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Practice Tips for M&A Practitioners for 2014

Based on a number of cases decided by the Delaware courts in 2013, below we summarize practice tips regarding careful drafting of contractual provisions and complying with technical and statutory requirements.

Disclaimers of Reliance and Accuracy Clauses Likely Do Not Bar Fraud Claims

The Delaware courts have had several opportunities to examine a range of disclaimer provisions in agreements, usually an integration (or "entire agreement") clause and a disclaimer of extra-contractual statements, to determine if they were adequate in barring fraud claims. Although in the past the courts have disallowed fraud claims based on rather thinly worded disclaimers of extra-contractual statements (i.e., disclaimers that do not include an express statement of non-reliability or non-reliance), recently the courts seem to be requiring an express statement that the buyer was not relying on extra-contractual statements to bar such fraud claims. See, for example, the decisions of the Court of Chancery in Anvil Holding Corporation v. Iron Acquisition Company, Inc. (May 17, 2013), and of the Superior Court in Alltrista Plastics, LLC v. Rockline Industries (September 4, 2013) and TEK Stainless Piping Products, Inc. v. Smith (October 14, 2013).

In another exculpation case, TransDigm Inc. v. Alcoa Global Fasteners, Inc. (May 29, 2013), the Court of Chancery distinguished between barring fraud claims resulting from the concealment of material information and contractually barring fraud claims based on extra-contractual statements. Because a concealment claim does not depend on a demonstration of reliance on extra-contractual statements, a fraud claim may not be barred, as long as the agreement did not include a disclaimer of the accuracy and completeness of the information provided, as in this case.

Modification of Default Fiduciary Duties in Limited Liability Companies (LLCs) Versus the Covenant of Good Faith and Fair Dealing

Recently, there has been extensive discussion and debate over the existence of "default fiduciary duties" in Delaware LLCs. This debate was effectively resolved when an amendment to Section 18-1104 of the Delaware Limited Liability Company Act was approved by the Delaware state legislature, effective August 1, 2013. The amendment clarifies that fiduciary duties govern the internal affairs of LLCs if the operating agreement is silent on the matter, but parties to an operating agreement may expressly provide for a waiver of fiduciary duties or limit the scope of such duties with respect to its members and/or managers.

In many cases, while business partners may not want the full range of fiduciary duties, there is a desire for duties of loyalty (i.e., members and managers put the interests of the business above other competing interests), duties of candor (i.e., sharing in full detail information necessary to make an investment or voting decision) and/or duties of care (i.e., people who are granted the authority to manage the operations of the business do so based upon a prudent businessperson standard). The assumption, as codified by the recent amendment, is that all of these duties and more are embedded on a default basis in the LLC relationship among members and their management team. The parties to an operating agreement should thoughtfully identify those categories of protections that are not needed and expressly waive those and retain the others by default.

Since LLCs and partnerships (or "alternative entities") are "purely creatures of contract," the Delaware courts are unwilling to provide protections to members outside of the express terms included in the LLC and partnership agreements. As former Chief Justice Steele has indicated, case law is still developing in the alternative entity area, but in light of the large increase in alternative entities in the last ten years, we can also expect to see an increase in the number of cases involving these entities. Some examples of the significant reduction of the duty of managers of LLCs and limited partnerships to act in good faith and deal fairly in operating agreements include the Delaware Supreme Court decisions in Norton v. K-Sea Transportation Partners L.P. (May 28, 2013), Brinckerhoff v. Enbridge Energy Company, Inc. (May 28, 2013) and Allen v. Encore Energy Partners, L.P. (July 22, 2013).

Nevertheless, in Gerber v. Enterprise Products Holdings, LLC (June 10, 2013), the Delaware Supreme Court, reversing the decision of the Court of Chancery, clarified in the limited partnership context that there are two separate legal principles: the contractual fiduciary duty regarding good faith and the implied covenant of good faith and fair dealing that applies to all provisions. So, while the alternative entity form allows the waiver of many fiduciary duties and liabilities, those contractual waivers have to be specific and explicit to be effective. If there is only a general waiver in the operating agreement, the implied covenant of good faith and fair dealing, which is always in effect but has to be properly alleged in a complaint, could undermine the waiver. In addition, the relevant Delaware statutes prohibit the elimination of the implied covenant of good faith and fair dealing in an operating agreement.

Attorney-Client Privilege Passes to the Surviving Corporation in a Merger

In Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP (November 15, 2013), the Court of Chancery held that attorney-client privilege passes to the surviving corporation in a merger. Section 259 of the Delaware General Corporation Law ("DGCL") provides that "all property, rights, privileges, powers and franchises, and all and every other interest shall be thereafter as effectually the property of the surviving or resulting corporation." The court decided that, in the absence of a contractual provision excluding pre-merger attorney-client communications from the transferred assets, all privileges, including the attorney-client privilege over all pre-merger communications (even regarding the merger negotiations), passed to the surviving corporation in the merger. As a practical matter, parties should carefully draft their contractual provisions to express the intent to exclude the transfer of any attorney-client communications they want to retain at the acquired company.

No Assignment of Agreements in Reverse Triangular Mergers

In Meso Scale Diagnostics, LLC v. Roche Diagnostics (February 22, corrected March 8, 2013), the Court of Chancery held and reaffirmed that the acquisition of a company through a reverse triangular merger does not result in the assignment, by operation of law or otherwise, of a target's agreements and licenses. This case serves as a reminder to carefully review boilerplate language in key contracts, including the assignment provisions. The court noted that parties could have negotiated a prohibition of change of control that would have required the consent of the plaintiff regardless of the form of the acquisition structure, instead of agreeing to a mere prohibition of the assignment of the contract, by operation of law or otherwise.

Survival Clauses Can Shorten Statute of Limitations

In ENI Holdings, LLC v. KBR Group Holdings, LLC (November 27, 2013), the Court of Chancery confirmed that in Delaware parties may contractually agree to a period of limitations that is shorter than that provided for by statute, as long as the shorter period is reasonable. In other words, survival clauses can shorten the statute of limitations for filing a claim.

Need for Provisions Regarding Status of Former Partners and Valuation of Capital Account

In Policemen's Annuity and Benefit Fund of Chicago, Illinois v. DV Realty Advisors LLC (November 27, 2013), the Court of Chancery considered the status of a general partner (GP) in a Delaware limited partnership after that GP was removed. The court stated that unless the partnership agreement provides otherwise, a person may be admitted to the partnership as a limited partner only upon the consent of all of the limited partners (Section 17-301(b)(1) of the DRULPA). Here, absent such consent or a provision in the partnership agreement, the former GP was not a limited partner, but just a holder of an economic interest (or perhaps of a "mere economic interest"). To avoid uncertainty, parties should consider including a provision in the partnership agreement, as it would also help determine the former GP's buy-out rights. In addition, the court held that to determine the valuation of the capital account without a clear basis for setting the date in the agreement, the "focus must be on reasonableness." In this case, the end of the tax (calendar) year date was the better choice because it more accurately reflected the economic realities of the partnership.

Earn-Out and Indemnification Provisions Need to be Clear and Specific

In Winshall v. Viacom International Inc. (October 7, 2013, corrected October 8, 2013), the Delaware Supreme Court addressed the earn-out and indemnification provisions in a merger agreement. With respect to the earn-out provisions, plaintiffs claimed that the target company had an implied obligation under the merger agreement to take advantage of an opportunity to increase the amount of the earn-out payment, in this case by renegotiating certain distribution fees. The Delaware Supreme Court, however, agreed with the Court of Chancery's decision that such obligation could not be implied and that the implied covenant of good faith and fair dealing cannot be applied to give plaintiffs contractual provisions they failed to negotiate themselves. The opinion highlights the importance of using clear and specific language to clarify the intent of the parties.

Regarding the indemnification provisions, in its cross-appeal, the defendant claimed it was entitled to indemnification for breaches of representations and warranties by the sellers relating to subsequent third party intellectual property claims, and that even absent a breach, the sellers should pay defendant's defense costs in such claims. The Delaware Supreme Court also agreed with the Court of Chancery that there was no such breach of the representation and warranties, and that without a breach, the sellers did not have an independent contractual duty to pay defendant's defense costs. The indemnification provision only provided for a duty to "indemnify . . . and hold them harmless," and did not create separate duties to indemnify and defend, which would require language such as "indemnify and defend against claims." In addition, the Delaware Supreme Court found that the indemnification obligation did not include a right to the legally distinct concept of advancement, which is the right to payment of defense costs as they are incurred, whether or not the party is ultimately entitled to indemnification.

Strict Requirements for Valid Stock Issuance

In Boris v. Schaheen (December 2, 2013), the Court of Chancery reviewed the requirements to validly issue stock. Delaware law requires that the stock issuance be reflected by a "written instrument," not just an oral agreement (Section 151(a) of the DGCL). In addition, the Court of Chancery will not use its equitable powers to cure a void stock issuance, so such stock will be held to not exist and all the corporate acts taken in reliance of that stock being issued will be called into question, in this case the removal and appointment of directors.

Technical Requirements for Valid Stockholder Consents

In The Ravenswood Investment Company L.P. v. Winmill (November 27, 2013), the Court of Chancery confirmed that certain requirements must be met to act by stockholder consent (Section 228 of the DGCL). The DGCL requires that every written consent bears the date of signature of each stockholder who signs the consent. In this case there was no factual disagreement about what the stockholders did and because the consent complied with the statutory requirement, the court was not so concerned with the failure to observe all the technical requirements (only one signature was dated). The court also indicated that the use of "as of" a certain date language does not automatically disqualify a consent. However, to the extent signatures are delivered on a date different from the date of the consent, this case indicates possible concerns with the validity of the underlying consent.

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