MFW Framework Inapplicable Where Conflicts Are Not Adequately Disclosed to Stockholders

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Following other recent decisions addressing the applicability and scope of *Kahn v. M&F Worldwide Corp*. ("*MFW*"), including *In re Match Group Inc., Derivative Litigation* and *Tornetta v. Musk*, on May 1, 2024, the Delaware Supreme Court in *City of Sarasota Firefighters' Pension Fund et al. v. Inovalon Holdings, Inc.* held that Inovalon Holdings, Inc., its CEO and its board of directors failed to comply with *MFW*'s fully informed stockholder vote requirement and therefore could not avail themselves of business judgment rule protection.

As previously described in an earlier Quorum article, in *In re Match Group, Inc.*, the Delaware Supreme Court held that in order to receive business judgment review, a transaction must be subject to both (1) approval by an independent special committee and (2) an uncoerced, fully informed vote by minority stockholders. The Court found that the stockholder vote approving the transaction in the Inovalon case was not fully informed because potential conflicts of interest of the financial advisors were not adequately disclosed to the company's board or to its stockholders in the proxy statement. The decision highlights the importance of disclosure of potential conflicts to qualify for business judgment rule treatment under *MFW*.

Following an acquisition proposal from Nordic Capital, Inovalon's board engaged J.P. Morgan to explore strategic alternatives. Inovalon's founder and CEO, along with a former Inovalon director, collectively held approximately 86% of Inovalon's voting power and the CEO, along with certain other Inovalon stockholders, intended to roll over a portion of their equity. As a result, a special committee of the Inovalon board was formed and Evercore was hired as the special committee's financial advisor. The board and special committee became aware of certain conflicts of interest involving the financial advisors. Both J.P. Morgan and Evercore had provided advisory services to Nordic and members of the buyer investor consortium in the past and Evercore was performing concurrent work for Nordic in an unrelated $20 billion fundraising. The conflicts were disclosed to the board two weeks after the parties had signed a merger agreement and were not described in the proxy statement.

Certain stockholders challenged the transaction, accusing the CEO and the other Inovalon directors of breaching their fiduciary duties, and claiming that Inovalon's proxy statement failed to adequately disclose the conflicts of the two financial advisors. The Court of Chancery had previously dismissed the claims, finding that the *MFW* requirements had been satisfied and that the majority-of-the-minority vote for the transaction was sufficiently informed.

On appeal to the Delaware Supreme Court, the plaintiffs argued that (1) the transaction failed the *MFW*'s "*ab initio*" test because the founder had engaged in significant negotiations prior to the formation of the special committee and (2) the majority-of-the-minority vote was not fully informed due to inadequate disclosure of potential conflicts of interest of the financial advisors. Focusing on the plaintiffs' second argument, the Supreme Court reversed the Court of Chancery, finding that the proxy statement failed to include important details involving J.P. Morgan and Evercore, thus rendering the minority stockholders' vote not fully informed. In its decision, the Court stated, that it was "misleading for the Proxy to state that Evercore 'may' provide advisory services to Nordic and [a member of its investor consortium] when, in fact, it was providing such services, and thus there was an actual concurrent conflict. Evercore's concurrent representation, in unrelated transactions, of Nordic, the bidder of the Company, and the equity consortium member, a co-investor, were material facts." The Court also found that the proxy statement failed to disclose the fact that J.P. Morgan had collected nearly $400 million in fees for prior work it had done for members of the buyer investor consortium.

The decision also reinforced the Delaware Supreme Court's March 24, 2024 decision in *City of Dearborn Police & Fire v. Brookfield Asset Management*, with the Court finding in both cases that information relating to the independence and potential conflicts of a special committee and its advisors "are uniquely important considerations for minority stockholders when deciding how to vote." The Court further explained that whether information is material and thus should be disclosed in the proxy statement should be assessed from the viewpoint of a reasonable stockholder. However, due to "the central role played by investment banks in the evaluation, exploration, selection, and implementation of strategic alternatives…full disclosure of investment banker compensation and potential conflicts" is required. Consequently, the "cleansing" process under the *MFW* framework could not apply, and the Court remanded the matter to be reviewed under the entire fairness standard.

The decision emphasizes the need for special committees to examine any potential conflicts of interest among their financial and legal advisors at the outset of engagement, ensure inquiries are made to identify any such conflicts and, if material conflicts are identified, consider whether continued engagement is appropriate and/or fully disclose such conflicts to minimize their impact.

After Referral from CFIUS President Biden Prohibits the Purchase of Wyoming Real Estate and Cryptocurrency Facility

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On May 13, 2024, President Biden, acting on a transaction referred to him from the Committee on Foreign Investment in the United States ("**CFIUS**"), took the unusual step of ordering the prohibition of a real estate acquisition two years after it closed (the "**Order**"). The Order requires a relatively rapid sale of the land to a third-party, among other interim obligations. This transaction and the resulting presidential action is another indication of the U.S. government's scrutiny of foreign investment in both U.S. real estate and U.S. business. Moreover, it offers a case study for transaction parties on the need to carefully consider the pros and cons of making a voluntary disclosure to CFIUS prior to entering into binding documentation with respect to, or closing, cross-border transactions.

The Order requires the foreign acquirers to divest a parcel of real estate located near the Francis E. Warren Air Force Base in Wyoming, a strategic missile base. Public statements from the Departments of the Treasury and Defense cited proximity of the land to the base as well as the addition, post-close, of cryptocurrency mining equipment as factors that gave rise to the national security risk. In addition to a forced sale, the Order also requires the owners to remove all equipment and improvements made on the property within 90 days. The divestment transaction is also subject to CFIUS approval, and the Order imposes monitoring measures in excess of what is customary for CFIUS mitigation.

The transaction raises several important lessons with respect to closing and post-closing risk for those engaging with foreign investors.

- *Advantages of voluntary CFIUS filings in certain circumstances*. The Foreign Investment Risk Review Modernization Act of 2018 ("**FIRRMA**") imposed limited mandatory filing requirements for certain foreign investments but largely left intact the voluntary filing approach that had historically characterized the CFIUS regulatory regime over acquisitions of U.S. businesses. FIRRMA extended this voluntary approach to CFIUS jurisdiction over certain acquisitions of U.S. real estate.

Here, the parties elected not to file with CFIUS voluntarily, which decision in the end resulted in potentially costly interim mitigation measures, potential losses on the initial investment through a forced sale process and potentially unwanted publicity in connection with the Order. While a transaction party's hesitancy to voluntarily submit to an additional regulatory regime may be understandable, the potential for a burdensome investigation or a deal-disrupting outcome should be balanced against the possible benefits of confidentially obtaining the regulatory certainty that comes with pre-closing CFIUS review – or at least knowing CFIUS

concerns before a transaction closes. Similar value-related concerns can easily arise if CFIUS were to take post-closing mitigation action after an acquisition of or investment in a U.S. business.

- *CFIUS's efforts to identify transactions not voluntarily disclosed can be expected to focus on those transactions that have higher potential to raise national security concerns*. As stated in the Department of the Treasury's release, the blocked transaction was identified through a public tip, which resulted in outreach from CFIUS staff to request the parties file the transaction. CFIUS here was acting on its authority to gather transaction information and request filings from transaction parties that chose not to voluntarily alert CFIUS of a transaction that falls within the scope of its jurisdiction. As discussed in the May 2024 Quorum, a proposed rule, if implemented, would expand CFIUS's information collection authority with respect to transactions not voluntarily filed with CFIUS.

CFIUS has disclosed in its Annual Report that the transactions that it targets with non-notified inquiries are some of the more complex transactions that CFIUS reviews and that such transactions often require mitigation. Consequently, should CFIUS reach out about a transaction that parties have elected not to voluntarily disclose, transaction parties could reasonably anticipate that such transaction has raised some interest among CFIUS staff and leadership.

- *Mitigation of national security risk is not always feasible*. CFIUS is authorized to negotiate and enter into agreements to implement, or to unilaterally impose, conditions on transactions that fall within its jurisdiction to mitigate identified national security risk. However, as demonstrated by and suggested in the Order, mitigation is not always feasible. Risk arising from proximity of real estate to a government facility is naturally difficult to overcome, but the infeasibility of mitigation can arise in any context. As shown by the Order, parties cannot be certain that CFIUS regulatory risk to a deal can always be addressed later with mitigation measures.

Moreover, even if CFIUS identifies feasible mitigation measures, the conditions that it seeks to impose on business operations might be so expensive, or so significantly impact deal rationale, that mitigation is economically infeasible from the perspective of one or more transaction parties. Pre-closing, such circumstances can cause a deal to fail, with unwelcome but limited consequences. Post-closing however, the stakes are vastly higher. A buyer may be required to conduct an accelerated post-closing sale or could be faced with an action similar to the Order imposed in this transaction.

The foreign acquirers of the Wyoming real estate have 120 days from the date of the Order to divest the property.

Delaware Court of Chancery Clarifies “Commercially Reasonable Efforts” in Earn-Out Provisions

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On April 30, 2024, in *Himawan, et al. v. Cephalon, Inc., et al.*, the Delaware Court of Chancery held that the defendant acquiror complied with its contractual obligations to use commercially reasonable efforts to achieve certain milestones under the “earn-out” provision of the merger agreement.

As part of Cephalon Inc.’s 2010 acquisition of Ception Therapeutics, Inc., a privately held biopharmaceutical company, in addition to amounts paid at the closing, the parties agreed to certain earn-out payments totaling up to $400 million. The payments were to be based on the achievement of certain milestones, including FDA and European EMA approval of Reslizumab (“RSZ”), a treatment for inflammation in the lungs and esophagus. RSZ was Ception’s sole asset at the time of the sale. The merger agreement required Cephalon to use “commercially reasonable efforts to develop and commercialize” RSZ to achieve the milestones and defined commercially reasonable efforts as “the exercise of such efforts and commitment of such resources by a company with substantially the same resources and expertise as [Cephalon], with due regard to the nature of efforts and cost required for the undertaking at stake.” The relevant provision also provided that Cephalon “shall have complete discretion with respect to all decisions related to the business of the Surviving Corporation.” The Court further noted that under the merger agreement Cephalon “did not have an obligation to (i) conduct clinical trials; (ii) pursue regulatory approvals; (iii) maximize payment to Ception stockholders; (iv) follow Ception’s business plan; or (v) consult with Ception stockholders with respect to the business.”

While RSZ showed promise for lung inflammation, from the beginning its indication for esophagus inflammation was not favorable. Even prior to the closing of Cephalon’s merger, Ception’s Phase IIb/III clinical trial of RSZ failed as a treatment for pediatric esophagus inflammation. Following the closing of the merger, Cephalon continued its development of RSZ for inflammation in the esophagus, working with Ception’s principal research and development employees to remedy the failed study. Cephalon spent months devising an alternative plan for FDA approval and met with the FDA on several occasions to discuss three separate updated proposals. At each such meeting, the FDA rejected the updated proposal, providing only “general recommendations”.

Eventually, Cephalon, and its successor following an unrelated acquisition, Teva Pharmaceutical Industries Ltd., determined to focus on RSZ’s indication for lung treatment and abandon commercialization of RSZ for inflammation in the esophagus. Cephalon obtained FDA approval of RSZ for lung treatment and paid $200 million to Ception in earn-out payments. Ception’s former stockholders then

brought a breach of contract action, alleging that Cephalon failed to use commercially reasonable efforts to develop and commercialize RSZ because it abandoned RSZ for esophagus inflammation.

In analyzing whether Cephalon used commercially reasonable efforts, the Court determined that the merger agreement imposed an objective standard beyond Cephalon's subjective good faith but also provided Cephalon "complete discretion with respect to all decisions relating to the research, development, manufacture, marketing, pricing and distribution of [RSZ]." The Court held that after a failed study relating to RSZ's indication for esophagus treatment, numerous discussions of potential remedies and submission of three separate alternative plans to the FDA, Cephalon's decision not to proceed with the development of RSZ for esophagus treatment was within its contractual rights and consistent with the use of commercially reasonable efforts under the terms of the agreement.

The earn-out provision in the merger agreement required Cephalon to use efforts consistent with a company with the same resources and expertise. However, the Court found this method "unworkable" noting that no company operates under the same circumstances as those in the present case. Instead, the Court interpreted the merger agreement to assume that the parties intended to require Cephalon to use commercially reasonable efforts "as it found itself situated". The Court pointed to examples of several companies that abandoned development of pharmaceutical products following failed clinical studies as helpful context in concluding that Cephalon's decision was consistent with the use of commercially reasonable efforts under the agreement.

According to the Court, the commercially reasonable efforts provision in the merger agreement operated "only to disallow actions of the buyer that would be against the buyer's self-interest." The Court disagreed with the plaintiffs' position that the earn-out provision required Cephalon "to take all reasonable steps to solve problems." The Court noted that the plaintiffs' argument was "akin to a best efforts obligation, under which Defendants must pursue commercialization, through the milestones, at least, unless it would be unreasonable to do so", and distinguished this view from the standard set forth in the merger agreement which gave Cephalon complete discretion, adding that the parties could have agreed to a best efforts clause if they so desired.

Parties negotiating earn-out provisions in M&A transactions will want to pay close attention to the express contractual terms and should consider a variety of potential approaches, from complete buyer discretion with no obligation to work towards achieving the applicable milestone to best efforts requiring a buyer to take all actions, even those against its own interest. Sellers should consider, at a minimum, limiting discretionary language around a buyer's development and commercialization activities and consider seeking specific minimum requirements. Buyers, however, who are looking to receive the same outcome from the Delaware Court of Chancery should seek to preserve discretionary language and consider expressly stating that the only required actions with respect to continued development and commercialization are those which are economically in such buyer's interest.

IRS Distributes New Ruling Requirements for Corporate Spin-Off Transactions


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On May 1, 2024, the IRS released Revenue Procedure 2024-24, which sets forth new requirements for requests for private letter rulings (PLRs) on corporate spin-off and split-off transactions. (Both spin-offs (transactions in which a corporation ("Remainco") distributes stock of a subsidiary ("Spinco") to its shareholders as a dividend in kind) and split-offs (transactions in which the stock of the subsidiary is exchanged for outstanding Remainco stock) are generally subject to the same tax rules, and this article refers to both types of transactions as spin-offs.) This month's long-anticipated Revenue Procedure represents the first systematic guidance on spin-off and split-off transactions since the IRS's release of Revenue Procedure 2017-52 and reaffirms the IRS's stated intention, first announced in the 2017 Revenue Procedure as a pilot program, to provide comprehensive rulings that address as many legal aspects of a spin-off transaction as possible. (To conserve resources, between 2013 and 2017, the IRS would provide rulings only on so-called significant issues in spin-off transactions.) The Revenue Procedure updates or expands representations that taxpayers must provide in a number of areas, and it represents an important shift in IRS policy in a few particular areas.

Debt-for-Debt and Debt-for-Equity Exchanges

In many spin-off transactions, a Remainco is permitted not only to distribute Spinco stock to its shareholders, but also to distribute either stock or newly issued debt of Spinco to its creditors—effectively repaying its existing debt with Spinco stock or debt. While this exchange of Remainco debt for Spinco debt (a debt-for-debt or "D4D Exchange") or equity (a debt-for-equity or "D4E Exchange") can be effected via private negotiation with or tender offers to existing creditors, Remaincos have generally found it easier to adopt either an "intermediated" exchange (where an intermediary, generally a financial institution, acquires Remainco's existing debt in anticipation of exchanging it for Spinco stock or debt) or a "direct issuance" transaction (where Remainco issues new debt, repaying existing indebtedness with the proceeds, and shortly thereafter agrees to exchange the new debt for Spinco stock or debt).

The new Revenue Procedure addresses both structures. "Intermediated" transactions are largely approved, although the IRS requires a number of specific representations, as well as a detailed description of Remainco's relationship with any intermediary in order to ensure that the intermediary will be respected for tax purposes as a creditor of Remainco, rather than as its agent. (If the intermediary is not treated as holding Remainco's debt for its own account, the exchange of Remainco debt for Spinco debt or equity could be recast as a transaction that is taxable to Remainco.) By contrast, the "direct issuance" model is effectively

prohibited: any Remainco debt that is repaid in a D4D or D4E Exchange, whether held by an intermediary or a longstanding creditor, must be "old and cold" debt that was issued at least 60 days before the spin-off was announced, agreed to or approved by Remainco's board of directors.

Delayed Distribution vs. Retention

In order for a spin-off to qualify as tax-free, Remainco must distribute stock constituting "control" of Spinco—broadly speaking, 80% of Spinco's stock. In the most straightforward variation of a spin-off, Remainco simply distributes 100% of the stock of Spinco to its shareholders at once. In some cases, however, Remainco may wish to distribute some Spinco stock up front, but keep the rest for a period of time. The tax rules permit this to occur in two different ways—and with the new Revenue Procedure, the IRS is now making taxpayers choose between them up front.

Delayed Distribution. In cases where Remainco wishes to hold back a portion of the Spinco stock for a short period of time before distributing the remainder, the tax rules permit the subsequent distributions to occur tax-free and to count toward the 80% distribution requirement, effectively treating all phases as part of a single distribution. For example, in a D4E Exchange, Remainco may distribute some Spinco stock to its shareholders in the form of a dividend, then wait for a period while trading in the Spinco stock settles before entering into a D4E exchange, paying off some of its indebtedness with its remaining Spinco stock at then-prevailing prices. Under the new Revenue Procedure, this is generally permitted so long as all distributions occur within 12 months, although the guidance indicates that delayed distributions that occur more than 90 days after the first distribution will be subject to additional scrutiny.

Retention. By contrast, because Remainco is required to distribute only 80% of Spinco stock, it could retain up to 20% of Spinco stock for an extended period of time. For example, Remainco may wish to distribute Spinco's stock to its shareholders but needs to retain some Spinco stock to serve as collateral securing its debt. The Internal Revenue Code permits this, but only if the taxpayer requests a PLR and establishes that this retention is not being done with a tax avoidance purpose. The new Revenue Procedure provides enhanced guidance on how the IRS will make that determination, setting out the criteria it will use and requiring taxpayers to explain the business purpose for retaining the stock, describe the period for which the stock will be retained and any overlap between the officers, directors and key employees of Spinco and Remainco, and promise to vote any retained shares in the same proportion as the votes cast by unrelated shareholders. Remainco will be required to dispose of any retained stock no later than five years after the initial distribution (at which point, the disposition will be taxable).

…But not both. In recent years, the IRS has given "backstop" rulings allowing for retained stock to potentially qualify as *either* a delayed distribution or a true retention, depending on future events. For example, Remainco may distribute less than 100% of the stock of Spinco intending to engage in a tax-free D4E exchange with the remainder, but if it is unable to complete the D4E Exchange within 12 months due to market conditions, a "backstop" ruling would have allowed it to continue to retain the Spinco stock to dispose of in some other way during the next four years (albeit taxably). Under the new Revenue Procedure, "backstop" rulings

will no longer be available—taxpayers must choose at the time they seek rulings whether any retained Spinco stock will be distributed within 12 months in a delayed tax-free distribution or retained for a longer period and disposed of in a taxable transaction within five years.

This requirement potentially presents taxpayers with a dilemma: if a Remainco wants to secure a ruling for a transaction that requires a delayed distribution (such as a D4E Exchange), it must be confident that it can distribute all of its Spinco stock (whether to creditors or shareholders) within 12 months. If it fails to do so, then it has arguably retained Spinco stock without the IRS permission required by the statute, meaning that it would be taxed not only when it disposes of the retained stock, but also on the stock distributions that it was able to complete within the allotted time. This apparent "hell or high water" distribution requirement may deter some taxpayers from seeking to engage in D4E Exchanges and similar transactions in the first place.

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The Revenue Procedure also contains important updates or expansions to representations involved in cases where Spinco assumes debt of Remainco or where Spinco may be required to make post-spinoff payments to Remainco. At the same time it released the Revenue Procedure, the IRS also released Notice 2024-38, requesting further public comment with respect to many of the issues underlying the changes in Revenue Procedure 2024-24, suggesting that it is unlikely that this is the final word on spinoffs and PLRs.