CLEARY GOTTLIEB

2022 Developments in Securities and M&A Litigation

February 2023

Overview

Securities Litigation

4 **Supreme Court Certiorari Grants**

- 4 *Supreme Court Grants Certiorari to Address Securities Act Tracing Requirement in Context of Direct Listing*
- 5 *Supreme Court Grants Certiorari to Determine Whether Federal District Courts Have Jurisdiction to Hear Suits Concerning Ongoing SEC Administrative Proceedings*

5 **Notable Circuit Court Decisions**

- 5 *Scheme Liability in the Second Circuit*
- 6 *Second Circuit Limits Rule 10b-5 Standing*
- 6 *Fourth Circuit Affirms Dismissal of Data Breach Case*
- 7 *Ninth Circuit Addresses Puffery and Loss Causation*

7 **Other Notable Litigation**

- 7 *Denial of Class Certification in Case Involving Unsponsored ADRs*
- 8 *Digital Assets and Extraterritoriality*

M&A and Corporate Governance Litigation

9 ***Twitter v. Musk*—the M&A Decision of the Year That Wasn't**

10 ***Twitter* Shareholder Lawsuit**

11 **The Importance of Price in Entire Fairness Review—*Tesla Motors***

12 **When a Desire for Liquidity Creates a Conflict of Interest—*Manti Holdings***

12 **When a Special Committee is Required to Try to Extract Concessions From a Conflicted Controller—*Styslinger***

13 **Delaware Court of Chancery Further Clarifies the Meaning of "Ordinary Course of Business"**

14 **Is Delaware a Pro-Sandbagging Jurisdiction?—*Arwood***

15 **A Reminder That a "No Oral Modifications" Clause Can Be Modified Orally—*CPC Mikawaya***

15 **What Happens When Hackers Steal Merger Consideration?—*Sorenson Impact Foundation***

Looking Ahead

Overview

2022 was an active year for both securities and M&A litigation. With respect to securities litigation, the Supreme Court granted certiorari in two cases: *Pirani v. Slack Technologies, Inc.* and *SEC v. Cochran*. In *Slack*, the Court will consider the application of Section 11's tracing requirement in the context of direct listings. In *Cochran*, the Court may resolve a circuit split regarding whether federal district courts have jurisdiction to hear suits concerning ongoing SEC administrative proceedings.

At the circuit court level, courts clarified issues related to scheme liability in *SEC v. Rio Tinto plc*, what duties corporations have to disclose their cybersecurity efforts in *In re Marriott International, Inc.*, and loss causation pleading standards in *In re Nektar Therapeutics Securities Litigation*, among others.

In the world of M&A litigation, *Twitter v. Musk* promised to be a blockbuster decision concerning the ability of a buyer to terminate a merger agreement (and a seller to specifically enforce one)—until Elon Musk mooted the case by agreeing to close on his $44 billion acquisition of Twitter on the original terms. Even though the case did not result in a decision, the outcome confirmed for many M&A practitioners that Delaware courts will strictly enforce merger agreements.

While the *Twitter* case may have received the most attention, the Delaware courts were busy issuing notable decisions in other cases related to M&A in 2022. For example, in one case, the Delaware Court of Chancery found that an expressed desire for immediate liquidity by a private equity firm was enough to trigger entire fairness review of a sale of one of its controlled portfolio companies that would otherwise have been subject to the deferential business judgment rule, while in another case (this one also involving Elon Musk) the court found that even though the merger process was flawed, the transaction satisfied the entire fairness test because the price was ultimately fair. In yet another case arising from a busted merger resulting from the COVID-19 pandemic, the Court of Chancery interpreted an "ordinary course" covenant to allow a seller to substantially modify its business practices in light of the pandemic because it did so in a manner that was consistent with the way it handled prior crises (even though the business had never before encountered anything like the pandemic itself before). These and other notable decisions are further described below.

Securities Litigation

Supreme Court Certiorari Grants

Supreme Court Grants Certiorari to Address Securities Act Tracing Requirement in Context of Direct Listing

In December 2022, the Supreme Court granted certiorari in *Pirani v. Slack Technologies, Inc.* to determine whether plaintiffs bringing claims under Section 11 of the Securities Act of 1933 (the "Securities Act") must satisfy the tracing requirement that has traditionally been applied to such claims, by pleading and proving that they bought shares registered under the registration statement they claim is misleading. Claims under Section 11, which imposes strict liability for any material, untrue statement of fact or omission in a registration statement, can only be brought by "any person acquiring such security."[1] Traditionally, to recover under Section 11, plaintiffs have been required to trace their shares to a registration statement containing an allegedly false or misleading statement.[2] In *Pirani*, Slack Technologies, Inc. ("Slack") went public through a direct listing,[3] rather than an initial public offering ("IPO"). Unlike an IPO, which generally offers new (i.e., primary) shares to the public to raise capital, a direct listing can permit insiders and certain early investors to sell their outstanding shares to the public in addition to (or instead of) issuing new shares. Pirani bought Slack shares after the company went public but could not allege that they were part of the new shares registered under the registration statement as opposed to shares held by insiders or early investors existing before the filing of the registration statement.

On appeal at the Ninth Circuit, a divided panel affirmed the district court's decision to allow investors to bring such claims notwithstanding their inability to trace their share purchases to the registration statement.[4] The Ninth Circuit found dispositive that "[a]ll of Slack's shares sold in this direct listing, whether labelled as registered or unregistered can be traced to that one registration [statement]," concluding that "Slack's unregistered shares sold in a direct listing are 'such securities' within the meaning of Section 11 because their public sale cannot occur without the only operative

[1] *See* Petition for Writ of Certiorari, *Pirani v. Slack Technologies, Inc.*, No. 22-200 (Dec. 13, 2022); 15 U.S.C. § 77k.

[2] *See Barnes v. Osofsky,* 373 F.2d 269, 273 (2d Cir.1967) (citing *Fischman v. Raytheon Mfg. Co.*, 9 F.R.D. 707 (S.D.N.Y.1949)).

[3] This mechanism was introduced in 2018 by the New York Stock Exchange and later approved by the Securities and Exchange Commission ("SEC").

[4] *Pirani v. Slack Techs., Inc.*, 13 F.4th 940 (9th Cir. 2021). For a full discussion of the Ninth Circuit decision, see Cleary Gottlieb's September 30, 2021 Alert Memo.

registration in existence."[5] In dissent, Judge Miller took a stricter approach, upholding the traditional tracing requirement to registration statements. He found the majority's "concern that it would be bad policy for a Section 11 action to be unavailable when a company goes public through a direct listing" to be "neither new nor particularly concerning" because investors have other ways to hold issuers accountable (e.g., under Section 10(b) of the Securities Exchange Act of 1934 (the "Exchange Act")).[6]

The Supreme Court is expected to make a ruling in *Slack* by the summer.

Supreme Court Grants Certiorari to Determine Whether Federal District Courts Have Jurisdiction to Hear Suits Concerning Ongoing SEC Administrative Proceedings

In May 2022, the Supreme Court granted certiorari in *SEC v. Cochran* to decide the question of whether a respondent in a Securities and Exchange Commission ("SEC") administrative proceeding can pursue a constitutional challenge in federal district court to the authority of SEC Administrative Law Judges ("ALJs") based on their removal protections without first exhausting the administrative appeals process.[7] Cochran was the subject of an SEC proceeding and sued to enjoin the proceeding on the basis that the presiding ALJ was unconstitutionally protected from removal.[8] The district court dismissed the case, holding that the Exchange Act stripped district courts of jurisdiction to hear challenges to ongoing SEC enforcement proceedings.[9] On appeal, the Fifth Circuit reversed, holding the Exchange Act did not divest the district court of its jurisdiction to hear Cochran's challenge to the constitutionality of the ALJ's removal protection.[10] In so doing, the Fifth Circuit created a circuit split with the Second, Fourth, Seventh, Eleventh, and D.C. Circuits, which have all held that the Exchange Act implicitly strips district courts of jurisdiction to hear constitutional challenges to ongoing SEC proceedings.

On November 7, 2022, the Supreme Court heard oral arguments during which several Justices pressed Cochran as to why her constitutional claim could not wait until the SEC rendered its final decision. A decision by the Supreme Court is forthcoming.

Notable Circuit Court Decisions

Scheme Liability in the Second Circuit

In *SEC v. Rio Tinto plc*,[11] the Second Circuit addressed whether claims for scheme liability under Section 10(b) of the Exchange Act and Section 17(a) of the Securities Act can be based on "misstatements and omissions—without more."[12] In *Lorenzo v. SEC*,[13] the Supreme Court held that scheme liability can extend to "those who do not make statements" but who "disseminate" false or misleading statements with intent to defraud. Before *Lorenzo*, the Second Circuit held in *Lentell v. Merrill Lynch & Co.*[14] that scheme liability requires fraudulent conduct beyond misstatements or omissions. In *Rio Tinto*, the Second Circuit held that *Lentell* "remains vital" in *Lorenzo*'s wake and stated that "misstatements and omissions can form part of a scheme liability claim, but an actionable scheme liability claim also requires something beyond misstatements and omissions, such as dissemination."[15] Thus, for example, where a defendant is merely alleged to have made misleading statements by failing to correct previously issued information or by failing to prevent misleading statements from being disseminated by others (as was the case in *Rio Tinto*), there is no actionable scheme liability claim against him or her.[16]

[5] *See Slack*, 13 F.4th at 947.

[6] *Id.* at 953.

[7] *See* Petition for Writ of Certiorari, *SEC v. Cochran*, No. 21-239 (March 11, 2022).

[8] *Cochran v. SEC*, 20F.4th 194 (5th Cir. 2021).

[9] *Id.* at 198.

[10] *Id.* at 195.

[11] 41 F.4th 47 (2d Cir. 2022).

[12] *Id.* at 49.

[13] 139 S. Ct. 1094 (2019).

[14] 396 F.3d 161 (2d Cir. 2005).

[15] *Rio Tinto*, 41 F.4th at 49, 53.

[16] *Id.* at 52-53.

Second Circuit Limits Rule 10b-5 Standing

In *Menora Mivtachim Insurance Ltd. v. Frutarom Industries Ltd.*,[17] the Second Circuit affirmed a decision by the Southern District of New York, which held that purchasers of a security of a company acquiring another company in a merger lack standing to bring claims pursuant to Section 10(b) and Rule 10b-5 against the target corporation for alleged misstatements that the target made prior to the acquisition. In so doing, the Second Circuit limited Rule 10b-5 standing to plaintiffs who purchased securities of the corporation about which the alleged misstatements were made,[18] thereby rejecting previous dicta from *Ontario Public Service Employees Union Pension Trust Fund v. Nortel Networks*.[19] In *Nortel*, the Second Circuit held plaintiff-stockholders "do not have standing to sue under § 10(b) and Rule 10b-5 when the company whose stock they purchased is negatively impacted by the material misstatement of another company, whose stock they do not purchase."[20] In dicta, the *Nortel* court opined that a case involving a merger might require a "different outcome" because statements made by one company in the context of a merger "ha[ve] a much more direct relationship to the value of [the other company's] stock," but left that question "for another day."[21] In a concurring opinion in *Menora*, Judge Pérez contended that the court could have reached the same outcome by simply applying *Nortel*: she reasoned that the target corporation's misrepresentations in *Menora* had only a remote connection to plaintiffs' purchase of the acquiring company's stock rather than the "direct relationship" required by *Nortel*.[22] Judge Pérez therefore would not have created a new categorical rule limiting standing to purchasers of securities in companies about which the alleged misstatements were made, and criticized the majority for engaging in "judicial policymaking."[23]

[17] 54 F.4th 82, 84 (2d Cir. 2022).

[18] 54 F.4th at 88-89.

[19] 369 F.3d 27 (2d Cir. 2004).

[20] *Id.* at 34.

[21] *Id.*

[22] 54 F.4th at 91-92.

[23] *Id.* at 94-95.

Fourth Circuit Affirms Dismissal of Data Breach Case

In *In re Marriott International, Inc.*,[24] the Fourth Circuit affirmed a district court's dismissal of a securities class action alleging that Marriott International, Inc. ("Marriott") misled investors about the company's cybersecurity protections by failing to disclose material information in its public filings.[25] The plaintiffs focused on statements by Marriott where it allegedly "repeatedly stated that 'the integrity and protection of customer, employee, and company data is critical to us as we use such data for business decisions and to maintain operational efficiency.'"[26] The Fourth Circuit, however, held that the facts the plaintiffs alleged (that Marriott's cybersecurity protections were "vulnerable") did not contradict Marriott's disclosures, which "made no characterization at all with respect to the quality of its cybersecurity" and instead "only [stated] that Marriott considered it important."[27] The court therefore recognized that "Marriott certainly could have provided more information to the public about its experience with or vulnerability to cyberattacks" but held that "federal securities laws did not require it to do so."[28] And the court noted that the SEC itself "advises companies against mak[ing] detailed disclosures that could compromise [their] cybersecurity efforts."[29] The *Marriott* decision signals that plaintiffs will face significant hurdles if they choose to pursue a securities claim following a cyberattack on the basis of a corporation's statements regarding its cybersecurity—corporations need not provide in exact detail its cybersecurity efforts to comply with federal securities laws even where the corporation later suffers a data breach.

[24] *In re Marriott International, Inc.*, 31 F.4th 898 (4th Cir. 2022).

[25] *Id.* at 901.

[26] *Id.* at 902 (citations omitted).

[27] *Id.* at 902-03.

[28] *Id.* at 905.

[29] *Id.*

Ninth Circuit Addresses Puffery and Loss Causation

In *Weston v. Family Partnership LLLP v. Twitter, Inc.*,[30] the Ninth Circuit addressed the standard for rejecting alleged misstatements as non-actionable corporate "puffery." Twitter, Inc. ("Twitter") made several public statements regarding development of one of its products—specifically that it was "continuing [its] work to increase the stability, performance, and flexibility of [the product] . . . but we're not there yet" and that work was still "ongoing."[31] Later, Twitter disclosed several software bugs and a stock decrease followed.[32] This prompted plaintiffs to bring a class action alleging that Twitter's statements about its product were misleading.[33] The district court dismissed plaintiffs' claims and the Ninth Circuit upheld dismissal, holding that Twitter had no obligation to "disclose immediately the software bugs in its [product], especially given that its earlier statements . . . were qualified and vague" and that "Twitter's statements are so imprecise and vague that they are incapable of objective verification" and thus were "non-actionable vague puffery."[34]

In *In re Nektar Therapeutics Securities Litigation*,[35] the Ninth Circuit addressed the standard for pleading loss causation under the Exchange Act. There, plaintiffs alleged that Nektar Therapeutics ("Nektar") published misleading test results for a cancer drug's first clinical trial, causing plaintiffs to suffer losses when Nektar later published "disappointing test results" from the drug's second clinical trial.[36] The district court dismissed the case, and the Ninth Circuit affirmed, holding that the plaintiffs failed to plead loss causation.[37] Plaintiffs were relying on the assumption that the disappointing results for the second clinical trial meant the first clinical trial was conducted improperly, but the Ninth Circuit rejected this as insufficient because there was only a "tenuous causal connection" between the alleged falsehoods from Nektar's original test results and the second trial's "disappointing test results."[38] For example, the two tests focused on different treatments and used different diagnostic measures.[39] Moreover, the court found that nothing about the second trial's results indicated that the original trial's results were "manipulated" or flawed."[40] Ultimately, the Ninth Circuit recognized that "[p]harmaceutical companies often suffer setbacks in their clinical trials after earlier testing offer[s] highly promising results" but that "without more," this does not establish loss causation.[41]

Other Notable Litigation

Denial of Class Certification in Case Involving Unsponsored ADRs

In *Stoyas v. Toshiba Corp.*,[42] investors in Toshiba Corporation's ("Toshiba") unsponsored American depository receipts ("ADRs") moved to certify a class of: (1) all persons who purchased the ADRs over the counter, and (2) all citizens and residents of the United States who had purchased Toshiba's common stock, which is listed on the Tokyo Exchange, during the relevant time period. The district court denied the class certification motion, holding that Rule 23's typicality requirement was not satisfied because the relevant named plaintiff had not acquired its securities in domestic transactions.[43] The court did not view the transactions as domestic because plaintiffs' "ability to acquire ADRs was contingent upon the purchase of underlying shares of common stock [in Japan] that could be converted into ADRs." Traders in Japan executed the purchase of common stock for conversion on behalf of the plaintiff's investment manager's broker,

30 29 F.4th 611 (9th Cir. 2022).

31 *Id.* at 620.

32 *Id.* at 616.

33 *Id.* at 616-17.

34 *Id.* at 621.

35 *In re Nektar Therapeutics Sec. Litig.*, 34 F.4th 828 (9th Cir. 2022).

36 *Id.* at 838-39.

37 *Id.* at 838 (internal citations and quotation marks omitted).

38 *Id.* at 839.

39 *Id.*

40 *Id.*

41 *Id.* at 840.

42 *Stoyas v. Toshiba Corp.*, 424 F. Supp. 3d 821, 830 (C.D. Cal. 2020). For further background on prior *Stoyas* litigation, see Cleary Gottlieb's prior alert memos here, here and here.

43 *Stoyas v. Toshiba Corp.*, No. 2:15-cv-04194 DDP-JC, 2022 WL 220920, at *3 (C.D. Cal. Jan. 25, 2022).

and once the underlying common stock was acquired, plaintiffs were "bound to take and pay for the ADRs, once converted."[44] Therefore, "the triggering event that caused [Plaintiffs] to incur irrevocable liability occurred in Japan"[45] and not in New York, where plaintiffs' investment manager's broker initially executed the order for the unsponsored ADRs.[46] The court also held that plaintiffs' Japanese-law claim raised "potentially dispositive questions of [Japanese] law," including whether plaintiffs lacked statutory standing to bring the claims because they were beneficial owners of the securities rather than direct owners.[47] The court found that these questions were "more appropriate to a motion for summary judgment rather than a class certification motion," and therefore denied plaintiffs' class certification motion with respect to these claims without prejudice.[48]

Digital Assets and Extraterritoriality

This year, a number of lower courts considered the application of the Supreme Court's decision in *Morrison v. National Australian Bank, Ltd.*, 561 U.S. 247 (2010), which held that the U.S. securities laws do not apply extraterritorially,[49] to digital asset transactions. For example, in *Anderson v. Binance*,[50] the Southern District of New York rejected plaintiffs' arguments that Binance could be considered a "domestic exchange" subject to the federal securities laws under *Morrison* because its infrastructure is U.S.-based.[51] In addition, *Binance* held that the plaintiffs failed to establish a domestic transaction in a security not traded on a domestic exchange because their allegations (that they bought tokens while located in the United States and that title passed on servers in California) did not sufficiently establish that irrevocable liability was incurred or that title passed within the United States."[52] Similarly, in *Ocampo v. Dfinity*, the court rejected as insufficient plaintiff's allegation that he established a domestic transaction merely by alleging he is a California resident.[53] Meanwhile, in *Williams v. BlockOne*,[54] in an order denying class certification, the court provided in *dicta* that "'irrevocable liability' is incurred when the transaction has been verified by at least one individual node of the blockchain . . . and the location of the node that verified the specific transaction at issue should control . . . ."[55] However, the court reserved judgment as to whether the cryptocurrency transactions at issue were domestic in nature under this analysis, instead holding that class certification was unwarranted.[56]

[44] *Id*. at *4.

[45] *Id*. at *5.

[46] *Id*. at *3.

[47] *Id*. at *6.

[48] *Id*.

[49] 561 U.S. at 266-67.

[50] No. 20-CV-2803 (ALC), 2022 WL 976824 (S.D.N.Y. Mar. 31, 2022).

[51] *Id*. at *4.

[52] *Binance*, 2022 WL 976824, at *4.

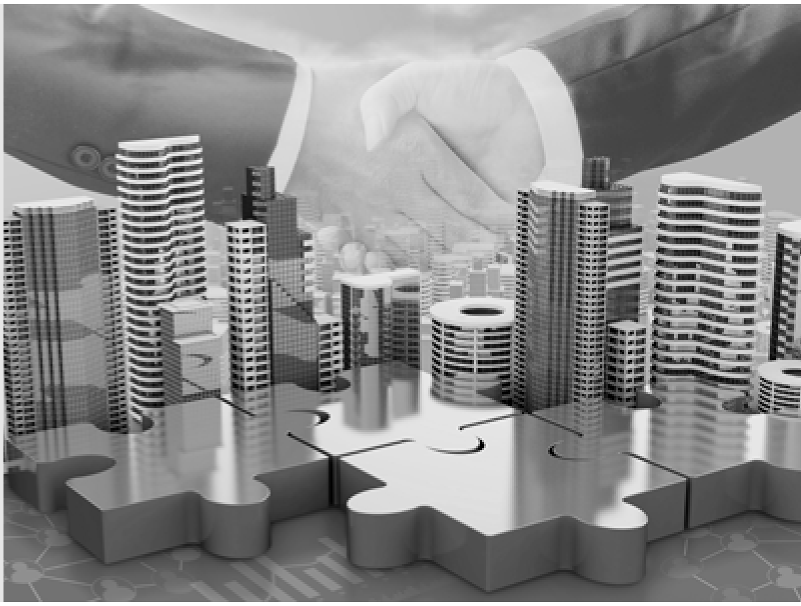
[53] Order Sustaining Demurrers With Leave to Amend at 6, *Ocampo v. Dfinity*, No. 21-CIV-3843 (Cal. St. Ct. Apr. 7, 2022).

[54] Memorandum Opinion, *Williams v. BlockOne*, No. 20-CV-2809 (Aug. 15, 2022).

[55] *Id*. at 17.

[56] *Id*. at 17-18.

M&A and Corporate Governance Litigation



Twitter v. Musk—the M&A Decision of the Year That Wasn't

Hands down, the most-high profile M&A litigation of the year was *Twitter, Inc. v. Musk*, which pitted Twitter, Inc. ("Twitter") against Elon Musk in an epic battle to determine whether he could walk away from a $44 billion agreement to acquire Twitter.[57] The case riveted the M&A community and raised several interesting issues before the parties settled on the eve of trial, with Elon Musk agreeing to close on the original deal terms. While there was therefore no formal judicial decision on the central issues in the case, the outcome confirms what many court watchers predicted, namely that the opportunities for buyers to walk from a merger agreement by pointing to a material adverse effect ("MAE") or a material breach of an interim operating covenant are limited, and Delaware courts will not hesitate to specifically enforce such agreements (no matter the size of the deal).

The facts of the case have been extensively covered elsewhere, but in brief: Twitter signed a $44 billion merger agreement with Elon Musk in April 2022. Musk's purchase of Twitter was funded in large part by his own fortune, together with a $7.1 billion equity commitment from other investors and a $13 billion debt commitment from a consortium of lenders.[58] Musk signed the merger agreement, which contained a number of seller-friendly terms, before completing meaningful due diligence. Just two months after signing, however, Musk began to have second thoughts (notably after the market had significantly deteriorated) and alleged Twitter was in material breach of its information-sharing obligations.[59] A month after that, he purported to terminate the merger agreement on these grounds and on the ground that Twitter's representations in the merger agreement regarding its estimates of the percentage of accounts that were fake (or "bots") were false, which Musk asserted would likely lead to an MAE.[60] Musk also claimed that Twitter violated the merger agreement's ordinary course covenant by firing senior employees and instituting a hiring freeze in response to the market downturn.[61] On July 14, 2022, Twitter sued Musk in the Delaware Court of Chancery (the "Chancery Court"), seeking specific performance of the merger agreement.[62]

57 *Twitter, Inc. v. Musk*, C.A. No. 2022-0613 (Del. Ch. 2022).

58 *Twitter, Inc. v. Musk*, No. 2022-0613, 2022 WL 4140502 at *1 (Del. Ch. Sept. 13, 2022).

59 June 6, 2022 Letter to Twitter, Inc., https://www.sec.gov/Archives/edgar/data/1418091/000110465922068347/tm2217761d1_ex99-o.htm

60 July 8, 2022 Letter to Twitter Inc. https://www.sec.gov/Archives/edgar/data/1418091/000110465922078413/tm2220599d1_ex99-p.htm

61 *Id.*

62 Verified Complaint ¶ 11, *Twitter, Inc. v. Musk*, C.A. No. 2022-0613.

While the non-occurrence of an MAE was a condition to Musk's obligation to close,[63] there were several issues with Musk's purported termination. First, the representation that Musk argued had been breached—that, to Twitter's knowledge (based on a disclosed methodology), "fewer than 5%" of Twitter's daily active users were "false or spam" accounts[64]—was heavily caveated, and thus it was not clear Musk could prove it was breached at all.[65] Second, Twitter pointed to statements by Musk himself before signing the merger agreement stating his belief that the percentage of fake accounts was higher than Twitter claimed (and again, Musk declined to perform meaningful due diligence on this issue before signing).[66] Third, it was also not clear that Musk could prove that any breach would lead to an MAE, which Delaware courts have interpreted to impose a high bar on buyers looking to terminate.[67]

Some commentators questioned whether the Chancery Court would be reluctant to order Musk to close, even if the court ultimately determined his termination was unjustified. Among other questions raised was what would happen if Musk's financing fell away—would the court order Musk to pay the entire purchase price himself (even though the merger agreement conditioned specific performance on the existence of debt commitments at closing)? Or would the court decline to order specific performance and consider a damages remedy instead? While interesting, these issues were ultimately mooted in October 2022 when Musk settled and closed on the original deal terms, effectively giving Twitter the full relief it was seeking.

Twitter Shareholder Lawsuit

One decision that did come out of the Twitter-Musk merger was *Crispo v. Musk*.[68] That case was a separate lawsuit brought by a Twitter shareholder against Musk directly on behalf of a class of Twitter shareholders who sought to enforce the merger agreement through an order of specific performance. The Chancery Court, however, dismissed the complaint on the grounds that (as is typical in public company merger agreements) shareholders had no standing to enforce the merger agreement.[69] In particular, the court held that the plain language of the no-third-party-beneficiary clause supported a holding that the parties to the merger agreement (i.e., Twitter and Musk) did not intend to confer third-party beneficiary standing on Twitter's shareholders, at least for purposes of specific performance.[70] Because the clause was "customized" and contained "carve-outs" listing some groups as third party beneficiaries for some purposes, the court concluded that the parties "knew how to confer third-party beneficiary status and deliberately chose not to do so with respect to any unlisted groups."[71]

Notably, however, *Crispo* left the door open for the plaintiff to pursue a claim for damages under an alternative theory.[72] The court *sua sponte* noted that plaintiff might have a claim for damages despite the "no third-party beneficiaries" clause under a separate section of the merger agreement which described the effect of termination and defined damages to include "the benefits of the transactions contemplated by this agreement . . . including lost stockholder premium."[73] The court raised the possibility that this language could be evidence of an intent to confer third-party beneficiary status on Twitter stockholders but noted that any related claim would be restricted to damages.[74] The Chancery

63 *Id.* ¶ 41.

64 *Id.* ¶ 64; Twitter Inc. Annual Report on Form 10K at 5, https://s22.q4cdn.com/826641620/files/doc_financials/2021/ar/FiscalYR2021_Twitter_Annual_-Report.pdf

65 *Twitter v. Musk*, Verified Complaint, ¶ 66-67.

66 *Id.* ¶¶ 67-68.

67 *Id.* ¶ 131.

68 No. 2022-0666-KSJM, 2022 WL 6693660 (Del. Ch. Oct. 11, 2022)

69 *Id.* at *11.

70 *Id.* at *4-5.

71 *Id.* at *5.

72 *Id.* at *9-11.

73 *Id.* at *9.

74 *Id.*

Court reserved decision on this issue because the parties had not fully briefed it, stating that it would "revisit that argument in the context of supplemental briefing."[75] Ultimately, however, the issue became moot when Musk closed on his acquisition of Twitter shortly thereafter.

The Importance of Price in Entire Fairness Review—*Tesla Motors*

Twitter was not the only high-profile M&A case involving Elon Musk in 2022. In another case—*In re Tesla Motors, Inc. Stockholder Litigation*[76]—Musk was much more successful. *Tesla Motors* arose out of the acquisition of SolarCity Corporation ("SolarCity") by Tesla Motors Inc. ("Tesla") in a stock-for-stock merger in 2016.[77] At the time of the acquisition, Musk owned 22% of Tesla's common stock and was also SolarCity's largest shareholder and chairman of its board of directors.[78] Tesla shareholders brought shareholder derivative claims against Musk and members of Tesla's board of directors, alleging that Musk forced Tesla's "servile" board to "approve the [a]cquisition of an insolvent SolarCity at a patently unfair price, following a highly flawed process" to "bail out" Musk's "foundering investment in SolarCity."[79]

After two previous decisions in this case declining to decide whether the merger should be reviewed under the deferential business judgment rule or the far more searching entire fairness standard,[80] the court once again ducked that question in its post-trial opinion and analyzed the case as if entire fairness applied.[81] The court focused on the two prongs of entire fairness: fair process (fair dealing) and fair price.[82] With respect to process, the court acknowledged that the Tesla board's process for negotiating and recommending the acquisition of SolarCity was "far from perfect."[83] In particular, the board did not form an independent special committee, which meant that Musk was more involved in the negotiation process than the court believed he should have been as a conflicted fiduciary.[84] For example, Musk helped select Tesla's deal counsel, reviewed Tesla's offer letter for its first acquisition proposal, was in frequent communication with the financial advisor for the potential merger, and was present for part of a Tesla board meeting where the board discussed a revised offer from SolarCity.[85]

With respect to fair price, however, the Chancery Court rejected the plaintiffs' argument that SolarCity was "worthless" and insolvent when Tesla acquired it.[86] Based on the evidence presented at trial, the Chancery Court found that SolarCity was not insolvent and that, on the contrary, the stock market had valued SolarCity at approximately $2.1 billion prior to the acquisition.[87] The court also found that the approval of the merger by 85% of disinterested Tesla stockholders was "compelling evidence that the price was fair."[88]

Thus, the court concluded that the transaction passed muster even under the more exacting entire fairness standard; central to this conclusion was that "the price Tesla paid for SolarCity was fair—and a patently fair price ultimately carries the day."[89] The court emphasized that the "paramount consideration" in determining entire fairness is "whether the price was a fair one" and that "all roads in the realm of entire fairness ultimately lead to fair price."[90]

75 *Id.* at *11.

76 No. CV 12711-VCS, 2022 WL 1237185 (Del. Ch. Apr. 27, 2022), *judgment entered sub nom. In re Tesla Motors, Inc.* (Del. Ch. 2022)

77 *Id.* at *1

78 *Id.*

79 *Id.*

80 No. CV 12711-VCS, 2018 WL 1560293 (Del. Ch. Mar. 28, 2018); No. CV 12711-VCS, 2020 WL 553902 (Del. Ch. Feb. 4, 2020).

81 *Id.* at *27

82 *Id.* at *27, 31.

83 *Id.* at *2.

84 *Id.* at *34.

85 *Id.* at *34-35.

86 *Id.* at *40.

87 *Id.* at *43.

88 *Id.* at *44.

89 *Id.* at *27.

90 *Id.* at *31.

When a Desire for Liquidity Creates a Conflict of Interest—*Manti Holdings*

In *Manti Holdings, LLC, et al. v. Carlyle Group, Inc., et al. [Authentix]*,[91] the Chancery Court found that a desire for liquidity by a controlling shareholder could trigger entire fairness review of an arm's length merger that would otherwise be subject to the deferential business judgment rule. This case involved the arm's length sale of Authentix Acquisition Company, Inc. ("Authentix") to Blue Water Energy in 2017. At the time of the sale, Authentix's majority shareholder was a private equity firm.[92] Authentix shareholders sued the private equity firm and certain Authentix directors for breaches of their fiduciary duties, alleging that the sale was a conflicted transaction at an unfair price.[93] Although the private equity firm was not the buyer and received the same consideration in the sale as every other Authentix shareholder, plaintiffs alleged that the private equity firm was conflicted because it received "something uniquely valuable" from the sale—specifically, liquidity.[94]

The court acknowledged that several prior cases had held that general allegations that a controlling stockholder desired liquidity are insufficient to plead a "conflict" triggering entire fairness, as the court generally presumes that all stockholders (regardless of their desire for liquidity) are incentivized to obtain the best price available.[95] On the facts pled in this case, however, the court found it "reasonably conceivable" that the desire for liquidity was more acute than in past cases and that this was therefore a "conflicted controller transaction" to which entire fairness applied.[96] The court found it relevant that one of Authentix's directors at the time of the sale, who was also a managing director of the private equity firm, allegedly said that he was "under pressure" to sell Authentix because the private equity firm wanted to monetize its investment, close the applicable fund and return cash to its investors. The court also found it significant that, under the terms of the relevant agreement, the private equity firm, through its holdings of preferred stock, was allegedly "poised to receive the bulk of the $77.5 million in guaranteed Sale consideration . . . before common stockholders received anything."[97] The court found that plaintiffs' allegations gave rise to a "reasonable inference" that the private equity firm derived a "unique benefit from the timing of the [s]ale not shared with other stockholders."[98]

When a Special Committee is Required to Try to Extract Concessions From a Conflicted Controller—*Styslinger*

In *Styslinger v. Pan*,[99] the Chancery Court rejected defendants' attempt to employ an *MFW*[100] defense to escape entire fairness review of a going-private transaction for Highpower International Inc. first proposed by the company's founder and CEO, Pan, who owned approximately 20% of the company's shares.[101] Following the CEO's initial indication of interest, the board formed a special committee to consider the proposal and gave the special committee the power to grant any waiver under Delaware General Corporation Law Section 203, Delaware's "anti-takeover" statute.[102] During negotiations, the CEO formed a consortium with other stockholders.[103] Rather than negotiating for concessions in exchange for a waiver of Section 203, the board (not the special committee) agreed to grant the consortium a waiver without asking for any concessions in return.[104] The full board then approved the merger agreement, and more than 58% of the outstanding shares unaffiliated with the consortium voted in favor of the merger.[105] Plaintiffs sued the CEO and another

91 *Manti Holdings, LLC, et al. v. Carlyle Group, Inc., et al. [Authentix]*, C.A. No. 2020-0657-SG, memo. op. (Del. Ch. June 3, 2022)

92 *Id.* at 1.

93 *Id.* at 1-5, 21.

94 *Id.* at 22-23.

95 *Id.*

96 *Id.* at 21.

97 *Id.* at 24.

98 *Id.* at 24-25.

99 *John Styslinger, et al. v. Dang Yu (George) Pan, et al. [Highpower International]*, C.A. No. 2020-0651-PAF, tr. ruling (Del. Ch. Jan. 24, 2022; filed Feb. 7, 2022)

100 *Kahn v. M & F Worldwide Corp. (MFW)*, 88 A.3d 635, 638 (Del. 2014).

101 *Styslinger* at 4-5.

102 *Id.* at 6.

103 *Id.* at 7.

104 *Id.* at 7-8.

105 *Id.* at 10.

participant in the consortium for breach of fiduciary duties as conflicted participants in the consortium, and defendants moved to dismiss.[106]

The defendants in *Styslinger* conceded for purposes of the motion to dismiss that the transaction was a controlling stockholder transaction, rendering the merger a conflicted transaction which would typically be governed by the entire fairness standard.[107] The defendants attempted to avoid entire fairness review, however, by employing an *MFW* defense.[108] According to the Delaware Supreme Court's decision in *MFW*, the business judgment standard of review will govern going-private mergers between a controlling stockholder and its corporate subsidiary if the transaction satisfies six conditions: "(i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority."[109]

The *Styslinger* court concluded that it was "reasonably conceivable" that the special committee there was "not fully functioning and did not satisfy the *MFW* standard," and therefore denied defendants' motion to dismiss.[110] In particular, the court focused on the fact that, while the committee had been given exclusive authority to grant any Section 203 waiver, there was no indication that the special committee had met to consider whether to do so before the full board voted to grant the waiver.[111] The court also emphasized that Section 203 gives a board (or special committee) leverage to negotiate with a potential acquirer, and that a Section 203 waiver has value such that a "failure to seek concessions for a Section 203 waiver . . . raises serious doubts [as to] whether the special committee negotiated diligently."[112] The court concluded that the special committee's failure to consider the Section 203 waiver and use the leverage created by Section 203 to extract concessions created a reasonable inference that the committee was not functioning independently, and therefore defeated defendants' *MFW* **d**efense.[113]

Delaware Court of Chancery Further Clarifies the Meaning of "Ordinary Course of Business"

Last year, in *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC*,[114] the Delaware Supreme Court affirmed the Chancery Court's finding that a buyer was justified in terminating an agreement for the acquisition of a portfolio of hotels after the seller substantially changed the hotel's operations during the COVID-19 pandemic. In *AB Stable*, the purchase agreement included an "ordinary course" covenant requiring that the seller conduct the hotel's business "only in the ordinary course of business consistent with past practice in all material respects" unless the buyer otherwise provided prior consent, which was not to be unreasonably withheld.[115] After a delay in closing, the pandemic had impacted the seller's hotel operations, leading the seller to close two hotels, shut down amenities at other hotels, lay off employees and minimize marketing and capital expenditures.[116] The Delaware Supreme Court affirmed the Chancery Court's ruling that the seller's drastic changes to its hotel operations in response to the COVID-19 pandemic without first obtaining the buyer's consent breached the ordinary course covenant and excused the buyer from closing.[117]

---

[106] *Id.*

[107] *Id.* at 12.

[108] *Id.*

[109] *MFW*, 88 A.3d at 645.

[110] *Styslinger* at 14.

[111] *Id.* at 14-15.

[112] *Id.* at 15-16.

[113] *Id.* at 18-19.

[114] *AB Stable VIII LLC v. MAPS Hotels & Resorts One LLC*, 268 A.3d 198, 200 (Del. 2021). For a full discussion of this case, see Cleary Gottlieb's December 20, 2021 Alert Memo.

[115] *Id.* at 210.

[116] *Id.* at 211.

[117] *Id.* at 216-18.

In March 2022, the Chancery Court's decision in *Level 4 Yoga, LLC v. CorePower Yoga, LLC, et al.*,[118] offered additional insight into how the court will interpret merger agreements' ordinary course covenants. *Level 4 Yoga*, like *AB Stable*, involved a merger agreement signed during the COVID-19 pandemic and a buyer who refused to close, but the court in *Level 4 Yoga* reached the opposite result.

In May 2019, before the pandemic, the defendants in *Level 4 Yoga* (the franchisors) exercised a pre-existing contractual option to require plaintiff (one of defendants' franchisees) to sell all of plaintiff's assets, mostly yoga studios, to defendants.[119] The parties signed an asset purchase agreement, memorializing the acquisition.[120] As the first closing date approached, with businesses throughout the country shutting down due to COVID-19, defendants wanted to delay or terminate the transaction, but plaintiff would not agree to delay closing.[121] Around the same time, the defendants directed their franchisees, including plaintiff, to close their yoga studios.[122] Defendants then invoked the MAE clause and the ordinary course covenant in the purchase agreement, and declared that the agreement was no longer valid and that defendants were therefore no longer obligated to perform.[123] Plaintiff argued that it had operated its studios in compliance with the franchise agreement, including by closing its studios, and that doing so had been in the ordinary course.[124] Defendants refused to close the transaction on time, and plaintiff-seller sued for breach of contract.[125]

Following trial, the Chancery Court held that the plaintiff was entitled to specific performance, damages, and interest.[126] With respect to determining what constitutes "ordinary course" the court noted that, consistent with the guidance provided by the Supreme Court in *AB Stable*, it will look at "how the company has operated in the past, both generally and under similar circumstances," and that the court would look at "how comparable companies are operating or have operated, both generally and under similar circumstances."[127] The court also explained that where an ordinary course provision contains the phrase "consistent with past practice," as was the case here, the court would focus on how plaintiff-seller itself historically operated.[128] The court found that all of the evidence at trial showed that plaintiff-seller had historically adhered to defendants' standards for its franchisees, and that when defendants gave a direction to plaintiff, plaintiff was obligated to comply.[129] The court found that although closing yoga studios and furloughing staff due to the pandemic may have been extraordinary, when seller took those actions, it had been following the directions of its franchisor, which was "entirely ordinary and consistent with past practice."[130] The court therefore concluded that there had been no breach of the ordinary course covenant.[131]

Is Delaware a Pro-Sandbagging Jurisdiction?—*Arwood*

In *John D. Arwood, et al. v. AW Site Services, LLC*,[132] the Delaware Court of Chancery discussed Delaware law on the issue of "sandbagging," which is when a buyer closes on a transaction with knowledge that a seller's representations are false and then sues the seller for post-closing damages for the breach. In this case, the court concluded that, while it was not entirely certain, in the absence of a definitive statement from the Delaware Supreme Court, Delaware likely is a "pro-sandbagging jurisdiction" in that "Delaware law allows a buyer to

[118] *Level 4 Yoga, LLC v. CorePower Yoga, LLC, et al.*, C.A. No. 2020-0249-JRS, memo. op. (Del. Ch. Mar. 1, 2022) *aff'd*, No. 109, 2022, 2022 WL 16579468 (Del. Nov. 2, 2022).

[119] *Id.* at *1.

[120] *Id.*

[121] *Id.*

[122] *Id.*

[123] *Id.*

[124] *Id.*

[125] *Id.* at *2.

[126] *Id.* at *30.

[127] *Id.* at *24 (citing *AB Stable*).

[128] *Id.*

[129] *Id.* at *24-25.

[130] *Id.* at *25.

[131] *Id.*

[132] *John D. Arwood, et al. v. AW Site Services, LLC*, C.A. No. 2019-0904-JRS, memo. op. (Del. Ch. Mar. 9, 2022).

'sandbag' a seller."[133] Even if that were not the case, the court explained, "'sandbagging' only applies when a buyer *knows* a representation is false pre-closing but seeks post-closing indemnification on the representation anyway."[134] It is not enough that the buyer *should have known* or was recklessly indifferent to a breach before closing.[135]

A Reminder That a "No Oral Modifications" Clause Can Be Modified Orally—*CPC Mikawaya*

In *CPC Mikawaya Holdings, LLC v. MyMo Intermediate, Inc., et al.*,[136] the Chancery Court issued a reminder that Delaware law recognizes oral waivers notwithstanding a contractual provision requiring that all amendments to the agreement must be in writing only. There, the merger agreement at issue included an express prohibition on oral amendments, stating clearly that "[n]o amendment of any provision of this Agreement shall be valid unless the same shall be in writing and signed . . . ."[137] The court explained, however, that "contract provisions deeming oral modifications unenforceable can be waived orally or by a course of conduct just like any other contractual provision."[138] The court stated that the issue of whether such waiver has occurred is a "fact-intensive inquiry."[139] The court concluded that the seller had sufficiently alleged an oral agreement and that it was "reasonably conceivable" that the buyer had orally waived the no-oral-modification provision.[140]

133 *Id.* at 3, 28.

134 *Id.* at 70 (emphasis in original).

135 *Id.* at 80.

136 *CPC Mikawaya Holdings, LLC v. MyMo Intermediate, Inc., et al.*, C.A. No. 2021-0707-MTZ, memo. op. (Del. Ch. June 29, 2022).

137 *Id.* at *12.

138 *Id.* at *13 (internal quotation marks omitted) (citing *Symbiont.io, Inc. v. Ipreo Hldgs., LLC*, 2021 WL 3575709, at *52 (Del. Ch. Aug. 13, 2021)).

139 *Id.* at *13.

140 *Id.* at *14.

What Happens When Hackers Steal Merger Consideration?—*Sorenson Impact Foundation*

In *Sorenson Impact Foundation v. Continental Stock Transfer & Trust Co.*,[141] the Chancery Court declined to dismiss a complaint alleging breach of contract and unjust enrichment against defendants, who mistakenly wired the merger consideration in a merger transaction to hackers.

Plaintiffs in this case were two former shareholders of the acquisition target company, Graduation Alliance, Inc. ("Graduation Alliance"), which was purchased via merger by Tassel Parent Inc. ("Tassel Parent").[142] As a result of deception by hackers, described below, plaintiff-shareholders delivered their shares without receiving payment, and Tassel Parent received the shares and paid the cash consideration to the hackers.[143]

The merger agreement between Graduation Alliance and Tassel Parent required plaintiffs to surrender their stock certificates and deliver an executed letter of transmittal "LOT" to the paying agent, Continental Stock Transfer & Trust Company ("CST") in order to receive the merger consideration.[144] The LOT also included the instruction that if the wire transfer were to be received by a stockholder *other than* the stockholder named on the stock certificate, such certificate would need to be "properly endorsed" and would require a "medallion guarantee" confirming that the signature authorizing the transaction was genuine.[145] Plaintiffs tendered their stock certificates and executed LOTs to the CST in accordance with the merger agreement, and defendants accepted plaintiffs' shares and directed CST to make the required payment to plaintiffs' bank accounts in Utah.[146]

141 *Sorenson Impact Found. v. Cont'l Stock Transfer & Tr. Co.*, No. CV 2021-0413-SG, 2022 WL 986322 (Del. Ch. Apr. 1, 2022)

142 *Id.* at *2

143 *Id.* at *1

144 *Id.* at *3

145 *Id.*

146 *Id.* at *1.

Prior to making the required payment, however, the law firm involved with the merger received a communication from hackers asserting that they were plaintiff-shareholders.[147] The hackers then sent a revised LOT and stock certificates, which updated the payment information to a Hong Kong bank account and updated the beneficiary name from plaintiffs' names to "Hongkong Wemakos Furniture Trading Co. Limited."[148] The hackers did not provide a medallion guarantee, as required by the original LOTs.[149]

Plaintiffs alleged that upon noticing that the name on the bank account differed from the stockholders' names on their stock certificates, CST simply modified the payment schedule to match the fraudulent LOT, did not require a medallion guarantee or further assurances, and subsequently transferred the merger consideration to the hackers' account.[150] Plaintiffs filed suit claiming breach of contract and unjust enrichment due to defendants' failure to comply with the terms of the LOT and transfer of the merger consideration to the hackers' account without receiving a medallion guarantee.[151] Defendants moved to dismiss for failure to state a claim.[152]

The court found that under Delaware law, a LOT was not a contract, but rather was "a procedural device for assigning payment by CST, the payment agent, to Plaintiffs."[153] The court reasoned that since there was no consideration associated with the LOT, and because its terms had not been adopted in a separate agreement, it "did not create duties enforceable in contract."[154] In analyzing the parties' obligations under the merger agreement itself, however, the court found that the merger agreement included a provision explaining the conditions precedent for consideration to be paid, which, when met, entitled stockholders to receive the merger consideration.[155] The court noted that the merger agreement explained the duties of the acquiror, which were to pay the sum due to each compliant stockholder to the paying agent.[156] The court found that it was "reasonably conceivable" that the merger agreement could be read as having "impose[d] an obligation on [the acquiror] to do more than make a payment to its agent" and to actually "ensure payment to the 'entitled' stockholders." The court therefore declined to dismiss plaintiffs' claim that defendants had violated the merger agreement by failing to ensure payment to plaintiffs.[157] The court also declined to dismiss plaintiffs' claim for unjust enrichment.[158]

---

147 *Id*. at *4.

148 *Id*.

149 *Id*. at *5.

150 *Id*.

151 *Id*. at *10.

152 *Id*. at *5

153 *Id*. at *10.

154 *Id*. at *11.

155 *Id*. at *12.

156 *Id*.

157 *Id*.

158 *Id*. at *13.

Looking Ahead

In the coming months, we will be watching for:

— Whether the Supreme Court applies the traditional tracing requirement to direct listings in *Pirani v. Slack Technologies, Inc.* and allows federal district courts to hear suits concerning ongoing SEC administrative proceedings in *SEC v. Cochran*.

— The Second Circuit's decisions concerning price impact in the *Goldman Sachs* appeal and concerning whether syndicated loans are securities in *Kirschner*.

— How lower courts rule on pending motions in cases alleging that various cryptocurrencies are securities subject to the federal securities laws.

— The Delaware Supreme Court's decision in the *Tesla Motors* appeal.

— More decisions from the Delaware Chancery Court concerning fiduciary duty challenges to de-SPAC mergers.

Contacts

Victor L. Hou
Partner
New York
T: +1 212 225 2609
vhou@cgsh.com

Roger A. Cooper
Partner
New York
T: +1 212 225 2283
racooper@cgsh.com

Jared Gerber
Partner
New York
T: +1 212 225 2507
jgerber@cgsh.com

Mark E. McDonald
Partner
New York
T: +1 212 225 2333
memcdonald@cgsh.com

Joon H. Kim
Partner
New York
T: +1 212 225 2950
jkim@cgsh.com

Matthew C. Solomon
Partner
Washington, D.C.
T: +1 202 974 1680
msolomon@cgsh.com

Jennifer Kennedy Park
Partner
Bay Area, New York
T: +1 650 815 4130
T: +1 212 225 2357
jkpark@cgsh.com

Lisa Vicens
Partner
New York
T: +1 212 225 2524
evicens@cgsh.com

Rishi N. Zutshi
Partner
New York
T: +1 212 225 2085
rzutshi@cgsh.com

Nowell D. Bamberger
Partner
Washington, D.C., Hong Kong
T: +1 202 974 1752
T: +852 2532 3785
nbamberger@cgsh.com

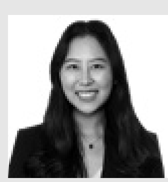
Abena Mainoo
Partner
New York
T: +1 212 225 2785
amainoo@cgsh.com

Lina Bensman
Partner
New York
T: +1 212 225 2069
lbensman@cgsh.com

Alexander Janghorbani
Counsel
New York
T: +1 212 225 2149
ajanghorbani@cgsh.com

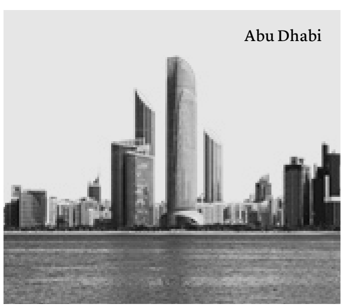
Lyuba Shamailova
Associate
New York
T: +1 212 225 2763
lshamailova@cgsh.com

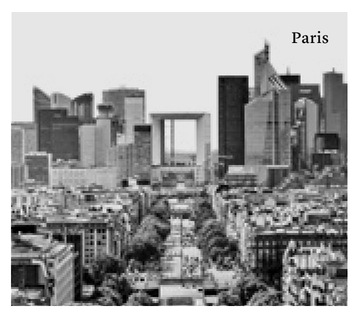
Laura Harder
Associate
New York
T: +1 212 225 2494
lharder@cgsh.com

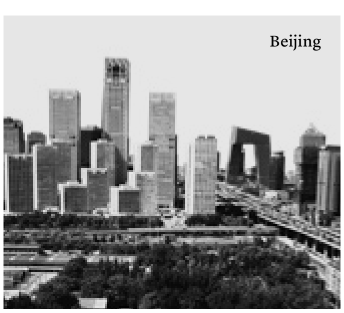


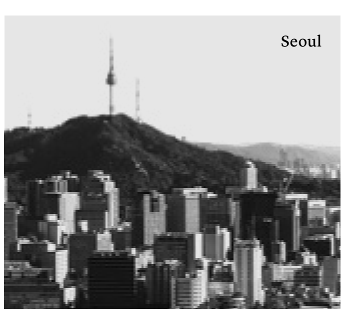
Gabrielle J. Kim
Law Clerk
New York
T: +1 212 225 2680
gakim@cgsh.com

CLEARY GOTTLIEB









clearygottlieb.com

23.02.01.06_020923