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PREPARING THE "BACKGROUND OF THE MERGER" SECTION IN MERGER PROXY STATEMENT

The "background of the merger" section in the proxy is an important section that is scrutinized by both the plaintiffs' bar and the SEC. In this article, the authors discuss the (1) legal framework governing the disclosure of the "background of the merger," (2) the process of preparing the "background of the merger" section, and (3) common areas of focus for both the Delaware courts and the SEC. The legal framework governing the disclosure of the "background of the merger" section includes the federal securities law and state law. The preparation of the "background of the merger" section should follow a few recommended protocols to ensure accuracy and completeness. The common topics scrutinized by Delaware courts and the SEC include non-disclosure agreements, material interactions between the parties, and potential conflicts of interest. The article concludes by providing a number of takeaways for practitioners.

By James Hu, Andrew Hammond, and Melissa Curvino *

In a public company merger involving a target company incorporated in Delaware, federal securities law and Delaware law require the disclosure of certain material events leading up to the merger agreement. The disclosure is commonly known as "the background of the merger" section in a merger proxy statement.[1] The "background of the merger" section is an area that is scrutinized by both the SEC and the plaintiffs' bar in Delaware.[2] This article explores the best practices in preparing the "background of the merger" section with a view to position parties to both satisfy SEC requirements and defend against potential plaintiff lawsuits.

LEGAL FRAMEWORK

SEC Requirements

When security holders of the acquiring company and/or the target company are voting to approve a

[1] A similar section will appear in Schedule TO and Schedule 14D-9 in a tender offer or Schedule 13e-3 of a "going private" transaction and in a Registration Statement on Form S-4 or F-4 in a transaction where the consideration includes the issuance of securities. However, for purposes of simplifying the discussion, this article will focus on disclosure requirements in the merger proxy statement in an all-cash acquisition.

[2] The SEC often elects not to review a merger proxy statement for an all-cash merger. The comment letters cited in this article were largely in relation to registration statements on Form S-4 and F-4, which the authors believe are nonetheless helpful guidance when it comes to a merger proxy statement for an all-cash merger.

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business combination, Item 14 of Schedule 14A requires the disclosure of the past contacts, transactions, or negotiations of the parties. In this respect, the parties must provide the information required by Item 1005(b) of Regulation M-A, which requires the description of any negotiations, transactions, or material contacts during the past two years between the buyer (including subsidiaries of the buyer and certain other persons) and the target company or its affiliates concerning the business combination.[3]

In addition, Rule 14a-9 promulgated by the SEC under the Securities Exchange Act of 1934, as amended,[4] imposes an overarching prohibition against material misstatements or the omission of any material fact necessary in order to make the disclosure not false or misleading. This would require the disclosure of any additional information that would significantly alter the "total mix" of information made available to stockholders.[5]

Practically, in the context of M&A, SEC rules and regulations require the disclosure of the target company's material contacts with the acquiror and other potential transaction parties in the two years leading up to the signing of the merger agreement. Importantly, the disclosure should address which party initiated the contact.[6]

Delaware Law

As part of the directors' duties of care, loyalty, and candor, Delaware law requires directors to make full and fair disclosure of material information pertinent to the solicitation of shareholder votes.[7] Similar to how federal courts have interpreted whether a fact is material, Delaware courts apply the "total mix" standard. As applied to the "background of the merger" section of the proxy statement, while "Delaware law does not require a blow-by-blow description of fluid sale negotiations,"[8] "sell-side fiduciaries must provide their stockholders with an accurate, full, and fair description of significant meetings or other interactions between target management and a bidder."[9] Delaware courts are cautious in "balancing the benefits of additional disclosures against the risk that insignificant information may dilute potentially valuable information."[10]

The accuracy and completeness of corporate disclosures have additional benefits. Under the landmark *Corwin* case, the board's decision to approve a change of control transaction (which had historically been evaluated under the intermediate *Revlon* standard of scrutiny)[11] will be evaluated under the more deferential business judgment standard if the merger has been approved by a majority of fully informed and uncoerced stockholders.[12] Similarly, the *MFW* decision allows for a transaction with a controlling stockholder to be evaluated under the business judgment rule if the deal is conditioned *ab initio* on the approval of (1) an independent special committee and (2) the uncoerced informed vote of a majority of the minority stockholders.[13] A pre-condition to securing this more favorable "business judgment" standard of review is the

[3] 17 CFR § 229.1005.

[4] 17 CFR § 240.14a-9.

[5] *Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988).

[6] Instruction to paragraphs (b) and (c) of Item 1005.

[7] *Pfeffer v. Redstone*, 965 A.2d 676, 684 (Del. 2009); *see also Stroud v. Grace*, 606 A.2d 75, 84 (Del.1992).

[8] *Feldman v. AS Roma SPV GP*, LLC, No. CV 2020-0314-PAF, 2021 WL 3087042, at *7 (Del. Ch. July 22, 2021).

[9] *In re Columbia Pipeline Group Merger Litigation*, No. 2018-0484-JTL, 2023 WL 4307699, at *74 (Del. Ch. June 30, 2023).

[10] *In re Volcano Corp. S'holder Litig.*, 143 A.3d 727, 749 (Del. Ch. 2016) (citing *Solomon v. Armstrong*, 747 A.2d 1098, 1128 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000)).

[11] Under the intermediate standard of scrutiny, directors must establish the reasonableness of the decision-making process employed by directors, including the information on which the directors based their decision and the reasonableness of the directors' action in light of the circumstances then existing. *Paramount Commc'ns, Inc. QVC Network, Inc.*, 637 A.2d 34, 45 (Del. 1994).

[12] *Corwin v. KKR Financial Holdgs. LLC*, 125 A.3d 304, 308–09 (Del. 2015).

[13] *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 645 (Del. 2014).

disclosure of all material facts prior to the stockholder vote. To identify potential inaccuracies in corporate disclosures, and thus defeat the application of a more favorable standard of review, prospective plaintiffs have increasingly been using Section 220 books and records requests under Delaware General Counsel Law. Accordingly, it is more important than ever to ensure the accuracy and adequacy of such disclosures and the consistency of such disclosure with other corporate records.

WHEN DOES PREPARATION OF "BACKGROUND OF THE MERGER" SECTION START?

Parties should not wait until after the announcement of the merger to consider the "background of the merger" section of the merger proxy statement. Rather, parties should consider the "background of the merger" section from the outset of a strategic review process or the initial contacts between the parties. A designated deal team member should keep contemporaneous records of the dates, participants, and topics being discussed at each meeting, which can later be relied on as the basis to draft the "background of the merger" section.[14]

In addition, the participants in the transaction process should conduct themselves in a manner with a view that all material interactions will need to be publicly disclosed after the transaction is announced. In shaping the transaction process, sequence, and steps, in addition to considering substantive deal economics, fiduciary duties, and other factors, each party should adopt a forward-looking perspective and consider how the disclosure would read eventually if a certain path is selected or a certain action is taken (or omitted to be taken).

PROCESS OF DRAFTING "BACKGROUND OF THE MERGER" SECTION

When drafting the "background of the merger" section, parties' advisors should set up a process to ensure that material events are accurately described and captured. This will start from the "deal journal" kept by the designated deal team member, but it will nonetheless often require the M&A lawyers to interview key participants to gather additional color of meetings or telephone calls during the sale process. If multiple individuals participated in a meeting, we recommend that lawyers drafting the disclosure seek input from all participants.

In addition, other contemporaneous records should be cross-checked to confirm consistency. For example, the "background of the merger" section should be consistent with the facts reflected in board minutes that accurately record the discussions and decisions made at board meetings.

The "background of the merger" section is an especially important part of the proxy statement that merits board-level attention. Once a draft is prepared, counsel should provide the draft to board members for review. Directors should, of course, review the proxy statement generally for accuracy and completeness to satisfy their duty of candor.

CERTAIN AREAS OF SEC AND DELAWARE COURT SCRUTINY

There are several recurring themes in the "background of the merger" section that have attracted the attention of the plaintiffs' bar, Delaware courts, and the SEC. The areas discussed below are only intended to illustrate the types of issues that may arise in connection with proxy disclosures and are not meant to be an exhaustive checklist.

NDAs signed by other bidders

One area that the plaintiffs' bar has scrutinized is the existence and nature of non-disclosure agreements ("NDAs") signed by other potential bidders. In particular, plaintiffs tend to focus on (1) the number and terms of NDAs and (2) the existence of any standstill obligations (including "don't ask, don't waive" provisions).

Notably, in *In re Ancestry.com Inc. S'holder Litig.*, then-Chancellor Strine granted a limited injunction, enjoining a stockholder vote and requiring the target company to disclose to its stockholders information concerning a "don't ask, don't waive" provision before the transaction was allowed to proceed to a vote. The court determined that this information was "absolutely essential" to stockholders because the existing disclosures "created the false impression that [anyone] who signed the standstill could have made a superior proposal."[15] In *In re Columbia Pipeline Group Merger Litigation*, the Delaware Chancery Court similarly concluded that a proxy statement "created the misleading impression that [certain bidders] were not bound by standstills [in an NDA] during the pre-signing

[14] For consistency, it is recommended that one individual be designated with the task of record keeping.

[15] *In re Ancestry.com, Inc. S'holder Litig.*, C.A. No. 7988-CS (Del. Ch. Dec. 17, 2012) Hr'g Tr. at 26:10–12.

period," that these disclosure problems were material and that, as a result, the stockholders of the target company were not fully informed when voting on the transaction and thus the director defendants were not entitled to the *Corwin* cleansing protections.[16] Accordingly, the failure to disclose material information concerning standstill provisions in NDAs (or whether such obligations have been waived) could have significant ramifications, including the potential issuance of an injunction enjoining the stockholder vote pending the disclosure of such information in pre-closing litigation or the loss of *Corwin* protections from defendants in post-closing litigation.

Similarly, the SEC has issued comments seeking additional disclosure around standstill provisions where the "background of the merger" section includes a brief reference but does not include enough detail to fully inform stockholders of the nature of the standstill.[17]

Material discussions between the target and bidders

The second area where plaintiffs' counsel and the SEC have focused is the nature of the interactions between the target company and the acquiror or other potential bidders.

The types of interactions between target and acquiror which have been considered by Delaware courts or the SEC to be material include:

- meetings between the principals where material deal terms (including valuation) were discussed;[18]
- all material discussions between a founder and a buyer when the proxy statement only disclosed one such discussion (thereby leaving the impression that only one discussion occurred);[19]
- how the parties' negotiating positions differed and how deal points were resolved;[20]
- communications from target CEO to a PE buyer that he wanted to find a "good home" for the company and he expected to retire in 2-3 years;[21]
- "tip" from a target representative to a PE buyer of a price potentially acceptable to the target;[22] and
- message from target CEO to a PE buyer on the target's intention to explore a sale process without board's authorization.[23]

Similarly, Delaware courts and the SEC have focused on disclosures relating to discussions between the target and other potential counterparties:

- finding that disclosure characterizing another potential buyer as "equivocal and unresponsive" was misleading when the potential buyer only walked away after a 24-hour ultimatum was imposed by the target company;[24]
- finding that the communications between a director and a potential bidder about the bidder's interest in acquiring the company and the likely timeframe for a bid were material;[25]
- seeking more information on the other potential alternatives that were explored by the board, the reasons why discussions with another potential counterparty ended, and whether it was the target or the counterparty that ceased the discussion; and[26]

[16] *In re Appraisal of Columbia Pipeline Grp., Inc.*, No. CV 12736-VCL, 2019 WL 3778370, at *35–36 (Del. Ch. Aug. 12, 2019), judgment entered, (Del. Ch. 2019).

[17] *See, e.g.*, Berry Plastics Group, Inc., Registration Statement on Form S-4 (File No. 333-213803), Comment Letter of the Staff of the Division of Corporation Finance dated October 21, 2016; Alere Inc., Preliminary Proxy Statement on Schedule 14A (File No. 001-16789), Comment Letter of the Staff of the Division of Corporation Finance dated September 13, 2016.

[18] *Alessi v. Beracha*, 849 A.2d 939, 946 (Del. Ch. 2004).

[19] *Morrison v. Berry*, 191 A.3d 268, 284–85 (Del. 2018), *as revised* (July 27, 2018).

[20] Noble Finco Limited, Registration Statement on Form S-4 (File No. 333-261780), Comment Letter of the Staff of the Division of Corporation Finance dated January 20, 2022.

[21] *In re Mindbody, Inc., S'holder Litig.*, No. 2019-0442-KSJM, 2023 WL 2518149, at *43–44 (Del. Ch. Mar. 15, 2023).

[22] *Id.*

[23] *Id.* at 41.

[24] *Chen v. Howard-Anderson*, 87 A.3d 648, 691 (Del. Ch. 2014).

[25] *In re PLX Tech. Inc. S'holders Litig.*, No. CV 9880-VCL, 2018 WL 5018535, at *32–35 (Del. Ch. Oct. 16, 2018), *aff'd*, 211 A.3d 137 (Del. 2019).

[26] *See, e.g.*, First Commonwealth Financial Corporation, Registration Statement on Form S-4 (File No. 333-267944), Comment Letter of the Staff of the Division of Corporation Finance dated November 18, 2022; Neogen Corporation, Registration Statement on Form S-4 (File No. 333-263667)

- requesting disclosure on whether potential bidders that were contacted presented any acquisition proposal.[27]

Potential conflicts of interest

The third area that has drawn the attention of the SEC and the plaintiffs' bar is disclosures relating to facts suggesting potential conflicts of interest, particularly with respect to anticipated post-closing officer or director positions or the role of financial advisors. In this respect, the following facts have been considered material by the SEC or the Delaware courts:

- information concerning the CEO's desire to monetize a material portion of his retirement benefits while remaining CEO where the CEO led discussions with private equity buyer;[28]
- full disclosure of investment banker compensation and potential conflicts; and[29]
- whether any persons responsible for negotiating the agreements are accepting any position or remuneration from any party in connection with the transaction, including payments for managing the company following the acquisition, and whether such remuneration was a negotiated item, who negotiated it, and how terms were set.[30]

While the above three areas and the accompanying examples are not exhaustive, they provide a flavor of the types of issues that Delaware courts and the SEC have considered material.

KEY TAKEAWAYS

- In the pre-merger discussions, parties should proceed under the assumption that all contacts in connection with a merger process will be publicly disclosed.
- Reliable records are the basis for preparing the "background of the merger" section. Protocols should be adopted early to track and record, in a consistent manner, material discussions between the target and potential bidders.
- Contemporaneous board minutes should be maintained with sufficient detail to document the relevant reports, discussions, and decisions made at board meetings as an additional backup for the "background of the merger" section.
- The draft of the "background of the merger" section should be cross-checked against available corporate records to confirm consistency, especially in light of plaintiffs' tactic of using a Section 220 demand to identify potential disclosure deficiencies.
- The "background of the merger" section should be reviewed and vetted by key participants and approved by the target company board to ensure consistency and completeness.
- Transaction advisors should affirmatively inquire if certain recurring fact patterns deemed material by the Delaware courts or the SEC exist in a particular transaction, in particular facts around discussions between a target principal and acquiror that involve potential conflicts of interest issues.
- Disclosing material facts proactively would (1) avoid delay of the transaction due to potential injunction from the Delaware court or comments from the SEC and (2) ensure shareholders are fully informed about the transaction and therefore make it more likely that *Corwin* or *MFW* (as applicable) would be applied to lower the standard of review to the business judgment rule. ■

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Comment Letter of the Staff of the Division of Corporation Finance dated March 17, 2022.

[27] Twitter, Inc., Preliminary Proxy Statement on Schedule 14A (File No. 001-36164), Comment Letter of the Staff of the Division of Corporation Finance dated June 17, 2022.

[28] *In re Lear Corp. Shareholder Litig.*, 967 A.2d 640, 644 (Del. Ch. 2008).

[29] *In re Del Monte Foods Co. S'holders Litig.*, 2011 WL 532014 at *16 (Del Ch. Feb. 14, 2011) ("This Court has not stopped at disclosure, but rather has examined banker conflicts closely to determine whether they tainted the directors' process."); *see also In re Rural Metro Corp.*, 88 A.3d 54, 106 (Del. Ch. 2014) (holding that a proxy statement failed to disclose financial advisor's material conflicts regarding financial incentives and further roles in acquisition).

[30] Intercontinental Exchange, Inc., Registration Statement on Form S-4 (File No. 333-265709), Comment Letter of the Staff of the Division of Corporation Finance dated July 14, 2022.