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Delaware Supreme Court: Controller Buyout Mergers can now be Reviewed under Business Judgment Rule

Must be Conditioned Up Front on Dual Approval Safeguards, But, Do the Benefits of Doing This Outweigh the Execution Risks in Every Case?

By Clifford E. Neimeth.[1]

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In a significant case of first impression, the Delaware Supreme Court, in *Kahn v. M&F Worldwide Corp.* (M&F Worldwide), No. 334, 2013 (Del. Mar. 14, 2014), unanimously affirmed that a controller's buyout of its subsidiary in a negotiated merger is entitled to judicial review under the deferential "business judgment" standard — instead of the exacting "entire fairness" standard — if certain procedural safeguards are locked in place at the outset of the transaction. In doing so, the Delaware Supreme Court answered an important 20-year-old question never raised directly in *Kahn v. Lynch Commc'ns Sys.* (Lynch), 638 A.2d 1110 (Del. 1994) and upheld the Delaware Court of Chancery's (Delaware Chancery Court) post-merger (summary judgment) decision in *In re MFW S'holders Litig.*, 67 A.3d 496 (Del. Ch. 2013).

In *Lynch*, the Delaware Supreme Court was faced with the use of a special committee of independent directors (Special Committee) only, and held that in a controller's buyout merger the existence and effective use of either a Special Committee or a majority-of-the-minority stockholders vote (M-O-M Vote) condition shifts the burden of persuasion on entire fairness from the defendants to the plaintiff, but that entire fairness nonetheless remains the default standard of judicial review. The premise for this is that the entire fairness standard cannot (and should not) be altered if only one of the aforementioned procedural safeguards is used because neither one is

sufficient, alone, to sterilize the self-dealing, potential informational imbalances, conflicts of interest and undermining influences inherent in a controller's buyout merger.

In *M&F Worldwide*, the Delaware Supreme Court confirmed that *Lynch* did not address whether a controller's going-private merger ever could be subject to business judgment review if both a Special Committee were established and used to prosecute the transaction and a M-O-M Vote condition were obtained to adopt the merger agreement. The Court then announced that the business judgment review standard will apply to controller buyouts if, and only if, (1) the controller conditions the transaction on both the approval of a Special Committee and a M-O-M Vote (2) the Special Committee is independent, (3) the Special Committee is empowered to freely select its own advisors and to say no definitively, (4) the Special Committee meets its duty of care in negotiating a fair price, (5) the M-O-M Vote is informed, and (6) there is no coercion of the minority. If any one of these elements is absent or ineffective, entire fairness will remain the unaltered standard of review.

The Court noted that the existence and proper use of both a Special Committee and M-O-M Vote condition — as dual, instead of disjunctive, safeguards — serve "independent integrity enforcing" functions and that the M-O-M Vote provides minority stockholders with a voluntary opportunity to decide for themselves whether the deal is fair. An uncoerced and fully informed vote of disinterested stockholders always has been accorded substantial weight under Delaware law. A vote is informed if there are no omissions, misstatements or other disclosure defects in the disclosure documents submitted to stockholders that they would consider material in making a voting decision.

Key facts and findings in *M&F Worldwide* included MacAndrews & Forbes Holdings, Inc.'s (MacAndrews) statements in its initial proposal letter that it would not proceed with the merger unless it was approved by a Special Committee, that the merger must be approved by a non-waivable M-O-M Vote, and that if the merger was not approved and recommended by the Special Committee or the requisite M-O-M Vote condition failed, the future long-term relationship between MacAndrews and its 43 percent owned subsidiary, M&F Worldwide Corp. (MFWC), would not be adversely affected. In other words, MacAndrews committed on day one not to do an "end run" around the Special Committee by launching a unilateral tender offer for the 57 percent of MFWC's outstanding shares it didn't already own, and the full Board was effectively bound by the Special Committee's recommendation — the Special Committee could say "no" definitively.

The Special Committee's mandate was clear and explicit, and stated that "the Board [would] not approve the [merger] without a prior favorable recommendation of the Special Committee" and the independent directors' resolutions expressly authorized the Special Committee to retain independent legal and financial advisors and to negotiate the terms of the transaction with MacAndrews (not just vote up or down on pre-baked terms).

The Delaware Supreme Court affirmed that the Special Committee exercised due care in discharging its mandate, including obtaining all relevant information and reviewing with its professional advisors the range of values obtainable in various strategic and financial alternatives to MacAndrews' merger proposal and the viability of undertaking such transactions, notwithstanding the Special Committee's inability to conduct a market check and shop MFWC because MacAndrews made clear in its initial proposal letter that it was a buyer of MFWC only and would not sell its stake in a competing deal. Lastly, the Delaware Supreme Court affirmed the Delaware Chancery Court's findings that plaintiffs proferred no convincing evidence that any of the Special Committee directors were beholden to or under the influence or domination of MacAndrews (or to its sole stockholder) or that they otherwise lacked requisite "independence."

Some Takeaways

M&F Worldwide is an Important Decision: For the first time, the Delaware Supreme Court has created a tangible incentive to avoid entire fairness review of controller buyout mergers by irrevocably deploying, up front, dual independent approval mechanisms (*i.e.*, the Special Committee plus the M-O-M Vote condition). The substitution of business judgment review for entire fairness review is not merely an esoteric benefit. An entire fairness review involves detailed substantive analyses by a Delaware court of the fairness of the deal price and fairness of the deal process. Where entire fairness is applied, if a comprehensive factual record has not yet been developed through discovery, a motion to dismiss on the pleadings is virtually unobtainable. By contrast, the deferential business judgment standard requires the dismissal of claims against the controller and the directors and dismissal of the action challenging the transaction unless it can be demonstrated that no rational person would find the transaction favorable to the minority stockholders.

Indeed, the Delaware Supreme Court conceded that "deciding whether an independent committee was effective in negotiating a price is a process so fact-intensive and inextricably intertwined with the merits of an entire fairness review ... that a pretrial determination of burden shifting [where, either, an effective Special Committee or M-O-M Vote condition is used] is often impossible." Accordingly, the ability to shift the exacting entire fairness standard to the deferential business judgment standard should help deter the commencement of frivolous strike suits. Escaping entire fairness review also should reduce the settlement value of weak litigation, where little or no deal price increase or additional disclosure benefit will or can be obtained by the minority stockholders. Thus, the framework for obtaining business judgment review of a controller's freeze-out merger has now been articulated definitively by the final arbiter of Delaware's corporate fiduciary law.

A Cautionary Note: At the same time, *M&F Worldwide* should not be over read. It is important for deal principals and their professional advisors to note that the decision did not (and, indeed, the Delaware Supreme Court and Delaware Chancery Court never would) announce a "blueprint" whereby controllers or directors can perfunctorily "check a box," consummate a deal and foreclose any possibility that a plaintiff's well-pled factual challenge to the use and efficacy of the dual procedural protections will survive the defendants' motion to dismiss.

Indeed, *M&F Worldwide* cautioned that if a complaint sufficiently pleads "a reasonably conceivable set of facts" demonstrating that any or all of the six requisite elements (recited above) are absent or ineffective, the complaint should survive the defendants' motion to dismiss and the plaintiff can proceed with pre-trial discovery. In addition, "if, after discovery, triable issues of fact remain about whether either or both of the dual procedural protections were established, or if established, were effective, the case will proceed to a trial in which the court will conduct an entire fairness review."

Moreover, and quite notably, in footnote 14 (on page 18) of the decision, the Delaware Supreme Court offered that the complaint in the litigation would have survived a motion to dismiss under the "reasonable conceivability" standard because it contained four fact-based, price insufficiency allegations that were pled well enough to raise issues concerning the adequacy of the Special Committee's negotiations. Thus, the Court noted that discovery would have been necessary to obtain further facts before applying the business judgment standard to review the transaction. The Court continued that the dual protection structure requires two price-related determinations before trial: "that a fair price was achieved by an empowered, independent committee that acted with care, and second, that a fully-informed, uncoerced majority-of-the-minority stockholders voted in favor of the price that was recommended by the independent committee." Accordingly, future plaintiff's counsel now have a

roadmap to better articulate their allegations and more precisely draft their complaints with factual details (assuming such facts exist) regarding the absence of one or more of the six requisite elements and, specifically, to attack the deal price, independence and effectiveness of the Special Committee.

Because the Delaware Supreme Court noted that sufficiently well-plead allegations of price inadequacy concomitantly implicate whether the Special Committee's negotiating process was adequate, the court in such instance is effectively undertaking a mini-entire fairness review at the first stage of the litigation to determine whether to apply the business judgment rule subsequent to the development of a more complete factual record through discovery. Also, if the factual allegations are well-plead and complex and uncertain enough, the court still may not be in a position to grant defendant's motion for summary judgment after a period of initial discovery and the standard of review may not be determined much before (or until the eve of) trial. If this is so, query whether the settlement value of controller buyout merger litigation will really decrease even where *M&F Worldwide's* dual-approval model is used at the outset of the transaction?

A Practical Choice for Transaction Planners and Deal Principals: One of the important premises of the M&F Worldwide decision is that the presence and effective use, in tandem, of the Special Committee and the M-O-M Vote condition (in the context described above) replicates the disinterested and independent approval process in a merger transaction negotiated at arms' length with an unaffiliated third party under Section 251 of the DGCL because (1) binding decisional authority is granted to the Special Committee in its capacity as the fiduciary and independent bargaining agent for minority stockholders and (2) dispositive voting authority is relinquished by the controller and transferred to the holders of minority (non-affiliate) shares.

Although the use of a properly constituted, properly empowered and well-functioning Special Committee has been *de rigueur* in controller buyout mergers for many years, a decision to irrevocably transfer veto power to minority stockholders at the outset of the transaction — especially where a target's stockholder base is not institutionally concentrated — could be a "bridge-too-far" for certain controllers depending on the circumstances. As with any cost-benefit analysis, prior to submitting its initial buyout proposal to the target's board of directors, controllers are certain to weigh, with their professional advisors, the benefits of obtaining business judgment rule review vis-a-vis the increased execution risk of the transaction and the fact that the judicial review standard may not be determined at the early stages of the deal litigation. Many controllers may simply conclude that burden-shifting through the use of a Special Committee alone suffices, especially if the facts are such that it remains uncertain whether the litigation will get knocked out on defendant's first motion for judgment on the pleadings or motion to dismiss.

An Open Question Remains: Although a very important open question in *Lynch* has now been answered definitively by the Delaware Supreme Court regarding the use, *ab initio*, of a Special Committee and a M-O-M Vote condition in controller buyout mergers to obtain business judgment review, it is unclear how *M&F Worldwide* impacts the judicial review dichotomy between controller going-private transactions effected pursuant to a negotiated merger agreement, on the one hand, and the same transaction effected pursuant to a controller's unilateral tender offer and subsequent short-form merger, on the other hand.

Historically, the Delaware Supreme Court has articulated that a freeze-out merger is inherently "less voluntary" and potentially more vulnerable to coercion and structural bias than a controller's unilateral tender offer to cash out minority stockholders followed by a subsequent short-form merger. Accordingly,

even after *M&F Worldwide*, entire fairness remains the default standard of judicial review for controller freeze-out mergers (if any, or all, the six elements announced in *M&F Worldwide* are absent or, if present, ineffective); whereas business judgment review pertains to the latter deal structure. To address this judicial incongruity — which seemingly exalts transaction form over substance — the Delaware Chancery Court has announced in a number of its decisions over the past 13 years, a so-called "unifying standard" of business judgment review for all controller going-private transactions, irrespective of its one-step or two-step form and irrespective of whether it is negotiated or unilaterally commenced at the outset. *See e.g., In re Siliconix Inc. S'holders Litig.,* 2001 WL 716787 (Del. Ch. June 21, 2001); *In re Pure Res., Inc. S'holders Litig.,* 808 A.2d 421 (Del. Ch. 2002); *Next Level Commc'ns, Inc. v. Motorola, Inc.,* 834 A.2d 828 (Del. Ch. 2003); *In re Cox Commc'ns, Inc. S'holders Litig.,* 879 A.2d 604 (Del. Ch. 2005); and, *In re CNX Gas Corp. S'holders Litig.,* 4 A3d 397 (Del. Ch. 2010).

It remains to be seen how the Delaware Supreme Court will weigh in to clarify this dichotomy if, and when, it addresses this issue on appeal in a future case.

All-in-all, going-forward *M&F Worldwide* will impact the structuring, negotiation and execution of controller buyout mergers, and the Delaware Supreme Court's decision is an important and positive development for deal principals, transaction planners and minority stockholders.

Addendum

"At the outset" means *ab initio*.

In *In re Orchard Enterprises, Inc. Shareholder Litigation*[2], the Delaware Chancery Court, on cross-motions for summary judgment following consummation of Dimensional Associates, LLC's squeeze out merger of its subsidiary, Orchard Enterprises, Inc., ruled, among other things, that the business judgment standard of review was inapplicable to Dimensional's squeeze out merger irrespective of Dimensional's agreement to condition the merger both on approval by a Special Committee and adoption of the merger agreement pursuant to a M-O-M Vote. This was so because Dimensional did not agree to be bound by a fully informed M-O-M Vote until later in the negotiation process with the Special Committee. To obtain the benefit of business judgment review in a controller's buyout merger, every element espoused in *M&F Worldwide* must be present, including the controller's agreement to both approval mechanisms at the outset of the proposed transaction. Accordingly, entire fairness remained the default standard of judicial review in this case. Notably, the Delaware Chancery Court also held that the defendants were not entitled to a shift in the burden of persuasion (via *Lynch*) because (i) the plaintiff demonstrated that the merger proxy statement contained one or more omissions of material fact (thereby, negating the informed nature of the M-O-M Vote); and (ii) (at least at the summary judgment stage of the litigation) the plaintiffs sufficiently established the existence of a factual dispute regarding the independence of the Special Committee chairman and the fairness of the process undertaken by the Special Committee to, among other things, negotiate the cash out price.

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[1] Mr. Neimeth's article was published in its entirety under "Expert Analysis" in the March 18, 2014 edition of *Law360's Mergers & Acquisitions*; *Private Equity*; *Securities Law*; *Class Action Litigation and Appellate Litigation* newsletters.

[2] *In re Orchard Enterprises, Inc. S'holder Litig.*, Consol. C.A. No. 7840-VCL (Del. Ch. Feb. 28, 2014).

Don't Leave It Out of Your Earn-Out – Delaware Court of Chancery Addresses Implied Covenant of Good Faith and Fair Dealing in the Context of Contingent Purchase Price Provisions

By Kenneth A. Gerasimovich and Jennifer Brady.

When negotiations over the purchase price in a business acquisition hit an impasse, an earn-out may be a useful device to bridge the gap between the buyer and seller. Under an earn-out provision, a portion of the purchase price is paid post-closing based on the future performance of the acquired business. If the business achieves agreed targets, the seller is rewarded with additional compensation. On the other hand, the purchaser is protected from spending too much up front on a business that then falters in the first few years. A few bullet points on a term sheet under "earn-out" and problem solved - at least until it comes to negotiating the definitive agreement.

The devil is in the details with an earn-out. Who will run the business after closing? Will the purchaser make necessary investments in the business? How can the seller be assured that the purchaser will not divert opportunities to its other business units or acquire a competing business in the future? A seller needs reasonable guarantees regarding the operation of the business during the earn-out period, while the purchaser needs the flexibility and control to successfully manage its business. The challenge for counsel is how to achieve this without turning the purchase agreement into a tome that has to be consulted with every future management decision.

While it may not be practical to spell out every detail regarding the operation of an acquired business during the earn-out period, affirmative obligations that are necessary to make the earn-out targets achievable, such as investments by the purchaser to support and expand the business, should be addressed in the purchase agreement. The Delaware Court of Chancery emphasized this point in an opinion issued earlier this year in *American Capital Acquisition Partners, LLC v. LPL Holdings*.[1]

American Capital Acquisition Partners, LLC v. LPL Holdings

In *American Capital Acquisition Partners, LLC v. LPL Holdings*, the Delaware Court of Chancery dismissed claims that a purchaser breached its implied covenant of good faith and fair dealing by failing to make technical adaptations to its computer systems required to achieve the synergies necessary to meet earn-out targets under a stock purchase agreement. However, the court denied the purchaser's motion to dismiss a claim that the purchaser breached the implied covenant by allegedly diverting the acquired company's clients and employees to another subsidiary of the purchaser and discouraging clients and prospective clients from using the acquired company's resources.[2]

In June 2011, LPL Holdings, Inc. (LPL), a Massachusetts corporation focused on providing technology, brokerage and investment advisory services to financial advisors, acquired Concord Capital Partners, Inc. (Concord), a subsidiary of American Capital Acquisition Partners, LLC (American Capital) that specialized in providing services to trust departments of financial institutions.[3] The stock purchase agreement governing the transaction included an earn-out provision that called for additional purchase price payments based on the future success of the acquired business.[4] In connection with the acquisition, LPL also entered into employment agreements with several officers and directors of Concord that contained bonus provisions contingent on Concord's future performance.[5] When LPL refused to make the earn-out and bonus payments due to Concord's failure to achieve the projected targets, American Capital and the

former officers and directors of Concord brought claims against LPL, asserting among other matters, that LPL breached its implied covenant of good faith and fair dealing.[6]

According to American Capital, it elected to pursue a transaction with LPL based in part on the expectation that LPL's acquisition of Concord would enable Concord to develop a custody services business for its trust accounts.[7] American Capital's complaint asserted that it and the other plaintiffs rejected a competing acquisition offer that proposed a greater initial cash payment and a potentially greater overall sale price from a potential purchaser that did not perform custody services, because an acquisition by a company such as LPL that performed custody services would generate significant synergies.[8]

Prior to closing, executives from Concord met with LPL's CEO, the managing director of its technology group and other members of LPL's management team to discuss issues of potential concern regarding any technical limitations in LPL's computer system, including possible problems relating to LPL's custody of trust assets.[9] American Capital's complaint specifically noted that the parties anticipated that LPL's computer system would require some technical adaptation.[10] American Capital asserted that LPL assured it that LPL would make any necessary ministerial technical changes to its computer system, and claimed that LPL's public and private statements regarding its technical capabilities concealed the serious difficulties of integrating Concord into the LPL system.[11] According to American Capital, after the closing LPL refused to customize its system to allow LPL to provide custody services to Concord, and consequently, Concord was unable generate revenue it could have generated prior to its acquisition by LPL, or if the technological changes had been made.[12]

American Capital argued that the implied covenant of good faith and fair dealing imposed on LPL an obligation to make the technological adaptations necessary to enable LPL to provide custody services to Concord.[13] The court pointed out in the opinion, however, that although the parties anticipated that LPL's systems would require some changes, they did not include any provision in the purchase agreement obligating LPL to make any technical adaptations necessary to allow Concord to develop its custody business after closing.[14]

The court stated in the opinion that "the implied covenant of good faith and fair dealing, as the Plaintiffs recognize, serves a gap-filling function by creating obligations only where the parties to the contract did not anticipate some contingency, and had they thought of it, the parties would have agreed at the time of contracting to create that obligation."[15] The court dismissed this portion of the implied covenant claim because American Capital "anticipated, but failed to bargain for, a requirement that [LPL] adapt their software and data-handling capabilities." [16]

The court, however, denied LPL's motion to dismiss American Capital's claim that LPL breached the implied covenant of good faith and fair dealing by shifting employees and customers from Concord to Fortigent, another LPL subsidiary, in order to avoid earn-out payments.[17] According to American Capital, Concord's staff was told to discourage prospective clients and current clients from using Concord's services and to "stand down" with existing clients and some Concord employees were transferred to Fortigent.[18]

The court found that taken together, the contingent purchase price provision in the stock purchase agreement, the compensation targets in the employment agreements with Concord's former directors and officers, and the section of the stock purchase agreement that provided for the calculation of revenue for the purposes of the earn-out targets "demonstrate that, had the parties contemplated that

[LPL] might affirmatively act to gut [Concord] to minimize payments under the [purchase agreement] and employment agreements, the parties would have contracted to prevent LPL from shifting revenue from [Concord] to Fortigent."[19]

Rubin Squared, Inc. v. Cambrex Corporation

The United States District Court for the Southern District of New York reached a similar conclusion in *Rubin Squared, Inc. v. Cambrex Corporation*,[20] applying Maryland law in an analysis of the implied covenant of good faith and fair dealing in connection with an earn-out in an asset purchase transaction.

The plaintiff in that case, Rubin Squared, Inc. (Rubin Squared), claimed, among other allegations, that the defendant, Cambrex Corporation (Cambrex), breached the asset purchase agreement that it entered into with Rubin Squared's predecessor corporation Bio Science Contract Production Corp. (Bio Science), by violating the implied covenant of good faith and fair dealing. The asset purchase agreement for the purchase of the Bio Science business contained a provision for earn-out payments over four years based on Bio Science's annual earnings.[21] During the negotiation of the asset purchase agreement, Bio Science's president, an experienced lawyer, proposed changes to the draft earn-out provision, including clauses rejected by Cambrex that would have obligated Cambrex to provide the reasonably necessary management, financial and operational resources and support to achieve Bio Science's strategic and growth plans, and a provision that would have prevented Bio Science from acquiring a competing business.[22]

Rubin Squared claimed that during the negotiations, Cambrex made oral representations to Bio Science that it would fund a $60 million expansion of Bio Science's facilities, that during the earn-out period Bio Science's principal, Jacques Rubin, would have full authority over Bio Science's operations, that Cambrex was not considering acquiring any competitor to Bio Science, and that Cambrex would make Jacques Rubin a corporate vice president of Cambrex and would not divert his efforts in a manner that would interfere with the achievement of the full earn-out.[23]

After completion of the acquisition, however, Jacques Rubin was not made a corporate vice president, Cambrex did not invest in an expanded facility for Bio Science, and Cambrex acquired Marathon, a competitor of Bio Science, and placed Jacques Rubin in charge of both Bio Science and Marathon.[24]

Rubin Squared argued that Cambrex violated its implied duty of good faith and fair dealing by failing to fulfill its pre-contractual promises and thus frustrating the achievement of the earn-out.[25] The court rejected this argument, noting with respect to the anticipated facilities expansion that "the implied duty of good faith and fair dealing cannot possibly be understood to require that Defendant provide a $60 million facilities expansion when such a term was not included in the contract, particularly when language supporting such an obligation was expressly rejected by Defendant."[26]

The court did, however, state that Rubin Squared's assertion of bad faith relating to the acquisition of Marathon could have merit. The court found that the acquisition alone could not constitute a violation of the duty of good faith and fair dealing, as an earn-out provision does not inherently prohibit the purchaser from acquiring the target company's competitors in the future. It also noted that Rubin Squared had attempted to negotiate a veto over future acquisitions, which was rejected. "Diversion of revenue to, or expenses from, Marathon would, by contrast, likely constitute bad faith," according to the court.[27] The court noted that it is "inherent in an agreement to share a percentage of a business unit's earnings that the unit's earnings will not be artificially diverted to another unit not covered by such

profit-sharing obligations."[28] The court granted Cambrex's motion to dismiss the claim, however, because Rubin Squared had not presented any evidence of diversion of revenue by Cambrex.

More is Sometimes More in Drafting an Earn-Out

As *American Capital Acquisition Partners, LLC v. LPL Holdings* and *Rubin Squared, Inc. v. Cambrex Corporation* demonstrate, courts are reluctant to read obligations into an earn-out clause where the parties have failed to address previously identified issues through specific covenants in the purchase agreement. On the other hand, courts are less tolerant of actions by a purchaser that demonstrate an attempt to divert resources, opportunities or revenue away from an acquired company to avoid paying an earn-out.

Although it is impractical to try to anticipate and draft for every contingency that may impact an earn-out, counsel should review business plans and participate in discussions between the parties regarding the post-closing operation of the business. At a minimum, any anticipated post-closing investments from the purchaser that are necessary to achieve expected synergies or earn-out targets should be memorialized in the purchase agreement. In addition, if the purchaser has many different business units or is likely to make future acquisitions, affirmative covenants regarding conflicts or allocation of resources should also be considered.

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[1] *American Capital Acquisition Partners, LLC v. LPL Holdings, Inc. et al.*, Del. Ch., C.A. 8490-VCG, Glasscock, V.C. (February 3, 2014).
[2] *Id.*, at 2.
[3] Id., at 2-3.
[4] *Id.*, at 4.
[5] *Id.*, at 3.
[6] *Id.*, at 10.
[7] *Id.*, at 5.
[8] *Id.*, at 6.
[9] *Id.*, at 7.
[10] *Id.*
[11] *Id.*, at 8.
[12] *Id.*, at 8-9.
[13] *Id.*, at 12.
[14] *Id.*, at 7.
[15] *Id.*, at 14.
[16] *Id.*, at 17.
[17] *Id.*, at 11-12, 19.
[18] *Id.*, at 17.
[19] *Id.*, at 18.
[20] *Rubin Squared v. Cambrex Corp.*, 2007 WL 2428485 (S.D.N.Y. 2007).
[21] *Id.*, at 2.
[22] *Id.*
[23] *Id.*
[24] *Id.,* at 1.
[25] *Id.*, at 7.
[26] *Id.*
[27] *Id.*, at 8.
[28] *Id.*

California Court Broadly Defines What Information Can Qualify as a Trade Secret

By Koray J. Bulut and Kurt A. Kappes.

A California appeals court recently explored some of the outer contours of trade secret law, and held that designs and ideas are protectable as trade secrets. In doing so, it affirmed a $5 million judgment awarded to a small Silicon Valley technology company. See *Altavion, Inc. v. Konica Minolta Systems Laboratory Inc.*, 14 C.D.O.S. 5160 (May 9, 2014).

The *Altavion* case is notable – not only because of its expansion of what qualifies as a protectable trade secret – but also because it allowed recovery for misappropriation of trade secrets that were more general than what the plaintiff had identified prior to discovery or trial.

The Defendant, Konica Minolta Systems Laboratory, Inc. (KMSL), manufactures multifunction printers. The plaintiff, a small company named Altavion, invented a process to create self-authenticating documents by using barcodes with encrypted data about the contents of the original document that enable detection if the document had been altered from the original.

KMSL approached Altavion about embedding its technology in one of KMSL's printer products. After forty meetings over the course of a year to discuss licensing, under the auspices of a non-disclosure agreement and a memorandum of understanding where KMSL promised to recognize Altavion's proprietary technology and keep it confidential, the parties amicably parted ways without coming to an agreement.

A year later, Altavion began to notice KMSL filed for a number of patents encompassing Altavion's unique barcoding technology. Altavion brought suit for trade secret misappropriation in San Mateo County Superior Court.

After a bench trial, the trial court concluded that Konica Minolta had misappropriated trade secrets Altavion disclosed to KMSL during negotiations. The trial court found that KMSL exploited Altavion's technology, including Altavion's unique document barcoding concept as a whole, as well as particular design concepts. The trial court awarded Altavion $1 million in damages, $513,400 in prejudgment interest, and almost $3.3 million in attorneys' fees.

On appeal, KMSL argued that generalized ideas and inventions are protected under the rubric of patent law and thus could not be trade secrets. The Court of Appeal disagreed, noting that nothing in the definition of "information" as set forth in California's version of the Uniform Trade Secret Act, section 3246.1 (d) excludes patentable ideas, and that there is substantial overlap between patents and trade secrets. The Court concluded that "when KMSL secretly filed patent applications disclosing Altavion's ideas, and subsequently obtained patents covering Altavion's ideas, it was a classic violation of trade secret law." The appellate panel reasoned that if a patentable idea is kept secret – instead of being publically filed in a patent application — the idea itself can constitute information that is protected under trade secret law.

Further, the court found that "even if some or all of the elements of Altavion's design were in the public domain and thus unprotectable, the *combination* [of these elements] was a protectable trade secret if it was secret and had independent economic value." Because Altavion maintained its barcode concept as a

secret, and the concept had independent economic value, the concept as a whole was protectable -- without separately examining its individual elements one at a time.

The Court of Appeal also outlined some of the factors it considered in determining whether the barcode had independent economic value, noting that Altavion invested substantial time and effort in developing its concept. On the other side of the ledger, it also noted that KMSL devoted resources to develop its own barcode that would achieve "Altavion'esque" results.

KMSL also argued that even if a concept was a protectable trade secret, Altavion failed to take reasonable efforts to protect the secrecy of the concept because it had publically disclosed the concept of verifying documents using a unique barcode technology. The Court of Appeal rejected this argument, noting that any public discussion of the barcode concept was generalized to how the technology could be applied, and did not divulge the unique design details.

The outcome of the case demonstrates that trade secrets are not limited to specific facts, such as a set of products, a specific formula, a line of code, or an algorithm, but rather concepts and designs to solve problems can also be protected. If adequately shielded from public disclosure, the idea for a technology can be safeguarded from replication and can represent a protectable property interest as a trade secret.

On a final note, the Court of Appeal noted what may be a growing trend in this area: in light of the substantial number of patents that are invalidated by courts, "many businesses now elect to protect commercially valuable information through reliance upon the state law of trade secret protection." If Congress passes a national trade secret law, we can expect that to increase.

A View from Amsterdam: Dutch Supreme Court Says Redeemable Preference Shares Covered by the Dutch Participation Exemption

By Thomas van der Vliet and Job Leusink.

The Dutch Supreme Court recently concluded that Australian Redeemable Preference Shares (RPS) should be regarded as equity for the purposes of the Dutch participation exemption.

Facts

A private limited liability company (BV) incorporated under Dutch law held RPS in an Australian subsidiary. The Australian company in turn held RPS in another Australian company. The consideration paid under the RPS qualifies as a tax deductible interest expense in Australia. In parallel, the received consideration is considered taxable interest income under Australian law. The BV took the position that the RPS qualified as equity for Dutch tax purposes and therefore the connected income received should be exempted from Dutch corporate income tax under the participation exemption.

Some of the key RPS characteristics were as follows:

- The RPS can be redeemed after 10 years (if all conditions under Australian law have been complied with);

- The RPS bears an annual cumulative remuneration (started with eight percent and could increase up to 12 percent);
- The issuance of the RPS can – based on economic terms – be in line with entering into a (subordinated) loan; and
- Under Dutch and Australian accounting principles, the RPS are considered to be debt.

What Did the Dutch Supreme Court Rule?

The lower court decided that RPS' are similar to cumulative preference shares, which are equity under Dutch law and hence the participation exemption should apply. The Dutch Supreme Court based itself initially on the corporate law qualification of the form of the RPS. In case the RPS could be considered debt from a Dutch corporate law point of view, it would have been possible to reclassify such debt to equity for Dutch tax purposes.

Based on its prior case law on comparable matters, the Supreme Court came, however, to the same conclusion as the lower court, *i.e.*, that the RPS classifies as equity. Irrespective of the key RPS conditions as explained above, the Supreme Court ruled that it is not possible for a capital injection that qualifies as equity under Dutch corporate law to be reclassified for Dutch tax purposes into debt. After all, the application of the Dutch participation exemption does not depend on whether or not the relevant consideration paid by the (foreign-based) participation is tax deductible in its home country.

Conclusion

Based on this recent case law, when structured comparably as in the case ruled upon by the Dutch Supreme Court, RPS should be considered as equity under Dutch corporate law and consequently for Dutch tax purposes as well. As a result, the consideration received under the RPS qualifies as a dividend and, if the interest held in the participation is sufficient (over-simplified: an equity interest of at least five percent), it will be exempt under the participation exemption for Dutch corporate income tax purposes. Due to possible classification differences between the Netherlands and the source country (in this case, Australia), this may mean that the RPS consideration is tax deductible in the source country, while the consideration in the Netherlands remains untaxed.

A View from Italy: New Italian Private Corporate Debt Rules—Opportunities for Foreign Investors

By Luigi Santa Maria and Ada Villa.

The Italian government extensively amended the laws governing corporate bonds through **Growth Decrees**[1] and ***Destinazione Italia*** **Decree**[2], with the aim of rendering the corporate bond market an effective source of financing, alternative to traditional bank funding, for non-listed companies, and removing certain unfavorable features of civil and tax law rules, which made the issuance of bonds by non-listed companies impractical.

1. Issuance of Bonds by Non-Listed Companies

As of 2012, Italian corporate bonds have only been issued by large companies. After the legal provisions described above, which apply to non-listed companies other than banks and micro-sized enterprises,[3] entered into force small and medium companies falling within one of the following definitions also are allowed to issue bonds, notes and commercial papers:

(i) *Small-Sized Companies*, employing more than 10 and less than 50 employees and having an annual turnover and/or a total annual balance sheet higher than €2 million and not exceeding €10 million;
(ii) *Medium-Sized Companies*, employing less than 250 employees and having an annual turnover not exceeding €50 million and/or a total annual balance sheet not exceeding €43 million; and
(iii) *Non-Listed Companies other than those referred to under (i) and (ii) above*: including large commercial and industrial non-listed companies, other than small and medium-sized enterprises, based on the aforesaid quantitative criteria.

2. Main News Introduced by the Growth Decrees

Under the 2012 Growth Decrees, Italian joint stock companies can turn to the bond market. The amount of bonds such a company can issue is unlimited if the bonds are convertible into common equity of the issuer or, alternatively, if not convertible, are intended to be listed on either a regulated market or a multilateral trading facilities (**MTFs**) within the EU.

Non-listed companies are now allowed to issue bonds with a profit-sharing clause (including in the form of subordinated participating bonds), provided that payments to the holders of the issued bonds can benefit from the same tax treatment applicable to bonds issued by banks and listed companies, to the extent that such bonds are listed on a regulated market or a MTF of an EU member State or of States part to the Agreement on the European Economic Area and included in the "white list," provided for under Article 168-*bis* of the Italian Income Tax Code (respectively, **Qualified Regulated Market** and **Qualified MTF**).

In addition, the Growth Decrees have removed certain limitations on the deductibility of interest payments with respect to bonds issued by non-listed companies. This benefit applies in so far as the bonds are either listed on a Qualified Regulated Market or a Qualified MTF or where not so listed, are held by qualified investors.[4]

3. Exceptions to the Limits on the Issuance of Bonds

Firstly, the Growth Decree derogated and widened the limits for the issuance of bonds by joint-stock companies set forth under Article 2412 of the Italian Civil Code.[5] Such limits do not apply to non-listed companies when the non-convertible bonds are intended to be listed on either a EU regulated market or a EU MTF, or convertible bonds entitle the holder to purchase or subscribe for the issuer's common

equity. As a consequence, in order to exceed the limits on bond issuances, it is sufficient that the bonds are listed on either an EU regulated market or an EU MTF.

In order to issue corporate bonds, the Italian joint stock companies must satisfy the following conditions. Notes and commercial paper can only be issued up to an aggregate value equal to twice the issuer's share capital together with its legal or available reserves, as indicated in its most recent financial statements; the issuer's most recent financial statements must be approved internally and audited by external auditors; and, in respect of offerings relating to commercial paper only, a sponsor is required.

The above quantitative limits may be exceeded if either of the following requirements is satisfied:

(i) The part of the offering that exceeds the limits is only distributed among qualified investors, provided that if the debt instruments are subsequently passed onto a non-qualified investor, the qualified investor will have to reimburse the principal amount as well as any interest due under the bond when the original issuer defaults;
(ii) Notes are secured by a first ranking mortgage over the issuer's real estate assets for an amount equal to 66 percent of the value of the assets;
(iii) The corporate bonds are listed on regulated markets or any other multilateral trading facility; or
(iv) The corporate bonds are structured so to allow the investors to convert them into equity.

Offerings of notes and commercial paper issued by Italian limited liability companies are subject to the same restrictions set out above for Italian joint stock companies. However these companies can only distribute their debt instruments among qualified investors.

4. Participating Bonds

As described above, the Growth Decree allows non-listed companies to issue bonds and similar securities, such as notes and commercial paper, with a profit sharing clause. Participating bonds bear a floating remuneration related to the issuer's financial results, entitling their holders to directly share a portion of the issuer's net profits. Participating bonds also may include subordination clauses, subordinated participating bonds, and benefit from the same tax treatment described with reference to ordinary bonds issued by non-listed companies. The subordination clause specifies that the issuer's creditors are to be paid in preference to the note holders (with the note holders to be paid only ahead of the shareholders).

The main characteristics of participating bonds are as follows. Their initial maturity shall be equal to, or longer than, three years (36 months) and any profit to be paid on the notes is composed of a fixed as well as a floating part.

Particularly, the floating remuneration representing a portion of the issuer's net profits must be paid to bondholders on an annual basis, within 30 days from approval of the issuer's annual financial statements. Such floating remuneration shall be proportional to the ratio between (X), the aggregate nominal value of issued and outstanding participating bonds and (Y) the amount of the shareholders' equity (share capital, legal reserve, and available reserves) as resulting from the last financial statements approved by the

issuer, plus the aggregate nominal value of issued and outstanding participating bonds. The method of calculating the floating remuneration must be set out upon issuance of the participating bonds and may not be changed until maturity, must depend on objective criteria and cannot derive, even partially, from corporate resolutions adopted at the end of each relevant financial year.

Even if the issuer does have profits, at maturity the bondholder has the right to the full reimbursement of the principal outstanding amount of the participating bonds.

Regardless of the issuer's financial results, bondholders are in any case entitled to receive - on top of the floating remuneration - fixed interest not lower than the official reference interest rate applicable at the time of the payment.

To further foster the distribution of such bonds, the floating remuneration will not be subject to the limits arising from the anti-usury provisions set forth in Law No. 108/1996.

5. Tax Incentives

One of the main objectives pursued by the recent Decrees described above includes the introduction of tax incentives, (both for the bond holders and for the issuers) removing the hurdles that have prevented non-listed companies from issuing bonds and similar securities.

5.1 Deductibility of Interest Payable by Non-Listed Issuing Company Before and After the Growth Decree

Firstly, issuers without stock-market listings are allowed to deduct the cost of servicing the bond debt from their tax bill, provided that the notes are traded on regulated markets or other multilateral trading facilities in Italy or in another white-list country.

The deduction of passive interest paid in connection with bonds issued by companies (other than banks), whose shares were not traded on a Qualified Regulated Market was subject to certain limitations provided by Law No. 549/1995.

Passive interests were deductible by the issuer, for corporate income tax purposes, provided that, at the issue date, the effective yearly return of the debt instruments was not higher than:

(i) twice the official reference interest rate established by the European Central Bank for bonds and similar securities traded on a Qualified Regulated Market, or offered to the public; or
(ii) the official reference interest rate increased by two thirds, for debentures different from those under (i).

Therefore, whenever the effective yearly return exceeded the thresholds under (i) or (ii) above, the portion of passive interest exceeding such thresholds could not be deducted by the issuer for corporate income tax purposes. In light of the current levels of the official reference interest rate, the possibility for such companies to deduct passive interest accrued on the corporate bonds issued by them was significantly impaired.

Article 32 of the Growth Decree abolished such limitations concerning the deduction of passive interest in the hands of corporate issuers, provided that the mini-bonds, to which such interest relates:

(a) have been issued after the entry into force of the Growth Decree *bis* (*i.e.*, 20 October 2012);
(b) are traded on a Qualified Regulated Market or a Qualified MTF; or
(c) in case the requirement under (b) above is not met, are subscribed by and circulate only among qualified investors, as defined by Article 100 of TUF, not holding, either directly or indirectly, even through intermediaries, more than 2 percent of the share capital or equity of the issuer and provided that the beneficiary is resident either in Italy or in a State allowing the exchange of information with the Republic of Italy.

Provided that all the above requirements are met, the interest deduction regime for the issuer falls within the general provisions of Article 96 Italian Income Tax Code, pursuant to which passive interests are deductible within the amounts of active interest accrued and, with reference to the portion exceeding such threshold, up to 30 percent of EBITDA.

5.2 Tax Treatment of Interest in the Hands of Investors

Secondly, the Growth Decree also introduced a provision aimed at making the purchase of mini-bonds more appealing to foreign investors, due to an exemption from taxation in Italy, similar to exemptions that apply to securities issued by banks and listed companies. Any cost relating to the offering can be deducted from the issuer's tax bill in the tax period in which they have been incurred, thus effectively representing a substantial tax credit for issuers.

Particularly, Article 32 extended the substitutive tax regime applicable to bonds issued by banks or companies whose shares are traded on a Qualified Regulated Market to the following securities:

(i) corporate bonds issued by companies whose shares are traded on a Qualified MTF; and
(ii) mini-bonds issued by non-listed companies (other than banks), provided that the mini-bonds themselves are listed in a Qualified Regulated Market or a Qualified MTF.

Based on the foregoing:

(a) interest paid on the aforementioned securities to Italian institutional investors (including banks and insurance companies) does not trigger any withholding tax or substitutive tax and is subject to ordinary income taxation in the hands of the recipient;
(b) non-Italian investors established in "white list countries" may benefit from a full exemption from Italian taxation on interest paid to them, subject to compliance with certain requirements and fulfilments;
(c) in all other cases, interest remains subject to a substitutive tax at a 20 percent rate.

5.3 Deductibility of the Issuance Charges

All costs related to the issue of mini-bonds are deductible by the issuer, for corporate income tax purposes, in the tax return of the fiscal year during which they have been incurred, irrespective of their computation criterion for accounting purposes. Taxes that could potentially apply to a bond offering in Italy and the related security included: registration tax, stamp duty, mortgage tax or taxes relating to the granting of other forms of securities.

5.4 Lower Substitute Tax

The *Destinazione Italia* Decree introduced a new rule whereby issuers may opt for the application of the more favorable regime of the 0.25 percent substitute tax, which will replace any other applicable tax. The 0.25 percent substitute tax shall apply to the aggregate principal amount of the debt offering and extend to the granting of any security, even when they are given by third parties, in connection with the debt offering and on the occurrence of any subsequent change such as the transfer of the bonds or their cancellation.

Issuers must elect the application of the 0.25 percent substitute tax in the corporate resolution authorizing the debt offering. The taxpayer liable for the payment of the substitute tax is the financial intermediary that has arranged the debt offering or the issuer when no financial intermediary participates in the transaction.

5.5 Withholding Tax Exemption

Pursuant to the Growth Decree no withholding tax (currently at 20 percent) shall be paid by professional investors, whether established in Italy or not, on interest and other floating profits paid on notes and commercial paper issued by small and medium sized companies, provided that they are traded on regulated markets or other multilateral trading facilities in Italy or in another white list country.

Thanks to the *Destinazione Italia* Decree, the withholding tax exemption for corporate bonds now also applies to investment funds whose investors are exclusively “qualified investors” under Italian law and whose assets are for the most part invested in corporate bonds. Therefore, no withholding tax shall apply to the payment of interest and other profits made by issuers of corporate bonds, including small and medium sized companies without stock-market listings, for the benefit of such investment funds.

6. Additional Incentives for Italian Corporate Bonds

Offerings of corporate bonds with a maturity longer than 18 months and that are only distributed among qualified investors can now be secured by the super-priority ranking (so-called *privilegio speciale*). Such super-priority ranking previously could only be granted by borrowers to secure their bank loans.[6] Now it applies to assets that the chargor is free to deal with and often comprise a shifting pool which, provided that the registration requirements below are complied with, may be turned over on a regular basis in the ordinary course of the chargor’s business.[7]

The deed creating the *privilegio speciale* will specify the assets that are covered and the general conditions of the bond offering that is secured. To be enforceable against third parties (*e.g.*, creditors of the issuer other than the bond holders), the document must be notarized and registered with the competent office of the court in the district in which the relevant parties are based.

The *Destinazione Italia* Decree introduced provisions allowing for the appointment of a bond holder representative in the aforesaid deed in order to avoid an amendment to the bond holder details, which have to be registered, when the bonds are subsequently transferred onto other investors.

Finally, the *Destinazione Italia* Decree clarified that corporate bonds and other debt instruments issued in the context of securitization transactions shall be eligible in terms of assets (i) that can be used by insurance companies as technical reserves and (ii) are in line with the investment limits set out for pension funds, even when they are not listed on any regulated market or any other multilateral trading facility and have not received an independent rating.

7. Conclusions

The Italian bond market has become a real alternative to bank loans for small and medium companies, due in part to the Italian Stock Exchange, which in 2012 set up a platform, the ExtraMot Pro, allowing institutional and other qualified investors to trade bonds issued by such companies without stock market listings, and to the *Destinazione Italia* Decree, which has completed the legal framework for Italian corporate bonds.

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[1] Law Decree No. 83/2012 (Growth Decree) and Law Decree No. 179/2012 (Growth Decree *bis*), respectively converted into converted into Law No. 134/2012 and Law No. 221/2012.
[2] Law Decree No. 145/2013, converted into Law No. 9/2014.
[3] Micro-sized enterprises have less than 10 employees and a total turnover of less than €2 million.
[4] Pursuant to Article 100 of the Italian Unified Financial Code, qualified investors are not holding, either directly or indirectly, more than 2 percent of the issuer's share capital or equity, and the beneficiary of the payments under the bonds is resident either in Italy or in a "white-list" country. Consob, the Italian supervisory authority, has identified three types of qualified investors: (i) banks, financial institutions, financial investment companies, insurance companies and other regulated entities; (ii) large companies with a balance sheet of at least €20M and a turnover of at least €40M; and (iii) other financial intermediaries such as SPVs formed in the context of securitization transactions.
[5] Article 2412, paragraph 1, of the Italian Civil Code, lays down the maximum aggregate amount of allowed bonds issuances (*i.e.*, twice the sum of the share capital, legal reserves and available reserves); and Article 2412, paragraph 2, of the Italian Civil Code, sets forth the possibility to exceed the above mentioned limit if the bonds are placed with professional investors subject to prudential supervision which remain liable for the issuer's solvency in the case of subsequent re-sale to non-professional investors.
[6] See Section 46 of the Italian Banking Act.
[7] Generally, the super-priority covers the following asset classes: plants and machinery; raw materials, inventory, finished products and commodities; any of the above assets that are acquired with the proceeds of the corporate bonds; and receivables arising out of the sale of the above assets.

A View from London: IPO Update from London

By Andrew Caunt.

Significant momentum in European markets and London

The European IPO market has enjoyed the most successful first quarter in seven years. According to PwC's "IPO Watch Europe Survey Q1 2014," €11.4bn of cash was raised; this exceeded the aggregate Q1 proceeds in the previous four years. There were 32 IPOs in London raising €5.9bn (or 52 percent of the total European IPO proceeds). Five of the top 10 IPOs were on the London Stock Exchange, with the remainder spread between Euronext, NASDAQ OMX Nordic and the Spanish BME. The retail and real estate sectors dominated the quarter, raising in aggregate €5.2bn (45 percent of total European IPO proceeds) and accounted for seven of the top 10 IPOs in the quarter. Five of the top 10 IPOs were private equity backed.

Neither the U.S. nor Hong Kong markets have been able to match the European markets in the first quarter (US: €8.0bn; Hong Kong: €4.3bn).

The London Stock Exchange is divided between the main market and AIM. There were 14 IPOs in the quarter on the main market raising €4.6bn and 18 IPOs on AIM raising €1.3bn. In the year to date, our London office has advised on over 10 percent of all London main market IPOs.

New rules in London to protect minority shareholders

Against the backdrop in 2011 and 2012 of high profile debates about the quality of the listing regime in London, triggered in large part by the bitter shareholder battles at mining companies Bumi and ENRC, the UK regulator (the FCA) introduced new rules to better protect minority shareholders in May of this year. The new rules only apply to those companies on the main market of the London Stock Exchange with a premium listing. These companies already face higher standards of regulation than those with a standard listing. The new rules require companies with a controlling shareholder to have a relationship agreement and set out the minimum standards required. The aim is to ensure that companies can operate independently from the controlling shareholder (essentially someone who, individually or with others, controls 30 percent or more of a company's voting rights). Companies must report in their annual financial report as to whether or not the independence provisions have been complied with. Any breach means that any transaction between the company and the controlling shareholder, regardless of size, must be first approved by the independent shareholders until such time as the company can give a clean independence statement in its annual financial report.

The FCA has also introduced a dual voting structure for the appointment (and re-election) of independent directors for companies with a controlling shareholder. Such appointments will need to be approved not only by the shareholders as a whole, but also by the independent shareholders. Further voting is required if the appointment is not approved by both and the company still wishes to proceed with the appointment.

In the FCA's view, they have come up with a package that will not impose any increased regulatory burden on companies which comply with the expected standards of behaviour, but will have a very significant impact where this is not the case. The Association of British Insurers does not think the rules have gone far enough and would like to see controlling shareholders punished for breaches. They are also concerned about the pressure the new rules put on independent directors.

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