Insights:
The Delaware Edition

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05 / 24 / 22

Contents

1 / Gad-*Zoox*: Stockholders Obtain Books and Records Through Statutory Appraisal Proceeding, and Other Section 220 Developments

5 / Delaware Courts Continue To Enforce Unambiguous Advance Notice Bylaws, But Incumbent Director Conduct Remains Subject to Equitable Review

9 / In Appraisal Cases, Court of Chancery Increases Deal Price-based Valuation if Evidence Shows Pre-Closing Change

12 / Court of Chancery Continues to Reject Demand Futility Claims Post-*Zuckerberg*

16 / Seventh and Ninth Circuits Split Over the Scope of Exclusive Forum Provisions

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

In this issue we discuss how plaintiffs are finding creative ways to obtain books and records, and appraisal cases where Delaware courts held that fair value rose between signing and closing. Other articles describe how the state's courts continue to reject many demand futility claims and enforce unambiguous bylaws requiring advance notice of board nominations. Finally, we analyze conflicting federal circuit court decisions involving exclusive forum bylaws that required derivative actions to be filed in Delaware courts — a split that leaves the enforceability of such bylaws in question where they involve Securities Exchange Act claims.

Gad-*Zoox*: Stockholders Obtain Books and Records Through Statutory Appraisal Proceeding, and Other Section 220 Developments

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> See page 4 for key takeaways

As discussed in prior issues, Delaware courts have recently refined and limited defenses to Section 220 books and records actions. No longer does a stockholder need to specify the ends to which it might use the books and records or demonstrate that the alleged wrongdoing or mismanagement it seeks to investigate is actionable.

At the same time, the Delaware courts confirmed as "well-settled" law that a stockholder must "strictly adhere" to the statutory requirements under Section 220, including by having proper standing to make a demand: A stockholder must be a stockholder at the time of seeking books and records and have a proper purpose. See 8 Del. C. § 220(c)(1), (3). Despite this, three recent decisions allowed stockholders access to company books and records through unconventional means where those stockholders would not have been able to obtain them in a direct 220 action. Those cases are discussed below.

Books and Records Obtained in Appraisal Action After 220 Rights Were Extinguished by Merger

Delaware courts have held that loss of standing through a merger either prevents a stockholder's access to books and records entirely or may limit a stockholder's proper purposes.[1] This standing rule has been applied strictly, even where a stockholder loses standing through no fault of its own. However, in *Wei v. Zoox, Inc.*,[2] the Delaware Court of Chancery allowed stockholders access to books and records through an appraisal action, even though they lacked standing to pursue a 220 action.

[1] See *Weingarten v. Monster Worldwide, Inc.*, 2017 WL 752179, at *5 (Del. Ch. Feb. 27, 2017); *Cutlip v. CBA Int'l, Inc.*, No. 14168 NC, 1995 WL 694422, at * (Del. Ch. Oct. 27, 1995).

[2] *Wei v. Zoox, Inc.*, 268 A.3d 1207 (Del. Ch. 2022).

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In *Zoox*, two stockholders served a Section 220 demand to inspect books and records in order to investigate possible wrongdoing in connection with a merger. But the merger closed before the five-day deadline under the statute for the company to respond to the demand, cutting off the stockholders' 220 rights.[3] The stockholders, concerned that they had lost standing under Section 220, filed an appraisal action and served discovery requests to obtain the same documents they sought originally through their 220 demand. The stockholders even admitted that one of their aims with document discovery in the appraisal action was to investigate potential fiduciary duty claims.

Although the court expressed some reservations, and acknowledged that the stockholders lost standing under Section 220, it permitted the stockholders access to documents they had sought in their books and records demand.[4] In doing so, the court acknowledged competing policy issues — ordinarily, stockholders who are cashed out in a merger lose standing to obtain books and records.[5] In addition, plaintiffs generally are not permitted to file litigation solely for the purpose of developing new causes of action.[6] But the court noted a third policy consideration — that fiduciary duty breaches may go unremedied if stockholders seeking appraisal cannot file claims based on documents they obtain in discovery.[7]

The court recognized that the stockholders in *Zoox* were unique, as they had obviously filed the appraisal action to (by analogy to Section 220) investigate suspected fiduciary breaches and had no real interest in appraising their shares.[8] Yet the court granted discovery because of the disadvantages faced by stockholders of private companies where mergers may close in a very short time frame, cutting off standing to pursue 220 actions.[9]

[3] *Id.* at 1210-11.

[4] *Id.* at 1222.

[5] *Id.* at 1218.

[6] *Id.* at 1216.

[7] *Id.* at 1220.

[8] *Id.* at 1222, 1223.

[9] *Id.* at 1222.

Recognizing that its holding could encourage stockholders to prefer appraisal over Section 220 as a means of pre-suit investigation (because broader discovery is available in appraisal), the court limited the stockholders to documents they could have received in a 220 action.[10]

On the other hand, the court also expressed concern that defense attorneys would use the ruling to their advantage and "engage in wasteful discovery and motion practice" in the hope of limiting discovery in appraisal actions. The court emphasized that the facts of *Zoox* were "unusual" and warned that "[i]t would be a mistake to conclude from this decision that it is open season on an appraisal petitioner's purposes."[11]

Federal Securities Plaintiff Subject to PSLRA Automatic Stay Successfully Challenged Confidential Treatment of Information Obtained From Books and Records

Another long-standing rule in Delaware is that a federal securities plaintiff subject to the Private Securities Litigation Reform Act (PSLRA) cannot use Section 220 to circumvent the federal law's automatic stay on discovery.[12] Yet, in two recent cases, the Court of Chancery allowed federal securities plaintiffs access to books and records information where they challenged the confidentiality of court filings that made use of documents other stockholders had obtained through Section 220.[13]

In connection with the merger of a special purpose acquisition company (SPAC) with Lordstown Motors Corp., a company developing an electric pickup truck, stockholders of the SPAC filed a class action in the Court of Chancery. Stockholders of the combined entity filed a separate derivative complaint.

[10] *Id.* at 1223.

[11] *Id.* at 1223, n.83.

[12] *See Beiser v. PMC-Sierra, Inc.*, No. 3893-VCL, 2009 WL 483321, at *1 (Del. Ch. Feb. 26, 2009).

[13] *Cormier v. Burns*, No. 2021-1049-MTZ (Del. Ch. Jan. 24, 2022); *In re Lordstown Motors Corp. Stockholders Litigation*, No. 2021-1066-LWW (Del. Ch. Feb. 28, 2022).

Both complaints cited information from documents that Lordstown had produced in response to 220 demands. Because those documents were protected by confidentiality agreements, the stockholders filed their complaints under seal pursuant to Rule 5.1.

A week after the Court of Chancery actions were filed, a non-party who was a plaintiff in a related consolidated federal securities class action against Lordstown filed a challenge to the confidential treatment of the complaints, seeking to access information from the 220 productions that had been redacted from the Delaware case filings.

Because the securities plaintiff was subject to the PSLRA automatic stay (it had lost a motion in federal court to lift that), it would have been barred from using Section 220 itself to obtain the documents. Yet the securities plaintiffs prevailed in their challenges under Chancery Court Rule 5.1, which provides for public access to court records, and the confidentiality restrictions were lifted for parts of both state court complaints.

In the derivative case, Vice Chancellor Zurn ruled in a summary order that the information the securities plaintiff sought was "not tantamount to discovery," so the policies supporting the PSLRA stay would not be undermined by granting the motion. The court also ruled that the confidentiality agreement the parties had entered had to yield to Rule 5.1 when 220 materials are used in a stockholder action.[14]

In the class action, Vice Chancellor Will sustained the confidentiality challenge in part because Rule 5.1 permits anyone to bring a challenge.[15] Although the court explained that the challenger's motives should be a factor to consider in balancing the public's interests with the corporation's,[16] it still required the corporation to meet the good cause standard to maintain confidentiality and ordered most of the complaint to be unredacted because the information related to core issues in the litigation.[17] However, the court noted that the securities plaintiff's "unique goals [we]re not indicative of a broader public interest, and left protections in place for some information because it might prejudice Lordstown, which operates in a hyper-competitive market.[18]

[14] *Cormier*, No. 2021-1049-MTZ.

[15] *Lordstown*, No. 2021-1066-LWW, at 2-3, 17.

[16] *Id.* at 18.

[17] *Id.* at 11-14.

[18] *Id.* at 14-16, 19.

Takeaways

- In addition to limiting merits-based defenses to Section 220 demands, Delaware courts have made it even easier for stockholders to access books and records by allowing other policy considerations to override the usual standing requirements under Section 220. Given the trend toward greater access, stockholders may seek even more creative ways to obtain books and records.
- Although an appraisal petitioner's motives in seeking discovery may be relevant, the Chancery Court still expects companies to be judicious and mindful about probing their purposes, and to avoid "wasteful" motion practice and discovery in an effort to limit or avoid production of company books and records.
- Protections may be available for particularly sensitive company information contained in public filings. But corporations should take care to limit what they agree to produce to truly necessary and essential documents, understanding that the documents may be used by individuals other than those who requested them — even individuals who would ordinarily be barred from obtaining the same documents under Section 220.

Delaware Courts Continue To Enforce Unambiguous Advance Notice Bylaws, But Incumbent Director Conduct Remains Subject to Equitable Review

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> See page 8 for key takeaways

In early 2020, in *BlackRock Credit Allocation Income Tr., et al. v. Saba Capital Master Fund, Ltd.*,[1] the Delaware Supreme Court reiterated that Delaware courts will enforce clear and unambiguous advance notice bylaws according to their terms using ordinary contractual principles. Its ruling reversed a decision by the Court of Chancery and held that a dissident stockholder was barred from presenting its slates of nominees for two closed-end investment funds and a trust because the nominees failed to provide supplemental information within the time period set by clear and unambiguous bylaws.

The Delaware Supreme Court highlighted that there was no evidence of manipulative or inequitable conduct on the part of the entities in enforcing the bylaws, and noted that the dissident stockholder had ignored a clear deadline to provide the supplemental nominee information without raising any objections, and then appeared to proffer after-the-fact justifications for its noncompliance.[2]

More recently, two Court of Chancery decisions again reiterate that, as a default rule, clear and unambiguous advance notice bylaws will be enforced. Nevertheless, both courts held that application of such bylaws remains subject to equitable review to determine if the incumbent board acted manipulatively or otherwise inequitably in rejecting stockholder board nominees. Notably, the two courts applied slightly different standards of review.

The decisions further indicate that clear and unambiguous bylaws adopted on a "clear day" in order to achieve the legitimate goal of an orderly corporate electoral process are unlikely to fail equitable review in the absence of specific evidence of inequitable conduct.

Furthermore, these recent decisions make clear that the Delaware courts will not use equitable review to bail out a stockholder whose own conduct played a role in causing its notice to be deemed ineffective by the corporation and its incumbent board, or who failed to allow sufficient time to correct deficiencies in the notice prior to the relevant deadline.

CytoDyn

In *Rosenbaum v. CytoDyn Inc.*,[3] the Court of Chancery denied a request for permanent, mandatory injunctive relief on behalf of dissident stockholders and their proposed slate of board nominees and entered judgment on behalf of the defendants, CytoDyn and the incumbent board. The dissidents asked the court to find that the incumbent board and CytoDyn had wrongfully rejected the plaintiffs' nomination notice and compel CytoDyn to allow plaintiffs' nominees to stand for election at the annual meeting.

The court began by considering the appropriate standard of review to apply to the rejection of the dissidents' nomination notice. Plaintiffs argued that enhanced scrutiny under *Blasius Indus., Inc. v. Atlas Corp.*[4] applied, requiring a "compelling justification" for the incumbent board's actions, because, by rejecting the nomination notice, the board sought to prevent CytoDyn's stockholders from exercising their franchise in selecting

[1] 224 A.3d 964 (Del. 2020).

[2] The *Saba Capital* decision was itself consistent with longstanding Delaware case law on the enforcement of advance notice bylaws. *See, e.g., Openwave Sys. Inc. v. Harbinger Capital Partners Master Fund I, Ltd.*, 924 A.2d 228 (Del. Ch. 2007) (post-trial decision holding that insurgent stockholder's director nominees had not been properly nominated due to noncompliance with deadlines imposed by advance notice bylaw and that, under the circumstances, the corporation was not required to waive compliance with the deadlines).

[3] 2021 WL 4775140 (Del. Ch. Oct. 13, 2021).

[4] 564 A.2d 651 (Del. Ch. 1988).

directors. Plaintiff advocated for *Blasius* to apply "whenever a board of directors deprives the stockholders of their right to elect directors through the wrongful enforcement of an advance notice bylaw."[5]

The court rejected this approach, holding that that would extend *Blasius* beyond its intended limits and that the court would only employ a *Blasius* review if "the evidence reveals the Board engaged in manipulative conduct in responding to the Nomination Notice."[6]

Defendants, meanwhile, argued that the business judgment rule applied to their decision to reject the nomination notice. The court held that this approach also went too far and that room existed for equitable review of the application of even validly-enacted advanced notice bylaws under the principles set forth by the Delaware Supreme Court in *Schnell v. Chris-Craft Indus., Inc.*[7] Therefore, "while the burden may not lie with Defendants to prove a compelling justification for their rejection of the Nomination Notice under *Blasius*, Plaintiffs may still turn to equity for relief by proving there are compelling circumstances that justify a finding of inequitable conduct."[8]

After confirming that the incumbent board's decision to reject the nomination notice remained subject to equitable review for manipulative conduct, the court returned to first principles and emphasized that bylaws, including advance notice bylaws, must be strictly construed under Delaware's highly contractarian public policy. In this case, the court found, the nomination notice was deficient in at least two key respects: (i) It did not disclose who was supporting the dissidents' proxy contest and (ii) it did not disclose that one proposed board nominee might seek to pursue a self-interested merger transaction if elected to the board.

Having concluded that the nomination notice failed to strictly comply with the unambiguous terms of the advanced notice bylaw, the court concluded that there was no basis for "*Schnell*-inspired" equitable principles to override the incumbent board's decision. The court noted that the plaintiffs submitted their nomination notice on the eve of the deadline with full understanding of the potential consequences of doing so and without any guarantee based on the terms of the bylaw that the board would engage with them after the deadline. Even though the incumbent board may have delayed in responding to the nomination notice, the court determined that the notice was rejected on reasonable grounds given the nature of the omissions and that there was no manipulation or inequitable conduct.

Lee Enterprises

A few months later, in *Strategic Investment Opportunities LLC v. Lee Enterprises, Incorporated*,[9] the Court of Chancery again denied declaratory and injunctive relief on behalf of a dissident stockholder attempting to run a slate of director nominees as part of a takeover attempt. The court held that plaintiff failed to comply with the terms of the bylaw and therefore the company's rejection of the nomination notice was contractually proper.

The court then conducted an equitable review of the board's rejection of the nomination notice and applied enhanced scrutiny, ultimately concluding that "the board acted reasonably in enforcing a validly adopted bylaw with a legitimate corporate purpose" and did not engage in manipulative or inequitable conduct.

The court reiterated that, if a bylaw's language is unambiguous, it will be construed as written. The court concluded that the plaintiff's nomination notice failed to comply with the unambiguous bylaw in two respects: (i) The nomination was not made by a record holder and (ii) the company's form of questionnaire was not included with the nomination notice. The company's rejection of the nomination notice was therefore not a breach of contract.

Moving to the appropriate standard of review of the incumbent board's decision to reject the nomination notice, the court first noted that the parties agreed that *Schnell* empowers

[5] *CytoDin*, 2021 WL 4775140, at *13.

[6] *CytoDin*, 2021 WL 4775140, *14.

[7] 285 A.2d 437 (Del. 1971).

[8] *CytoDin*, 2021 WL 4775140, at *15.

[9] 2022 WL 453607 (Del. Ch. Feb. 14, 2022).

the court to invalidate board action, including action that inequitably manipulates corporate machinery to impair stockholder rights. The parties disagreed, however, about whether the court should undertake an equitable review of the incumbent board's conduct.

Plaintiff argued that the incumbent board's actions failed to satisfy enhanced scrutiny and that the incumbent board members' fiduciary duties required them to waive the bylaw's requirements. Defendants contended that, if a stockholder fails to comply with the unambiguous requirements of an advance notice bylaw, then the court should continue on to an equitable review only if the plaintiff can prove manipulative conduct or compelling circumstances to justify something other than business judgment review.

Rejecting this argument by defendants, the court concluded that enhanced scrutiny, "[w]hether labeled as *Unocal*[10] or *Blasius,*" was the appropriate standard of review due to the "inherent conflicts of interest" present when conduct by an incumbent board prevents stockholders from replacing incumbent board members in a contested election.

Even under the enhanced scrutiny standard, however, the court concluded that the incumbent directors were justified in rejecting the nomination notice. The court emphasized that the bylaw was validly enacted, had a legitimate purpose and was adopted on a "clear day," before any dissident threat surfaced. Furthermore, there was no evidence of manipulative conduct that suggested uneven enforcement of the bylaw or a lack of good faith. An "overarching point," in the court's words, was that the dissident stockholder's "own delay is what ultimately prevent it from satisfying the Bylaws' record holder (and, by extension, form) requirements."[11]

[10] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

[11] *Lee Enterprises*, 2022 WL 453607, at *18.

Takeaways

- The most recent decisions by the Court of Chancery involving advance notice bylaws reiterate that the starting point for analysis will be the principle that unambiguous bylaws should be enforced according to their terms.
- However, Delaware courts will conduct an equitable review of an incumbent board's decision to reject a nomination notice even if that notice failed to comply with unambiguous terms of the advance notice bylaw. Even when a bylaw's terms are clear and unambiguous, business judgment review is not the appropriate standard given that an incumbent board's enforcement of an advance notice bylaw to reject dissident nominees touches on the stockholder franchise.
- The two Court of Chancery decisions approached the standard of review slightly differently. While the court in *CytoDyn* permitted equitable review, it did not expressly apply enhanced scrutiny. Rather, the court held that, in the absence of manipulative conduct, it was not the incumbent board's burden to provide a "compelling justification" for its conduct; but, under the principles of *Schnell*, a stockholder could still prove "compelling circumstances" justifying a finding of inequitable conduct. In contrast, the court in *Lee Enterprises* expressly applied enhanced scrutiny, which places the burden on the incumbent board to demonstrate it acted reasonably by identifying proper corporate objectives and justifying its actions as reasonable in relation to those objections. In short, both courts agreed some level of equitable review was appropriate, but the exact standard of review remains to be developed.
- Nevertheless, both recent decisions, as well as the Delaware Supreme Court's holding in *Saba Capital*, emphasize that equitable review, whatever its form, will not, without evidence of manipulative board conduct, excuse a stockholder's own conduct when that was responsible for the nomination notice not complying with the bylaw.
- Furthermore, both recent Court of Chancery decisions indicate that, as a practical matter, clear and unambiguous bylaws adopted on a "clear day" in order to achieve the legitimate goal of an orderly corporate electoral process are unlikely to fail equitable review in the absence of specific evidence of inequitable conduct.

In Appraisal Cases, Court of Chancery Increases Deal Price-Based Valuation if Evidence Shows Pre-Closing Change

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> See page 11 for key takeaways

For the purposes of a statutory appraisal under Delaware law, a corporation's fair value is determined "on the date of the merger"[1] — in other words, at closing, not signing. However, deal terms, including price, are typically agreed upon months in advance of completion, and the value of the corporation can change during that span. In 1996 the Delaware Supreme Court addressed this issue in the appraisal context for the first time, holding that changes in value to the corporation as a going-concern prior to closing must be included in the valuation.[2]

When the Delaware courts began using the deal value as a starting point in valuing companies (as opposed to the traditional discounted cash flow method),[3] they had to determine whether the deal price should be adjusted to account for any changes in circumstances between signing and closing. Until recently, there have been only a handful of cases addressing this valuation issue, and the courts in most cases declined to adjust the deal price, finding there was a lack of evidence to show a change in value.[4]

Then, in 2019, the Court of Chancery issued back-to-back decisions that suggested expert evidence may be helpful in that context. In the first case, appraising the value of Columbia Pipelines Group, Inc.,[5] the court declined to make an adjustment because petitioners failed to "suggest a means of adjusting the deal price,"[6] but said that "[p]erhaps an expert could have constructed a metric."[7]

Nine days later, the Court of Chancery appraised Stillwater Mining Company based on the deal price less applicable synergies.[8] The court declined to adjust the deal price in large part because, much like in *Columbia Pipeline*, the *Stillwater* petitioners failed to present expert testimony regarding how the increased price of some metals increased Stillwater's value.

Court of Chancery Adjusts Deal Price Due to Post-Signing Increases in Value

In two cases in 2021 and 2022, however, the Court of Chancery increased a deal-price-less-synergies valuation due to a change in corporate value between signing and closing. In both cases, the court relied on expert evidence where the potential change in corporate value may not have been reflected in the deal price. These cases, discussed below, provide guidance for directors, officers and advisors negotiating transactions.

[1] *Cede & Co. v. Technicolor, Inc.,* 684 A.2d 289, 299 (Del. 1996).

[2] *Technicolor*, 684 A.2d 289 at 299.

[3] See our May 8, 2019, client alert, "Supreme Court Reinforces Deal Price Minus Synergies as 'Strong Indicator' of Fair Value," and our May 9, 2020, client alert, "Court of Chancery Continues To Rely on Market-Based Metrics in Appraisal Decisions."

[4] *Union Illinois 1995 Inv. Ltd. P'ship v. Union Fin. Grp., Ltd.*, 847 A.2d 340 (Del. Ch. 2004); In re PetSmart, Inc., C.A. No. 10782–VCS (Del. Ch. May 26, 2017).

[5] *In re Appraisal of Columbia Pipeline Grp., Inc.*, Consol. C.A. No. 12736-VCL (Del. Ch. Aug. 12, 2019).

[6] *Columbia Pipeline Group*, C.A. No. 12736-VCL, Slip Op. at 95.

[7] *Columbia Pipeline Group*, C.A. No. 12736-VCL, Slip Op. at 95.

[8] *In re Stillwater Mining Co.*, Consol. C.A. No. 2017-0385-JTL (Del. Ch. Aug. 21, 2019).

In 2021, *In re Appraisal of Regal Entertainment Group*,[9] the court determined that the deal price ($23.00) minus synergies (yielding a fair value of $19.23) was the most reliable indicator of fair value. However, after the merger agreement was signed but before the transaction closed, U.S. corporate tax rates were lowered. Regal agreed that the tax reform increased the corporation's value, but argued that the increase was not as large as the petitioners claimed.

Both parties relied on expert testimony regarding the increase in value. The court agreed that the lowered tax rate was part of the "operative reality" of Regal at closing and that an upward adjustment was warranted. Regal argued that the upward adjustment should be discounted because a portion of the increase was factored into the deal price, but the court disagreed. Although Regal provided evidence of market commentary about the impact generally of the lower tax rates, the court required specific evidence about Regal.[10] The court added $4.37 to result in a fair value of $23.60, slightly above the deal price.

[9] *In re Appraisal of Regal Entm't Grp.*, Consol. C.A. No. 2018-0266-JTL (Del. Ch. May 13, 2021), *judgment entered*, (Del. Ch. May 28, 2021).

[10] *Regal*, Consol. C.A. No. 2018-0266, JTL Slip Op. at 125.

In 2022, the Court of Chancery again adjusted a deal-price-less-synergies valuation ($44.29), this time due to outperformance of projections and analysts' expectations. In *BCIM Strategic Value Master Fund, LP v. HFF, Inc.*,[11] after signing, the corporation had a significant earnings beat and there was evidence that the increased performance would continue into the future.

Relying in part on expert evidence, the court found that the corporation's "outperformance was both more significant and durable,"[12] distinguishing it from *In re PetSmart.*[13]

The court noted that the projections the board relied on when it negotiated and approved the transaction at $49.16 per share did not anticipate the increased performance, and the valuation analysis of the corporation's financial advisor "did not incorporate value from the Company's pipeline of deals, which suggested that the Company would perform better than budgeted."[14] The court increased the deal price less synergies number by $2.30 for a fair value determination of $46.59.

[11] *BCIM Strategic Value Master Fund, LP v. HFF, Inc.*, C.A. No. 2019-0558-JTL (Del. Ch. Feb. 2, 2022).

[12] *HFF*, C.A. No. 2019-0558-JTL, Slip Op. at 70.

[13] *In re PetSmart, Inc.*, 2017 WL 2303599 (Del. Ch. May 26, 2017)).

[14] *HFF*, C.A. No. 2019-0558-JTL, Slip Op. at 25.

Takeaways

- In recent appraisal cases, the Chancery Court has shown a willingness to find fair values in excess of the deal price if petitioners can prove that a corporation increased in value between signing and closing. On the other hand, the court has indicated that a company's value may also *decrease* if new information is negative.
- A petitioner must provide sufficient evidence, including possibly expert analysis, in order to convince the court an adjustment is warranted. On the company side, meanwhile, absent explicit evidence, the court may decline to find that a board considered possible future increases in value when negotiating a deal price. Defense lawyers should consider this in formulating their fact and expert discovery strategies, as both sides carry the burden of proving their cases in an appraisal action.
- If a board negotiating a transaction is aware of a pending market or legal change that has the potential to alter a corporation's value, it should consider that and document its deliberations regarding that issue, particularly where appraisal rights may be available.

Court of Chancery Continues to Reject Demand Futility Claims Post-*Zuckerberg*

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> See page 15 for key takeaways

In September 2021, in *United Food and Commercial Workers Union v. Zuckerberg*, the Delaware Supreme Court embraced the Court of Chancery's suggestion that the analysis for evaluating demand futility in derivative cases should be streamlined. Rather than employing the prior *Aronson v. Lewis or Rales v. Blasband* standards, the Supreme Court set forth a new, three-part test that "is consistent with and enhances" those standards, so that "cases properly construing *Aronson, Rales*, and their progeny remain good law."1

Under *Zuckerberg*, when ruling on a motion to dismiss where the plaintiff asserts demand futility, Delaware courts will examine whether a director: (1) received a material personal benefit from the alleged misconduct; (2) would face a substantial likelihood of liability on any of the claims that would be the subject of the litigation demand; or (3) lacks independence from someone who received a material benefit from the alleged misconduct, or would face a substantial likelihood of liability on any of the claims that are the subject of the litigation demand. If the answer to any of those questions is "yes" for at least half of the members of the board that would be considering the demand, then demand would be excused as futile. (See our September 28, 2021, client alert, "Delaware Supreme Court Issues Two Opinions Simplifying Delaware Law on Derivative Claims.")

Since *Zuckerberg*, practitioners, companies and directors have watched to see how the new standard was applied, and if it would alter Delaware's traditional approach to evaluating demand futility, including deference to directors' ability to make decisions about litigation brought in the company's name. In a series of opinions, discussed below, the Court of Chancery has applied the *Zuckerberg* formulation to evaluate director disinterest and independence and found that a demand would not have been futile.

In re Vaxart, Inc. Stockholder Litigation (November 30, 2021)

In September 2020, plaintiffs filed a stockholder class action derivatively on behalf of Vaxart, Inc., a small biotechnology company that was developing a vaccine for COVID-19 in the early stages of the pandemic. Plaintiffs challenged amendments to two warrant agreements between the company and a purported controlling stockholder, Armistice, which, "[i]n effect, … enabled the stockholder to exercise and dispose of the warrant shares faster than under the terms of the original warrants."[2]

Plaintiffs alleged that the Vaxart board and Armistice had advance knowledge of the company's participation in a non-human primate study sponsored by the federal government's Operation Warp Speed vaccine development program. Plaintiffs alleged that the board amended these documents to the benefit of directors and Armistice in advance of a jump in Vaxart's stock price that occurred on announcement of the participation.

The court first found that Armistice was not a controller at the time of the challenged transaction, because at the time it did not own more than 50% of Vaxart's voting power or exercise actual control over Vaxart. The Court of Chancery then applied the *Zuckerberg* test and "conclude[d] that Plaintiffs have failed to establish that at least half the members of the

[1] *United Food & Commercial Workers Union & Participating Food Indus. Employers Tri-State Pension Fund v. Zuckerberg*, 262 A.3d 1034, 1059 (Del. Sept. 23, 2021).

[2] *In re Vaxart, Inc. Stockholder Litig.*, 2021 WL 5858696, at *1 (Del. Ch. Nov. 30, 2021).

Demand Board were incapable of fairly and impartially considering a litigation demand as to the Warrant Amendments."[3]

Whether a majority of the demand board was able to impartially consider a demand turned on the disinterest and independence of two directors, Wouter Latour and Andrei Floroiu. The court rejected the allegations that Latour was not independent from the Armistice directors because the Armistice directors supported Latour's stock option grant supposedly in exchange for Latour's support of the Warrant Amendments and the Armistice directors allowed Latour to remain on the board after his resignation as CEO and approved his separation package.

With respect to Floroiu, the court rejected the claim that he was indebted to the Armistice directors because the Armistice directors appointed him as CEO of Vaxart and approved his "enormously lucrative stock options." In doing so, the court reiterated that, "[w]ithout more, pleading that a board of directors elevated an executive to her current role or approved her compensation is insufficient to establish that the recipient is 'beholden' to any director who approved that decision."

Turning to the third *Zuckerberg* prong, the court found that the complaint failed to plead that a majority of the board would receive a material benefit or face a substantial risk of personal liability for the claims related to the warrant amendments, because the board did not amend the warrant agreements in bad faith, since such amendments "were hardly a gift; their exercise 'increase[d] the Company's cash on hand by $5 million.'"[4]

In re Kraft Heinz Company (December 15, 2021)

In July 2019, stockholders began filing derivative complaints on behalf of The Kraft Heinz Company related to the sale by 3G Capital, Inc. of a 7% stake in Kraft, resulting in proceeds of over $1.2 billion for 3G, which owned 24% before the sale.

Plaintiffs alleged that 3G, entities affiliated with it and certain dual fiduciaries of 3G and Kraft breached their fiduciary duties to Kraft stockholders by "either approv[ing] 3G's stock sale based on adverse material nonpublic information or allow[ing] 3G to effectuate the sale to the detriment of Kraft Heinz and its non-3G stockholders."[5]

In analyzing demand futility, the Court of Chancery applied the *Zuckerberg* "universal test" to "count heads" to determine whether a majority of the Kraft board of directors were disinterested and independent. The court analyzed only six of the 11 directors, as defendants conceded that three 3G-affiliated directors could not exercise impartial judgment regarding a demand, and plaintiffs allowed that two other directors were independent and disinterested.

The court focused on just the third prong of *Zuckerberg* (lack of independence) because no director was alleged to have sold Kraft stock during the relevant period or personally benefitted from 3G's sale. The court ultimately concluded that plaintiffs failed to plead particularized facts sufficient to create reasonable doubt about the independence of four of the six examined directors.

In particular, the court rejected plaintiffs' argument that two directors were not independent because both had close ties and affiliations with Warren Buffett and Berkshire Hathaway Inc., which has a "close co-investing relationship with 3G." One of those directors had worked as a financial assistant to Buffett, served as a director and CEO of Berkshire Hathaway subsidiaries and Buffett allegedly walked her down the aisle at her wedding in 2013.[6]

The court explained that plaintiffs' "transitive theory of independence," disqualifying directors tied to Berkshire Hathaway because of its relationship to 3G, failed for several

[3] *Id.* at *18. However, the court did not determine whether demand was futile concerning plaintiffs' derivative unjust enrichment claim, which alleged that directors breached their fiduciary duties by issuing spring-loaded options in violation of the company's 2019 equity incentive plan. The court requested supplemental briefing on that issue.

[4] *Id.* at *22.

[5] *In re Kraft Heinz Co. Derivative Litig.*, 2021 WL 6012632, at *1 (Del. Ch. Dec. 15, 2021).

[6] *Id.* at *8.

reasons, including that the complaint failed to plead particularized allegations supporting a conclusion that either director felt subject to 3G's dominion or beholden to 3G based on its history of co-investing with Berkshire.

Simons v. Brookfield Asset Management Inc. (January 21, 2022)

In 2021, plaintiff filed a stockholder class action derivatively on behalf of GrafTech International, Ltd. challenging the fairness of the price GrafTech paid to repurchase stock from its controlling stockholder, Brookfield Asset Management, Inc. After the share repurchase, and seven months after plaintiff served a Section 220 books and records demand — but *before* plaintiff filed suit — GrafTech's board voted to expand from eight to nine seats and filled the vacancy with an independent director.

"To improve his odds, the plaintiff [sought] to exclude from the head-counting analysis" the independent director. However, the court concluded that GrafTech's certificate of operation and stockholder agreement permitted the board's expansion and dismissed plaintiff's claim that it was a breach of fiduciary duty, saying that the timing of the director's appointment "does not render it reasonably conceivable that the directors breached their fiduciary duties by appointing a concededly independent director to the Board."[7]

Ultimately, the court concluded that demand was not futile under *Zuckerberg* because no outside director (i) received a material personal benefit from the transaction, (ii) faced a substantial likelihood of liability or (iii) lacked independence. Notably, the court specifically held that one director did not lack independence simply because he was retired and the $140,000 he received annually in cash and stock as director fees were his sole source of income, because that was not excessive.

[7] *Simons v. Brookfield Asset Mgmt. Inc.*, 2022 WL 223464, at *9 (Del. Ch. Jan. 21, 2022).

In re Camping World Derivative Litigation (January 31, 2022)

Following disclosures in 2017 by Camping World Holding, Inc. about its integration of stores purchased in bankruptcy from Gander Mount Company, plaintiffs filed a derivative action for breach of fiduciary duty and unjust enrichment. Plaintiffs alleged that a majority of the Camping World board was not independent because they faced a substantial likelihood of liability based on three claims: (i) a *Brophy* claim against certain directors and officers "selling Camping World stock on the basis of the knowledge of improper information … before that information was revealed to the Company's stockholders"[8]; (ii) a related disclosure claim for issuing false and misleading disclosures; and (iii) a *Caremark* claim for the board allegedly disregarding its oversight duties.

Conducting the *Zuckerberg* test on a director-by-director and claim-by-claim basis, the Court of Chancery held that demand was not futile because a majority of Camping World's nine-member board could exercise independent and disinterested judgment in responding to a demand.

Plaintiffs did not challenge the independence of four directors, and two were assumed to be interested, so the court's examination was limited to two outside directors, K. Dillon Schickli and Andris Baltins. The court found that Schickli did not lack independence simply because he was appointed to the board by an alleged controller or was compensated approximately $200,000 per year for his services. The court held that plaintiffs failed to adequately plead materiality. The court also stated that the fact that Schickli served as the COO 25 years earlier for a company controlled by an assumed interested director "cannot, by itself, 'create a disabling interest' today."[9]

[8] *In re Camping World Holdings, Inc. S'holder Deriv. Litig.*, 2022 WL 288152, at *5 (Del. Ch. Jan. 31, 2022).

[9] *Id.* at *18.

With the determination that Schickli was able to consider a demand impartially, the court held that a majority of the board was disinterested and independent for demand futility purposes, and therefore did not reach the issue of whether Baltins lacked independence because he was a partner in a law firm that previously received fees from Camping World.

Takeaways

- Under the new *Zuckerberg* test, Delaware courts no longer have to decide whether the *Aronson* or *Rales* tests apply, but will instead apply a combined three-part test to "count heads" to determine whether a majority of directors that would be evaluating a demand are capable of doing so.
- Delaware courts continue to scrutinize directors' independence carefully when transactions are challenged, and have not strayed from traditional Delaware law in the demand context. Recent cases applying *Zuckerberg* have reiterated long-standing Delaware law that simply being appointed by a controlling stockholder does not establish that the director lacks independence from the controlling stockholder. Likewise, the receipt of standard directors fees, without more, is insufficient to render a director interested.
- Delaware courts continue post-*Zuckerberg* to examine whether directors face a substantial likelihood of liability. Even if one or more directors potentially do, the key for the demand futility analysis will be whether a *majority* of the directors face a substantial likelihood of liability, or are otherwise unable to consider a demand because they are not independent from someone who does.
- As before *Zuckerberg*, Delaware courts are not hesitant to dismiss derivative claims on demand futility grounds if a majority of directors would be able to impartially consider a demand.

Seventh and Ninth Circuits Split Over the Scope of Exclusive Forum Provisions

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Earlier this year the United States Courts of Appeals for the Seventh and Ninth Circuits each addressed the question of whether an exclusive forum provision adopted by a Delaware company and requiring derivative litigation brought on behalf of the corporation to be filed in the Delaware Court of Chancery could foreclose a derivative suit alleging a violation of the Securities Exchange Act of 1934 (the "Exchange Act") brought in federal court. In *Seafarers Pension Plan v. Bradway*,[1] the Seventh Circuit declined to apply the forum selection provision, concluding that the Exchange Act gives federal courts exclusive jurisdiction over actions under it. *In Lee v. Fisher*,[2] the Ninth Circuit applied the forum selection provision and dismissed the Exchange Act claim based on the doctrine of *forum non conveniens*.

Exclusive Forum Provisions Widely Adopted To Address 'Multi-Forum Litigation'

In 2010, Vice Chancellor Laster suggested in *In re Revlon, Inc. Shareholders Litigation* that "if boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution," they might decide to select "an exclusive forum for intra-entity disputes."[3] At the time, only a handful of public companies had enacted exclusive forum provisions in their charters or bylaws.

A few years later, in the 2013 case *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, then-Chancellor Strine addressed the validity of such a provision under Delaware law.[4] That suit presented a facial challenge to bylaws adopted by two public company boards designating Delaware as the exclusive forum for disputes related to "internal affairs" — those "matters peculiar to the relationships among or between the corporation and its current officers, directors, and shareholders."[5]

In holding that the bylaws were valid, Chancellor Strine explained that 8 *Del. C.* §109(b) "has long been understood to allow the corporation to set 'self-imposed rules and regulations [that are] deemed expedient for its convenient functioning.'"[6] Forum selection bylaws, which "regulate *where* stockholders may file suit, not *whether* the stockholder may file suit or the kind of remedy that the stockholder may obtain on behalf of herself or the corporation," govern disputes related to the "internal affairs" of the corporation, which is a proper subject matter under Section 109(b).[7]

By August 2014, more than 700 publicly traded corporations had adopted an exclusive forum provision,[8] and state and federal courts around the country regularly enforced the provisions, dismissing cases not brought in the specified jurisdiction.

Lead-Up to *Seafarers* and *Lee*

In 2015, the Delaware General Assembly enacted 8 Del. C. §115. The statute codifies the holding of *Boilermakers* and provides that a certificate of incorporation or bylaws "may require, consistent with applicable jurisdictional requirements, that any or all internal

[1] 23 F.4th 714 (7th Cir. 2022).

[2] --- F.4th ----, 2022 WL 1511322 (9th Cir. May 13, 2022).

[3] 990 A.2d 940, 960 (Del. Ch. 2010).

[4] 73 A.3d 934 (Del. Ch. 2013).

[5] *Id.* at 934 n.85 (quoting *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982)).

[6] *Id.* at 951 (alteration in original) (quoting *Gow v. Consol. Coppermines Corp.*, 165 A. 136, 140 (Del. Ch. 1933)).

[7] *Id.* at 952 (emphasis in original).

[8] *Sciabacucchi v. Salzberg*, 2018 WL 6719718, at *9 (Del. Ch. Dec. 19, 2018), *rev'd on other grounds*, 227 A.3d 102 (Del. 2020).

corporate claims shall be brought solely and exclusively in any or all of the courts in this State." In other words, a corporation may adopt an exclusive forum provision for "internal corporate claims," provided that Delaware is, or is among, the designated forum(s).

An interesting question that *Boilermakers* and the Delaware General Assembly anticipated is whether an exclusive forum provision could be used to deprive federal courts of jurisdiction over claims brought under the Exchange Act. *Boilermakers* stated that an exclusive forum provision would likely not apply to claims arising under the Exchange Act because (i) forum selection "provisions do not purport to regulate a stockholder's ability to bring a securities fraud claim or any other claim that is not an intra-corporate matter"; and (ii) if a forum selection provision "waive[s] the stockholder's rights under the Securities Exchange Act, such a waiver would be inconsistent with the antiwaiver provisions of that Act."[9]

The Delaware General Assembly appeared to agree. Although not controlling authority, the synopsis of Senate Bill 75 enacting Section 115 states that "Section 115 is also not intended to authorize a provision that purports to foreclose suit in a federal court based on federal jurisdiction, nor is Section 115 intended to limit or expand the jurisdiction of the Court of Chancery or the Superior Court."[10]

Seafarers and *Lee*

The question of whether an exclusive forum provision could foreclose suit in a federal court based on federal jurisdiction anticipated in *Boilermakers* and Section 115 was presented in *Seafarers* and *Lee*. The issue in both disputes was the apparent conflict between a plaintiff's derivative suit asserting claims under Section 14(a) of the Exchange Act and the respective forum selection bylaws of Boeing Company and The Gap, Inc., which required that any derivative action or proceeding brought on behalf of the corporation be adjudicated in the Delaware Court of Chancery.

[9] 73 A.3d at 962.

[10] S.B. 75, 148th Gen. Assemb., 2015-2016 (Del. 2015).

The bylaw notwithstanding, in *Seafarers*, a Boeing stockholder filed a derivative suit in the Northern District of Illinois alleging that Boeing directors and officers made materially false and misleading public statements about the 737 MAX in Boeing's proxy materials, in violation of the Exchange Act.

Similarly, in *Lee*, a Gap stockholder filed a derivative suit in the Northern District of California alleging that Gap and its directors made false statements to stockholders in its proxy statements about the level of diversity the company had achieved, in violation of the Exchange Act.[11]

In both cases, the defendants moved to dismiss the suits, relying on the respective forum selection bylaw. In both cases, the district courts applied the bylaws and dismissed the suits.

In *Seafarers*, the Seventh Circuit reversed the dismissal on appeal. The majority opinion held that the Boeing bylaw could not apply to derivative claims brought under the Exchange Act because "Delaware corporation law … reject[s] Boeing's use of its forum bylaw to foreclose entirely plaintiff's derivative action under Section 14(a)."[12]

It explained that, if the bylaw were applicable, it would "force plaintiff to raise its claims in a Delaware state court, which is not authorized to exercise jurisdiction over Exchange Act claims."[13] And, "[b]ecause the federal Exchange Act gives federal courts exclusive jurisdiction over actions under it, applying the bylaw to this case would mean that plaintiff's derivative Section 14(a) action may not be heard in any forum."[14] Pointing to Section 115 and *Boilermakers*, the majority explained that such an outcome "would be contrary to Delaware corporation law, which respects the non-waiver provision in Section 29(a) of the federal Exchange Act."[15] The majority also reasoned that *Boilermakers* "does not authorize application of the Boeing forum bylaw to this case,

[11] *Lee*, 2022 WL 1511322, at *1.

[12] *Seafarers*, 23 F.4th at 720.

[13] *Id.*

[14] *Id.* at 717.

[15] *Id.*

where it would effectively foreclose a claim under federal securities law."[16]

The majority concluded that Section 115 and *Boilermakers* "signal clearly that Delaware is not inclined to enable corporations to close the courthouse doors entirely on derivative actions asserting federal claims subject to exclusive federal jurisdiction."[17]

Judge Easterbrook dissented. His analysis focused on the nature of the claim, asserting that derivative claims are a matter of state law and, for that reason, there is nothing problematic about a bylaw directing derivative claims to state court. According to Judge Easterbrook, "[i]t is state law … that determines both when demand is required [for derivative actions] and when investors can step into a corporation's shoes."[18] He reasoned that "Section 14(a) plays a role in such litigation, to be sure, but does not create the claim."[19]

Judge Easterbrook further noted that a derivative claim is not necessary to enforce Section 14(a) because enforcement can be "done through investors' or the SEC's direct suits."[20] Indeed, he observed that "[m]any investors *have* sued Boeing directly about the 737 MAX debacle."[21] See our January 11, 2022, client alert, "Seventh Circuit Holds That Delaware Forum Bylaw Cannot Force Litigation of Securities Exchange Act Claims in Delaware State Court."

In *Lee*, the Ninth Circuit affirmed the district court's dismissal on appeal. The Ninth Circuit determined that "the appropriate way to enforce a forum-selection clause pointing to a state or foreign forum is through the doctrine of *forum non conveniens*."[22] A forum selection provision "creates a strong presumption in favor of transferring a case" and "a district court should transfer the case unless extraordinary circumstances unrelated to the convenience of the parties clearly disfavor a transfer."[23]

The Ninth Circuit determined that the only extraordinary circumstance warranting consideration was "when enforcement of the clause 'would contravene a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision.'"[24] The Court found unavailing the stockholder's argument that the Exchange Act's antiwaiver provision is proof of strong public policy in favor of rejecting the Gap bylaw because "the strong federal policy in favor of enforcing forum-selection clauses … supersede[s] antiwaiver provisions in state statutes as well as federal statutes, regardless whether the clause points to a state court, a foreign court, or another federal court."[25]

The Ninth Circuit further noted neither the Exchange Act's antiwaiver provision nor the exclusive federal jurisdiction provision "contain[s] a clear declaration of federal policy."[26] With respect to the Exchange Act's exclusive federal jurisdiction provision, the Ninth Circuit explained that "section forbids non-federal courts from adjudicating Section 14(a) claims. Gap's bylaws do not force the Delaware Court of Chancery to adjudicate Lee's derivative Section 14(a) claim. Rather, the bylaws result in this claim being dismissed in federal court. Therefore, enforcement of the forum-selection clause does not violate any express statutory policy of the Exchange Act's exclusive federal jurisdiction provision."[27] As did Judge Easterbrook, the Ninth Circuit observed that "the Supreme Court has held that the Exchange Act's exclusivity provision is waivable."[28]

Notably, the Ninth Circuit did not consider the effect of Delaware law "as part of [its] public

[16] *Id.* at 724.

[17] *Id.*

[18] *Id.* at 729.

[19] *Id.*

[20] *Id.*

[21] *Id.* (emphasis in original).

[22] *Lee*, 2022 WL 1511322, at *2 (quoting *Atl. Marine Constr. Co. v. U.S. Dist. Ct. for W. Dist. of Tex.*, 571 U.S. 49, 60 (2013)).

[23] *Id.* (citation omitted).

[24] *Id.* at *3 (quoting Y*ei A. Sun v. Advanced China Healthcare, Inc.*, 901 F.3d 1081, 1090 (9th Cir. 2018)).

[25] *Id.* at *3 (alterations in original) (quoting *Yei*, 901 F.3d at 1090).

[26] *Id.*

[27] *Id.*

[28] *Id.* (citing *Shearson/Am. Express, Inc. v. McMahon*, 482 U.S. 220, 228 (1987)).

policy analysis" because the stockholder had not "identified Delaware law clearly stating that she could not get any relief in the Delaware Court of Chancery."[29] The Ninth Circuit explained that the stockholder did not identify Section 115 in the district court or in her opening brief on appeal, and so waived reliance on that provision.[30] See our May 19, 2022, client alert "Ninth Circuit Enforces Exclusive Forum Bylaw in Derivative Suit Asserting a Section 14(a) Claim, Creating Split With Seventh Circuit."

Conclusion

Exclusive forum selection provisions have become commonplace and serve as an effective tool to manage litigation for Delaware corporations. However, as *Seafarers* and *Lee* illustrate, certain claims may lie beyond their reach. For now, it appears that forum selection provisions may be applied to derivative suits alleging violations of the Exchange Act in the Ninth Circuit but not the Seventh Circuit. The uncertainty resulting from these differing outcomes may persist until the circuit split is resolved.

[29] *Id.*

[30] *Id.* at *4.

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