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SECURITIES ENFORCEMENT

Kokesh, *Lucia*, and Their Impact on SEC Enforcement

Two recent Supreme Court decisions addressing disgorgement and administrative law judges have significant negative implications for the SEC's enforcement program. They also foreshadow a Court more willing to place limitations on the SEC's enforcement efforts going forward.

By Jonathan W. Hackbarth and Emily Stedman

In recent years, the United States Supreme Court has dealt two substantial blows to the Securities and Exchange Commission's (SEC) enforcement efforts. In June 2017, the Supreme Court issued a unanimous opinion in *Kokesh v. Securities and Exchange Commission*, holding that the SEC's disgorgement remedy constitutes a "penalty" and is therefore subject to a five-year statute of limitation. Approximately one year later, the Supreme Court issued an opinion in *Lucia v. Securities and Exchange Commission*, holding that the manner in which the SEC appointed its administrative law judges (ALJs) was unconstitutional. Both of these opinions have negative implications for the SEC's enforcement efforts; the former substantially decreased the total damages the SEC can recover for securities law violations and the latter increased the SEC's administrative burden related to certain enforcement actions. Apart from their immediate effects, these opinions, along with recent changes to the Supreme Court, foreshadow a Court more willing to place limitations on the SEC's enforcement efforts moving forward.

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Kokesh v. Securities and Exchange Commission

Background

Initially, the only statutory remedy available to the SEC in an enforcement action was an injunction barring future violations of securities laws.[1] Given this limited and oftentimes inadequate remedy, the SEC began petitioning courts to order parties who were found to have violated the securities laws to disgorge their ill-gotten gains, which courts began ordering in the 1970's.[2] The purpose of ordering disgorgement was twofold: to "deprive . . . defendants of their profits in order to remove any monetary reward for violating" securities laws and to "protect the investing public by providing an effective deterrent to future violations."[3] In 1990, Congress further strengthened the SEC's enforcement remedies by passing the Securities Enforcement Remedies and Penny Stock Reform Act, which authorized the SEC to also seek civil penalties related to the violation of securities laws.[4]

Despite its humble beginnings, the disgorgement remedy has evolved into one of the most imposing tools available to the SEC. Unlike civil penalties which are subject to a five-year statute of limitations, the SEC's ability to collect disgorgement was not subject to a statute of limitations before *Kokesh*. As a result, potential disgorgement-based damages easily could reach epic proportions, which served as a powerful inducement for defendants to settle their disputes with the SEC. To put the magnitude of this remedy into perspective, the SEC obtained roughly *$2.81* billion in disgorgement in fiscal year 2016 (as compared to roughly $1.27 billion in penalties) and roughly *$2.96* billion in disgorgement in fiscal year 2017 (as compared to the roughly $832 million in penalties).[5]

The *Kokesh* Opinion

In 2009, the SEC brought suit against an investment advisor named Charles Kokesh for allegedly using investment-adviser firms he owned to misappropriate approximately $34.9 million from clients between 1995 and 2005.[6] In its lawsuit, the SEC requested disgorgement of the $34.9 million in misappropriated funds, a civil monetary penalty, and an injunction against Mr. Kokesh.[7]

After the SEC prevailed at trial, the district court considered the SEC's request for damages.[8] The Court first held that the SEC's attempt to impose penalties against Mr. Kokesh was subject to the five-year statute of limitations period set forth in 28 U.S.C. § 2462.[9] As a result, the SEC was precluded from obtaining any penalties for misappropriation that occurred prior to October 27, 2004, which was exactly five years prior to the date the SEC filed its complaint.[10] Therefore, Mr. Kokesh was ordered to pay approximately $2.3 million in penalties.[11]

The district court agreed with the SEC that disgorgement was not a "penalty".

However, when it came to disgorgement, the district court was of a different opinion. Specifically, the district court agreed with the SEC that disgorgement was not a "penalty" within the meaning of § 2462.[12] As a result, the SEC's disgorgement remedy was not subject to any limitations period, meaning that, for the purposes of calculating disgorgement, the court could reach back to 1995, which is when the misappropriation allegedly started to occur.[13] The impact of this holding was draconian: it resulted in the imposition of an additional $29.9 million of damages and millions more in prejudgment interest that otherwise would have fallen outside of the five-year statute of limitations.[14] All told, the Court ordered Mr. Kokesh to pay roughly $34.9 million in disgorgement, $18.1 million in prejudgment interest, and a civil penalty of $2.3 million.[15]

The Tenth Circuit subsequently affirmed the district court's holding and the Supreme Court granted certiorari.[16] Writing for a unanimous Court, Justice Sotomayor held that disgorgement imposed as a sanction for violating a federal securities law was a "penalty" within the meaning of § 2642 and therefore subject to a five-year statute of limitations.[17]

The Court based its holding on three findings: First, the Court found that the disgorgement remedy being sought by the SEC was for a violation committed against the United States, not an aggrieved individual.[18] In support of this point, the Court noted that a securities-enforcement action "may proceed even if victims do not support or are not parties to the prosecution."[19] Even the SEC conceded that it was acting "in the public interest, to remedy harm to the public at large, rather than standing in the shoes of particular injured parties."[20] Second, the Court found that disgorgement was imposed for "punitive purposes" and its "primary purpose" was to "deter violations of the securities laws by depriving violators of their ill-gotten gains."[21] Third, the Court found that, in many cases, disgorgement obtained by the SEC was not compensatory.[22] To the contrary, although some funds obtained through disgorgement are paid to victims, other funds are paid to the United States Treasury.[23]

Although the holding in *Kokesh* has far-reaching implications for the SEC's enforcement efforts, a footnote to that opinion ultimately may prove to be even more consequential:

> Nothing in this opinion should be interpreted as an opinion on whether courts possess authority to order disgorgement in SEC enforcement proceedings or on whether courts have properly applied disgorgement principles in this context. The sole question presented in this case is whether disgorgement, as applied in SEC enforcement actions, is subject to § 2462's limitations period.[24]

This footnote, when combined with questions from certain justices during oral argument expressing skepticism as to whether the SEC can obtain disgorgement in federal court, has given rise to questions surrounding the very basis for the SEC's disgorgement remedy. Indeed, since *Kokesh*, this issue is being litigated in lower courts and may come before the Supreme Court in future terms.

Lucia v. Securities and Exchange Commission

Background

The SEC can prosecute enforcement actions via administrative proceedings.[25] Although the Commission may preside over these hearings itself, it more often "delegate[s] that task to an ALJ."[26] Presently, the SEC has five ALJs.[27] Prior to *Lucia*, these ALJs were not appointed directly by the Commission, a "head of department."[28] Instead, the SEC assigned this task to its staff.[29]

ALJs presiding over enforcement actions have "extensive powers," including and not limited to:

> supervising discovery; issuing, revoking, or modifying subpoenas; deciding motions; ruling on the admissibility of evidence; administering oaths; hearing and examining witnesses; generally regulating the course of the proceeding and the conduct of the parties and their counsel; and imposing sanctions for contemptuous conduct or violations of procedural requirements.[30]

These duties make the Commission's ALJs akin to federal trial judges with Article III powers.

After hearing an administrative proceeding, the ALJ issues an initial decision containing findings of fact and conclusions of law.[31] An ALJ's initial decision is subject to *de novo* review by the SEC, which may affirm, reverse, modify, set aside, or remand the decision.[32] This review by the Commission is discretionary.[33] The respondent may request review, the SEC might review the case *sua sponte*, or it might deny review and issue an order making the ALJ's findings the final decision.[34] The respondent's next recourse is an appeal to the appropriate United States Court of Appeals.[35]

In 2012, the SEC initiated an enforcement action against Raymond Lucia, bringing fraud charges under the Investment Advisers Act.[36] The SEC alleged that "Lucia used misleading slideshow presentations to deceive prospective clients."[37] Judge Elliot presided over the nine-day administrative proceeding and ultimately found that Lucia violated securities laws.[38] The ALJ imposed hefty sanctions on Lucia: (1) a monetary fine of $300,000; and (2) a lifetime ban from the investment industry.[39]

Lucia appealed to the Commission, seeking to invalidate the ALJ's decision by arguing that Judge Elliot was an "Officer of the United States," subject to the Appointments Clause, and therefore lacking the constitutional authority to hear this matter because Judge Elliot was not constitutionally appointed.[40] The SEC overruled the argument and affirmed the ALJ's decision, holding that the SEC's ALJs lacked sufficient independence to qualify as "officers of the United States" and instead served as "mere employees" not subject to the Constitution's Appointments Clause.[41] The D.C. Circuit Court of Appeals affirmed, but Lucia requested review *en banc*.[42] The ten-member *en banc* court split evenly on the issue, resulting in a *per curiam* opinion, upholding the lower courts' decision.[43] The Supreme Court granted certiorari.[44]

The *Lucia* Opinion

Justice Kagan, writing for the majority—joined by Chief Justice Roberts, and Justices Kennedy, Thomas, Alito, and Gorsuch—set out to decide one issue: Are the Commission's ALJs "officers of the United States" subject to the Appointments Clause, or are the ALJs merely employees of the United States Government?[45] Relying on existing precedent, the Court answered: SEC ALJs are officers of the United States subject to the Appointments Clause, and because Judge Elliot was not appointed by a

head of department, here the SEC, Lucia is entitled to a new hearing before a constitutionally appointed ALJ (that cannot be Judge Elliot).[46]

Two previous cases laid the foundation for the Court's decision: *United States v. Germaine*[47] and *Buckley v. Valeo.*[48] In *Germaine*, the Supreme Court decided that "civil surgeons" did not hold "continuing position[s] established by law," but instead performed "occasional or temporary" duties.[49] Thus, "civil surgeons" are employees of the United States and not officers. *Buckley* addressed "members of a federal commission" who "exercised significant authority pursuant to the laws of the United States," and therefore are officers subject to the Appointments Clause.[50]

Relying on these foundational holdings, the Court then turned to a third prior decision: *Freytag v. Commissioner.*[51] In *Freytag*, taxpayers challenged the authority of the United States Tax Court's Special Trial Judges (STJs).[52] STJs "take testimony, conduct trials, rule on the admissibility of evidence, and have the power to enforce compliance with discovery orders," all while "exerc[ing] significant discretion."[53] STJs also hold "a continuing office established by law."[54] The significant discretion, the ongoing nature of their positions, and the establishment of STJs under the law collectively make STJs officers of the United States, subject to the Appointments Clause.[55]

The *Lucia* majority analogized STJs to the SEC's ALJs and found that *Freytag* controls.[56] Like STJs, ALJs hold continuing offices established by law, the positions are continuing (SEC ALJs hold career appointments), ALJs have significant discretion, and with "nearly all the tools of federal trial judges," ALJs have substantial authority to ensure the fair and orderly disposition of the administrative proceedings.[57] Specifically, ALJs take testimony, receive evidence, examine witnesses, conduct trials, administer oaths, rule on motions, regulate hearings and the conduct of the parties, rule on the admissibility of evidence, shape the administrative record, enforce orders, punish conduct, and issue decisions that can become final.[58] Although the *Lucia* Court left open the question of which of these duties "is necessary for someone conducting adversarial hearings to count as an officer," the totality of these duties mandate that the Commission's ALJs be constitutionally appointed as officers of the United States pursuant to the Appointments Clause.[59]

Judge Elliot, an officer of the United States but appointed by the Commission's staff, did not have the authority to hear Lucia's administrative proceeding.[60] The Supreme Court remanded the case for new administrative hearing before a constitutionally appointed ALJ.[61] That ALJ, however, cannot be Judge Elliot.[62] Instead, the Court held, "another ALJ" must hear the matter, because Judge Elliot "cannot be expected to consider the matter as though he had not adjudicated it before."[63]

Implications of and Developments since *Kokesh* and *Lucia*

Apart from their financial and administrative implications for the SEC's enforcement efforts, *Kokesh* and *Lucia* display a Supreme Court willing to place limitations on the SEC's enforcement efforts. They also leave open the possibility that the Supreme Court will place additional limitations on the SEC's enforcement efforts in the future; a possibility made all the more likely by Justice Kavanaugh's recent appointment to the Supreme Court. Indeed, before joining the Supreme Court, Judge Kavanaugh, then a Circuit Judge, had demonstrated a willingness to limit the SEC's enforcement efforts. In *Saad v. Securities and Exchange Commission*, Judge Kavanaugh filed a concurrence arguably in favor of expanding *Kokesh's* application in which he noted that pursuant to *Kokesh*, the expulsion or suspension of a securities broker is also a "penalty" and therefore, presumably, subject to a five-year statute of limitations.[64]

The Supreme Court's opinion in *Kokesh* has had, and will continue to have, a profound impact for the SEC's enforcement efforts. Speaking earlier this year to Congress, Steve Peikin, the co-director of the SEC's Enforcement Division, acknowledged that as a result of *Kokesh*, the SEC has been unable to recover

approximately $800 million in disgorgement of ill-gotten gains since the issuance of that opinion.[65]

Although this lost recovery is substantial, the impact of *Kokesh* goes far beyond dollars and cents. Now that disgorgement damages are subject to § 2462's five-year statute of limitations, fewer parties will be faced with exceedingly large disgorgement demands and corresponding prejudgment interest. The removal of this threat undoubtedly will embolden parties alleged to have violated securities laws to test their luck at trial as opposed to settling with the SEC, which will further burden the SEC's enforcement resources.

But the biggest potential implication from *Kokesh* can be found in the third footnote to that opinion where the Supreme Court left open the question of whether the SEC may obtain disgorgement in federal court.[66] Indeed, litigants already have begun challenging the SEC's disgorgement authority.[67] This issue is likely to make its way to the Supreme Court in the future, where it will be ruled on by nine justices, some of whom have expressed skepticism concerning the SEC's ability to obtain disgorgement and most of whom already have approved of limiting the SEC's disgorgement remedy.

On the other hand, Lucia's most immediate impact can be seen in action that the SEC has taken to insulate itself from challenges to its administrative proceedings. On November 30, 2017, the SEC "ratified" its staff's prior appointments of its existing ALJs. The SEC explicitly stated this was its attempt to "resolv[e] any concerns that administrative proceedings presided over by its ALJs violate the Appointments Clause."[68] In *Lucia*, the Supreme Court saw "no reason to address" this ratification, noting, "[t]he Commission has not suggested that it intends to assign Lucia's case on remand to an ALJ whose "authority rests on the ratification order."[69]

Post-*Lucia*, the SEC issued another order noting, in pertinent part, that respondents in approximately 130 enforcement actions would be given the opportunity for a rehearing by an ALJ who previously had not heard their case, and reiterating its prior approval of the ALJs' appointments as the SEC's own under the Constitution.[70] Apart from any *Lucia*-based challenges to the SEC's administrative proceedings that may be forthcoming, this order has the potential to place a substantial burden on the SEC's enforcement resources in the coming years.

Advice to Practitioners

When faced with a SEC enforcement action or administrative proceeding, practitioners may be able to use *Kokesh* and *Lucia* to their client's advantage. As it relates to *Kokesh*, practitioners should first and foremost make sure that any demand for disgorgement is limited strictly to the five-year statute of limitation. Practitioners also should review the basis for the SEC's demand for disgorgement and consider challenging that demand. If, for example, the disgorgement being sought by the SEC cannot or will not be returned to alleged victims of a securities law violation, that type of disgorgement demand (and possibly, more broadly, courts' authority to order disgorgement in SEC enforcement proceedings) may be subject to increased judicial scrutiny. Apart from disgorgement, practitioners also should consider arguing for the application of the five-year statute of limitation at issue in *Kokesh* to other forms of relief being sought by the SEC. Applying *Kokesh* to, for example, industry suspensions or expulsions would be a natural extension of that opinion and appears to be favored by the Supreme Court's newest justice.

When it comes to *Lucia*, practitioners facing an administrative proceeding should consider whether to raise challenges to actions taken by a "ratified" ALJ. This includes raising challenges to the appointment of and judicial actions taken by the presiding ALJ that explicitly were referenced in *Lucia* or, more broadly, resemble actions taken pursuant to the authority vested in an Article III judge. Likewise, if the decision is made to raise these challenges, practitioners should work to preserve diligently these challenges at every step of the process. Because the timing required to challenge an ALJ remains unclear, a failure to raise these challenges

throughout the administrative proceeding, and on appeal, has the possibility to result in a party waiving that defense.

Notes

1. *Kokesh v. Securities and Exchange Commission*, —U.S.—, 137 S. Ct. 1635, 1640 (2017)
2. *Id.*
3. *Id.* (citation and quotation marks omitted).
4. *Id.*
5. "Annual Report: A Look Back at Fiscal Year 2017," SEC Div. of Enforcement, *available at https://www.sec.gov/files/enforcement-annual-report-2017.pdf.*
6. *Kokesh*, 137 S. Ct. at 1641.
7. *Id.*
8. *Id.*
9. *Id.*
10. *Id.*
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.* at 1643.
18. *Id.*
19. *Id.*
20. *Id.*
21. *Id.* (citation and quotation marks omitted).
22. *Id.* At 1644.
23. *Id.*
24. *Id.* at 1642, n.3.
25. *Lucia v. Securities and Exchange Commission*, —U.S.—, 138 S. Ct. 2044, 2049 (2018)
26. *Id.*
27. *Id.*
28. *Id.*
29. *Id.*
30. *Id.* (quotation marks, alterations and citations omitted).
31. *Id.*
32. *Id.*
33. *Id.*
34. *Id.*
35. *Id.* at 2050.
36. *Id.* At 2049.
37. *Id.*
38. *Id.* at 2050.
39. *Id.*
40. *Id.*
41. *Id.*
42. *Id.*
43. *Id.*
44. *Id.* at 2050-51.
45. *Id.* at 2051.
46. *Id.* at 2053-55.
47. 99 U.S. 508 (1879).
48. 424 U.S. 1 (1976).
49. *Germaine*, 99 U.S. at 511-12.
50. *Buckley*, 414 U.S. at 126.
51. 501 U.S. 868 (1991).
52. *Lucia*, 138 S. Ct. at 2052.
53. *Id.*
54. *Id.*
55. *Id.*
56. *Id.* at 2053.
57. *Id.*
58. *Id.*
59. *Id.* at 2054.
60. *Id.* at 2055.
61. *Id.*
62. *Id.*
63. *Id.*
64. 873 F.3d 297, 305 (D.C. Cir. 2017).
65. Oversight of the SEC's Division of Enforcement: Hearing Before the House Financial Services Comm. 115 Cong. 91 (2018), *available at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=403383.*
66. *Kokesh*, 137 S. Ct. at 1642, n.3.
67. *See, e.g.*, *Jalbert v. SEC*, 327 F. Supp. 3d 287, 294 (D. Mass. 2018) and *SEC v. Arcturus Corp.*, No. 3:13-CV-4861-K, 2018 WL 1701998, at *2 (N.D. Tex. Jan. 10, 2018).
68. Press Release, "SEC Ratifies Appointment of Administrative Law Judges, Nov. 30, 2017, *https://www.sec.gov/news/press-release/2017-215.*
69. *Lucia*, 138 S. Ct. at 2055, n.6.
70. *In re Pending Administrative Proceedings*, SEC Order (Aug. 22, 2018), *available at https://www.sec.gov/litigation/opinions/2018/33-10536.pdf.*

MERGERS AND ACQUISITIONS

Delaware Court Finds Material Adverse Effect Allowing Buyer to Terminate Merger Agreement

The Delaware Court of Chancery's opinion in Akorn, Inc. v. Fresenius Kabi AG *constitutes what is believed to be the first decision of a Delaware court permitting a buyer to terminate a merger agreement due to the occurrence of a material adverse effect. While the headline holding is significant in and of itself, the Court's analysis is ground in existing Delaware precedent and it must be viewed in light of the extensive factual record Corporations and practitioners are cautioned, however, that the decision has been appealed to the Delaware Supreme Court.*

By John Mark Zeberkiewicz and Robert Greco

In *Akorn, Inc. v. Fresenius Kabi AG*,[1] the Delaware Court of Chancery issued what is believed to be the first decision of a Delaware court permitting a buyer to terminate a merger agreement due to the occurrence of a material adverse effect. The opinion is significant not only for its headline holding, but also for the substantial gloss it provides on the interpretation and construction of many other provisions customarily found in M&A agreements. Corporations and practitioners are cautioned, however, that the Court's decision has been appealed to the Delaware Supreme Court and that the matters addressed in the opinion are accordingly subject to further development.

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Background

In February 2016, Akorn's board decided to commence a review of strategic alternatives.[2] After being contacted by Akorn's financial advisor, Fresenius began to evaluate the potential opportunity to acquire Akorn.[3] At that time, Fresenius noted the potential advantages, including Akorn's product portfolio and pipeline of Abbreviated New Drug Applications (ANDAs), as well as the potential risks, including certain regulatory issues with respect to its ephedrine new drug application.[4]

As the parties engaged in negotiations, Akorn granted Fresenius access to its data room, and Fresenius commenced its due diligence.[5] While the diligence process was underway, Akorn announced positive earnings results and that it had received FDA approval for a new ephedrine product. Fresenius continued its diligence, identifying a few issues in the regulatory area, but concluding there were no "'deal breakers.'"[6]

After completing due diligence and engaging in further negotiations, Fresenius entered into a merger agreement with Akorn pursuant to which Fresenius would acquire Akorn for a total of $4.75 billion, consisting of $4.3 billion in cash and the assumption of roughly $450 million in debt. Given the regulatory environment in which Akorn operates, including the strict requirements of its primary regulator, the FDA, Fresenius negotiated for extensive representations and warranties from Akorn regarding its compliance with FDA regulations, including "compliance with . . . all applicable Laws" (defined broadly) and compliance with good manufacturing processes, as well as representations and warranties to the effect that Akorn had not made untrue or fraudulent statements to the FDA and that all of its ANDAs were true, complete and correct—all subject

to a general "Material Adverse Effect" qualifier.[7] In addition, during the interim period between signing and closing, Akorn agreed to use its commercially reasonable efforts to carry out its business in the ordinary course in all material respects and to grant Fresenius and its representatives "reasonable access" to information regarding Akorn and its business.[8]

Akorn agreed to use its commercially reasonable efforts to carry out its business in the ordinary course in all material respects.

The merger was subject to various closing conditions and included specified termination triggers.[9] First, Fresenius was not required to consummate the merger unless Akorn's representations were true and correct at signing and closing, except where the failure to be true and correct would not reasonably be expected to have a Material Adverse Effect. If this condition was not satisfied (and was incurable) by the outside date (which was initially set at April 24, 2018, but would extend automatically to July 24, 2018, if antitrust approval was the only condition remaining at the initial outside date),[10] Fresenius would be entitled to terminate the merger agreement, so long as it was not then in material breach of its own obligations. Second, Fresenius was not required to close if Akorn failed to comply in all material respects with its contractual covenants, which included the covenant to operate in the ordinary course during the interim period. If this condition was not met (and was incurable) by the outside date, Fresenius would be entitled to terminate the merger agreement—again, provided it was not in breach of its own obligations. Finally, Fresenius was not required to close if Akorn suffered a Material Adverse Effect. Although the occurrence of a Material Adverse Effect did not provide Fresenius an independent right to terminate the merger agreement, it did allow either party to terminate the merger agreement after the outside date, so long as the terminating party's breach of the merger agreement had not been a principal cause of the failure to close the merger.[11]

Soon after the agreement was reached, Akorn's business performance declined dramatically.[12] Shortly after the stockholder vote to adopt the merger agreement, Akorn previewed its 2017 second-quarter earnings, announcing relatively steep declines in revenues compared to the business plan, and attributing a portion of the decline to competition in the ephedrine space. At the same time, Akorn lowered its revenue forecast for the year.[13] In its public announcement of its second-quarter results, Akorn announced a 29 percent decline in revenues over the prior year, an 84 percent decline in its operating earnings from the prior year, and a 96 percent decline in year-over-year earnings per share.[14] Akorn attributed the declines largely to increased market competition, including new entrants in the ephedrine space.

As Fresenius began considering its legal options, Akorn's downward trend continued. The 2017 third-quarter results looked similar to those of the second quarter, with year-over-year earnings and operating income declining by 29 percent and 89 percent, respectively, and a reported loss of $0.02 per share.[15] Akorn also missed targets on its product launches, and the products that it did launch yielded sales below expectations.[16] Despite its internal review of its legal options, Fresenius nonetheless "maintained a positive outlook" regarding the merger in communications with its investors and declined to revise its expectations for Akorn's performance, explaining that Akorn's relatively poor performance could be attributed to additional competition, disruptions in supply and delays in product launches.[17]

On October 5, 2017, an anonymous whistleblower sent Fresenius a letter containing allegations regarding Akorn's product development processes.[18] Approximately one month later, Fresenius received a longer letter that included more detailed allegations about flaws in Akorn's quality control processes. Fresenius's senior executives then met to address the

complaints.[19] By that time, the Court concluded that Fresenius "did not want to proceed" with the Akorn acquisition, having "regarded Akorn's disastrous performance as falling within a businessperson's understanding of what should qualify as a material adverse effect."[20] Although their legal advisors were not as confident that Fresenius would be able to satisfy the high threshold for proving the occurrence of a material adverse effect under Delaware law, the whistleblower letters provided Fresenius a basis to investigate Akorn's compliance with its representations and warranties. Fresenius notified Akorn of the whistleblower letters and, relying on its contractual inspection rights, stated that it was seeking documents and information, as well as access to knowledgeable parties, regarding the allegations in the whistleblower letters.

Akorn shared the whistleblower letters with its board. One of its directors with FDA experience described them as "'very worrisome'" and indicated that an extensive investigation likely would ensue if they were to reach the FDA.[21] Akorn engaged its deal counsel to assist with an internal investigation designed principally to facilitate Fresenius's investigation.[22] Fresenius, by contrast, retained a firm with experience in FDA enforcement and compliance.[23] Fresenius's attorneys reviewed the materials in Akorn's data room in connection with their investigation. While these materials were subject to a confidentiality agreement between Akorn and Fresenius, Fresenius's counsel determined that they were entitled to receive such information as "Representatives" of Fresenius and that their use of the confidential information for this purpose was permitted because the investigation constituted part of "executing" the transaction.[24]

Fresenius's investigation identified "serious data integrity concerns."[25] The investigations yielded facts indicating, among other things, issues regarding the integrity of certain information submitted to the FDA as well as issues regarding the manner in which data were logged and stored.[26] During this period, Akorn's revenues, operating income and earnings continued to decline. After presenting its supervisory board with a presentation regarding Akorn's declining performance and the expected costs of remediating the regulatory issues, Fresenius notified Akorn of its view that Akorn had breached its representations and warranties regarding regulatory compliance and offered to extend the outside date. After Akorn declined the offer, Fresenius terminated the agreement two days before the outside date, citing Akorn's breach of its representations and warranties, including those related to its regulatory compliance, and Akorn's failure to comply with its covenants, including its covenant to use "commercially reasonable efforts to carry on its business in all material respects in the ordinary course of business."[27] Fresenius further asserted that Akorn had experienced a Material Adverse Effect, which would ripen into a termination right once the outside date occurred.

Akorn filed suit the next day, seeking specific performance of Fresenius's obligation to close the agreement. While the litigation was underway, Akorn's financial performance continued its downward trend, and additional facts regarding its data integrity deficiencies continued to emerge.[28]

Legal Analysis

The Court's analysis focused on three key issues: (1) whether Akorn's representations and warranties were true and correct at signing and closing except as would not reasonably be expected to have a Material Adverse Effect; (2) whether Akorn complied in all material respects with its covenants; and (3) whether Akorn experienced a Material Adverse Effect.[29] The analysis of those issues, the Court noted, would dictate whether Akorn was entitled to specifically enforce the merger agreement, or whether Fresenius had validly terminated the merger agreement and could refuse to close.[30]

General Construction of Material Adverse Effect Provisions

The Court upheld the validity of Fresenius's termination of the merger agreement and its refusal

to close on several bases. First, the Court addressed whether Akorn had experienced a Material Adverse Effect. In connection with its analysis, the Court observed that, as a general matter, material adverse effect provisions address four categories of risk, consisting of: (1) systematic risks, generally described as those outside of the control of all parties and affecting firms beyond the parties; (2) indicator risks, which are those that may signal the occurrence of a material adverse effect, such as a drop in stock price, but are not material adverse effects in and of themselves; (3) agreement risks, which generally are described as those relating to the announcement of the merger and the performance of obligations relating thereto; and (4) business risks, which generally are described as those relating to the party's operation of its business and as to which it has control.[31] The Court then stated that, in general, "the seller retains the business risk," while "[t]he buyer assumes the other risks."[32]

Hewing closely to the Delaware precedent on material adverse effect provisions, the Court noted that "'[a] buyer faces a heavy burden when it attempts to invoke a material adverse effect clause to avoid its obligation to close.'"[33] As the Court observed, "short-term hiccups" will not constitute a material adverse effect.[34] Rather, given that reasonable acquirors are expected to have a long-term strategy, the effect must have an adverse effect over a significant duration—one "measured in years rather than months."[35] Applying these basic principles, the Court proceeded to find that Akorn's financial performance, measured by its revenues, operating income and earnings per share, dropped precipitously, commencing with the second quarter of 2017 and continuing through the first quarter of 2018.[36] The Court also found that over a five-year span commencing in 2012, Akorn's performance had grown under a variety of financial metrics, but witnessed a steep decline by those metrics commencing in 2017.[37]

Akorn argued that the declines should not be measured against Akorn as a standalone entity but should instead be evaluated in light of Akorn's value to Fresenius, taking into account any deal synergies. The Court declined the invitation to do so, finding no support for the position in the plain language of the merger agreement, which, the Court noted, would have made reference to an effect on the surviving corporation if the parties had intended to adopt such an approach.[38] The Court also rejected Akorn's argument that no Material Adverse Effect could be found to have occurred if Fresenius could still profit from the transaction, noting that this position would require the introduction of a new contractual standard not apparent from the language of the merger agreement. The Court next analyzed whether any of the carve-outs included in the definition of Material Adverse Effect applied. The Court found that, despite Akorn's arguments seeking to attribute its decline to "industry headwinds," Akorn's "dismal performance" was in fact attributable to issues unique to it, including new market entrants gaining a larger market share in Akorn's top products as well as Akorn's loss of a key contract.[39] In other words, even if the effects were industry-wide, they disproportionately affected Akorn.[40]

In analyzing whether a Material Adverse Effect had occurred, the Court rejected Akorn's argument that Fresenius was not entitled to rely on risks as to which it was on notice following its due diligence review or other risks as to which it was on notice due to industry knowledge.[41] In rejecting the argument, the Court reaffirmed Delaware's strong public policy in favor of freedom of contract, noting that the parties "could have . . . excluded 'certain specific matters that [the seller] believes will, or are likely to, occur during the anticipated pendency of the agreement,' or matters disclosed during due diligence, or even risks identified in public filings," or "could have defined [Material Adverse Effect] as including only unforeseeable effects, changes, events, or occurrences."[42] The Court nevertheless found that even if material adverse effect clauses were construed generally to guard only against unknown risks, Fresenius did not know of the events leading to Akorn's "collapse."[43]

Ultimately, the Court found that Fresenius carried the "heavy burden" to show that Akorn had

experienced a Material Adverse Effect due to a durationally significant decline in performance arising from unforeseen company-specific problems. Although the merger agreement did not provide Fresenius with a separate right to terminate the agreement upon a general Material Adverse Effect, it did entitle Fresenius to refuse to close the merger on that basis.

Breach of Representations and Warranties

The Court then addressed whether Akorn had breached its representations and warranties relating to regulatory compliance.[44] The Court noted that Fresenius would be required to show that the deviation between Akorn's actual condition with regard to regulatory compliance would have to deviate from its condition on that front as represented in the merger agreement such that it "would *reasonably be expected* to result in a Material Adverse Effect."[45] Construing the provision, the Court noted that the "reasonably be expected to" qualifier sets forth an objective standard that allows for future occurrences to have a material adverse effect, such that a Material Adverse Effect could occur without the concomitant effects then being experienced. The Court noted that "mere risks" would not suffice to establish a Material Adverse Effect; rather, the party asserting the Material Adverse Effect must establish a basis in law and fact for the severe consequences being forecast.[46] To this end, the Court must address the question from a qualitative and a quantitative lens.[47] On the qualitative front, the Court found overwhelming evidence of pervasive regulatory noncompliance issues at Akorn and indicated that the problems worsened post-signing.[48] On the quantitative front, the Court determined that Akorn's regulatory compliance issues—expected to take at least three to four years to remedy—were durationally significant and gave rise to estimated remediation costs of approximately 20 percent of Akorn's standalone value.[49] With regard to these metrics, the Court found that Akorn had breached its representations and warranties and that the breach would reasonably be expected to have a Material Adverse Effect. As the Court found that Akorn's breaches were not susceptible to cure, it held that Fresenius was entitled to terminate for the reasons it asserted.

Breach of Ordinary Course Covenant

Finally, the Court found that Akorn, in failing to take appropriate action in response to the regulatory compliance issues detailed in the opinion, failed (incurably) to satisfy its interim covenant to use "commercially reasonable efforts to carry on its business in all material respects in the ordinary course of business,"[50] thereby giving Fresenius additional grounds to terminate the merger agreement.[51] At the outset, the Court settled the debate over the construction of the "in all material respects" qualifier, finding that it is less onerous than the common law doctrine of material breach (where a breach is material if it goes to the essence of the parties agreement or touches upon its fundamental purpose), but is one that builds upon the principles of materiality in the disclosure context (where the phrase requires a showing that the fact of breach would be viewed by a reasonable investor as altering the total mix of information). Thus, the Court construed the phrase as limiting the operation of the covenant, as so qualified, to issues "that are significant in the context of the parties' contract, even if the breaches are not severe enough to excuse a counterparty's performance under a common law analysis."[52]

The Court then addressed the construction of the "commercially reasonable efforts" qualifier in the ordinary course covenant. The Court noted that "practitioners have a general sense of a hierarchy of efforts clauses"—starting with "best efforts" as setting forth the most rigorous standard and cascading downward through "reasonable best efforts," "commercially reasonable efforts" and "good faith efforts."[53] The Court, however, found little support in the case law for the fine distinctions among the standards. In fact, the Court noted that the Delaware Supreme Court, in *Williams Cos. v. Energy Transfer Equity, L.P.*,[54] had interpreted the terms "commercially reasonable efforts" and "reasonable best efforts" as effectively imposing requirements to "take

all reasonable steps," and did not make a distinction between the two formulations.[55] Even "best efforts," the Court noted, would be construed under existing precedent to incorporate a reasonableness component.[56]

Concluding that Akorn's obligation to use commercially reasonable best efforts implied an obligation "to 'take all reasonable steps' to maintain its operations in the ordinary course of business," the Court found that Akorn had fallen short in multiple respects.[57] The Court found that after entering into the merger agreement, Akorn took various actions that would be outside the course of business for a company operating in the generic pharmaceutical space, including cancelling regular audits in favor of less rigorous "verification audits," and cancelling inspections from outside consultants that had been scheduled to occur before the execution of the merger agreement. Moreover, the Court found that Akorn did not maintain the type of data integrity system that a company operating in the generic pharmaceutical company is obligated to maintain, nor did it devote adequate resources to data integrity or adequately address data integrity issues as they arose.[58]

The Court further found that Akorn's submission of "fabricated data" to the FDA was outside the ordinary course of business.[59] The Court also found that Akorn's failure to conduct what it referred to as a "'responsive and credible'" investigation in response to the whistleblower letters likewise was a departure from ordinary course operations.[60] These failings, according to the Court, were "material" in that, among other things, no reasonable acquirer would have agreed to acquire Akorn if it understood that Akorn would cease to conduct regular audits or cease to engage in ordinary quality control and data integrity activities.[61] Taking into account that Akorn was in the early stages of remediation efforts on its data integrity and other issues, the Court found the breaches of the ordinary course covenant were not curable by the outside date.

The Court's finding that Akorn had breached the ordinary course covenant, however, did not end the inquiry into whether Fresenius had validly terminated on that basis. As noted above, Fresenius could only terminate on that basis if it was not then in material breach of its own obligations. To that end, Akorn argued that Fresenius had breached its obligation to seek antitrust approval.[62] The Court observed that Fresenius was subject to a "flat obligation to take 'all actions necessary' to secure antitrust approval," but also noted that this covenant was "[s]omewhat in tension" with the other provisions of the merger agreement vesting Fresenius with "sole control over the strategy for securing antitrust approval."[63] The parties did not dispute whether Fresenius, in the six months following the execution of the merger agreement, diligently sought antitrust approval.[64] But, the Court found, in February 2017, while Akorn's performance was in its continued decline and the investigations were yielding troubling facts, "Fresenius contemplated a path that could have constituted a material breach of the Hell-or-High-Water Covenant had Fresenius continued to pursue it."[65] Indeed, the Court found that Fresenius had sought a course that would have constituted a technical breach of its obligations; however, Fresenius changed course in approximately one week and effectively cured its non-compliance, leading the Court to conclude that the breach was not material. Accordingly, as Fresenius had not materially breached its contractual covenants, it was not precluded from exercising its termination right triggered upon Akorn's breach of the ordinary course covenant.

Observations and Practical Implications

Material Adverse Effect Provisions

No per se rule, but. The *Akorn* Court was careful to caution against the inference that it was making any *per se* rule, and warned readers not to "fixate on a particular percentage as establishing a bright-line test" or construe its "decision as suggesting that there is one set of percentages for revenue and profitability metrics and another for liabilities."[66] Nevertheless, the opinion indicates that events giving rise to a 20

percent decrease in a target's value, when considered with other factors, could constitute a material adverse effect.

Allocation of known or knowable risks. The Court indicated that, in most cases, a seller will not be able to overcome the finding that a material adverse effect had occurred on the basis that the buyer, through its due diligence efforts or its industry knowledge, should have known about the risks. As noted above, the Court indicated that parties may allocate these risks by contract. Thus, sellers seeking to prevent buyers from claiming a material adverse effect on the basis of known or reasonably knowable risks should seek to include express provisions preventing the invocation of a material adverse effect provision under those circumstances (just as buyers should resist the inclusion of such carve-outs).

Factors that are reasonably expected to result in a material adverse effect. Practitioners should take care to observe the distinction throughout any acquisition agreement between actions or factors causing a material adverse effect, on the one hand, and actions or factors that could "reasonably be expected to" cause a material adverse effect, on the other. As noted above, while the Court in *Akorn* made clear that the latter formulation is not satisfied through the "mere risk" of a material adverse effect, it did note that the formulation would allow for "'future occurrences [to] qualify as [a] material adverse effect'" such that a material adverse effect "'can have occurred without the effect on the target's business being felt yet.'"[67]

Carve-outs and carve-outs to carve-outs. The *Akorn* Court established a general framework for material adverse effect provisions, identifying four categories of risks, consisting of systematic risks, indicator risks, agreement risks and company-specific risks, and finding that, in general, the seller will retain only the company-specific risks. Buyers and sellers should take care in drafting the carve-outs to the material adverse effect provisions (and the exceptions to the carve-outs) to ensure that, in cases where they are deviating from this general framework, they are doing so deliberately and with an eye toward the manner in which the risks of specific facts, circumstances or events will operate.

Representations and Warranties

Materiality qualifiers. As noted above, the *Akorn* Court observed that representations couched with a material adverse effect qualifier are more forgiving (from the standpoint of the seller) than those requiring that the representation be true in "all material respects." That is, a representation, warranty or covenant subject to a material adverse effect qualifier will not be breached unless it gives rise to material and durationally significant qualitative and quantitative damage to the seller. By contrast, the "all material respects" qualifier in a representation, warranty or covenant operates in a manner similar to the test used to determine materiality under disclosure law and looks to whether a reasonable buyer would have considered the issue significant in the context of the parties' agreement.

A note on sandbagging. Without directly addressing the issue, the *Akorn* Court articulated a number of policy arguments that could be read to support the position that Delaware law is "pro-sandbagging."[68] The Court's statements should be viewed, however, in light of the Delaware Supreme Court's recent decision in *Eagle Force Holdings, LLC v. Campbell*, in which it declined to affirmatively decide the issue, but questioned the view that Delaware was pro-sandbagging.[69]

Covenants

The hierarchy of efforts standards. The Court found scant support in the case law for the careful hierarchy and fine distinctions among various efforts standards. Transaction parties should be aware that drafting disputes over "reasonable best efforts" and "commercially reasonable efforts" may have little practical effect—and transaction parties should be aware that even though they are required to use commercially reasonable efforts (rather than reasonable best efforts), they likely will be expected to "take all reasonable steps"[70] to perform the applicable obligation.

Hell-or-high-water covenants. The *Akorn* Court found that Fresenius had breached the merger agreement's "hell-or-high-water" covenant (albeit immaterially) in seeking antitrust approval of the merger, but its analysis on this issue was colored by the fact that the merger agreement vested Fresenius with the right to control the strategy for obtaining antitrust approval. To avoid potential dilution of the strength of a hell-or-high-water provision, sellers negotiating for such provisions should seek to obtain some level of input on antitrust strategy or limit the buyer's discretion to formulate antitrust strategy in a way that could delay antitrust approval.

Access to Information

Inspection rights. As the regulatory issues underlying Fresenius's termination rights were largely uncovered through its own independent investigation, the *Akorn* opinion underscores the importance of the buyer's contractual information rights. Buyers should strive to secure the type of information rights secured by Fresenius, which gave Fresenius reasonable access to Akorn's "officers, employees, agents, properties, books, [c]ontracts, and records.'"[71]

Confidentiality agreements. The *Akorn* Court found that outside counsel engaged by Fresenius to investigate Akorn's alleged regulatory violations was entitled to use the information originally furnished to Fresenius in connection with its due diligence. Although the confidentiality agreement between the two parties provided that such information "could be used 'solely for the purpose of evaluating, negotiating, and executing' a transaction,"[72] the Court determined that the outside counsel's investigation formed part of the process of executing the transaction.

Termination

Defining the scope of a breach that precludes termination. The merger agreement at issue in *Akorn* did not allow Fresenius to exercise either of the termination rights it ultimately relied upon if it was in material breach of any of its own obligations under the merger agreement. It is not uncommon for a merger agreement to only limit a party's termination right to the extent that such party's breach was the cause of the conditions giving rise to the termination right. If Fresenius's unrelated breach of the merger agreement had been found to be material, the merger agreement's use of the former approach could have been significant.

Conclusion

While the *Akorn* opinion is significant in that it represents the first instance in which a Delaware court found that a buyer was entitled to terminate a merger agreement on the basis of a material adverse effect, the Court's analysis does not represent a material departure from established Delaware law in the space, and, given the factual record summarized in the opinion, the outcome should come as no surprise. Nevertheless, given the Court's extensive analysis of the merger agreement, the opinion provides M&A practitioners and their clients substantial guidance in drafting and negotiating merger agreements, along with determining whether and when they may (or may not) be entitled to terminate the agreement.

Notes

1. 2018 WL 4719347 (Del. Ch. Oct. 1, 2018).
2. *Id.* at *14.
3. *Id.*
4. *Id.*
5. *Id.* at *16.
6. *Id.*
7. *Id.* at *18.
8. *Id.*
9. *Id.* at *44–46.
10. *Id.* at *1.
11. *Id.* at *45.
12. *Id.* at *21.
13. *Id.*
14. *Id.* at *54.
15. *Id.* at *24.
16. *Id.*
17. *Id.* The Court stated its impression that Fresenius's chairman, in making the pronouncements, "knew that the expectations would have to be lowered" but "did not

have numbers that he trusted" and would not have them until after Fresenius had obtained control of Akorn. *Id.*

18. *Id.* at *26.
19. *Id.*
20. *Id.*
21. *Id.* at *27.
22. *Id.* at *27–28, *30.
23. *Id.* at *28.
24. *Id.* at *29.
25. *Id.* at *30.
26. *Id.* at *31.
27. *Id.* at *39, *46.
28. *Id.* at *43–44.
29. *Id.* at *44–45.
30. *Id.* The Court noted that Akorn's failure to bring down its representations and warranties would allow Fresenius to terminate only if the breach was incapable of cure by the outside date. *Id.* at *45. The Court also noted that Fresenius would not be entitled to terminate on the basis that Akorn had not complied with its covenants if Fresenius itself was then in material breach of its own representations, warranties and covenants. *Id.* Finally, the Court noted that the occurrence of a general Material Adverse Effect did not provide Fresenius with an independent termination right but would instead allow it to refuse to close. *Id.*
31. *Id.* at *49–50.
32. *Id.* at *50. The definition of "Material Adverse Effect" in the merger agreement at issue largely followed the Court's construction of material adverse effect provisions generally, starting with a customary statement regarding what would constitute a material adverse effect and then specifically carving out most systematic risks (other than, in certain cases, to the extent they would disproportionately affect Akorn), various indictor risks (but clarifying that the underlying event would not be carved out) and agreement risks. *Id.* at *51–52.
33. *Id.* at *53 (quoting *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 965 A.2d 715, at 738 (Del. Ch. 2008)).
34. *Id.*
35. *Hexion*, 965 A.2d at 738.
36. *Akorn*, 2018 WL 4719347, at *54.
37. *Id.* at *55.
38. *Id.* at *56.
39. *Id.* at *58.
40. *Id.*
41. *Id.* at *60.
42. *Id.* at *61 (footnote omitted).
43. *Id.* at *62.
44. *Id.*
45. *Id.* at *65 (emphasis added).
46. *Id.*
47. *Id.*
48. *Id.* at *66.
49. *Id.* at *73.
50. *Id.* at *18.
51. *Id.* at *91.
52. *Id.* at *86.
53. *Id.* at *86–87.
54. 159 A.3d 264, 272 (Del. 2017).
55. *Akorn*, 2018 WL 4719347, at *87. The *Akorn* Court noted, however, that Chief Justice Strine, in a dissenting opinion in *Williams*, maintained a distinction between the two formulations, describing "best efforts" as requiring efforts that "can potentially lead to the party making the promise having to take extreme measures to fulfill it" and "commercially reasonable efforts" as imposing "a strong, but slightly more limited, alternative." *Id.* at *87 n.797 (citing *Williams Cos.*, 159 A.3d at 276 & n.45).
56. *Id.* at *87 (citing *Alliance Data Sys. Corp. v. Blackstone Capital P'rs V L.P.*, 963 A.2d 746, 763 n.60 (Del. Ch. 2009)).
57. *Id.* at *88.
58. *Id.*
59. *Id.*
60. *Id.*
61. *Id.* at *89–90.
62. *Id.* at *91.
63. *Id.* at *97.
64. *Id.* at *98.
65. *Id.* at *99.
66. *Id.* at *74 n.740.
67. *Id.* at *65.
68. *Id.* at *60–61.
69. 187 A.3d 1209, 1236 n.185 (Del. 2018); *id.* at 1247 (Strine, C.J. & Vaughn, J., concurring in part and dissenting in part).
70. *Akorn*, 2018 WL 4719347, at *88.
71. *Id.* at *26.
72. *Id.* at *29.

EXECUTIVE COMPENSATION

Taking Stock of IRC Section 162(m) Changes

The Tax Cuts and Jobs Act has upended significant parts of Section 162(m)'s $1 million compensation deduction limitation, including the repeal of the performance-based compensation exemption. It, and subsequent IRS guidance, requires companies and boards to pay careful attention to the impact on new and old compensation programs.

By Gabriel Marinaro

Publicly traded companies have worked closely with their legal advisors and compensation consultants to design incentive compensation awards to preserve deductibility under Internal Revenue Code Section 162(m) (Section 162(m),[1] satisfy institutional shareholder advisory firms' pay practice positions, and otherwise show shareholders and the public that they are paying management for their individual and company performance, and not just to have a pulse. The Tax Cuts and Jobs Act of 2017 (TCJA) created many changes in the U.S. Tax Code, including upending significant parts of Section 162(m)'s $1 million compensation deduction limitation, including the repeal of the performance-based compensation exemption from this limitation.[2] Much has been written on the changes the TCJA made to Section 162(m)[3] and the subsequent IRS guidance in IRS Notice 2018-68 (Notice 2018-68) and this article does not go through all of the changes in detail. Instead, it highlights certain issues that a company's compensation committee should consider under the TCJA changes and Notice 2018-68.

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Who Are Your Covered Employees for 162(m) Purposes?

Section 162(m) generally limits the amount a publicly traded corporation can deduct for compensation paid to "*covered employees*" to $1 million. Under the new Section 162(m) rules, the term "covered employee" includes any employee of the company:

- who is the principal executive officer (CEO) or principal financial officer (CFO) at any time during the tax year;
- any employee who is one of the top three highest compensated officers for the tax year; or
- any employee who was a covered employee for any preceding taxable year beginning after December 31, 2016.

Continued Status as Covered Employee and Disregarding SEC Disclosure Requirements

With the changes under the TCJA, once an employee is tagged as a covered employee, they remain a covered employee, even if they no longer serve in one of the other enumerated categories summarized above. Notice 2018-68 further clarified that the Section 162(m) deductibility limitation applies regardless of whether disclosure is required under Item 402 of Regulation S-K, the SEC's rules regarding executive compensation disclosure, (Disclosure Rules) or the corporation has a short tax year.

The Notice contains the following illustrative example:

> If during the 2018 tax year, Employee A served as the Company's CEO, Employee B and Employee C both served as the CFO (at different times during the tax year), and Employees D, E, and F were the three highest compensated employees (other than

the CEO and CFO), all would be covered employees for the 2018 tax year for purposes of Section 162(m). If Employees D, E, and F were to retire prior to the end of 2018 and Employees G, H, and I were the corporation's fourth, fifth, and sixth highest compensated employees, D, E, and F would still each be considered covered employees for Section 162(m) purposes, even if G, H, and I were subject to the Disclosure Rules. Note that G, H and I would not be treated as covered employees for the 2018 tax year under this example.

The Notice also clarifies that the covered employees of smaller reporting companies and emerging growth companies are not limited by the Disclosure Rules, which generally limit compensation disclosure to the CEO and the two most highly compensated executive officers other than the CEO who were serving in such roles at the end of the last completed fiscal year. Thus, although the TCJA provided new rules for identifying "covered employees," the Notice clarifies the importance of determining the covered employees during a particular tax year, regardless of whether the compensation for such individuals is required to be disclosed under the Disclosure Rules.

Corporate Transactions—Tracking Covered Employees

Additionally, in reversing prior IRS guidance, the Notice clarifies that, in the context of a corporate transaction, employees of the target company will be covered employees for the short tax year (*i.e.*, the date of the transaction), even though their compensation is not required to be reported under the Disclosure Rules for the year in which the transaction occurs. Determining the three most highly compensated employees of the target corporation in this context may be more difficult due to the fact that the tax year ends on a different date (*i.e.*, the date of the transaction) than the previously completed fiscal year. The IRS has deferred guidance on this issue, requiring the parties to the transaction to make a good faith determination when identifying the target company's three most highly compensated individuals.

Another identified complexity in a merger or stock acquisition is that the covered employees of the acquired or merged corporation likely will need to be tracked by the surviving company, as amounts paid to such covered employees will still be subject to the Section 162(m) deductibility limitation at the surviving company. Until additional guidance is issued by the IRS, acquirers should make sure they track covered employees of target.[4]

What Performance-Based Compensation Is Grandfathered?

As noted above, the TCJA repealed the performance-based compensation exception from the Section 162(m) $1 million deductibility limitations. Although the performance-based exemption came with certain requirements, including periodic shareholder approval of performance criteria, makeup of the compensation committee or directors who could otherwise grant such compensation, both public companies and their advisors were familiar with these requirements and awards generally were designed to meet this important exemption. Designing awards as performance-based compensation not only preserved deductibility for compensation paid to covered employees that would otherwise exceed the $1 million deductibility limitation, but also shareholder advisory firms increasingly demanded performance-based awards in place of time-vested awards.

An important exception under the TCJA's repeal of the performance based exemption is a grandfathering rule that provides that the TCJA's changes do not apply to remuneration which is made pursuant to a written binding contract in effect on November 2, 2017, as long as no material modifications have been made to such contracts. The terms "binding contract" and "material modification" have significant consequences for purposes of this grandfathering rule.

Written Binding Contract

Notice 2018-68 provides that remuneration is payable under a written binding contract that was in effect on November 2, 2017, only to the extent that the corporation is obligated under applicable state law to pay the remuneration under such contract if the employee satisfies his or her obligations under the agreement.

Importantly, the Notice requires the company determine whether state contract law would treat a performance-based award that was granted prior to November 2, 2017 (but provided the company with discretion to reduce the award payout, even if the performance goals were satisfied (i.e., negative discretion)) as grandfathered under the old Section 162(m) performance-based compensation rules. Prior to the Notice, the IRS received comments requesting bright line rules or grandfathering for awards that contained negative discretion. Unfortunately, the IRS did not provide any bright line rules or explicit extension of grandfathering treatment to performance-based awards that permit negative discretion. The Notice, however, provides the following example:

(i) Facts. Employee P serves as the PEO of Corporation U for the 2017 and 2018 taxable years. On February 1, 2017, Corporation U establishes a bonus plan, under which Employee P will receive a cash bonus of $1,500,000 if a specified performance goal is satisfied; the outcome of the performance goal is uncertain on February 1, 2017. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to no less than $400,000 if, in its judgment, other subjective factors warrant a reduction. On November 2, 2017, under applicable law, which takes into account the employer's ability to exercise negative discretion, the bonus plan established on February 1, 2017 constitutes a written binding contract to pay $400,000. On March 1, 2018, the compensation committee certifies that the performance goal was satisfied. However, the compensation committee reduces the award to $500,000 due to the sale of certain corporate assets that resulted in the lowering of the fair market value of Corporation U's goodwill. On April 1, 2018, Corporation U pays $500,000 to Employee P. The payment satisfies the requirements of §1.162-27(e) as qualified performance-based compensation.

(ii) Conclusion. Employee P is a covered employee for Corporation U's 2018 taxable year. Prior to the TCJA's amendment to Section 162(m)(4), Section 162(m) did not apply to qualified performance-based compensation because such compensation was excluded from the definition of applicable employee remuneration. Thus, the $500,000 payment constitutes applicable employee remuneration solely as a result of the amendment to Section 162(m)(4). Because, under applicable law, as of November 2, 2017, the bonus plan established on February 1, 2017, constitutes a written binding contract to pay $400,000, the TCJA's amendments to Section 162(m) do not apply to $400,000 of the $500,000 payment to Employee P. Furthermore, the failure of the compensation committee to exercise negative discretion to reduce the award to $400,000, instead of $500,000, does not result in a material modification of the contract. Accordingly, the $400,000 is not subject to the deduction limitation under Section 162(m). The remaining $100,000 of the $500,000 payment is subject to the deduction limitation under Section 162(m) regardless of whether the payment satisfies the requirements of §1.162-27(e) as qualified performance-based compensation. (emphasis added)

Although this example calls into question the ability to grandfather awards as written binding contracts when the company retains discretion to reduce the award, companies and compensation committees should analyze state contract law with their counsel to determine whether, notwithstanding the presence of negative discretion, a court in the

applicable jurisdiction would consider the award as a binding written contract between the employee and company that allows for grandfathering.[5]

Material Modifications

As noted above, to retain grandfathered status for a written binding contract that was in effect on or before November 2, 2017, the contract must not be materially modified after such date. The Notice provides that material modifications include:

- amendments that increase the amount of compensation payable under the contract's terms (excluding reasonable cost-of-living increases);
- amendments that accelerate the payment of compensation, unless the accelerated amount is discounted to reasonably reflect the time value of money;
- adoption of supplemental contracts that provide for payments of increased or additional compensation if the payments are based on substantially the same elements or conditions as the original agreement; and
- amendments that defer compensation if any amount paid exceeds the original amount payable to the covered employee, unless the additional amount is based on either a reasonable interest rate or a predetermined actual investment.

Contracts renewed after November 2, 2017, will be subject to the post-TCJA Section 162(m) rules. Additionally, contracts with evergreen provisions will be treated as renewed as of the date that a termination otherwise would be effective had a notice to terminate been given. This is an important consideration for multi-year employment agreements with renewal provisions, where the initial term may be treated as grandfathered but the renewal option will effectively cut off continued grandfathering of such arrangement.[6] If a written contract is materially modified, it is treated as a new contract entered into as of the date of the material modification and any amounts received by the employee before the material modification are not affected (*i.e.*, remain grandfathered), but amounts received after the material modification are no longer grandfathered. The Notice also clarifies that a failure, in whole or in part, to exercise negative discretion under a contract does not result in a material modification of that contract.

Considerations for Compensation Committees

Should committees limit the grant of stock options or restrict exercisability now that they are not exempt as performance-based compensation? Non-grandfathered stock options and stock appreciation rights will no longer qualify as performance-based compensation, and income recognized by covered employees on exercise will subject covered companies to the deductibility limitation under Section 162(m). To the extent that stock options and stock appreciation rights are a part of covered employees' total compensation, committees should consider whether it is appropriate to limit the grant of such awards or to restrict their exercisability in an effort to reduce the impact of a lost deduction. Similarly, companies may now instead consider deferred compensation programs with fixed payment dates or formulae (instead of flexibility of exercise timing) that could account for Section 162(m)'s deduction limitation.

Should performance-based compensation be deferred beyond vesting to spread out the income inclusion? With TCJA's repeal of the performance-based exception to Section 162(m) and the existence of potentially large sums of compensation tied to multi-year performance-based goals, committees could consider whether amounts payable as a result of the achievement of these goals should be deferred automatically to a future year (or spread out over multiple years) to reduce the impact of the deductibility limitation for covered employees. Although many incentive programs provide the opportunity to defer some or all of an individual's performance-based compensation, committees have not previously had to consider whether such deferrals should be mandatory or formulaic to preserve greater

deductibility for the company as payments come due under these incentive programs. Given that disclosure will be made regarding non-deductibility of certain compensation, committees should at least explore options that could better preserve the possibility of deduction.

Should committees revise non-grandfathered performance-based compensation programs to provide more flexibility now that the performance-based exception is no longer a factor? Committees of covered companies should look at their current cash and equity incentive compensation programs to see what modifications could be made to post-2017 programs, since committees are no longer constrained by the requirements of Section 162(m)'s pre-Act performance-based exception. For example, a committee may wish to consider the ability to upwardly adjust the payment of incentive compensation, adjust payout amounts for certain extraordinary items that may have not been considered at the time of the award, and add performance measures that were not previously approved by shareholders. Further, in the post-Act era, at least with respect to non-grandfathered compensation, boards may wish to expand the makeup of committee members given that Section 162(m)'s committee framework for performance-based compensation will no longer apply. Although performance-based compensation likely will continue to be used as part of an executive's compensation package due to continued pressure by shareholders and shareholder advisory groups, the repeal of the performance-based compensation exception (and all of the related requirements), should provide committees with additional flexibility in designing and administering certain performance-based compensation going forward.

Conclusion

In the post-TCJA era, compensation committees and boards must pay careful attention to the impact of the deduction limitation on new and old programs, carefully review existing arrangements so as to not inadvertently lose grandfathered status, and balance shareholder's (and their advisory firms) continued push for performance-based compensation with concerns over tax efficient performance-based compensation programs.

Notes

1. Section 162(m) generally limits the amount a publicly traded company can deduct for compensation paid to "covered employees to $1 million.
2. *See* Treas. Reg. Section 1.162-27(e).
3. *See* Section 13601 of the TCJA.
4. The Treasury Department is considering additional guidance on: the application of the definition of covered employee to an employee who was a covered employee of a predecessor of the publicly held corporation; the application of Section 162(m) to corporations immediately after they become publicly held either through an IPO or a similar business transaction; and the application of the Disclosure Rules for determining the three most highly compensated executive officers for a taxable year that does not end on the same date as the last completed fiscal year.
5. For performance-based compensation awards subject to negative discretion, companies should consider whether the certain common law contracting standards of good faith and fair dealing might otherwise apply in certain contexts, *i.e.*, where the courts have opined that contracting parties refrain from acting in a manner that injures the other party to receive the benefits of the contract.
6. *See* Example 1 in Section III.B.2. of Notice 2018-68.

STATE CORNER

Business Judgement Review of Controller Transactions

By Mark Director, Marina Szteinbok, and Justice Flores

On October 9, 2018, in *Flood v. Synutra Int'l, Inc.*,[1] the Delaware Supreme Court further refined when in a controller transaction the procedural safeguards of *Kahn v. M & F Worldwide Corp*.[2] (*MFW*) must be implemented to obtain business judgment rule review of the transaction. Under *MFW*, a merger with a controlling stockholder will be reviewed under the deferential business judgment rule standard, rather than the stringent entire fairness standard, if the merger is conditioned *ab initio* upon approval by both an independent, adequately empowered Special Committee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders.[3]

Writing for the majority in *Synutra*, Chief Justice Strine emphasized that the objective of *MFW* and its progeny is to incentivize controlling stockholders to adopt the *MFW* procedural safeguards early in the transaction process, because those safeguards can provide minority stockholders with the greatest likelihood of receiving terms and conditions that most closely resemble those that would be available in an arms' length transaction with a non-affiliated third party. Accordingly, the Court held that "*ab initio*" (Latin for "from the beginning") requires that the *MFW* protections be in place prior to any substantive economic negotiations taking place with the target (or its board or Special Committee). The Court declined to adopt a "bright line" rule that the *MFW* procedures had to be a condition of the controller's "first offer" or other initial communication with the target about a potential transaction.

Mark Director *is a partner,* **Marina Szteinbok** *is a senior attorney, and* **Justice Flores** *is an associate, at Gibson, Dunn & Crutcher LLP.*

Factual Background

Synutra affirmed the Chancery Court's dismissal of claims against Liang Zhang and related entities, who controlled 63.5 percent of Synutra's stock. In January 2016, Zhang wrote a letter to the Synutra board proposing to take the company private, but failed to include the *MFW* procedural prerequisites of Special Committee and majority of the minority approvals in the initial bid. One week after Zhang's first letter, the board formed a Special Committee to evaluate the proposal and, one week after that, Zhang submitted a revised bid letter that included the *MFW* protections. The Special Committee declined to engage in any price negotiations until it had retained and received projections from its own investment bank, and such negotiations did not begin until seven months after Zhang's second offer.

Ab Initio Requirement

The plaintiff argued that because Zhang's initial letter did not contain the dual procedural safeguards of *MFW* as pre-conditions of any transaction, the "*ab initio*" requirement of *MFW* was not satisfied and therefore business judgment standard of review had been irreparably forfeited. The Court declined to adopt this rigid position, and considered that "*ab initio*" for *MFW* purposes can be assessed more flexibly. To arrive at this view, the Court explored the meaning of "the beginning" as used in ordinary language to denote an early period rather than a fixed point in time. The Court also parsed potential ambiguities in the language of the Chancery Court's *MFW* opinion, which provided that *MFW* pre-conditions

must be in place "from the time of the controller's first overture"[4] and "from inception."[5]

Ultimately, the Court looked to the purpose of the *MFW* protections to find that "*ab initio*" need not be read as referring to the single moment of a controller's first offer. As *Synutra* emphasizes, the key is that the controller not be able to trade adherence to *MFW* protections for a concession on price. Hence the "*ab initio*" analysis focuses on whether deal economics remain untainted by controller coercion, so that the transaction can approximate an arms' length transaction process with an unaffiliated third party. As such, the Court's reasoning is consistent with the standard espoused by the Chancery Court in its prior decision in *Swomley v. Schlecht*,[6] which the Court summarily affirmed in 2015, that *MFW* requires procedural protections be in place prior to the commencement of negotiations.[7]

In a lengthy dissent, Justice Valihura opined that the "*ab initio*" requirement should be deemed satisfied only when *MFW* safeguards are included in the controller's initial formal written proposal, and that the "negotiations" test undesirably introduces the potential for a fact-intensive inquiry that would complicate a pleadings-stage decision on what standard of review should be applied. Chief Justice Strine acknowledged the potential appeal of a bright line test but ultimately rejected it because of the Court's desire to provide strong incentive and opportunity for controllers to adopt and adhere to the *MFW* procedural safeguards, for the benefit of minority stockholders. In doing so, the Court acknowledged that its approach "may give rise to close cases." However, the Court went on to add, "our Chancery Court is expert in the adjudication of corporate law cases." The Court also concluded that the facts in *Synutra* did not make it a close case.[8]

Duty of Care

The Court also upheld the Chancery Court's dismissal of plaintiff's claim that the Special Committee had breached its duty of care by failing to obtain a sufficient price. Following the Chancery Court's reasoning in *Swomley*, *Synutra* held that where the procedural safeguards of *MFW* have been observed, there is no duty of care breach at issue where a plaintiff alleges that a Special Committee could have negotiated differently or perhaps obtained a better price—what the Chancery Court in *Swomley* described as "a matter of strategy and tactics that's debatable."[9] Instead, the Court confirmed that a duty of care violation would require a finding that the Special Committee had acted in a grossly negligent fashion. Observing that the Synutra Special Committee had retained qualified and independent financial and legal advisors and engaged in a lengthy negotiation and deal process, the Court found nothing to support an inference of gross negligence and thus deferred to the Special Committee regarding deal price.[10]

Procedural Posture

Synutra dismissed the plaintiff's complaint at the pleadings stage. In its procedural posture, the Court followed *Swomley*, which allowed courts to resolve the *MFW* analysis based on the pleadings. The dissent noted that adoption of a bright-line test would be more appropriate for pleadings-stage dismissals. However, the Court established that it would be willing to engage some degree of fact-finding at the pleadings stage in order to allow cases to be dismissed at the earliest opportunity, even using the Court's admittedly more flexible view of the application of *MFW*.

Takeaways

Synutra reaffirms the Court's commitment to promoting implementation of *MFW* safeguards in controller transactions. In particular:

- The Court will favor a pragmatic, flexible approach to "*ab initio*" determination, with the intent of determining whether the application of the *MFW* procedural safeguards have been used to affect or influence a transaction's economics;

- Once a transaction has business judgment rule review, the Court will not inquire further as to sufficiency of price or terms absent egregious or reckless conduct by a Special Committee; and
- Since the goal is to incentivize the controller to follow *MFW* at a transaction's earliest stages, complaints can be dismissed on the pleadings, thus avoiding far more costly and time consuming summary judgment motions.

Although under *Synutra* a transaction may receive business judgment rule review despite unintentional or premature controller communications that do not reference the *MFW* procedural safeguards as inherent deal pre-conditions, deal professionals would be well advised not to push this flexibility too far. Of course, there can be situations where a controller concludes that deal execution risks or burdens attendant to observance of the *MFW* safeguards are too great (or simply not feasible), and thus is willing to confront the close scrutiny of an entire fairness review if a deal is later challenged. However, if a controller wants to ensure it will receive the benefit of business judgment rule review, the prudent course is to indicate, in any expression of interest, no matter how early or informal, that adherence to *MFW* procedural safeguards is a pre-condition to any transaction. *Synutra* makes clear that the availability of business judgment review under *MFW* will be a facts and circumstances assessment, but we do not yet know what the outer limits of the Court's flexibility will be, should it have to consider a more contentious set of facts in the future.

Notes

1. *Flood v. Synutra Int'l, Inc.*, No. 101, 2018 WL 4869248 (Del. Oct. 9, 2018).
2. *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).
3. *Id*. at 644.
4. *In re MFW Shareholders Litigation*, 67 A.3d 496, 503 (Del. Ch. 2013).
5. *Id*. at 528.
6. *Swomley v. Schlecht*, 2014 WL 4470947 (Del. Ch. 2014), *aff'd* 128 A.3d 992 (Del. 2015) (TABLE).
7. The Court did not consider that certain matters that transpired between Zhang's first and second offer letters, namely Synutra's granting of a conflict waiver to allow its long-time counsel to represent Zhang (the Special Committee subsequently hired separate counsel), constituted substantive "negotiations" for this purpose since the waiver was not exchanged for any economic consideration.
8. *Synutra*, 2018 WL 4869248, at *8.
9. *Id*. at *11, citing *Swomley*, 2014 WL 4470947, at 21.
10. In a footnote, the Court expressly overruled dicta in its *MFW* decision that the plaintiff cited to argue that a duty of care claim could be premised on the Special Committee's obtaining of an allegedly insufficient price. *Id*. at *10, n.81.

CLIENT MEMOS

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

Arnold & Porter LLP
Washington, DC (202-942-5000)

Supreme Court Has Opportunity to Reexamine Implied Private Right of Action Under Section 14(e) of the Exchange Act (October 22, 2018)

A discussion of a petition for certiorari filed in *Varjabedian v. Emulex Corp.*, a Ninth Circuit decision holding that the requisite intent under Section 14(e) of the Securities Exchange Act of 1934 is negligence.

Baker Botts LLP
Houston, TX (713-229-1234)

SEC Approves Amendments to Nasdaq's 20 Percent Rule for Shareholder Approval of Certain Private Offerings (October 9, 2018)

A discussion of the SEC's approval of amendments to Nasdaq Rule 5635(d) to change the definition of "market value" for purposes of the 20 percent rule, eliminate the requirement for shareholder approval of certain private transactions at a price less than book value but greater than market value and make certain conforming changes.

Cleary, Gottlieb, Steen & Hamilton LLP
New York, NY (212-225-2000)

New DOJ Guidance on the Imposition and Selection of Corporate Monitors (October 16, 2018)

A discussion of guidance issued by the Department of Justice relating to the imposition and selection of corporate compliance monitors in Criminal Division matters.

Covington & Burling LLP
Washington, DC (202-662-6000)

Rulemaking Commenters Debate the SEC's Proposed Changes to Its Whistleblower Program (October 5, 2018)

A discussion of the over 3000 comments the SEC has received on its proposed amendments to its whistleblower rules. Most controversial is the proposal that would allow the SEC to decrease the size of the award if it determines that the award would be too large to advance the goals of the whistleblower program.

Davis Polk & Wardwell LLP
New York, NY (212-450-4000)

California Enacts Law Requiring Public Company Boards to Include Women (October 1, 2018)

A discussion of the new California law, S.B. 826, which will require all NYSE- and Nasdaq-listed companies with principal executive offices located in California, regardless of the state or jurisdiction of incorporation, to have at least one woman board member by December 31, 2019, and up to three women board members by the end of 2021, depending on the size of the board.

Eversheds Sutherland (US) LLP
Atlanta, GA (404-853-3000)

Standards of Conduct for Investment Professionals (October 5, 2018)

A discussion of the legal standards for broker-dealer firms and their representatives, particularly in the retirement market, including those imposed

by the federal securities laws, FINRA rules, tax provisions of the Internal Revenue Code and fiduciary standards and prohibited transactions of ERISA.

Gibson, Dunn & Crutcher LLP
Los Angeles, CA (213-329-7870)

2018 Mid-Year Activism Update (October 3, 2018)

An update of shareholder activism activity involving NYSE- and Nasdaq-listed companies with equity market capitalization above $1 billion during the first half of 2018.

SEC Warns Public Companies on Cyber-Fraud Controls (October 17, 2018)

A discussion of a SEC report warning public companies about the importance of internal controls to prevent cyber fraud. The report describes the Division of Enforcement's investigation of multiple public companies which had lost nearly $100 million in a range of cyber-scams typically involving payments to vendors or corporate executives.

Goodwin Procter LLP
Boston, MA (617-570-1000)

Tapping the U.S. Capital Markets Through American Depositary Receipt Programs (October 2, 2018)

A discussion of the use of American Depositary Receipts to broaden a foreign company's investor base by providing investors in the U.S. with a means to access securities listed on foreign exchanges.

Hinckley, Allen &Snyder LLP
Providence, RI (401-274-2000)

Key Lessons in Disclosure & Social Media from the Elon Musk and Tesla Inc. Settlement (October 9, 2018)

A discussion of the key lessons embedded in the settlement agreement entered into by Elon Musk and Tesla Inc. with the SEC after the SEC filed its enforcement action alleging that several statements made by Musk were materially misleading.

Jones Day LLP
Cleveland, OH (216-586-3939)

What Should Boards Really Do about ESG? (October 2018)

A discussion of the need for corporate boards to recognize their companies' ESG achievements and coordinate future efforts and disclosures in this area, emphasizing issues relevant to their own corporate culture and long-term shareholder value.

King & Spalding LLP
Atlanta, GA (404-572-4600)

The Catch with *Kokesh* Insurers Refusing to Cover Disgorgement to SEC (October 23, 2018)

A discussion of a New York decision holding that in light of *Kokesh* (defining disgorgement as a penalty), insurers were not required to cover a disgorgement-related claim where the policies in question excluded "fines or penalties imposed by law."

Latham & Watkins LLP
Los Angeles, CA (213-485-1234)

SEC Charges "ICO Superstore" as Unregistered Broker-Dealer (October 19, 2018)

A discussion of a SEC settled order that is its first action charging a seller of digital tokens as an unregistered broker-dealer.

The Secrets of Form 6-K: Getting Behind the Curtain with the FPI Wizard (October 22, 2018)

A discussion of SEC Form 6-K, the form used by foreign private issuers to update their disclosures with the SEC.

Mayer Brown LLP
Chicago, IL (312-782-0600)

SEC Petitioned for an ESG Rulemaking

A discussion of a petition filed with the SEC for a rulemaking on environmental, social and governance disclosure. It was filed by two law professors and signed by investors and associated organizations representing more than $5 trillion in assets under management.

Morgan, Lewis & Bockius LLP
Philadelphia, PA (215963-5000)

DOJ to Business; We Are Your Partners, Not Adversaries (September 28, 2018)

A discussion of remarks by Department of Justice (DOJ) Deputy Assistant Attorney General Miner urging the business sector to work cooperatively with DOJ and emphasizing the benefit of self-reporting in all corporate criminal cases.

SEC Staff Relieves Fund Boards of Certain Compliance Determinations (October 15, 2018)

A discussion of a SEC staff no-action letter relieving fund boards of directors of the responsibility for determining compliance with key affiliated transaction exemptive rules. They now will be able to rely on written representations from the fund's chief compliance officer that transactions are in compliance with the relevant rule.

Sidley Austin LLP
Chicago, IL (312-853-7000)

One Pie, Many Slices: Recent Court Decisions Carve Up SEC and CFTC Jurisdiction in Virtual Currency (October 1, 2018)

A discussion of three recent cases illustrating the interplay among federal regulators overseeing virtual currency that offers important support for the increasingly aggressive assertion of jurisdiction by the CFTC and the SEC and provide guidance as to when a virtual currency may be considered a commodity subject to the CFTC's jurisdiction or a security subject to the federal securities laws.

Stradley, Ronon, Stevens & Young, LLP
Philadelphia, PA (215-564-8000)

A Tale of Four Cyptocurrency Enforcement Actions (October 1, 2018)

A discussion of four regulatory actions against cyptocurrency firms by the SEC and Financial Industry Regulatory Authority, as well as a hedge fund, a cryptocurrency trading platform and a broker-dealer.

New Jersey Launches Uniform Fiduciary Standard Rulemaking (October 16, 2018)

A discussion of a notice of a pre-proposal issued by the New Jersey Bureau of Securities that is soliciting comments on whether to adopt amendments to require that broker-dealers, agents, investment advisers and investment adviser representatives be subject to an express fiduciary duty.

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

Launch of 2019 ISS Comment Period and Release of Commonsense Principles 2.0 (October 22, 2018)

A discussion of the announcement by Institutional Shareholder Services of the comment period for its 2019 benchmark voting policy and an updated statement of corporate governance principles by executives from US public companies and asset managers, as well as public pension funds and mutual fund companies.

Vinson & Elkins LLP
Houston, TX (512-542-8400)

A New SEC Focus on Short Activism? (October 8, 2018)

A discussion of a SEC enforcement action against a hedge fund and its adviser for perpetrating an unlawful short attack on a company, alleging that the fund built a short position in the company and then made a series of demonstrably false and misleading statements to destabilize the company's shareholder base and cause a drastic drop in the stock price.

Wachtell, Lipton, Rosen & Katz New York, NY (212-403-1000)

SEC Action Underscores Importance of Careful Disclosure Planning in Strategic Mergers (October 1, 2018)

A discussion of a SEC settled cease-and-desist order against a company and its former CEO and CFO charging each with misleading investors about the future financial performance of the company while the company's internal financial budgets indicated significant underperformance.

Activist Hedge Fund Overreach in Sale Process (October 17, 2018)

A discussion of a Delaware Chancery Court opinion, *In re PLX Technology Inc. Stockhlders Litigation*, finding misconduct by an activist hedge fund in its campaign and related proxy contest and questioning whether the incumbent board of directors had improperly allowed the activist to take control of the sale process.

Weil Gotshal & Manges, LLP
New York, NY (213-310-8000)

What's New for the 2019 Proxy Season (October 3, 2018)

A discussion of the SEC's approach to regulation of proxy advisory services, developments in anticipation of the SEC' November proxy roundtable and Glass-Lewis's announcement of its intent to integrate SASB's materiality-focused sustainability disclosure standards in its voting products.

White & Case LLP
New York, NY (212-819-8200)

The SEC Launches FinHub—New Resource for Public Engagement on FinTech Matters (October 2018)

A discussion of the SEC's announcement of its launch of a new "strategic hub for innovation and financial technology", it is calling FinHub. It is a resource for public engagement on such issues as distributed ledger technology (including digital assets), automated investment advice, digital marketplace financing and artificial intelligence/machine learning.

Winston & Strawn LLP
Chicago, IL 312-558-5600)

SEC Charges Broker-Dealer/Investment Adviser with Deficient Cybersecurity Procedure (October 3, 2018)

A discussion of a SEC enforcement action against a registered broker-dealer and investment adviser in connection with a cyber-intrusion that compromised the personal information of thousands of customers. The SEC's cease-and-desist order charges the firm had deficient cybersecurity and identity theft prevention programs, in violation of SEC Reg S-P (Safeguards Rule) and Reg S-ID (Identity Theft Red Flags Rule).

INSIDE THE SEC

SEC Staff Guidance on Shareholder Proposals

By Rich Parrino, Alan Dye and Alex Bahn

On October 23, the SEC's Division of Corporation Finance issued Staff Legal Bulletin No. 14J (SLB 14J) to provide new guidance on the application of the "ordinary business" and "economic relevance" exceptions to a public company's obligation under Exchange Act Rule 14a-8 to include shareholder proposals in its proxy materials. The guidance will govern SEC staff action during the 2019 proxy season on company no-action requests seeking exclusion of shareholder proposals on the basis of these exceptions.

The Division's new statement in part supplements guidance it issued in November 2017 in Staff Legal Bulletin No. 14I (SLB 14I), in which it solicited greater board-level involvement in a company's exclusion determination under the ordinary business and economic relevance exceptions and encouraged companies in appropriate circumstances to discuss the board's analysis in their no-action requests. The Division also provides insight in the new bulletin into how it approaches particular issues raised in exclusion determinations under the ordinary business exception.

Ordinary Business and Economic Relevance Exceptions

In SLB 14J, the Division revisits significant features of the ordinary business and economic relevance exceptions on which it issued significant guidance last year in SLB 14I.

Rich Parrino, Alan Dye, *and* **Alex Bahn** *are partners at Hogans Lovell LLP.*

Ordinary Business Exception

Rule 14a-8(i)(7) permits a company to exclude from its proxy materials a shareholder proposal that "deals with a matter relating to the company's ordinary business operations." This exception is based on the general principle of state corporate law that a corporation's directors and officers, rather than its shareholders, are responsible for conducting the corporation's day-to-day operations, and shareholders therefore should vote only on major corporate issues.

The "ordinary business" exception rests on two underlying considerations. First, as the Commission has observed, certain matters are

> so fundamental to management's ability to run a company on a day-to-day basis that they would not, as a practical matter, be subject to direct shareholder oversight.

Second, certain proposals that seek to "micromanage" the company's operations inappropriately probe into complex matters on which shareholders generally are unable to make an informed judgment. Notwithstanding these considerations, the SEC staff typically has not deemed a proposal's application to a company's ordinary operations sufficient to warrant exclusion under Rule 14a-8(i)(7) where the proposal implicates a "significant policy issue." The staff considers some policy issues to be sufficiently important that they transcend the company's ordinary business or its day-to-day operations and render the proposal appropriate for a shareholder vote. The staff acknowledged in SLB 14I, however, that determining whether a proposal subject to Rule 14a-8(i)(7) raises a significant policy issue often requires the staff to make difficult judgments regarding the connection between the policy issue and the company's business operations.

SLB 14I called for companies to assist the staff in making these judgments in appropriate cases by

involving the board of directors in the first instance to determine whether a proposal raises a policy issue that is significant for the company. The staff said in this bulletin that, if the board determines that a proposal does *not* raise a significant policy issue for the company, the company should consider including in its no-action request a discussion of the board's analysis of the policy issue and its purported lack of significance to facilitate the staff's review of the request. The discussion should include a description of the "specific processes" the board followed "to ensure that its conclusions [were] well-informed and well-reasoned." The guidance in SLB 14I reflects the staff's belief that a company's board, charged with fiduciary duties in overseeing management and the company's strategic direction, is best able to determine whether or not a policy issue is significant enough for the company that it transcends ordinary business.

Economic Relevance Exception

The "economic relevance" exception under Rule 14a-8(i)(5) permits a company to exclude from its proxy materials a proposal that (1) relates to operations accounting for less than five percent of the company's total assets at the end of its most recent fiscal year, and for less than five percent of its net earnings and gross sales for its most recent fiscal year, *and* (2) is "not otherwise significantly related to the company's business." Because of the "significance" determination, the considerations that must be weighed in an exclusion analysis under Rule 14a-8(i)(5) are similar to those involved in evaluating whether a proposal raises a "significant policy issue" that would preclude exclusion of a proposal under the ordinary business exception.

In recent years, notwithstanding the second part of the economic relevance test, and until it issued SLB 14I, the SEC staff rarely permitted exclusion of proposals on the basis that they are not significantly related to the company's business. Instead, the staff generally required inclusion of a proposal that reflected broad ethical or social issues, rather than economic concerns, so long as *any* amount of the company's business was implicated by the issues, even where the affected operations fell below the five percent thresholds specified in the rule.

The staff's approach, as it recognized in SLB 14I,

> simply considered whether a company conducted any amount of business related to the issue in the proposal and whether that issue was of broad social or ethical concern.

The staff acknowledged in SLB 14I that this application of Rule 14a-8(i)(5) "unduly limited the exclusion's availability" by failing to consider fully whether, as Rule 14a-8(i)5 directs, the proposal "deals with a matter that is not significantly related to the issuer's business" and therefore is excludable.

The staff announced in SLB 14I that it would analyze the economic relevance exception in a manner it believes is more consistent with the language and purpose of Rule 14a-8(i)(5). If a proposal relates to operations that account for less than five percent of the company's total assets, net earnings, and gross sales, the staff will assess whether the proposal is "significantly related" to the company's business, regardless of whether the proposal raises important social or ethical concerns. If the proposal is not significantly related to the company's business, the company may exclude it. This guidance potentially extends the economic relevance exception to proposals that address important social or ethical issues and therefore would not have been excludable in the past despite their marginal financial relevance to the company.

The staff observed in SLB 14I that the analysis of any policy issue's significance to a company's business will depend on the circumstances of the individual company, rather than on the importance of the issue "in the abstract." Therefore, an issue might be significant to the business of one company but not to the business of another. The staff cautioned, however, that it generally will view substantive governance matters to be significantly related to the business of almost all companies. The Division has reiterated this position in SLB 14J.

The staff emphasized that, as with an evaluation of the significance of a policy issue in the context of the ordinary business exception, determining whether a proposal is "otherwise significantly related to a company's business" under Rule 14a-8(i)(5) can involve difficult judgments. Accordingly, consistent with its guidance on the ordinary business exception, the staff indicated that a company's board is in a better position than the staff to make the significance determination in the first instance. Thus, the staff believes it often will be helpful if a company's no-action request under Rule 14a-8(i)(5) discloses the board's analysis of the proposal's significance to the company's business. The staff said in SLB 14I that a description of the board's analysis would be most helpful to the staff if it details the specific processes employed by the board in its analysis.

The staff concluded its guidance in SLB 14I on the economic relevance exception by observing that it no longer will look to its analysis of whether a proposal raises a policy issue that is sufficiently significant in relation to the company, for purposes of the ordinary business exception, when evaluating arguments for the availability of the economic relevance exception based on whether the policy issue is otherwise significantly related to the company's business. Instead, the staff will independently apply the analytical framework for each exception to "ensure that each basis for exclusion serves its intended purpose."

Inclusion of Board's Analysis in No-action Request

The 2018 proxy season afforded the staff its first opportunity to evaluate the usefulness of inclusion of the board's analysis in no-action requests under the ordinary business and economic relevance exceptions. The staff reports in SLB 14J that its experience confirmed that a "well-developed discussion of the board's analysis" can assist the staff's evaluation, even if, as in the case of some no-action requests submitted during the last proxy season, the staff is unable to concur with the company's exclusion determination.

The staff offers the following observations from its experience during the 2018 proxy season:

- The discussion of a board's analysis should address whether a particular policy issue raised by a proposal is (1) sufficiently significant in relation to the company, in a no-action request based on the ordinary business exception, or (2) otherwise significantly related to the company's business, in a no-action request based on the economic relevance exception.
- The inclusion of a board's analysis will be particularly helpful to the staff "where the significance of a particular issue to a particular company and its shareholders may depend on factors that are not self-evident and that the board may be well-positioned to consider and evaluate."
- During the 2018 proxy season, the staff found most helpful discussions that focused on (1) the board's analysis and (2) the specific substantive factors the board considered in its exclusion determination. The staff found less helpful discussions that described the board's conclusions or process without addressing the specific substantive factors the board considered.

The Division indicates that "submission of a board analysis is voluntary and the inclusion or absence of an analysis will not be dispositive in the staff's evaluation of a company's request" for no-action relief. The absence of a board analysis therefore will not create a presumption against exclusion of a proposal. The staff qualifies this assurance with the observation that it might be unable to concur with an exclusion determination if the company does not share with it the board's views on policy issues that are not "self-evident." This admonition appears consistent with informal staff statements since the issuance of SLB 14I suggesting that inclusion of a board's analysis might be of less value to the staff if there is a well-worn path to the company's exclusion determination in no-action precedent. Companies, however, should consider this suggestion in light of the staff's reminder in SLB 14J that exclusion determinations are made "on a case-by-case basis" and, accordingly, that

"a proposal that the staff agrees is excludable for one company may not be excludable for another" and "conversely, a proposal that is not excludable by one company would not be dispositive as to whether it is excludable by another." In instances where prior no-action submissions under the ordinary business or economic relevance exception do not clearly support excluding a proposal on the basis that it fails to present a significant policy issue, companies may wish to consider engaging their boards to perform a substantive analysis of the issue to support a no-action request on the exclusion determination.

Substantive Factors for Board's Analysis

The staff did not provide any guidelines in SLB 14I regarding the nature of the analysis the board should undertake in its exclusion determination. In SLB 14J, the Division offers guidance as to the types of "specific substantive factors" a board might consider and what a "well-developed discussion" of the board's analysis should describe to assist the staff in its evaluation of an exclusion determination. The staff's non-exhaustive list of such factors encompasses the following:

- the extent to which the proposal relates to the company's core business activities;
- quantitative data, including financial statement impact, related to the matter that illustrate whether or not a matter is significant to the company;
- whether the company has already addressed in some manner the issue raised by the proposal, including the differences—or the "delta"—between the proposal's specific request and the actions the company already has taken with respect to the matter, and an of whether the delta presents a significant policy issue for the company;
- the extent of shareholder engagement on the issue and the level of shareholder interest expressed through that engagement;
- whether anyone other than the proponent has requested the type of action or information sought by the proposal; and
- whether the company's shareholders have voted previously on the matter and the board's views as to the related voting results.

The Division indicates that a board is not required to address each of the foregoing factors, nor need it limit its analysis to these factors. The lesson of the guidance is that a board's analysis should be informed by a consideration of specific substantive factors and that these factors should be discussed in sufficient detail to permit the staff to evaluate the board's views on the policy issues raised by the proposal.

The last substantive factor listed by the staff is whether the company's shareholders have voted previously on the matter raised by the proposal and the board's views as to the related voting results. The inclusion of this factor suggests that a particular level of prior shareholder support for a proposal could elevate the significance of the policy issue raised by the proposal. The staff indicates that the weight it will give to this factor "will depend on the specific facts and circumstances." The facts and circumstances the staff says it might consider include the amount of shareholder support received by the previously voted-on matter, the length of time that has passed since the matter was last voted on by shareholders, and whether any subsequent company actions or intervening events might have mitigated the issue's significance to the company (if the matter received significant shareholder support) or increased the issue's significance to the company (if the matter did not receive significant shareholder support).

Application of the Ordinary Business Exception

In the balance of SLB 14J, the Division clarifies how it applies the ordinary business exception to specific types of proposals in light of the two considerations underlying the exception:

- *Subject matter of the proposal:* The subject matter of a proposal may require the proposal's exclusion if, in the Commission's formulation, the matter is one that is "so fundamental to management's ability to run a company on a day-to-day basis" that the matter "would not, as a practical matter, be subject to direct shareholder oversight."
- *Manner in which proposal addresses an issue:* Even if the subject matter of the proposal is appropriate for a shareholder vote, the proposal may be excludable if its manner of implementation seeks to "micromanage" the company.

Micromanagement of Company as Basis for Exclusion

In its new guidance, the staff clarifies the basis on which it evaluates claims that a proposal seeks to "micromanage" a company and therefore is excludable, even if the subject matter of the proposal is not an improper one for shareholder oversight. The staff uses as its framework the Commission's statement that a proposal entails micromanagement if it "involves intricate detail, or seeks to impose specific time-frames or methods for implementing complex policies." In applying this framework, the staff focuses on the manner in which the proposal seeks to address an issue, and looks both at the nature of the proposal and the circumstances of the company to which the proposal is addressed.

Proposals That Implicate Senior Executive or Director Compensation

The Division also provides guidance on the analysis it employs to determine whether proposals that address senior executive or director compensation may be excluded under the ordinary business exception as involving matters that are inappropriate for shareholder oversight. The staff performs its evaluation against a pattern of no-action determinations in which proposals that address "general employee compensation and benefits" are considered to relate to ordinary business matters and therefore generally are excludable, while proposals that focus on significant aspects of senior executive or director compensation generally are considered to raise significant policy issues and therefore are not excludable.

The staff clarifies its views on the excludability under Rule 14a-8(i)(7) of two types of proposals that implicate senior executive or director compensation:

- In evaluating a proposal that raises both ordinary business and senior executive or director compensation matters, the staff will consider the proposal to be excludable if its "focus" or "underlying concern" is an ordinary business matter (such as employee benefits). The fact that such a proposal "is connected to or touches upon" senior executive or director compensation will not protect it from exclusion.
- In evaluating a proposal that addresses aspects of senior executive or director compensation, the staff will consider whether those aspects of compensation also are available or applicable to the general workforce. A proposal relating to broadly available aspects of compensation may be excludable under Rule 14a-8(i)(7) because such forms of compensation are considered to relate to a company's ordinary operations and therefore generally do not raise significant compensation issues that transcend ordinary business matters. To illustrate this approach, the staff states that a proposal which focuses on the ability of senior executives or directors to receive golden parachute compensation may be excludable under the ordinary business exception if the company can demonstrate that the golden parachute compensation broadly applies to a "significant portion" of the workforce.

Finally, the Division announces a change to its historic position of denying exclusion of proposals addressing senior executive or director compensation on the basis of micromanagement arguments. The staff now will be guided by the view that there is no basis for treating executive compensation proposals differently from proposals on other topics. Accordingly, consistent with the framework it uses to assess micromanagement issues, the staff indicates

that it may concur with the exclusion of senior executive or director compensation proposals on the basis of micromanagement when the proposal "involves intricate detail" or seeks "to impose specific timeframes or methods for implementing complex policies." As an example, the staff indicates that it might exclude on this basis a proposal detailing the eligible expenses that should be covered by a company's relocation expense policy as well as the scope of eligible participants and amounts covered.

Conclusion

SLB 14J presents helpful new guidance to companies and proponents for assessing the excludability of proposals under the ordinary business and economic relevance exceptions and for addressing exclusion determinations in no-action letter requests. The new guidance is particularly welcome in answering questions about including a discussion of a board's analysis that were raised but not answered last year in SLB 14I.

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