derived from such security. However, a security will be a "reference security" only when it, or an index of which it is a component, is referred to in the actual terms of a subject security. A security of the same or a similar issuer will not be deemed a reference security merely because its price is used as a factor in determining the offering price of the security in distribution. *See* Reg M Adopting Release, n.32 and accompanying text.
4. ADTV can be obtained from publicly available sources as long as such sources are reasonably believed to be reliable. Note that the two-month or 60-day period must be met in full as specified in the ADTV definition. If the subject security has not been outstanding for the full period specified in the ADTV definition, the ADTV calculation cannot be made and, as a result, neither the one-business day restricted period, nor the exception for actively-traded securities, would be available. This situation typically arises in connection with initial public offerings by US issuers, the distribution of a new series of debt securities, or in connection with a related "tack on" offering or re-opening of the same series of debt securities that is proposed to be made before the end of the full period specified in the ADTV definition.
5. For purposes of Regulation M, a "business day" is a 24-hour period determined with reference to the principal market for the securities to be distributed and that includes an entire trading session for that market. Note that if a person becomes a distribution participant after the commencement of the restricted period, its activities prior to becoming a distribution participant will not be deemed to violate Regulation M (in effect, such person's restricted period will commence on the later of the applicable one- or five-day period or the time such person becomes a distribution participant).
6. Note, however, that Exchange Act Rule 14e-5 continues to apply and may (absent an applicable exemption) prohibit purchases or arrangements to purchase the securities that are the subject of a tender offer (or any security that is immediately convertible into or exchangeable for such security) from the time of public announcement of the offer until the expiration of the offer.
7. Pursuant to Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the SEC proposed an amendment to Regulation M in April 2011 that would remove the references to credit ratings in Rules 101 and 102 and replace them with new standards that focus instead on the trading characteristics of the covered securities. *See* SEC Release No. 34-64352 (Apr. 27, 2011). Briefly, the exception would (if adopted as proposed) exempt from Regulation M's trading prohibitions nonconvertible debt securities, nonconvertible preferred securities and asset-backed securities that (i) are liquid relative to the market for that asset class, (ii) trade in relation to general market interest rates and yield spreads, and (iii) are relatively fungible with securities of similar characteristics and interest rate yield spreads.
8. Note that this exception is *not* available in a distribution of a Rule 144A-eligible security that includes accredited investors. For this reason, following the adoption of Regulation M, distributions of Rule 144A-eligible securities are typically made solely to QIBs and do not include a side-by-side private placement or so-called "Section 4(1½)" offering to institutional accredited investors.

9. Although this exception generally is thought of as applying solely to transactions that satisfy the exemptions from Securities Act registration provided by Rule 144A and Regulation S, it also encompasses, for example, direct placements by issuers that are not eligible for Rule 144A (which applies to resale transactions) but instead satisfy the exemption from Securities Act registration provided by Section 4(a)(2) or Regulation D, provided that the securities are eligible for resale under Rule 144A and are offered and sold only to persons that are, or are reasonably believed to be QIBs or non-US persons under Regulation S.

10. Although Rule 102 does not contain an exception for actively-traded securities issued by the issuer or an affiliate of the issuer, transactions in reference securities (including securities into which the security being distributed is convertible or exchangeable) that are actively-traded securities and issued by an unaffiliated entity are exempt from Rule 102's trading restrictions.

11. *See* note 7 above with respect to proposed changes to the investment grade rating element of this exception.

12. "Stabilizing" is the placing of any bid, or the effecting of any purchase, for the purpose of pegging, fixing, or otherwise maintaining the price of a security.

13. A "syndicate covering transaction" is the placing of any bid, or the effecting of any purchase, on behalf of the syndicate (or a sole distributor) to reduce a short position created in connection with the offering. Note that the exercise of an overallotment option is not considered a syndicate covering transaction. *See* SEC Staff Legal Bulletin No. 9 (issued Oct. 27, 1999, and revised Sept. 10, 2010) (SLB No. 9).

14. The imposition of a "penalty bid" allows the managing underwriter to reclaim a selling concession from a syndicate member when the securities originally sold by the syndicate member are repurchased in syndicate covering transactions.

15. *See* Reg M Adopting Release, text accompanying n.126.

16. In connection with the adoption of Regulation M, certain amendments were made to Item 502(d) (with respect to the content of the "stabilizing legend" placed on the prospectus cover) and Item 508 (with respect to the disclosure in the "Plan of Distribution" section of the prospectus of general information regarding stabilizing and aftermarket activities) of SEC Regulations S-K and S-B.

Rule 17a-2 under the Exchange Act was also amended to require that managing underwriters keep records of syndicate covering transactions and penalty bids in addition to the information currently required with respect to stabilizing transactions.

17. Prior to its amendment in 2007, Rule 105 limited only "covering" transactions (*i.e.*, a short seller was prohibited from using securities purchased in a registered offering to cover short sales entered into during the pre-pricing period). According to statements made by the SEC at the time the amendments to Rule 105 were adopted, the changes to the rule were intended to (i) put an end to the progression of trading strategies designed to hide covering activity that was prohibited by Rule 105, (ii) streamline compliance with Rule 105, and (iii) facilitate enforcement of Rule 105. *See* SEC Release 34-56206 (Aug. 6, 2007) (the Rule 105 Release).

18. The SEC states in the Rule 105 Release that, although it chose not to cover derivative trading strategies in the amended rule, it will continue to monitor the use of such strategies (including the extent to which such strategies are the functional equivalent of equity trading covered by the rule) and reminds firms that, even if a transaction or series of transactions does not violate Rule 105, it remains subject to the general antifraud and antimanipulation provisions of the securities laws.

19. The SEC has acknowledged that this element of the exception may prevent its use in a "truly 'overnight deal' when an offering commences after the close of regular trading on the day of pricing" because such person will not have time to effect a qualifying covering purchase. *See* Rule 105 Release, n.58 and accompanying text.

20. The exception for separate accounts was based on a similar exception for "aggregation units" contained in Rule 200(f) of SEC Regulation SHO. Unlike the aggregation unit exception in Regulation SHO, however, which is available only to broker-dealers, the Rule 105 exception may be used by *any entity* that satisfies the exception's requirements.

21. Rule 105(b)(2). The SEC notes in the Rule 105 Release that the term "accounts" for purposes of this exception is used as a general term that may encompass the many types of accounts referenced in the various comment letters received in connection with the original proposal, including "portions of a particular fund," "units," "departments" and "identifiable divisions." *See* Rule 105 Release, n.64. The SEC also includes in the Rule 105 Release a non-exhaustive list of factors that can be used to demonstrate "separateness."

22. *See* Reg M Adopting Release, n.43 and accompanying text.

23. *See* Reg M Adopting Release, n.24 and accompanying text.

24. Note that Regulation M eliminated the additional restriction imposed by predecessor Rule 10b-6 that, in connection with the use of Rule 139 research, earnings estimates cannot be increased and recommendations cannot be upgraded. Note also that Rule 102 does not have a comparable exemption for Rule 138/139 qualifying research for issuers and selling securityholders and their affiliated purchasers.

25. The Staff of the SEC's Division of Trading and Markets has preliminarily informed us that they do not believe Regulation M conflicts with the JOBS Act mandate to eliminate post-IPO effective date research restrictions since Regulation M does not technically restrict research for a "prescribed period of time" following an offering. They are continuing to consider the issue raised with respect to follow-on and secondary offerings of non-actively-traded securities, but believe they may be

limited in their ability to act by the JOBS Act reference in this regard to IPOs.

26. *See also* SLB No. 9. Note that the non-affiliated syndicate members, however, can utilize the actively-traded securities exception.

27. The Reg M Adopting Release notes that this interpretation codifies the approach taken by the SEC staff in the *Letter Regarding VLI Corporation*, No-Action Letter (avail. Oct. 17, 1983). Whether or not affiliated purchasers of underwriters or other distribution participants can purchase in the offering may, however, be constrained by other rules and regulations, including, *e.g.*, those applicable to member firms of FINRA.

28. *See* FINRA Rules 5130 and 5141 for certain restrictions that limit the ability of underwriters and their affiliates to purchase (or retain) securities in certain types of offerings. *See also* SEC Division of Corporation Finance Compliance and Disclosure Interpretations, Securities Act Rules, Rule 144, Question 128.02.

29. Reg M Adopting Release, n.47.

30. Reg M Adopting Release, text following n.48.

31. *See also* SEC Release 34-51500 (Apr. 7, 2005) (Commission Guidance Regarding Prohibited Conduct in Connection with IPO Allocations).

32. Note, however, that Exchange Act Rule 14e-5 will continue to apply and may prohibit purchases of the target company's securities by the acquiror during a tender or exchange offer for the target's securities.

33. *See* FINRA Regulatory Notices 12-19 (Apr. 2012) and 08-74 (Dec. 2008); *see also SEC Regulation M-Related Notice Requirements Under FINRA Rules Frequently Asked Questions* (the FINRA Reg M FAQs), available at *http://www.finra.org/Industry/Regulation/Guidance/P118758*. Similar notification requirements may also apply under the rules of the NYSE, NASDAQ and other national securities exchanges. The FINRA Reg M FAQs remind firms that, even if a later notification to FINRA is warranted under the circumstances, in no event may the notification be filed later than the close of business on the day the distribution terminates. *See* FINRA Reg M FAQS, Response to Q1.34.

34. *See* FINRA Reg M FAQs, Response to Q1.4.

STATE CORNER

Negotiating in Good Faith in Delaware

By Christopher G. Green and Elizabeth D. Johnston

In a decision that gives serious bite to covenants to negotiate in good faith contained in preliminary agreements, the Delaware Supreme Court, in *SIGA Technologies, Inc. v. PharmAthene, Inc.*, *en banc*, established new law holding SIGA Technologies (SIGA) liable for expectancy damages for its breach of a covenant to negotiate in good faith a license agreement with rival biodefense company PharmAthene.[1] Notwithstanding the absence of definitive terms of agreement, the Court found that the parties would have entered into an agreement but for SIGA's bad faith negotiation, and then awarded PharmAthene benefit-of-the-bargain damages.

Background

The suit, brought by PharmAthene, arose out of a failed merger between PharmAthene and SIGA, a New York pharmaceutical company. The case revolves around one term sheet and two agreements. The term sheet—a License Agreement Term Sheet (LAT)—outlined a proposed license agreement that was discussed before the merger talks, but was never finalized. One of the agreements was a Bridge Loan Agreement, which allowed PharmAthene to provide financing to SIGA while merger discussions were ongoing. The other agreement was a Merger Agreement, which contemplated a merger between PharmAthene and SIGA.

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SIGA faced a funding crisis as it struggled to develop a new drug, now known as ST-246, designed to protect against smallpox. SIGA approached PharmAthene for a solution to SIGA's deteriorating financial condition. The two companies had considered a merger in 2003, but discussions had failed. When the two began discussing possible combinations again in 2006, SIGA insisted on agreeing to a license agreement before discussing a merger. The parties agreed to a term sheet (the LATS), but did not finalize an agreement.

The parties then moved to merger discussions. PharmAthene wanted to execute not only a merger agreement but also a license agreement in case the merger did not close. Instead of drafting a formal license agreement, PharmAthene (as instructed by SIGA) simply attached the LATS to the Merger Agreement. This would become important, as the Court concluded that despite the fact that the LATS was non-binding, the parties' attachment of the LATS reflected the parties' intent to negotiate a licensing agreement consistent with the LATS.

Because SIGA needed financing immediately, the parties also agreed to a Bridge Loan, which contemplated that PharmAthene would provide financing to SIGA while merger talks developed. The Bridge Loan Agreement obligated the parties to negotiate in good faith a license agreement "in accordance" with the terms of the LATS if the merger were terminated.

Likewise, the Merger Agreement provided that if the Merger Agreement was terminated, the parties were obligated to negotiate in good faith a definitive license agreement in accordance with the terms of the LATS. Specifically, there was a "best efforts" clause by which each party promised to use its best efforts to take such actions as might be necessary or reasonably requested by the other party to carry out and consummate the transactions contemplated by the Merger Agreement. The Merger Agreement also provided that the "best efforts" provision, among other provisions, would survive the Merger Agreement's termination.

Over the next year as SIGA's financial performance improved, SIGA had second thoughts about a merger. The SIGA board decided to terminate the Merger Agreement in October 2006. Shortly thereafter, SIGA announced it had received a $16.5 million grant from the National Institutes of Health and that the drug provided 100 percent protection against smallpox in a primate trial. After SIGA terminated the Merger Agreement, PharmAthene sent a draft licensing agreement to SIGA. SIGA sent its own proposed agreement, in the form of an LLC—which form and terms were not contemplated by the LATS. The terms were so radically different that negotiations broke down and PharmAthene brought suit for breach of the covenant to negotiate in good faith.

The Chancery Court's Decision

On September 22, 2011, after an 11-day trial, the Chancery Court found that SIGA was liable for breach of its obligation under both the Bridge Loan Agreement and Merger Agreement to negotiate in good faith a definitive license agreement in accordance with the terms of the LATS. The Chancery Court noted that in the appropriate case, expectancy damages might be available, but that in this instance, they would be too speculative. The Court thus awarded PharmAthene an equitable payment stream approximating the terms of the license agreement to which the Court found the parties would have ultimately agreed.

The Delaware Supreme Court's Decision

An Express Contractual Obligation to Negotiate in Good Faith Is Binding

The Delaware Supreme Court first examined whether the language "in accordance with the terms set forth" in the Term Sheet meant that the parties had a duty to negotiate a license agreement with economic terms substantially similar to terms of the LATS or whether the parties intended the LATS merely as a "jumping off" point, as PharmAthene contended. The Supreme Court held the former—that is, that the record supported the Vice Chancellor's factual conclusion that incorporation of the LATS into both the Bridge Loan Agreement and the Merger Agreement reflected an intent on the part of both parties to negotiate a license agreement with economic terms substantially similar to the terms of the LATS if the merger was not consummated.[2]

The Supreme Court examined the meaning of bad faith.[3] It highlighted that under Delaware law, bad faith implies "the conscious doing of a wrong because of dishonest purpose or moral obliquity; … it contemplates a state of mind affirmatively operating with furtive design or ill will."[4] The Supreme Court then affirmed the Vice Chancellor's conclusion that SIGA acted in bad faith when it negotiated the license agreement, and thus was in breach of its contractual obligations under the terms of both the Bridge Loan Agreement and the Merger Agreement.[5] Specifically, the Vice Chancellor found that SIGA acted in bad faith when negotiating with PharmAthene as its draft LLC had financial terms that "differed dramatically" from those contemplated by the LATS.[6] In addition, the Vice Chancellor found (and the Supreme Court agreed) that the noneconomic terms SIGA proposed were revised to favor SIGA heavily and to undermine PharmAthene's control of ST-246. Notable are the Court's multiple references to internal emails within SIGA expressing remorse for entering into an agreement with PharmAthene, saying for example, that it was "a damn shame" SIGA had entered agreements with PharmAthene.

The Supreme Court thus agreed with the trial court's conclusion that SIGA breached its contractual obligation to negotiate in good faith under both the Bridge Loan Agreement and the Merger Agreement. The Court reiterated that an express contractual obligation to negotiate in good faith is binding on the contracting parties, and thus that the parties were bound to attempt in good faith to finalize a licensing agreement with similar terms to those contained in the LATS, notwithstanding the fact that the LATS was not a binding license agreement.

Expectation Damages Are Available

The Supreme Court then turned to damages, which is a particularly challenging and somewhat vexing issue in the context of preliminary agreements. The Supreme Court noted that prior to *SIGA*, it was not clear what the proper remedy for breach of an agreement to negotiate in good faith was where the court found as a matter of fact that had the parties negotiated in good faith, they would have reached an agreement.[7] Even though Delaware law applied, the Court noted that New York law, which distinguishes between so-called "Type I" and "Type II" preliminary agreements, was instructive.[8] A Type I preliminary agreement "is a fully binding preliminary agreement, which is created when the parties agree on all the points that require negotiation (including whether to be bound) but agree to memorialize their agreement in a more formal document. Such an agreement is fully binding."[9] A Type II preliminary agreement, on the other hand, sets out certain major terms, but leaves other terms open for further negotiation.[10] A Type II agreement "does not commit the parties to their ultimate contractual objective but rather to the obligation to negotiate the open issues in good faith in an attempt to reach the alternate objective within the agreed framework."[11]

Breaking new ground in Delaware, the *SIGA* decision clarifies that under a Type II preliminary agreement, a party may collect expectation damages for the other party's failure to negotiate in good faith. Expectancy damages are warranted where the parties would have reached an agreement but for the breaching party's bad faith.

Applying that new law to this case, the Delaware Supreme Court held that damages were warranted. The Supreme Court noted the Vice Chancellor made two key factual findings: (1) the parties memorialized the basic terms of a transaction in the LATS, and expressly agreed in the Bridge Loan Agreement and the Merger Agreement that they would negotiate in good faith a final agreement in accordance with those terms; and (2) but for SIGA's bad faith negotiations, the parties would have consummated a license agreement. After holding that a non-breaching party can recover for a breaching party's failure to negotiate in good faith under Type II preliminary agreements, the Supreme Court reversed the Vice Chancellor's "equitable stream" damages award and remanded the case for reconsideration of the damages award consistent with its opinion. PharmAthene can obtain damages for its losses to the extent it can prove them with reasonable certainty.

Implications

This decision establishes new law in Delaware that will likely impact the terms on which contract negotiations will proceed. First, this decision cannot be written off as being limited to particularly odd facts or a notably bad record of "bad faith." With the finding of bad faith and award of expectancy damages in this case, one might have reasonably speculated that there were particularly damaging internal emails within SIGA evidencing bad faith in the negotiation. But the emails referenced in the Supreme Court's decision are relatively tame, at least as internal emails in the context of a deal negotiation go. To be sure, they reflect some clear regret on SIGA's part for entering into transactions with PharmAthene, but they do not evidence an explicit intent to tank the negotiations of the license agreement. It is notable that the inference of bad faith was based principally on the "radical" differences between the terms of the LATS and SIGA's later-proposed terms. Wide variances between the term sheet and the later proposal alone can constitute "bad faith" in certain contexts.

Second, practitioners and their clients should not take comfort in the fact that they have deferred to another day agreement on definitive terms. As every M&A lawyer knows well, negotiating parties often agree to the framework of a transaction while punting to another day the task of finalizing deal terms. And parties often sound the refrain that the "devil is in the details," acknowledging that there is often meaningful distance between an agreed upon framework and a finalized deal. But this decision gives parties a hammer they did not have before—the ability to get expectancy damages even when they have agreed to "punt" the details.

Parties can, however, take steps to blunt the impact of this decision. First, parties could consider specific provisions limiting the remedies available to the non-breaching party for any breach of a covenant to negotiate in good faith. They could, for example, limit the available remedy to liquidated damages. Second, they can bargain for much stronger disclaimer language than was present in this case, making abundantly clear that the term sheet does not constitute agreed upon terms until there is definitive documentation on all terms. Third, the parties could bargain for a quasi-MAC provision, permitting either party to negotiate for terms materially different from those contained in a preliminary agreement in the event of changed circumstances or a changed financial condition.

Notes

1. No. 314, 2012 (Del. Supr. May 24, 2013), slip op. at 6 (noting the LATS was not signed, and a footer on both pages stated "Non Binding Terms.").

2. *Id*. at 27.

3. *Id*. at 28.

4. *Id*.

5. *Id* at 30.

6. For example, as the Vice Chancellor noted, (1) the upfront payment from PharmAthene to SIGA increased from $6 million to $100 million; (2) the milestone payments to SIGA increased from $10 million to $235 million; (3) the royalty percentages owed to SIGA increased from 8%, 10%, and 12% depending on the amount of sales to 18%, 22%, 25%, and 28%; and (4) SIGA would receive 50% of any remaining profit whereas the LATS provided for profit sharing only from U.S. government sales having a margin of 20% or more. *PharmAthene, Inc. v. SIGA Techs., Inc.*, C.A. No. 2627-VCP, at 25-26 (Del. Ch. Sept. 22, 2011).

7. Slip op. at 31.

8. Slip op. at 34–35. The Court, acknowledging the lack of consensus on the nature and scope of remedies available for a breach of a Type II agreement, analyzed both Delaware and New York precedent (as well as an 8th Circuit decision applying New York law, *Fairbrook Leasing, Inc. v. Mesaba Aviation, Inc*., 519 F.3d 421, 426-27 (8th Cir. 2008), and a 7th Circuit decision applying Illinois law, *Venture Associates Corp. v. Zenith Data Systems Corp*., 96 F.3d 275 (7th Cir. 1996) (applying Illinois law).

9. Slip op. at 33, n.82, quoting *Adjustrite Sys., Inc. v. GAB Bus. Servs., Inc*., 145 F.3d 543, 548 (2d Cir. 1998) (citations omitted).

10. Slip op. at 33, quoting *Adjustrite*, 145 F.3d at 548.

11. Slip op. at 33–34, quoting *Teachers Ins. & Annuity Ass'n of Am. v. Tribune Co.*, 670 F. Supp. 491, 498 (S.D.N.Y. 1987) (citations omitted). A Type II agreement does not guarantee the parties will reach agreement on a final contract because "good faith differences in the negotiation of the open issues" may preclude final agreement. *Id.* A Type II agreement does, however, bar a party from renouncing the deal, abandoning the negotiations, or insisting on conditions that do not conform to the preliminary agreement. *Id.*

CLIENT MEMOS

A summary of recent memoranda that law firms have provided to their clients and other interested persons concerning legal developments. Firms are invited to submit their memoranda to the editor. Persons wishing to obtain copies of the listed memoranda should contact the firms directly.

Bingham McCutchen LLP
Boston, MA (617-951-8000)

Sixth Circuit Court of Appeals Creates Split Among Circuits for Pleading False Statements of Opinion or Belief for Section 11 Claims (June 3, 2013)

A discussion of a U.S. Court of Appeals for the Sixth Circuit decision, *Indiana State Dist. Council of Laborers v. Omnicare, Inc.*, 2013 WL 2248970 (May 23, 2013), creating a split in the circuits over the requisite standard to plead a false statement of opinion or belief under Section 11 of the Securities Act of 1933. Specifically, it declined to follow the Second and Ninth Circuits and held that plaintiffs need not plead subjective falsity in order to state such a claim.

Cahill Gordon & Reindel LLP
New York, NY (212-701-3000)

Retention of Profits May Impact Insurance Coverage for Disgorgement Payments to the SEC (June 13, 2013)

A discussion of a New York State Court of Appeals decision, *J.P. Morgan Securities Inc., et al. v. Vigilant Insurance Company et al.*, No. 113 (NY June 11, 2013), reversing the dismissal of an insured's coverage claim relating to monetary payments made by Bear Stearns to the SEC in connection with the settlement of claimed violations of the federal securities laws.

DLA Piper
Phoenix, AZ (*www.dlapiper.com*)

Second Circuit Reaffirms Standard for Director and Officer Bar (May 28, 2013)

A discussion of a U.S. Curt of Appeals for the Second Circuit decision, *SEC v. Bankosky*, No. 12-2943 (May 14, 2013), reaffirmed the standard for the imposition of a director and officer bar.

Drinker Biddle & Reath LLP
Philadelphia, PA (215-988-2700)

Supreme Court Decides to Hear Applicability of Sarbanes-Oxley's Whistleblower Protections (June 4, 2013)

A discussion of the Supreme Court's grant of certiorari in *Lawson v. FMR LLC* to determine whether the whistleblower protections of the Sarbanes-Oxley Act extend to employees of privately held contractors or subcontractors of a public company.

Haynes and Boone, LLP
Dallas, TX (214-651-5000)

Has Another Wave of "Say-on-Pay" Litigation Come to an End? (June 12, 2013)

A discussion of say-on-pay litigation during the 2012 and 2013 proxy seasons, including differences in the types of cases that have been brought and the lack of injunctive requests during 2013.

Latham & Watkins LLP
Los Angeles, CA (202-637-2200)

Delaware Supreme Court Addresses Master Limited Partnership Issues (May 30, 2013)

A discussion of two Delaware Supreme Court decisions addressing the conclusive presumption of good faith that can arise under a limited partnership agreement, which has been a topic of frequent debate in master limited partnership (MLP) litigation. In *Norton v. K-Sea Transportation Partners, L.P.*, the Court held that the LPA imposed a "good faith" requirement upon the general partner in deciding whether to approve a merger. In *Brinckerhoff v. Enbridge Energy Co., Inc.*, the Court held that the general partner was entitled to the conclusive presumption of good faith because it relied on the opinion of a qualified financial advisor, despite the opinion containing language different from that of a typical fairness opinion.

Mintz, Levin, Cohn, Ferris, Glovsky and Popeo, P.C. Boston, MA (617-542-6000)

Federal Court Rules That Issuers Face Strict Liability for Erroneous Statements About Legal Compliance in Registration Statements, even if They Did Not Know the Statements Were False (June 12, 2013)

A discussion of a U.S. Court of Appeals for the Sixth Circuit decision, *Indiana State District Council of Laborers and od Carriers Pension and Welfare Fund v. Omnicare, Inc.*, 2013 U.S. LEXIS 10385 (6th Cir. May 23, 2013), highlighting the potential dangers of giving broad assurances of legal compliance in registration statements.

Morrison & Foerster LLP New York, NY (212-468-8000)

FINRA Issues Sweep Letter Regarding Use of Social Media (June 19, 2013)

A discussion of a FINRA Targeted Examination Letter—otherwise known as a sweep letter—regarding the use of social media by broker-dealers. This follows on FINRA's enactment of new communication rules that specifically reference electronic communications and provide guidance to the securities industry on the use of social media.

SEC Proposes Floating NAV for Institutional Prime Money Market Funds; "Fees and Gates" for Non-Government Funds (June 5, 2013)

A discussion of the SEC proposal of two alternative requirements for money market funds: (1) require institutional prime money market funds to operate with a floating net asset value; and (2) require non-government money market funds to adopt "fees and gates" to stem redemptions in times of stress. The proposals could be adopted separately or combined into a single set of rules designed to address risk in money market funds.

Pepper Hamilton LLP Philadelphia, PA (215-981-4000)

Access to the U.S. Capital Markets by Foreign Issuers: A Guide to Rule 144A and Regulation S Offerings (June 11, 2013)

A discussion of the use of Rule 144A and Regulation S under the Securities Act of 1933 by public and private entities to access the U.S. capital markets without registering the offering of securities with the SEC.

Pillsbury Winthrop Shaw Pittman LLP New York, NY (212-858-1000)

J.P. Morgan Decision Curtails the Phantom "Restitution Defense" to D&O Coverage (June 20, 2013)

A discussion of a New York court decision in *J.P. Morgan Securities v. Vigilant Insurance*

Company, No. 113 (NY, June 13, 2013), curtailing to some extent insurer's ability to use a phantom exclusion to deny coverage under a director and officer liability insurance policy. Insurers increasingly have argued that their policies do not cover damages than can be characterized as restitutionary in nature even where the policy is silent on the issue.

Porter Wright Morris & Arthur LLP Washington, DC (202-778-3000)

Conflict Minerals: Public and Private Companies Should Examine Their Supply Chain Now (June 2013)

A discussion of the SEC conflict minerals rules and steps that companies should take now to be prepared to comply with the rules.

Shearman & Sterling LLP New York, NY (212- 848-4000)

Private Placement Update: FINRA Proposes Form of Electronic Filing for Private Placements Under Rule 5123 (June 25, 2013)

A discussion of a proposed FINRA rule change concerning the obligations of members under Rule 5123 to provide notice when participating in certain provate placements of securities. The rule change would require members covered by the rule to electronically file the Private Placement Form via FINRA Firm Gateway.

Sullivan & Cromwell LLP New York, NY (212-588-4000)

NYSE Proposes to Streamline Listing Application Materials and Processes (June 3, 2013)

A discussion of proposed changes to the New York Stock Exchange Listed Company Manual and listing application materials that have been published by the SEC. The proposed changes are an effort to streamline the listing application process and remove duplicative and obsolete provisions.

Wachtell, Lipton, Rosen & Katz New York, NY (212-403-1424)

Dealing with Activist Hedge Funds (June 21, 2013)

A discussion of the high and increasing level of activist campaigns experienced during the last 10 years and a checklist of matters to be considered in putting a company in the best possible position to prevent or respond to hedge fund activism.

INSIDE THE SEC

Greater Risk of SEC Enforcement Activity in Going-Private Transactions

By Evelyn Cruz Sroufe and Sean C. Knowles

On June 13, 2013, the Securities and Exchange Commission announced the settlement of administrative proceedings against Revlon, Inc.[1] In the settlement order, the SEC asserted that the company hid information regarding a 2009 "going private transaction" from its independent board members and minority shareholders in violation of Section 13 of the Securities Exchange Act of 1934 and Rule 13e-3 thereunder. The SEC alleged that Revlon actively worked to remain ignorant of a third-party financial adviser's opinion that the transaction did not provide adequate consideration to certain of the company's minority shareholders. The SEC described this tactic as "ring-fencing," designed to circumvent Revlon's public disclosure obligations.[2] Without admitting or denying the SEC's allegations, Revlon agreed to settle the SEC's charges, pay an $850,000 penalty and cease and desist from further violations.[3]

Civil lawsuits challenging going private transactions are common. In many cases, because of the inherent conflicts in such transactions, the decision must meet a stringent "entire fairness" standard in which both the decision process and the offered consideration must be fair to the minority shareholders.[4] However, SEC enforcement actions stemming from going private transactions are rare, with only a handful of enforcement actions filed alleging violations of Rule 13e-3. The Revlon settlement may signal the SEC's increased interest in enforcing the rule.

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The 2009 Exchange Offer

The SEC's allegations were based on Revlon's conduct in connection with a complex 2009 debt restructuring plan. Revlon sought to repay a certain portion of its long-term debt held by its controlling shareholder, MacAndrews & Forbes Holdings Inc. (M&F), by offering to issue new preferred shares to minority shareholders who tendered their common stock in exchange. The exchanged common stock would then be transferred to M&F, thereby reducing Revlon's debt.

Revlon's exchange offer constituted a going private transaction under Section 13 of the Exchange Act and Rule 13e-3, because it had "either a reasonable likelihood or a purpose" of causing a class of equity securities subject to the reporting requirements of the Exchange Act (a) to be deregistered or to otherwise cease to be subject to such reporting, or (b) to be delisted from a national exchange or inter-dealer quotation system.[5]

Revlon Allegedly Builds the "Ring-Fence"

Some of Revlon's minority shareholders were current and former employees who held shares of Revlon common stock in the company's 401(k) plan. The 401(k) plan trustee allegedly informed Revlon that it could only allow 401(k) plan members to participate in the exchange offer if a third-party financial adviser concluded that the offer provided "adequate consideration," a requirement of the Employee Retirement Income

Security Act of 1974. The results of this adequate consideration analysis would wholly determine whether the trustee could allow 401(k) plan members to tender their shares.

Rule 13e-3 was designed to protect minority shareholders from the conflicts of interest inherent in going private transactions.[6] It requires extensive disclosures regarding the transaction, covering in particular the potential conflicts, the approval processes and any material valuation materials that create an information imbalance between the minority shareholders and the company or the controlling shareholder. Accordingly, Schedule 13E-3 and Item 1015 of Regulation M-A, which governed Revlon's exchange offer documents, required Revlon to disclose whether it "received any report, opinion (other than an opinion of counsel) or appraisal from an outside party that is materially related to the … transaction."

According to the SEC's allegations, Revlon did not wish to disclose the existence or conclusions of the adequate consideration opinion to minority shareholders considering the exchange offer. In order to avoid this obligation, Revlon allegedly undertook a series of "ring-fencing" actions to keep the company "out of the flow of information" regarding the adequate consideration opinion and therefore to remain willfully ignorant of its existence or conclusions. In particular, the SEC alleged that Revlon:

- Amended its agreement with the 401(k) plan trustee to make clear that the 401(k) plan trustee had sole authority to determine whether to allow 401(k) plan members to tender their shares;
- Ensured that it was not a party to any engagement letter between the 401(k) plan trustee and the third-party financial adviser concerning the adequate consideration opinion, even though the company reimbursed the 401(k) plan trustee for the entire cost of engaging the third-party financial adviser;
- Directed the 401(k) plan trustee to refrain from mentioning the adequate consideration opinion when it informed Revlon whether it would allow the company's 401(k) plan members to participate in the exchange offer; and
- Removed references to the third-party financial adviser and the adequate consideration opinion from a notice to be sent by the 401(k) plan trustee to the 401(k) plan members concerning the exchange offer (which was also included as an exhibit to the company's exchange offer public filings with the SEC).[7]

Revlon subsequently received notice from the 401(k) plan trustee that it would not allow 401(k) plan members to participate in the exchange offer. Although this result indicated that the plan trustee had received an unfavorable consideration opinion, per Revlon's alleged instructions, the notice did not make reference to such opinion. The SEC alleged that Revlon's independent directors, who were charged with determining the fairness of the exchange offer to the company's minority shareholders, were unaware of the existence of the adequate consideration opinion.

Having received the plan trustee's notice, Revlon moved ahead with the exchange offer, disclosing in the final offer filing that its independent directors had determined the transaction was fair both to shareholders who decided to participate and those who did not participate. The exchange offer closed in early October 2009.[8] Minority shareholders tendered approximately 9.3 million shares of Revlon common stock, or 46 percent of the outstanding minority shares.[9]

The SEC Action

The SEC charged that Revlon's actions to "ring-fence" the adequate consideration opinion and thereby conceal the opinion from its independent directors and its minority shareholders violated Rule 13e-3(b)(1)(iii), which bans engaging in "any act, practice or course of business which operates or would operate as a fraud or deceit upon any person."[10] The SEC asserted that these actions made Revlon's public disclosures regarding the exchange offer—specifically the representation that the board had conducted a "full, fair and complete" evaluation of the exchange offer—materially misleading. The SEC claimed that the board's process was compromised because Revlon concealed from the independent directors that it had engaged in a course of conduct to "ring-fence" the adequate consideration opinion.[11]

In the SEC's release adopting Rule 13e-3, the SEC recognized that going private transactions present significant potential for shareholder harm and overreaching by issuers or their affiliates, and may have coercive effects on minority shareholders.[12] The Revlon settlement indicates that just as a going private transaction is likely to be the subject of civil litigation, the transaction and its related SEC filings may also be subject to increased scrutiny and possible enforcement action by the SEC.

Lessons for Boards and Management

Although SEC rules require disclosure of certain valuation information materially related to a going private transaction that the company "receives," companies that take affirmative steps to remain ignorant of such information expose themselves to potential liability under SEC rules barring fraud or deceitful conduct.

As part of the diligence required for approval of a going private transaction, independent board members must insist that they be presented with all information potentially material to the transaction, then hire their own independent advisers to assess the materiality of the information in order to determine whether it is relevant to their decision.

Materials relating to the adequacy of the consideration offered in a going private transaction will almost always be deemed material by the SEC. These materials should be shared with both the company's independent directors and their advisers in order to be evaluated for possible disclosure in the offering materials.

Notes

1. *In the Matter of Revlon, Inc.*, Exchange Act Release No. 69750, 2013 WL 2641116 (June 13, 2013).
2. *Id.* at 2.
3. *Id.* at 13.
4. *See*, *e.g.*, *Kahn v. Lynch Communications Systems, Inc.*, 638 A.2d 1110 (Del. 1994).
5. Going private transactions by certain issuers or their affiliates.
6. Interpretative Release Relating To Going Private Transactions Under Rule 13e-3, Release No. 34-17719, 22 SEC-DOCKET 783 (Apr. 13, 1981).
7. SEC, SEC Charges Revlon with Misleading Shareholders in Going Private Transaction, (June 13, 2013), *http://www.sec.gov/news/press/2013/2013-110.htm*.
8. *Revlon* at 9.
9. *Id.* at 9.
10. *Id.* at 12.
11. *Id.* at 11.
12. Release No. 34-17719, 22 SEC-DOCKET at 783-02.

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