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A recent dismissal of a case before the Delaware Court of Chancery may result in sellers seeking additional contractual commitments from financial sponsor buyers while also serving as a reminder to financial sponsor representatives to avoid statements that could be characterized as commitments made for the purpose of inducing the target to enter into an acquisition agreement.

Despite one recent troubling Delaware Court of Chancery opinion that is now on expedited appeal, two more recent well-reasoned opinions from other members of that Court should give directors comfort that, in the absence of any subjective bad faith or improper motives, they should not be at risk of losing their exculpation from liability under DGCL 102(b)(7) charter provisions in connection with a sale transaction.

Issuances of new equity to a significant stockholder are often critical to corporate survival. New caselaw instructs boards to pay careful attention to the context to determine the appropriate legal standards and guidelines that govern the negotiation and approval of these issuances.

In *Edwards v. Arthur Andersen LLP*, the California Supreme Court rejected the primary basis under California law for a prior decision that had upheld a claw back provision in a stock option plan and therefore calls into question the enforceability of similar non-compete forfeiture provisions.

Lessons from *Alliance Data v. Blackstone*

BY CHRISTOPHER E. AUSTIN

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On January 15, 2009, Vice Chancellor Strine of the Delaware Chancery Court dismissed in its entirety a complaint filed by Alliance Data Systems ("ADS") against Blackstone Capital Partners seeking to collect a termination fee from Blackstone as a result of the termination of a merger agreement pursuant to which a subsidiary of Blackstone agreed to acquire Alliance.[1] The termination fee (payment of which was guaranteed by Blackstone) would have been payable had the subsidiary breached its obligations in the merger agreement.

The complaint alleged, among other things, that the subsidiary breached the merger agreement by failing to cause Blackstone, which was not itself a party to the agreement, to agree to certain terms required by the Office of the Comptroller of the Currency (the "OCC") as a condition to the OCC approving the merger. The court dismissed the complaint, concluding that (1) the subsidiary's obligation to use reasonable best efforts to complete the transaction did not bind Blackstone, (2) although the subsidiary had agreed to ensure that Blackstone did not take any action to prevent the consummation of the transaction, that covenant did not impose any obligation on the subsidiary to cause Blackstone to take any affirmative action (including agreeing to the OCC's demands), and (3) Alliance's allegations regarding Blackstone's statements during the negotiations of the merger agreement related to the OCC process could not be the basis of a breach of contract claim since Blackstone was not a party to the contract.

Although the Vice Chancellor's decision was relatively straightforward, it does identify a few lessons for planning going forward:

- *Sellers may seek additional contractual commitments from financial sponsor buyers.* The structure used by Blackstone in its proposed acquisition of ADS was typical for financial sponsor acquisitions—the buying entity that was party to the merger agreement was a nominally capitalized subsidiary of the fund; the fund's only obligation was as guarantor of the termination fee. We would not be surprised if, going forward, sellers insisted on contractual commitments directly from the sponsors and/or the relevant fund in transactions where actions of the sponsors or fund could be critical to completion of the transaction (e.g., where divestitures of other portfolio companies may be needed for antitrust clearances or, as in Alliance, in regulated industries where the support of the sponsor or fund may be necessary to obtain regulatory approvals).
- *It remains unclear what actions a court might take to enforce a commitment of a subsidiary "to cause" its parent company to take actions.* Vice Chancellor Strine noted that the Blackstone subsidiary that was a party to the merger agreement had agreed to cause Blackstone to divest assets to obtain antitrust approval and had represented that it had the power to do so. It is clear from the opinion that the Vice Chancellor would have concluded that the subsidiary breached the merger agreement—and ordered payment of the termination fee—had such a divestiture been required as a condition to antitrust approval and Blackstone failed to make the divestiture. We believe it is unclear, however, whether a court would order a non-party parent company (such as Blackstone) to take actions that the party to the merger agreement committed to "cause" the parent to take.
- *Financial sponsors and other controlling persons should be cautious about statements made during merger agreement negotiations.* Vice Chancellor Strine dismissed the complaint notwithstanding allegations that Blackstone representatives had made statements during negotiations of the merger agreement that created an expectation that Blackstone would agree to the OCC's requests. The Vice Chancellor noted, however, that ADS had only brought a breach of contract claim and had not brought a separate fraud claim against Blackstone. This note is an important reminder to financial sponsors (and other control persons) that it would be prudent to avoid statements during negotiations that could be characterized as commitments of the financial sponsor made for the purpose of inducing the target to enter into the merger agreement.

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1 *Alliance Data Systems Corp. v. Blackstone Capital Partners V L.P.*, 2009 WL 117563 (Del. Ch. Jan. 15, 2009).

Director Exculpation from Liability in Sale Process

BY VICTOR I. LEWKOW AND PAUL J. SHIM

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Two recent Delaware Chancery Court decisions should allow directors of Delaware corporations (and their insurers) to rest more easily in that they confirm that claims of negligence (or even gross negligence) in the conduct of sale transactions can be dismissed before trial. These decisions are particularly important in view of a prior decision in which a different member of the Chancery Court declined to grant summary judgment in favor of the director-defendants and permitted a case to proceed to trial, thus requiring the taking of discovery and creating settlement value for the plaintiffs.

Background

After the Delaware Supreme Court's 1985 finding of director liability in *Smith v. Van Gorkom*,[1] some directors and potential directors of Delaware (or other) corporations began expressing reluctance about serving as directors. To help assure the continued availability of qualified directors, the Legislature of Delaware (and, soon thereafter, of other states) adopted §102(b)(7) of the Delaware General Corporation Law, which authorizes Delaware corporations to adopt provisions in their certificates of incorporation exculpating their directors from any potential liability for breaches of the duty of care, but not for "acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law."[2] As a result, in order for plaintiffs to collect damages for breach of the directors' fiduciary duties, they must demonstrate that the directors were not merely grossly negligent (the standard for a duty of care breach[3]), but rather were in bad faith or in knowing violation of law.

The terms "bad faith" and "knowing violation" suggest that the loss of exculpation protection of §102(b)(7) would require affirmative malfeasance on the part of directors. In the context of pretrial motions to dismiss or for summary judgment, it would seem impossible to plead such malfeasance with particularity absent extraordinary facts. Thus, §102(b)(7) has been quite effective in disposing of fiduciary duty-related claims at the pretrial stage.

The stakes for directors are rarely higher than in connection with a sale of the company. In a sale, particularly for cash consideration, the *Revlon* doctrine requires the company's directors to seek the highest price reasonably obtainable in the circumstances.[4] While initially some commentators construed this duty to require boards to conduct active auction processes, the courts soon clarified that such processes are not always necessary and, indeed, could be counterproductive in certain situations.

In 1989, the Delaware Supreme Court held in *Barkan v. Amsted Industries Inc.* that "there is no single blueprint a board must follow to fulfill its [*Revlon*] duties" and that a sale may be permissible in the absence of a proactive sales effort where the board has "a body of reliable evidence with which to evaluate the fairness of the transaction" and the deal protection provisions of the sale, such as "no-shop" agreements, termination fees and "lock-up" options, are reasonable and not preclusive of a third-party bid.[5] Merger lawyers have long relied on *Barkan* in advising boards that they may enter into merger agreements without undertaking proactive solicitation efforts, which could harm the company by distracting management and employees (and possibly causing them to leave), or unnecessarily revealing confidential information to competitors. When combined with §102(b)(7), *Barkan* has served as a formidable cudgel to dispose of *Revlon* claims for damages at the pretrial stage.[6]

Meanwhile, in a series of decisions led by the *Caremark*[7] and *Disney*[8] cases, the Delaware courts introduced a substantial fissure in the protective bulwark of §102(b)(7) by finding that directors who fail to take action in the face of a known duty to do so can be deemed to have engaged in bad faith conduct. The notion that exculpation could be lost with respect to decisions that were made with purity of the heart – even if negligent or grossly negligent – led to concern within corporate boardrooms. While the potential loss of exculpation does not equate to a finding of liability – the plaintiff still needing to demonstrate that the duty of loyalty had, in fact, been breached – the benefits of early disposition of claims are not merely technical. The risk of time-consuming, distracting litigation and the fear of an adverse result can all work together to create substantial settlement value. They can also discourage qualified individuals from serving as corporate directors.

'Lyondell'

It was against this backdrop that director-defendants sought summary judgment from Vice Chancellor John W. Noble in *Ryan v. Lyondell Chemical Company*.[9] The *Lyondell* case arose in connection with the 2007 sale of Lyondell Chemical Co. to Basell AF, another chemicals concern, at a 40 percent premium to the market price of the company's stock. Lyondell did not solicit the transaction, but had substantial advance notice of Basell's interest in such a transaction – Basell had filed a Schedule 13D disclosing its intentions two months prior to the transaction.

The Lyondell board of directors met to discuss Basell's filing, but decided that no response was then necessary and awaited further actions on the part of Basell and, possibly, other parties. Surprisingly, Lyondell's board did not retain financial advisers or otherwise authorize any preparatory action in connection with the Basell filing. Lyondell's chief executive officer did, however, communicate with Basell's chief executive and principal shareholder, apparently without the knowledge of the company's board. In a meeting between Lyondell's chief executive officer and Basell's principal shareholder, Basell proposed an acquisition at a price that, over time through discussions, was increased twice (by a total of 20 percent), but subject to the condition that a definitive merger agreement would be signed within one week. Basell also required that Lyondell agree to a break-up fee of approximately 3 percent of the deal value.

Lyondell's board convened, considered Basell's proposal and retained a financial adviser. It also attempted to negotiate a higher price, a lower break-up fee and a "go-shop" period, but only obtained a minimal reduction in the break-up fee. After receiving advice from its legal and financial advisers (including with respect to the likelihood that any superior proposal would be made), as well as a fairness opinion, Lyondell's board agreed to Basell's terms.

Lyondell shareholders brought suit against the directors, claiming that they breached their *Revlon* duties. The directors sought summary judgment on the basis of §102(b)(7). But Vice Chancellor Noble denied the motion, notwithstanding the lack of any conflict of interest on the part of the Lyondell board with respect to the transaction.

While the court suggested that the "better inference" from the record likely supported the director-defendants,[10] the Vice Chancellor concluded that in the context of a summary judgment motion in which he was required to construe questions of fact favorably to the plaintiffs, such record (which he characterized as "limited" and "sparse") did not, "as a matter of undisputed material fact, demonstrate the Lyondell directors' good faith discharge of their *Revlon* duties – a known set of 'duties' requiring certain conduct or impeccable knowledge of the market in the face of Basell's offer to acquire the company." In particular, he found that the Lyondell directors had not carried the burden of showing that they had acquired sufficient information about the market to rely upon *Barkan* and thereby to justify their failure to take more proactive steps in furtherance of their *Revlon* duties. Thus, the court concluded, the availability of the exculpatory shelter of §102(b)(7) presented a question of fact that could only be resolved at trial.[11]

The defendants argued that the court improperly conflated the issue of "good faith" with the underlying *Revlon* analysis, and that the court did not address the existence of "good faith" and the discharge of the directors' *Revlon* duties independently. But the Vice Chancellor opined that the "good faith" question had been properly analyzed, and reaffirmed his view that the "rudimentary summary judgment record" fairly raised a question of whether "taking no discernible action to prepare for a possible sale of [Lyondell] in light of the 13D filing, and then, later, by doing nothing (or virtually nothing) actively to confirm that Basell's offer really was the 'best' deal reasonably available" could manifest a conscious disregard for the directors' known fiduciary obligations in a sale scenario.[12]

It is unclear, however, why the Vice Chancellor gave short shrift to the defense's argument that the Schedule 13D filing put the company "in play," and that the participation by the Lyondell board in negotiations with Basell (albeit during a short period of time) served to inform the board sufficiently to permit them to adopt a *Barkan* "passive sale" approach.

'McPadden' and 'Lear'

The *Lyondell* decision was met immediately with concern that it weakened substantially the protections of §102(b)(7). But that concern was mitigated by two other Chancery Court cases that soon followed presenting similar facts and issues. *McPadden v. Sidhu*[13] involved the sale by i2 Technologies of a subsidiary to a company headed by an officer of that subsidiary who had run the sale process despite the board's knowledge that he wanted to buy the subsidiary. The directors allegedly engaged in little if any oversight in the process, and stood idly by while the executive did not contact the subsidiary's competitors, including one that had previously offered to acquire the subsidiary at a substantially higher price. This case seemed to present far more egregious potential breaches of fiduciary duty than in *Lyondell*.

The Chancellor described the §102(b)(7) jurisprudence under *Disney* as expressly permitting a board of directors to "act 'badly' without acting in bad faith."[14] Thus, even though the complaint alleged with particularity that the board's actions constituted gross negligence in violation of the duty of care, it did not allege facts supporting a claim that the directors had acted in bad faith through a conscious disregard for their duties. Accordingly, the Chancellor dismissed the claims against the i2 directors.[15]

The next week, Vice Chancellor Leo E. Strine Jr. decided *In re Lear Corporation Shareholder Litigation*.[16] Lear involved a proposed sale of Lear Corporation (a large supplier to U.S. auto makers) to an entity controlled by Carl Icahn (who owned a significant block of stock, but had no board representation). Although Lear had not been shopped, the acquisition agreement provided for a 45-day "go-shop" period that had been fully utilized. No other bidders surfaced during or after the go-shop period, despite the fact that Lear's large size and Mr. Icahn's commitment to vote in favor of a higher bid approved by Lear's board suggested that any other potential bidder would have been motivated to study the situation quickly.[17]

But Institutional Shareholder Services, the influential proxy advisory firm (ISS), and two other proxy advisers recommended against shareholder approval, and as the shareholder meeting approached it became clear that the vote was not likely to be successful at the agreed $36 per share price. Lear's financial advisers advised that a price increase of at least $1 would be required to obtain shareholder approval, while its proxy solicitor suggested that an increase of $1.50 to $2 per share could be needed in order to procure the desired recommendation from ISS. Based on this advice, a special committee of Lear's board negotiated with Mr. Icahn a price increase of $1.25 per share. As a condition, Mr. Icahn required a new termination fee of $25 million (approximately 0.9 percent of the deal value) that would be payable if Lear shareholders rejected the deal, regardless of whether an alternative bid was made. Such "naked" no vote breakup fees are unusual, although not unheard of.[18]

The price increase did not have its desired effect. ISS reiterated its negative recommendation of the deal, and Lear's shareholders voted it down. Notwithstanding that the fee clearly did not cause shareholders to vote in favor of the deal, Lear shareholders sued, claiming that the board acted in bad faith. The plaintiffs argued that since there was no realistic chance that shareholder approval of the transaction would be obtained, the grant of the $25 million fee was so devoid of care as to be disloyal.

Vice Chancellor Strine categorically rejected the plaintiffs' claim. Citing *Stone v. Ritter*[19] and *Disney*, the court held that the plaintiffs would need to "plead facts suggesting a fair inference that the directors breached their duty of loyalty by making a bad faith decision to approve the merger for reasons inimical to the interests of the corporation and its stockholders."[20]

In the court's opinion, actions viewed subjectively by the board to be in the best interests of the corporation and its shareholders cannot be characterized as disloyal simply because they entail a low probability of ultimate success. The Vice Chancellor commented further that courts should "be extremely chary about labeling what they perceive as deficiencies in the deliberations of an independent board majority over a discrete transaction as not merely negligence or even gross negligence, but as involving bad faith. In the transactional context, a very extreme set of facts would seem to be required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties."[21]

Conclusion

It is difficult to reconcile the opinions in *Lear* and *McPadden* with the court's decision in *Lyondell*. On the one hand, a technical interweaving of *Caremark* and *Disney* with *Barkan* and their collective application to the *Lyondell* facts as viewed by Vice Chancellor Noble, taken together with the rules of presumption applicable to motions to dismiss and for summary judgment, could arguably support the court's conclusion in that case. But by not requiring plaintiffs to show actual, subjective bad faith on the part of directors, the analysis essentially brings an alleged (but unproven) good faith failure to satisfy the requirements of *Barkan* into congruence with a bad faith breach of *Revlon*. And by doing so, it would appear to have the bizarre effect of giving plaintiffs in such cases a better hand against the directors where the record of their actions remains unclear than in cases where it is clear that the directors did things badly.

Directors can take comfort in that *McPadden* and *Lear* reaffirmed the requirement that plaintiffs demonstrate that there exists some evidence of subjective bad faith, or a suggestion of improper motive, in order to overcome a §102(b)(7) defense at the pretrial stage. In a footnote to the *Lear* opinion seemingly aimed directly at this issue, Vice Chancellor Strine reminds us that the *Revlon* case itself involved a "strong sniff of disloyalty" in that the board favored one bidder over another, and that its principles must be considered in that context.[22] Accordingly, in his view, when a §102(b)(7) provision is applied together with a strong rationale for the decision taken (such as to secure a premium for stockholders), and in the absence of any alleged self-interested director bias or "illicit directorial motive," it is difficult for a plaintiff to pursue a breach of loyalty claim.[23]

Notwithstanding *McPadden* and *Lear*, boards are always well advised to establish the best structural and factual record possible before entering into a sale transaction. This includes retaining financial and legal advisers early in the process and holding frequent meetings of fully informed and actively participating directors.

On January 14, 2009, the Delaware Supreme Court heard oral arguments on an interlocutory appeal of the Lyondell decision. The Court's ruling on the appeal is pending.

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1 488 A.2d 858 (Del. 1985).

2 Delaware General Corporation Law (DGCL) §102(b)(7).

3 *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).

4 *Revlon Inc. v. MacAndrews & Forbes Holdings Inc.*, 506 A.2d 173 (Del. 1986).

5 *Barkan v. Amsted Indus. Inc.*, 567 A.2d 1279, 1286 (Del. 1989).

6 As a practical matter, §102(b)(7) has no impact on motions for injunctive relief.

7 *In re Caremark Int'l Inc. Deriv. Litig.*, 698 A.2d 959, 967 (Del. Ch. 1996), holding that sustained or systematic failure of the board to exercise oversight constitutes a breach of the duty of loyalty and thus a failure to act in good faith.

8 *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006), holding that an intentional failure by directors to act in the face of a known duty to act, demonstrating a conscious disregard for their duties, constitutes bad faith conduct.

9 C.A. No. 3175-VCN (Del. Ch. July 29, 2008).

10 *Lyondell*, slip op. at 39, 42 and 46.

11 *Lyondell*, slip op. at 56.

12 Letter, dated Aug. 29, 2008, from Vice Chancellor Noble to counsel, at p. 6.

13 C.A. No. 3310-CC (Del. Ch. Aug. 29, 2008).

14 *McPadden*, slip op. at 1.

15 *McPadden*, slip op. at 26. However, Chancellor William B. Chandler III allowed the case to continue against the subsidiary officer who ran the auction and bought the subsidiary (and sold it two years later for over eight times the purchase price).

16 Cons. C.A. No. 2728-VCS (Del. Ch. Sept. 2, 2008).

17 Thus, 45 days, though a tight time frame, would likely have been sufficient to elicit any alternative proposals that were forthcoming (as compared with the facts of Vice Chancellor Strine's *NetSmart* opinion). See *In re NetSmart Techs. Inc. Shareholders Litigation*, 924 A.2d 171, 195 (De. Ch. 2007).

18 *Williams v. Geier*, 671 A.2d 1368 (Del. 1996); *H.F. Ahmanson & Co. v. Great Western Financial Corp.*, C.A. Nos. 15650, 15549, 15555-15557 (Del. Ch. June 3, 1997).

19 911 A.2d 362 (Del. 2006).

20 *Lear*, slip op. at 2.

21 *Lear*, slip op. at 26.

22 The Vice Chancellor also noted that *Caremark* and *Disney* arose in connection with claims that the board had abrogated its duty to monitor the conduct of the company's management, and suggested that their direct application to sale transactions – which often do not involve the luxury of long deliberation – may be inapposite. *Lear*, slip op. at 25.

23 *Lear*, slip op. at 26, fn 62.

New Investments by a Significant Stockholder – Guidelines for Boards

BY ETHAN A. KLINGSBERG

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Equity infusions from a company's existing significant stockholders represent an important potential source of capital and liquidity for a company facing risks of defaults and other financial constraints on its ability to execute its business plan. What guidelines should a board follow when evaluating a potential investment by a large stockholder?

The most prominent recent opinion analyzing an equity infusion by a significant stockholder concluded that the board of Loral Space and Communications violated its fiduciary duties when agreeing to issue new equity to its 36% stockholder.[1] The court chastised the board for failing to negotiate a "fair outcome equivalent to a market-tested deal."

The *Loral* case involved a confluence of circumstances that led Vice Chancellor Leo E. Strine, Jr. to apply an unusually rigorous set of standards to the directors' action. Not only was the 36% stockholder affiliated with a majority of the board and in possession of "the practical ability" to play a dominant role in much of Loral's strategic decision-making, but the new investment took the stockholder from its pre-transaction position as "a large blockholder who could *not* unilaterally prevent a control transaction *to* a preferred stockholder whose class voting rights gave it negative control over almost any major transaction," including any future sale of Loral or control of Loral. Consequently, the transaction was subject to both:

- the "entire fairness" standard applicable to transactions between the corporation and its control persons, which requires both a "fair process" and a "fair price" (due to the extent of the 36% stockholder's *pre*-transaction influence); and
- the *Revlon* standard applicable to sales of corporate control, which imposes a duty on the board to obtain the best value reasonably available for the stockholders generally (in view of the new investment's conferring on the 36% stockholder additional voting and governance powers that included sufficient veto and other rights to block unilaterally any *future* sale of control of the company).

In past appraisal rights decisions, which require a judicial determination of the "fair value" of shares following a merger, Vice Chancellor Strine has articulated the principle that a reliable indicator of "fair value" is the result of a market check.[2] In *Loral*, he drew upon this principle to hold that both the "entire fairness" standard and the *Revlon* mandate could be satisfied by undertaking an independent, pre-signing market check to support the directors' decision to approve the transaction. This market check, supervised by independent directors, would constitute a fair process and assure a fair price (to satisfy entire fairness), while also assuring satisfaction of the *Revlon* requirement to obtain the best deal reasonably available.

Before deciding that the process prescribed in *Loral* should be followed, boards and their advisors should take into account the following considerations:

- **How much control does the significant stockholder have before the new investment and how will that position change as a result of the new investment?**
  - *Significant, but not "controlling" – pre-transaction.*
    - If, before the investment, the significant stockholder is not a "controlling" shareholder, then the entire fairness standard should not apply. Reaching this conclusion would obviate the need for a special committee of independent directors and, rather than having to satisfy the heightened criteria of "fair process" and "fair price", the board's actions should generally be subject to the deferential business judgment rule. As the *Loral* decision indicates, "control" can exist where stockholdings are less than 50% and the indicia of control will be context specific. Relevant questions to ask: Is the large shareholder "affiliated" with a majority of the directors? Are its shareholdings, though less than 50%, of a magnitude and nature that would give it the practical ability to play a dominant role in the board's strategic decision-making process?

- If, however, the transaction will confer on a non-controlling stockholder the power (whether by way of increased shareholdings and voting power or by contract) to block a future sale of the company, then the *Revlon* test will likely apply to an evaluation of the board's decision. The board will want to be comfortable that the pre-signing and/or post-signing/pre-closing processes and deal terms, taken together with other relevant facts and circumstances, provide reasonable assurance that the best value for stockholders is being obtained.

- *Ability to block a sale of the company – pre-transaction.*
  - On the other end of the spectrum, if the significant stockholder *already* has a degree of control that permits it to block any sale of the company (*e.g.*, certainly where the stockholder holds at least a majority of the voting power before the new investment and probably at some lower levels of voting power depending on the specific context), then the *Revlon* standard should be inapplicable since any new obstacle that the transaction imposes in the path of the ability of the public shareholders (*i.e.*, the "minority") to reap a control premium in a future sale would be redundant with the obstacle that already exists as a result of the large stockholder's blocking right. Nevertheless, entire fairness will almost certainly apply in this scenario, since pre-transaction you will have a true "controlling" stockholder. However, with this control person in the picture, the "market-tested deal" ceases to be a meaningful approach to satisfying entire fairness review and boards will need to rely on the solution of having a well-advised committee of disinterested directors conduct itself with an independent mindset, negotiate aggressively with the controlling stockholder and rely in good faith upon a financial advisor's analyses of the fairness of the transaction to the company. Once the magnitude of the pre-transaction control possessed by the stockholder reaches the threshold of being able to block "sale of control" transactions, the focus of the entire fairness review should shift from indicia of whether the transaction is or will be "market-tested" to indicia of whether the transaction is negotiated on an "arm's length" basis.

- **How urgently is the new investment needed?**
  - *Emergency or Boom-time?* Vice Chancellor Strine emphasizes that the *Loral* case "was not a situation where Loral needed the financing to escape impending bankruptcy or some other emergency that might justify paying a 'high price' and not fully exploring all of the available options." When there is an urgent need for the equity infusion, what constitutes a "fair process" and a "fair price" for purposes of the entire fairness doctrine will not necessarily be a market-tested deal. In a distress situation, the conduct of a market check may impede the ability to obtain the best deal for stockholders (because checking the market would contribute to a "fire sale" atmosphere) or be redundant (because public signs of distress, such as a ratings downgrade, may constitute a "for sale" sign). Indeed, the Court of Chancery has recognized both these factors when upholding a "single-bidder process" as consistent with *Revlon* in a 2004 decision that may well be a better guide for complying with *Revlon* duties in a distress environment than more recent cases, such as *Loral*, set in the boom-era and predicated on a marketplace conducive to meaningful and constructive market checks.[3] Boards in distress situations should be circumspect before following guidelines prescribed in opinions discussing conduct from boom-times and in the absence of exigencies.

Issuances of new equity to a significant stockholder are often critical to corporate survival. In contrast to a process involving market checks, these transactions may often be executed quickly because the significant stockholder is already familiar with the company and has interests aligned with the company. Boards need to pay careful attention to the context to determine the appropriate legal standards and guidance that govern the negotiation and approval of these issuances.

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1 *In re Loral Space and Communications Inc. Consolidated Litigation*, 2008 WL 4293781 (Del. Ch. Sept. 19, 2008).

2 E. Klingsberg and Y. Efremov, "Delaware's M&A Wildcard – Appraisal Rights," *The M&A Lawyer*, 9:2 (June 2005).

3 Compare the court's upholding of a "single bidder sale process" as consistent with *Revlon* in *In re The MONY Group Inc. Shareholder Litigation*, 853 A.2d 661 (Del. Ch. Feb. 17, 2004), with the pro-market check sentiments in cases set, like *Loral*, in the boom-era, such as *Ryan v. Lyondell Chemical Co.*, 2008 WL 4293781 (Del. Ch. July 29, 2008) and *In re Netsmart Technologies Inc. Shareholders Litigation*, 924 A.2d 171 (Del. Ch. Mar. 14, 2007).

California Supreme Court Calls into Question the Enforceability of Non-Compete Forfeiture Provisions

BY A. RICHARD SUSKO AND MICHAEL ALBANO

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Almost a decade ago, employers breathed a sigh of relief when the Ninth Circuit, in *IBM v. Bajorek*,[1] interpreted California law and upheld a claw back provision in an IBM stock option plan, which required an employee to return to IBM any profits from the exercise of stock options if he worked for a competitor within six months of the exercise. It's now time for employers to inhale! In August, in *Edwards v. Arthur Andersen LLP*,[2] the California Supreme Court, again interpreting California law, specifically rejected the primary basis on which the Ninth Circuit upheld the IBM non-compete claw back provision.

Section 16600 of the California Business and Professions Code states: "Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." California state courts have stated that this prohibition represents the strong public policy of California to protect "the important legal right of persons to engage in businesses and occupations of their choosing."[3]

In the *IBM* case, the Ninth Circuit had concluded that a narrowly drafted non-competition forfeiture condition to an equity award did not prevent an employee from engaging in a lawful profession. The court reasoned that the employee either could have worked for a competitor if he returned the profits from the option exercises or could have exercised his option six months prior to working for a competitor. In either case, he was free to work for a competitor and thus the scope of the non-compete clause was sufficiently narrow. The Ninth Circuit's holding followed a narrowly based restraint exception to Section 16600 first articulated by the Ninth Circuit in *Campbell v. Trustees of Leland Stanford Jr. Univ.*[4]

At issue in *Andersen* was the validity, under California law, of a narrowly tailored non-competition agreement that was a required condition of employment. In invalidating the non-competition agreement, the California Supreme Court stated that no reported California state court decision had endorsed the Ninth Circuit's narrow restraint exception to Section 16600. The court reiterated that California courts "have been clear in their expression that Section 16600 represents a strong public policy of the state which should not be diluted by judicial fiat," that Section 16600 is an unambiguous codification of the legislature's intent and that if the legislature had intended to prohibit only those restraints that were unreasonable or overbroad, it would have included statutory language to that effect.[5] The court went on to reject the adoption of a narrow-restraint exception and to hold that under the plain meaning of Section 16600 an employer cannot contractually restrain an employee from engaging in his or her profession unless the agreement falls within one of the specific statutory exceptions relating to the sale of a business.[6] In so holding, the court relied heavily on a state court decision that held non-compete agreements in employment contracts and retirement pension plans, even if narrowly tailored, are invalid if they prohibit "an employee from working for a competitor after completion of his employment or impos[e] a penalty if he does so…unless they are necessary to protect the employer's trade secrets."[7] As a result of the *Andersen* decision, employers will find it increasingly difficult to enforce non-compete forfeiture conditions under California law.

Notwithstanding the *Andersen* decision, an employer may still be able to enforce a non-compete or similar forfeiture provision, including a non-solicitation of customers agreement, on the limited basis that it is necessary to protect an employer's trade secrets.[8] However, it is important to note that contractually defining particular information as a trade secret is not decisive in determining whether the court will regard it as such.[9] As a result, without the comfort of a judicially created reasonableness exception to Section 16600, employers may wish to consider whether the grant of equity awards to employees may be made contingent upon the employee's agreement to be subject to non-competition, non-solicitation or non-disclosure forfeiture provisions that are sufficiently tailored to protect legitimate trade secrets of the employer.

It is also important to note that although *Andersen* addressed the application of Section 16600 to a non-compete agreement entered into with a California resident working within the state, many California state courts have ruled that California law may be applied to determine the enforceability of a non-compete agreement between an employee who is not a resident of California and an employer whose business is based outside of California, when a California-based employer seeks to recruit or hire such employee.[10] To help mitigate the potential application of California law to a non-competition agreement entered into between two non-California parties, employers should consider including a choice of forum clause that assigns exclusive jurisdiction to the courts of a state that uphold non-compete agreements, though such a practice is not failsafe.[11]

The California Supreme Court's ruling in *Andersen* calls into serious question the enforceability, under California law, of non-compete forfeiture provisions similar to those previously upheld in *IBM*. Accordingly, employers with similar non-compete claw backs should carefully evaluate these provisions in light of this decision with a view to conditioning forfeitures on breaches of confidentiality or narrowly based non-solicitation agreements. Employers should also consider choice of forum and choice of law clauses that maximize the likelihood of the forfeiture provision being upheld.

* * *

1 191 F.3d 1033 (9th Cir. 1999).

2 44 Cal.4th 937 (Cal. 2008).

3 *See e.g., Morlife, Inc. v. Perry*, 56 Cal.App.4th 1514, 1520 (1997).

4 817 F.2d 499 (9th Cir. 1987).

5 *Edwards* at 949-950.

6 *Id*.

7 *Muggill v. Reuben H. Donnelley Corp.*, 62 Cal.2d 239 (1965).

8 *See Readylink Healthcare v. Cotton*, 126 Cal.App.4th 1006 (2005) (stating "we note that 'if a former employee uses a former employer's trade secrets or otherwise commits unfair competition, California courts recognize a judicially created exception to Section 16600 and will enforce a restrictive covenant in such case."); *John F. Matull & Associates, Inc. v. Cloutier*, 194 Cal.App.3d 1049 (1987).

9 *See Thompson v. Impaxx, Inc.*, 113 Cal.App.4th 1425 (2d Dist. 2003).

10 *See e.g., Application Group, Inc. v. Hunter Group, Inc.*, 61 Cal.App.4th 881 (1998) (applying California law to invalidate a non-compete agreement entered into between a Maryland employer and Maryland employee who sought subsequent employment in California).

11 *See e.g., Google, Inc. v. Microsoft Corp.*, 415 F.Supp.2d 1018 (N.D. Cal. 2005) (finding that pursuant to choice of law principles, Washington court should apply California law in reviewing the enforceability of a non-compete agreement despite validity of Washington forum selection clause, if the former officer successfully demonstrated that California's interest in invalidating the non-compete agreement was sufficiently compelling).

CG is representing thinkorswim Group in its cash and stock merger with TD Ameritrade.

Cleary Gottlieb is representing thinkorswim Group, Inc. in its cash and stock merger with TD Ameritrade. The consideration, representing a 54% premium for thinkorswim stockholders, consists of a combination of $3.34 in cash and 0.3980 of an Ameritrade share.

CG represented Bank of America in its sale of H shares with a market value of approximately $2.8 billion in China Construction Bank.

Cleary Gottlieb represented Bank of America in its sale of 5.6 billion H shares with a market value of approximately $2.8 billion in China Construction Bank Corporation. The sale, which constituted the largest block trade ever in Hong Kong, was launched and completed through an accelerated bookbuilding process before the start of trading in Hong Kong. Cleary Gottlieb previously represented Bank of America in its 2005 acquisition of an approximately 9.5% interest in China Construction Bank, which was the single largest foreign investment ever in a Chinese company.

CG represented TPG Capital and GS Capital Partners in the sale of Alltel to Verizon Wireless.

Cleary Gottlieb represented TPG Capital and GS Capital Partners in connection with the sale of Alltel Corporation to Verizon Wireless, the joint venture of Verizon Communications and Vodafone. Verizon Wireless paid approximately $5.9 billion for the equity of Alltel and assumed approximately $22.2 billion of Alltel’s debt, net of cash.

CG represented Grupo Bimbo in its acquisition of Weston Foods, the U.S. bakery division of George Weston Limited, for $2.38 billion.

Cleary Gottlieb represented Grupo Bimbo, S.A.B. de C.V. in its acquisition of Weston Foods, Inc., the U.S. bakery division of George Weston Limited, for $2.38 billion and its acquisition of related financial assets for $125 million. This is the largest cross-border acquisition financing in recent months in Latin America. As a result of this transaction Bimbo Bakeries USA became one of the largest baked-goods companies in the United States.

CG represented GlaxoSmithKline in connection with its two-step cash acquisition of Genelabs Technologies.

Cleary Gottlieb represented GlaxoSmithKline in connection with its two-step cash acquisition of Genelabs Technologies, Inc.

CG represented Henkel in the sale of Ecolab.

Cleary Gottlieb represented German corporation Henkel AG & Co. KGaA and its U.S. subsidiary, Henkel Corporation, in Henkel’s divestiture of its stake in Ecolab Inc. The divestiture consisted of two transactions: a $1.87 billion underwritten public secondary offering of shares of Ecolab common stock and a $300 million share repurchase by Ecolab of its common stock from Henkel.

CG represented Barclays Capital in its acquisition of Lehman Brothers’ North American investment banking and capital markets businesses.

Cleary Gottlieb represented Barclays Capital Inc., a subsidiary of Barclays PLC, in the purchase of the U.S. and Canadian investment banking and capital markets businesses of Lehman Brothers Inc. (LBI) and LBI's Manhattan headquarters and certain other real estate for an aggregate purchase price of approximately $1.54 billion.

CG counsel in going-private transaction by News Corporation and Permira for NDS Group.

Cleary Gottlieb represented Citigroup Global Markets Limited as financial advisor to the Independent Committee of the Board of Directors of NDS Group plc. NDS will be owned 49% by News Corporation, NDS’s current principal shareholder, and 51% by two newly-incorporated companies formed by funds advised by Permira Advisers LLP.

CG counsel in Bookham and Avanex Corporation stock for stock merger.

Cleary Gottlieb is representing Citigroup Global Markets Inc. as financial advisor to Bookham, Inc. in the proposed merger of Bookham and Avanex Corporation. The merger was structured as a stock-for-stock merger. Under terms of the agreement, Avanex’s shareholders would receive 5.426 shares of Bookham common stock in exchange for each share of Avanex common stock.

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