FundsTalk

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We are pleased to offer this issue of FundsTalk, Kramer Levin's newsletter devoted to discussing legal issues facing alternative asset managers and funds. Since 2008, the alternative asset market has seen a broad convergence of previously distinct asset classes and strategies, such as private equity, hedge funds, debt and claims trading, etc., into a single class — alternative assets. Extending that theme of convergence, this newsletter focuses on multi-disciplinary themes that affect all asset managers, with particular attention paid to new developments and changes in the legal landscape in which the industry operates. We hope you find the information contained in this newsletter to be helpful and profitable, and welcome your thoughts and suggestions.

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SEC Issues Risk Alert on Custody Rule: Advisers Should Take Note

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In March, the Office of Compliance Inspections and Examinations ("OCIE"), of the Securities and Exchange Commission ("SEC") issued a Risk Alert on compliance with the Custody Rule, Rule 206(4)-2 under the Investment Advisers Act of 1940, as amended (the "Advisers Act"), and an Investor Bulletin informing investors about the Rule. The Custody Rule is designed to protect advisory clients from theft or misuse of their funds and securities, and compliance has been subject to increased scrutiny since 2008. Although SEC Risk Alerts have increased in frequency in recent years, the issuance of an alert signifies that the SEC has designated the area as a "high risk" area, which means it will be the subject of examination. The SEC's stated goal is to examine registered advisers at least once every four years, and examine advisers engaging in the higher risk investment areas more frequently.

What is the Custody Rule?

The Custody Rule, Rule 206(4)-2 under the Advisers Act, imposes conditions on registered advisers who have "custody" of client assets. Generally, an adviser has custody if the adviser holds or has the authority to obtain possession of client funds or securities. When an adviser has custody, the adviser must:

- Maintain client funds and securities with a "qualified custodian" and notify clients of the custodial arrangement.
  - Assets must be maintained in a separate account for each client under the client's name, or in a combined account that contains only client funds and securities in the adviser's name as agent or trustee for the clients.
  - Advisers are required to tell clients who the custodian is, and update them if there are any changes to the custody arrangements or custodian.
- Have a reasonable basis for believing the client receives quarterly account statements.

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- > The adviser must have a reasonable basis, based on inquiry, to believe that the qualified custodian sends an account statement, at least quarterly, to each of the adviser's clients for which it maintains funds or securities.
- > Quarterly account statements must include all transactions from the account during the applicable period.
- > Advisers' own account statements should include a statement "urging" clients to compare it to statements from the custodian.

- Undergo an annual surprise examination.
  - > At least annually, an independent public accountant must conduct a "surprise examination" to verify the existence of client funds and securities for which the adviser has custody.
  - > The accountant's report of the surprise examination is filed with the SEC by the accountant, and the adviser must disclose this surprise examination and the examining accountant on Form ADV.
- Provide an internal controls report relating to custody, if the qualified custodian is a related person.
  - > If the adviser or a related person serves as the qualified custodian, the surprise examination must be performed, and the adviser must obtain an annual report of internal controls relating to custody of client assets.

Pooled investment vehicles

A special rule permits advisers to private funds and pooled investment vehicles[1] to avoid some of these requirements, if the pooled vehicle is audited in compliance with GAAP and the audited financial statements are distributed within 120 days after the fund's fiscal year end (180 days for funds of funds). The SEC calls this the "Audit Approach" to meeting custody obligations. Advisers relying on the Audit Approach are *deemed* in compliance with the surprise examination requirement and *exempt* from the notice and statement delivery requirements. Under the custody rule, privately offered securities owned by pooled vehicles and funds can be held by an adviser (instead of a qualified custodian) only if the adviser satisfies the conditions of the Audit Approach.

What the National Exam Program Staff Found

According to OCIE, the National Examination Program staff found four types of significant deficiencies in approximately one-third of the advisers examined.

Advisers did not seem to recognize that they had custody when:

- the adviser or the adviser's staff serve as trustee for a client or are authorized to write or sign checks for a client;
- the adviser or the adviser's staff are authorized to make withdrawals from a client's account as part of bill-paying services;
- the adviser or the adviser's staff have access to online accounts in the client's name and can move or withdraw funds or securities (including executing investment decisions);
- the adviser serves as a *general partner or managing member* for a pooled investment vehicle;
- the adviser has physical possession of client assets, such as actual securities certificates; or
- the adviser receives checks payable to clients.

Advisers did not have a proper surprise custody examination when one was required under the Custody Rule:

- Examinations that occur at the same time each year are not a "surprise"; and
- Accountants must file the report of examination on Form ADV-E within 120 days after completion of the examination.

Advisers failed to comply with the qualified custodian rules when:

- Advisers commingled proprietary, employee and client assets;
- Advisers held client property in safe deposit boxes;
- Custodial accounts identified the adviser as a principal when the adviser should have been identified as an agent or trustee for the client;

[1] Investment companies registered under the Investment Company Act of 1940 are exempted from Rule 206(4)-2 under subsection (b)(5) of the rule.

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- Adviser statements did not urge clients to compare them to custodian statements; and
- Advisers did not have a "reasonable basis, after due inquiry" to believe that custodians were sending account statements directly to clients.

Advisers failed to satisfy the conditions for the Audit Approach because:

- Audited financials did not comply with GAAP, *e.g.*
  - organizational expenses were amortized instead of expensed as they occurred,
  - the federal income tax basis of accounting was used for their preparation, or
  - they were issued without an unqualified opinion because the adviser could not substantiate fair valuations of assets;
- Accountants conducting audits were not PCAOB-registered;
- Final audits were not performed on liquidated pooled vehicles;
- Accountants lacked independence;
- In one case, an adviser asked its fund investors to waive the fund's annual financial audit, but then did not obtain a surprise examination;
- Adviser could not demonstrate that audited financials were distributed to all fund investors, and in some cases, were only "offered" to investors; and
- Advisers could not show that the financials were distributed in accordance with the 120-day and 180-day deadlines in the Custody Rule.

What Should Advisers Do Now?

OCIE's director, Carlo di Florio, has repeatedly announced that Custody Rule compliance would be emphasized on examinations, and the existence of the Risk Alert means advisers should devote more attention to custody.

- Advisers should review custody status as a part of their annual compliance review. As part of that review, advisers should consider whether they or their staffs have the ability to access client funds or securities for any reason. Generally, any access that is not for trading purposes will constitute custody, even if no activity other than trading takes place.
- Advisers should make sure that when completing their Form ADV, they answer questions on custody with reference to both the Custody Rule and instructions to Form ADV.
- Advisers relying on the Audit Approach should do a compliance review specifically directed to ensuring that they have complied with the conditions:
  - Are audited financials distributed to all investors?
  - Are audit opinions unqualified?
  - Are financials distributed within the time frame of the rule (120 days/180 days for funds of funds)?

What if the SEC finds deficiencies?

As with any other SEC rule, failing to comply with the Custody Rule can have a range of implications.

- If a deficiency is noted, the SEC may require an adviser to adopt or amend compliance policies and procedures to more clearly reflect the Custody Rule, change business practices to comply, or devote more compliance resources to custody issues.
- In many cases, the SEC will mandate a surprise examination to confirm the existence and valuation of client assets. This is a likely outcome if an adviser did not recognize that they had custody of client assets and cannot rely on the Audit Approach.
- OCIE can refer any deficiency to the SEC's Enforcement Division. This is more likely to occur when noncompliance is egregious, intentional, has occurred for a long period of time, or when the noncompliance has previously been identified by any regulator during any examination or review and has not been cured.

The Investor Bulletin issued by the SEC's Office of Investor Education and Advocacy (OIEA) describes, for investors, the requirements of the custody rule, including the requirement for custodians to send account statements to investment advisory clients at least every quarter. The Investor Bulletin urges clients to discuss custody of client assets with advisers, so advisers should expect more questions in this area from their clients and investors. ■

Recent and Upcoming Regulation Affecting U.S. Hedge Fund Activity in the EU

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Alternative Investment Fund Managers Directive (AIFMD)

The Alternative Investment Fund Managers Directive (the "Directive" or "AIFMD"), scheduled for implementation throughout the EU this summer, regulates alternative investment fund managers ("AIFMs") of hedge funds, private equity funds and other alternative investment funds ("Funds") that market to or raise funds from EU investors. Given its broad scope and fast-approaching implementation date, US advisors who plan to market Funds into any EU Member State after July 21, 2013 will need to urgently reviewing the potential impact of the Directive on their operations.

As a first step, advisors having an office (or subsidiary or affiliate) in a Member State should consider whether the activities of that office would render it an AIFM subject to full compliance with Directive. If so, an application for authorization as an AIFM must be submitted to the applicable Member State regulator by July 21, 2014, unless modifications to existing fund or management structures (for example, by delegating functions to an entity outside the EU) can be carried out prior to such date.

For practical purposes, although many of the obligations set out in the Directive will already apply to any managers already authorized in Europe under the Markets in Financial Instruments Directive ("MiFID") or national Member State regimes, a host of additional rules — relating, for example, to minimum regulatory capital, appointment of a depository and disclosure of remuneration — will also apply.

Advisors with no operations or funds in the EU should then nevertheless determine whether any Funds are likely to be marketed into the EU after July 22, 2013. If so, consideration should be given as to whether passive marketing ("reverse solicitation") or private placement will be used to market Funds.

Although there will be no need for an advisor with no operations or funds in the EU to be authorized under AIFMD until 2018, from July 22, 2013 any marketing of funds into the EU by non-EU AIFMs may occur solely through "reverse solicitation" (where a professional investor approaches the advisor, with no solicitation by the advisor prior to the approach) or each Member State's private placement rules (which differ among Member States).

"To-Do" List for US Advisors marketing funds into Europe

For advisors that will be marketing via private placement after July 21, 2013, the Directive imposes certain new obligations which will need to be taken into account:

- Ensure marketing materials contain the required pre-investment disclosures

  The PPM and other marketing materials must contain information relating to items set out in Article 23 of the Directive, which include a description of: the investment strategy and objectives of the Fund; professional indemnity insurance; any delegated functions; valuation procedures; fees, charges and expenses; how the AIFM ensures the fair treatment of investors, and the latest annual report.

- Put in place systems for preparation of annual reports, investor disclosure and regulator reporting

  The Directive imposes a variety of disclosure obligations, the timing of which will depend on the rules made in each Member State to give effect to these requirements of the Directive:

  > an annual report to investors and regulators, within four months of the end of the Fund's financial year;
  > disclosure to investors on changes to maximum levels of leverage and assets which are subject to special arrangements arising from their illiquid nature (if applicable); and
  > regular reports to Member State regulators relating to the main instruments in which the Fund is trading, the markets of which the Fund is a member or where it actively trades, and the diversification of the Fund's portfolio.

- Review duties that apply where the Fund acquires more than 50% of the voting rights of a non-listed company that has its registered office in the EU

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In such a case, certain notification and disclosure obligations will be triggered, including the duty to provide information regarding the Fund's intentions with respect to the future business of the company and the likely repercussions on employment and conditions of employment.

In addition, the Directive contains "asset-stripping" restrictions affecting distributions, capital reductions, share redemptions and/or purchases of own shares by controlled portfolio companies during the first two years of Fund ownership.

- Monitor implementing legislation and cooperation agreements in EU countries where Funds will be marketed

In particular, note that Member States will have some discretion to implement the Directive in such a way that that goes beyond the minimum requirements of the Directive. For example, some Member States do not (or will not, after implementation of the Directive) permit the marketing of any Fund without registration of the Fund or the appointment of a locally authorized entity to undertake the marketing.

Cooperation arrangements will also need to be in place between a relevant Member State competent authority, the advisor's regulator and the regulator in the jurisdiction of the Fund.

On the horizon:
Although the Directive does not yet allow a non-EU entity to be the AIFM for an EU Fund, provisions allowing such authorization are likely to come into effect **in 2015.**

From 2015 until 2018, an advisor will be able to choose between (a) marketing a Fund via reverse solicitation or private placement as summarized above, or (b) becoming authorized in a Member State, and which would then enable the advisor to obtain an "EU passport" to market Funds in other Member States without the need for further authorization in those Member States.

Finally, from **2018 onwards**, all advisors marketing in the EU will have to be fully compliant with the Directive, and will accordingly benefit from the EU passport.

Short Selling Regulation (SSR)

Funds that hold net short positions in EU shares or EU sovereign debt should consider whether their activity gives rise to reporting obligations in the EU under the Short Selling Regulation ("SSR"), which has been in effect since November 1, 2012. In summary, the SSR:

- bans uncovered sovereign CDS;
- prohibits uncovered short sales of shares and sovereign debt, subject to entering into third party arrangements which provide a reasonable expectation that settlement can be effected when due (or, for sovereign debt, with a third party which has confirmed that sovereign debt can be delivered in time for settlement);
- requires EU-wide notification and reporting to regulators when net short positions in shares exceed or fall below 0.2% of the issued share capital of the issuer company; positions must be publicly disclosed (on a named basis) when they exceed or fall below 0.5%, with further notification/reporting at each 0.1% above the initial threshold;
- requires holders of significant net short positions in sovereign debt to notify their positions privately to the relevant regulators when they exceed: (i) for sovereign issuers with €0-500bn outstanding debt -0.1% of the total outstanding amount of issued sovereign debt and each 0.05% above this; and (ii) for sovereign issuers with over €500bn outstanding debt or where there is a liquid futures market -0.5% of outstanding issued sovereign debt and each 0.25% above this; and
- provides national regulators and ESMA with additional powers to intervene in the markets in times of stress.

European Market Infrastructure Regulation (EMIR)

Similar to the Dodd-Frank Act, the European Market Infrastructure Regulation (EMIR) mandates:

- clearing of certain "eligible" OTC derivative contracts entered into between any financial counterparty and certain non-financial counterparties through a central counterparty (CCP);

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- obligatory risk mitigation techniques for un-cleared OTC derivative contracts; and
- compulsory reporting of the details of all derivative contracts to authorized trade repositories.

EMIR came into force on August 16, 2012 but full implementation will not be complete until a number of technical standards are finalized, likely around the middle of 2013. Currently, rules relating to the clearing obligation and operational risk management of non-cleared OTC derivatives are expected to apply beginning around the middle of 2013, with the reporting obligation beginning on July 1, 2013 (for credit and interest rate derivatives) or January 1, 2014 (for all other classes).

Although the implementation timetable is subject to change, to ensure EMIR readiness financial and non-financial counterparties should be preparing now, by considering:

- Are contracts in place with clearing members enabling it to access CCPs that clear the types of OTC derivatives it trades?
- Can existing systems and processes properly adequately carry out the operational risk mitigation required by EMIR?
- Are adequate collateral agreements in place and sufficient collateral available to collateralise non-cleared OTC derivative trades?
- Which trade repositories will it report to for the types of derivatives traded? Will reporting be carried out directly or delegated to a counterparty or third party?

Foreign Account Tax Compliance Act (FATCA)

In an effort to reduce U.S. tax evasion, FATCA requires "foreign financial institutions" (FFIs) (including hedge funds established outside the US) (i) to report information to the IRS about U.S. holders of their non-publicly traded debt and equity interests and other "financial accounts," and (ii) to withhold 30% on certain payments attributable to U.S. assets that are made to holders who do not provide the required information.

In practice, this means that offshore hedge fund investors, both U.S. and foreign, will have to provide additional documentation as part of the on-boarding process. Operationally, offshore funds will need to implement new document collection and due diligence processes by January 1, 2014, and adopt U.S. reporting capabilities by March 15, 2014, with tax withholding obligations coming into effect on January 1, 2017.

Failure to comply with FATCA can lead to a 30% withholding penalty, so funds should be speaking with service providers to ensure that they can comply as the relevant deadlines hit.

Other legislation currently in the proposal stages (but likely to be adopted and implemented by 2015) includes:

Financial Transactions Tax (FTT)

A proposed tax on financial transactions would impose 0.1% tax on equity/bond transactions (0.1% of notional derivatives value) where at least one party is established in an EU Member State and either that party or another is a financial institution. The proposal, issued in September 2011, is currently limited to 11 Member States, and not likely to be implemented prior to December 2014. In the meantime, advisors should review the potential impact of the FTT on their operations and consider whether modifications can be made to reduce such impact.

MiFID II / MiFIR

Review of the Markets in Financial Instruments Directive (MiFID) — which harmonizes the EU regulatory framework for the provision of investment services in financial instruments and the operation of regulated markets — was initiated by the European Commission in October 2011 and will likely be implemented by 2015 with the final adoption of two texts: (i) a revised Markets in Financial Instruments Directive (MiFID II) and (ii) a new Regulation (MiFIR). Together, these proposals would:

- extend the existing regime both in terms of instruments and firms covered, so that, for example, certain commodity trading firms will fall within scope of the regime;
- impose regulatory requirements on firms undertaking algorithmic trading (including HFT);
- impose position limits on the trading of commodity derivatives;

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- impose restrictions on third country firms providing services in the EU;
- introduce enhanced corporate governance requirements for investment firms; and
- introduce enhanced pre- and post-trade transparency provisions in respect of both equities and non-equities.

MAD II / MAR

The Market Abuse Directive (MAD) established a basic framework for the prevention of market abuse to prevent both insider dealing and market manipulation and to provide sanctions where the rules were breached. EC proposals for a revised Directive (MAD II) and a new Regulation (MAR), which are under discussion and likely to come into effect around 2015, would further harmonize criminal and administrative sanction regimes (in order to reduce potential regulatory arbitrage) and widen the scope of MAD to include:

- new instruments (*e.g.* OTC and commodity derivatives);
- new markets (MTFs and other venues);
- attempts to manipulate the market (where a person intends to manipulate the market but does not place an order or execute a transaction); and
- enhanced powers for competent authorities to tackle and investigate market abuse, including the power to enter private premises, to seize documents and to access telephone records. ■

Securitizations Saved from Drowning in Commodity Pool

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The Commodity Exchange Act (the "CEA") defines a "commodity pool" as any investment trust, syndicate or other enterprise operated for the purpose of trading "commodity interests." The Dodd-Frank Wall Street Reform and Consumer Protection Act amended the definition of "commodity interests" to include "swaps" (which generally includes interest rate swaps, most currency swaps and forwards, and credit default or total return swaps that reference various indices). As a result of this amendment, securitization market participants were highly concerned that a securitization transaction that employed the use of even a single swap was at risk of being deemed to be a "commodity pool" and that any party to such securitization transaction that had responsibilities to administer or provide trading advice to the securitization could be deemed to be a "commodity pool operator" ("CPO") or a "commodity trading advisor" ("CTA"). In October and December 2012, thanks to concerted efforts from industry participants, the Commodity Futures Trading Commission (the "CFTC") through the Division of Swap Dealers and Intermediary Oversight (the "Division") issued two letters which excluded a substantial portion of the securitization market from being treated as commodity pools and saved many sponsors, arrangers, trustees, servicers, collateral managers, swap counterparties and others from drowning in the deep pool of registration, compliance and reporting obligations under the CEA and CFTC regulations.

CFTC Letter 12-14 (the "October Letter")

The October Letter exempts from classification as commodity pools, and consequently exempts relevant parties from registration as CPOs or CTAs, structures that meet the following criteria:

(i) the issuer of asset-backed securities is operated consistently with the conditions set forth in Regulation AB under the Securities Act or Rule 3a-7 of the Investment Company Act, whether or not the issuer's security offerings are in fact regulated pursuant to either regulation, such that the issuer, pool assets, and issued securities satisfy the requirements of either regulation;

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Securitizations Saved from Drowning in Commodity Pool

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(ii) the entity's activities are limited to passively owning or holding a pool of receivables or other financial assets, which may be fixed or revolving, that by their terms convert to cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distributions of proceeds to security holders;

(iii) the entity's use of derivatives is limited to the uses of derivatives permitted under Regulation AB (including credit enhancement and the use of interest rate and currency swaps to alter the payment characteristics of the cash flows from the issuing entity);

(iv) the issuer makes payments to securities holders only from cash flow generated by its pool assets and other permitted rights and assets, and not from or otherwise based upon changes in the value of the entity's assets; and

(v) the issuer is not permitted to acquire additional assets or dispose of assets for the primary purpose of realizing gain or minimizing loss due to changes in market value of the vehicle's assets.

CFTC Letter 12-45 (the "December Letter")

Based on further discussions with market participants in October and November 2012, the Division issued the December Letter to provide for further exclusions from commodity pool regulation, legacy relief for existing securitization transactions and an extension of the registration period for CPOs.

Additional Exclusions. The December Letter provides that securitization vehicles that do not satisfy the operating or trading limitations contained in Regulation AB or Rule 3a-7 (and therefore do not satisfy the requirements of the October Letter) will not be commodity pools if such securitization vehicles:

(i) only use swaps in a manner no greater than that contemplated by Regulation AB or Rule 3a-7 and in no way to create an investment exposure, and

(ii) limit their activities to holding financial assets.

Legacy Relief. Most importantly, the December Letter provides that the Division will not recommend the CFTC take enforcement action against any operator of a securitization vehicle for failing to register as a CPO if:

(i) the issuer has issued fixed income securities before October 12, 2012 that are backed by and structured to be paid from payments on or proceeds received in respect of, and whose creditworthiness primarily depends upon, cash or synthetic assets owned by the issuer;

(ii) the issuer has not issued and will not issue new securities on or after October 12, 2012; and

(iii) within 5 business days of a request from the CFTC or any division or office thereof, the issuer delivers electronic copies of certain documents concerning its existing securities.

Registration Extension. If a securitization vehicle does not qualify for the exemption from the definition of "commodity pool," operators of such securitization vehicles have until March 31, 2013 to register as a CPO.

Next Steps

The October Letter and the December Letter (the "CFTC Letters") provided substantial relief for most of the securitization market. Parties to existing and proposed securitization transactions that contain a swap need to immediately undertake an analysis as to whether the related vehicle can rely on the relief afforded by the CFTC Letters. If not, parties should immediately undertake a simultaneous four pronged approach and determine: (i) which parties need to register as a CPO or a CTA, (ii) whether CFTC Regulation 4.7 is available to provide CPOs and CTAs substantial relief from certain disclosure, reporting and record keeping requirements, (iii) whether "*de minimis*" exemptions under CFTC Regulation 4.13(a)(3) apply (although, there is sufficient uncertainty regarding how certain calculations should be determined thereunder that further guidance from the CFTC may be required) and (iv) whether to engage the Division in discussions as to whether particular facts and circumstances justify a conclusion that the vehicle is not a commodity pool or is entitled to other relief. ■

Don’t Ask, Don’t Waive Standstills: Do the Benefits Justify the Costs?

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Public companies exploring a potential sale will often require potential suitors to sign confidentiality agreements as a condition to participating in a sale or auction process. These agreements often include “standstill” provisions, which bar the bidders from making a bid outside of the auction process for a certain period of time. It has become increasingly common in recent years for targets to include “don’t ask, don’t waive” standstill provisions in these agreements. These provisions not only prohibit an actual bid outside the auction process, but also prohibit any public or private request by the bidders that the board of the target company waive the standstill provision and allow them to make a bid. Target companies typically use these provisions as a way of drawing out the highest possible bids during an auction. The prohibition on requesting a waiver, together with the standstill provisions, is intended to provide assurance to bidders that, if they win the auction, other bidders will not have a second chance to top their prevailing bid.

A “don’t ask, don’t waive” provision may not deter a determined bidder from presenting a proposal to the board, notwithstanding that it has executed a standstill agreement with this provision. If the bidder violates the provision and presents a confidential proposal, the company may have difficulty showing damages or a basis for a remedy. Challenges of the provision may arise indirectly, however:

- Shareholders may sue to enjoin an issuer from enforcing a “don’t ask, don’t waive” provision, maintaining that the provision improperly restricts the bidding process;
- After the company enters into an acquisition agreement, shareholders may argue that the board process giving rise to the agreement was flawed because “don’t ask, don’t waive” chilled would-be bidders; or
- Shareholders may sue to compel consideration of a superior offer submitted in violation of a “don’t ask, don’t waive” provision, where the target board has refused to do.

Two recent bench rulings[1] by the Delaware Court of Chancery address the first two of these scenarios. The cases illustrate that “don’t ask, don’t waive” provisions will be subject to heightened scrutiny, but when used appropriately may be respected. The third scenario has yet to be the subject of a Delaware judicial ruling.

In re Complete Genomics, Inc. Shareholder Litigation

In *Complete Genomics*, Vice Chancellor Laster preliminary enjoined a company from enforcing a “don’t ask, don’t waive” provision. The Vice Chancellor held that the plaintiffs had established a reasonable probability of success on their argument that by prohibiting even private waiver requests, a board would remain unaware of the existence of an alternative bid. As a result, the board would be unable to fulfill its “statutory and fiduciary obligations to properly evaluate a competing offer, disclose material information, and make a meaningful merger recommendation to its stockholders.” While this ruling was technically a preliminary injunction enjoining the enforcement of a “don’t ask, don’t waive” provision in a single standstill agreement, it was initially understood by many practitioners as adopting a *per se* rule that “don’t ask, don’t waive” provisions are unenforceable.

In Re Ancestry.com

A few weeks later, a bench ruling by Chancellor Strine in *In Re Ancestry.com* dispelled the perception of *per se* invalidity of “don’t ask, don’t waive” provisions. In *Ancestry*, confidentiality agreements signed by twelve

[1] Bench rulings do not have the precedential force of formal opinions and are intended to be limited to the circumstances of the case in which they are issued. Nonetheless, practitioners see these rulings as indicative of the court’s thinking.

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Don't Ask, Don't Waive Standstills: Do the Benefits Justify the Costs? *continued from page 9*

separate bidders in a sale process all contained "don't ask, don't waive" provisions. These provisions were waived after commencement of litigation and shortly before the stockholder meeting to approve a merger agreement with the successful bidder. The target board had not been adequately informed of the effect of these "don't ask, don't waive" provisions, and Chancellor Strine observed that the board probably violated its duty of care in not properly considering their import. Holding that consideration of "don't ask, don't waive" provisions was material to the stockholder vote on the sale, the Chancellor enjoined the vote until corrective disclosure was made by the company. He declined to more broadly enjoin the acquisition, in part because the "don't ask, don't waive" provisions were waived in advance of the stockholder meeting.

In his bench ruling, Chancellor Strine offered some additional thoughts on "don't ask, don't waive" provisions. While the board in *Ancestry* likely violated its fiduciary duties in not weighing the costs-benefits of "don't ask, don't waive," contrary to the general impression following *Genomics*, there was no *per se* rule against the enforceability of the provision. It was possible, he said, that provisions of this sort could be effective to maximize value by forcing bidders to make their highest bid as part of the auction process. Without the provision, bidders could be incentivized to sit out the auction, awaiting the outcome of the process before deciding whether to lob in a topping offer. Those bidders participating in the auction, in turn, might be incentivized to hold back on their best bid, knowing that the game might not be over at the conclusion of the auction.

Takeaways

There are lessons to be learned from the perspectives of the target company, potential acquirers and activist shareholders.

From the company perspective. The two Delaware cases taken together suggest that there will be heightened scrutiny on the use of "don't ask, don't waive" provisions, and as a result, increased litigation risk. At the same time, when employed properly, they may withstand that scrutiny and better enable the target to achieve value maximization in the sale process. Target companies can take steps to increase the chances that these provisions survive court challenges. At the outset of a sale process, a target's board should not only be informed of the existence of clauses such as "don't ask, don't waive" provisions, but they should affirmatively approve their use after evaluating the associated costs and benefits. In its analysis, the board should consider that the provisions may be more likely to be upheld where there has been a robust auction process with multiple bidders. Finally, the operation of the provisions and their effects on the process should be disclosed in a proxy statement prior to any shareholder vote on the acquisition transaction.

From the potential acquirer perspective. For an acquirer that does not want to be saddled with a "don't ask, don't waive" provision, the best course is to resist its inclusion in the confidentiality/standstill agreement from the outset. Whether or not "don't ask, don't waive" is subject to a *per se* rule, the recent Delaware decisions demonstrate that these provisions are subject to infirmities. In the right circumstances, there is ammunition here to argue with reasonable cogency against having the provision in the standstill. As a fallback, the acquirer may successfully negotiate for a fall-away provision, for example if the target company signs an acquisition agreement. If "don't ask, don't waive" is included in the confidentiality agreements entered into between a target and a group of bidders, bidders should note that as a practical matter, there may be no remedy available to the company for its breach and as a result other bidders may determine to deliver a confidential topping proposal to the board notwithstanding the provision. This may not necessarily involve gamesmanship or bad faith. For example, the bidder may come into financing only late in the process, after an auction has run its course. There are, however, some practical considerations that may deter such a breach. Corporate officials may decline to deliver the proposal to board members, citing the "don't ask, don't waive" provision. Also, an acquirer that has earned a reputation of breaching standstill provisions, may be shut out of future acquisition opportunities, a point made by Chancellor Strine in *In Re Ancestry.com*. Finally, a board may deem itself constrained from considering a bid submitted in violation of "don't ask, don't waive" by the acquisition agreement with the successful bidder at auction. Typically, an acquisition agreement will require the target company to enforce confidentiality and standstill agreements, although some have been known to exclude standstill provisions.

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From the activist shareholder perspective. As evidenced by the recent Delaware cases, there is much that can go wrong in the implementation of a "don't ask, don't waive" provision. Where such a provision is lurking in the process, it may form a basis for challenging a board approved transaction that an activist shareholder deems inadequate. A challenging shareholder should be cautioned, however, that the Delaware courts have been reluctant to toss a transaction in-hand, where the challenger cannot offer an alternative and where shareholders may be deprived of all premium value if the transaction in-hand is enjoined. As noted, the Delaware courts have yet to address a situation where a bidder has presented the target board with a superior offer in violation of a "don't ask, don't waive" provision and the board has refused to consider it. It is difficult to predict the outcome of such a case, but given the bench comments in Delaware Chancery, there is a good chance that a Delaware court would be reluctant to allow a target board to hide behind "don't ask, don't waive" and deny shareholders a deal that clearly offered superior value. ■

"The Road to Hell is Paved with Good Intentions": The Fiduciary Limits on Shareholder-Director Actions

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Private equity fund managers need to be aware of a recent development in Delaware corporate law affecting their board director designees. In *Shocking Technologies, Inc. v. Michael*, the Delaware Court of Chancery found a shareholder-director can breach his fiduciary duty of loyalty, even if that director subjectively believes that he is acting in good faith to further the interests of the corporation.

Background

Shocking Technologies is a tech startup with a board consisting of four directors: three appointed by investors and one who was the corporation's founder, president and chief executive officer. Michael was the manager of the general partner of a venture capital firm that made a significant investment in Shocking Technologies and was appointed to serve as director.

In 2011, Shocking Technologies needed additional capital to remain solvent. Michael expressed concern that the other directors were not acting in the corporation's ultimate best interest. As a result, Michael sought to gain greater authority over the corporation to advance what Michael believed to be the corporation's ultimate best interest by interfering with the corporation's capital raise. Michael disclosed confidential corporate information to a potential investor in an attempt to dissuade it from injecting funds into the corporation. By leaving the corporation "desperate for funding," Michael believed the investor would be able to negotiate a better deal, such as a lower price or board representation, which would ultimately improve the corporation's governance structure. Michael's plan did not work; the investor ultimately injected funds into the corporation but at a price more favorable to the investor and did not obtain board representation. As a result, Shocking Technologies commenced a breach of fiduciary duty of loyalty action against Michael seeking his removal from the board and monetary damages.

Fiduciary Duty of Loyalty of Directors of Delaware Corporations

Under Delaware corporate law, the fiduciary duty of loyalty (1) imposes an affirmative obligation on a director to protect and advance the interests of the corporation and (2) requires a director to refrain from conduct that would harm the corporation. The duty of loyalty is ordinarily analyzed in the context of self-dealing by a director for the economic benefit of one contingency over all the shareholders and the requirement to act in good faith.

In *Shocking Technologies*, there was no self-dealing by Michael, a shareholder-director, in the typical, economic manner. Furthermore, the shareholder-director claimed

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to be acting in good faith. Nonetheless, the Court noted that "[a] director acting in subjective good faith may, nevertheless breach his duty of loyalty."

The Court found the shareholder-director breached his fiduciary duty by (a) trying to dissuade the potential investment that would have provided much-needed cash to the corporation and (b) disclosing confidential information about the corporation's financial position to the investor. The Court reasoned that Michael knew his actions would frustrate the corporation's efforts to raise "enough cash to survive" which could have caused the demise of the corporation, and therefore Michael breached his fiduciary duty of loyalty. Additionally, the Court ruled that "the disclosure of confidential information . . . to a potential investor [adverse to the corporation], especially when the director knows (and hopes) that the disclosure would benefit the potential investor to the substantial detriment of the [corporation]," is also a breach of the duty of loyalty. The Court held that even if the shareholder-director had the "best subjective intentions" or "reasonable goals," he "chose improper means . . . in an attempt to achieve them." But because Michael failed to achieve his goal of changing the corporation's governance structure, the Court declined to award Shocking Technologies damages and attorneys' fees and expenses.

Fiduciary Duties of Managers of Delaware Limited Liability Companies

Increasingly, we find our private equity clients invest through a limited liability company (LLC) rather than a corporation. The takeaways from *Shocking Technologies, Inc. v. Michael* should still be acknowledged and addressed in the LLC context. While the fiduciary duties of directors of Delaware corporations cannot be modified or waived, the Delaware Limited Liability Company Act does allow an LLC's members to modify or eliminate by contract a manager's fiduciary duties (although the implied covenant of good faith and fair dealing cannot be eliminated). Thus, private equity funds who invest through Delaware LLCs may seek to contractually modify or eliminate fiduciary duties of loyalty that would otherwise attach to their director designees to limit the liability their director designees are exposed to when they act in subjective good faith. ■

Practice Areas

This publication is a collaboration of the following practice areas:

- Capital Markets
- Claims Trading and Distressed Investment Advice
- Corporate
- Corporate Restructuring and Bankruptcy
- Electronic Discovery
- Employment Law
- Executive Compensation
- Financial Services/Investment Management
- Intellectual Property
- Litigation
- Mergers and Acquisitions/Joint Ventures
- Private Equity and Hedge Funds
- Securitization
- Swaps & Derivatives
- Tax