INSIGHTS

THE CORPORATE & SECURITIES LAW ADVISOR

Volume 29 Number 12, December 2015

MERGERS AND ACQUISITIONS

The New Paradigm (Burden) Shift: The Business Judgment Rule After *KKR*

The Delaware Supreme Court recently held that an uncoerced, fully informed vote of a majority of the disinterested stockholders adopting a merger agreement invoked the business judgment rule standard of review, even though the vote was statutorily required. The opinion left unanswered the question as to whether the business judgment rule invoked in that context was a rebuttable presumption or a substantive rule of law protecting the directors' decision. Two subsequent opinions of the Court of Chancery suggest that the business judgment rule applied in that context is a rebuttable presumption.

By John Mark Zeberkiewicz and Blake Rohrbacher

In *Corwin v. KKR Financial Holdings LLC*,[1] the Delaware Supreme Court affirmed the Delaware Chancery Court's holding that, when a third-party merger has been approved by a fully informed, uncoerced vote of a majority of the disinterested stockholders, the business judgment rule is the appropriate standard of review in a post-closing damages action.[2] The holding represented a departure from earlier opinions of the Court of Chancery applying intermediate scrutiny under *Revlon* to determine whether a post-closing damages action could proceed against one or more of the defendants.[3]

The question not answered in *KKR*, however, is what exactly is meant by the application of the business judgment rule. Traditionally, the business judgment rule has had a dual nature—both as an evidentiary rule that may be rebutted and as a substantive rule of law that serves to protect directors and their decisions.[4] In its first incarnation, the presumptions of the business judgment rule may be rebutted by a showing of a breach of the duty of care or the duty of loyalty.[5] In its second, the business judgment rule is a basis for dismissal.[6]

KKR leaves open which aspect of the business judgment rule is implicated by the informed stockholder vote. Thus, if the business judgment rule under *KKR* could be rebutted by a showing of a breach of the duty of care, motions to dismiss in M&A cases would allow for a counter-intuitive result: (1) director defendants (*i.e.*, the persons responsible for the decision to merge)

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could be dismissed, because they were covered by the corporation's exculpatory charter provision,[7] but (2) officers and financial advisors, not covered by exculpatory provisions, would not be dismissed, either for direct breaches of fiduciary duty (in the case of officers) or for aiding and abetting breaches of fiduciary duty (in the case of financial advisors).[8] Otherwise, the application of the business judgment rule would serve to dismiss the entire case, and all defendants, because there would be no predicate breach of fiduciary duty.[9]

Recent Delaware cases—four of which were decided in the same month—demonstrate the questions raised about the effect of the business judgment rule following an uncoerced, fully informed stockholder vote. The Court of Chancery's post-*KKR* opinions suggest that the business judgment rule applied in the *KKR* context is only a rebuttable presumption.

First Opinion: Chancery Allows Business Judgment in *KKR*

In the Court of Chancery, plaintiffs challenged the stock-for-stock merger between KKR & Co. L.P. (KKR), the leveraged buyout fund, and KKR Financial Holdings LLC (KFN), the public financing arm for KKR's leveraged buyouts.[10] Plaintiffs claimed that the transaction was subject to review under the entire fairness standard *ab initio*; plaintiffs argued that, although KKR owned only one percent of KFN's equity, it was KFN's controlling stockholder, since a KKR affiliate managed KFN's day-to-day operations through an investment management agreement.[11] Chancellor Bouchard found that the allegations did not support a reasonable inference that KKR controlled KFN's board and that, accordingly, KKR was not a controlling stockholder.[12] On that basis, the Chancery Court rejected plaintiffs' entire fairness argument.

The Court dismissed plaintiffs' claims, stating that the defendants were entitled to the presumption of the business judgment rule for two separate reasons:

> First, plaintiffs have failed to allege facts from which it is reasonably inferable that a majority of the KFN board was not disinterested in the transaction or independent from KKR. Second, even if plaintiffs had alleged sufficient facts to reasonably support such an inference, business judgment review still would apply because the merger was approved by a majority of disinterested stockholders in a fully-informed vote.[13]

Second Opinion: *Zale* Declines to Follow *KKR*

The day before the Supreme Court's decision in *KKR*, the Delaware Court of Chancery issued its opinion in *In re Zale Corporation Stockholders Litigation*, which involved a challenge to the completed merger by which Signet Jewelers Limited acquired Zale Corporation.[14] The plaintiffs, former stockholders of Zale, brought fiduciary duty claims against the directors, as well as aiding and abetting claims against Signet, the buyer, and Merrill Lynch, Pierce, Fenner & Smith Incorporated, Zale's financial advisor. The Court granted the director defendants' and Signet's motion to dismiss, but denied the motion as to Merrill Lynch.[15]

Plaintiffs claimed that the director defendants breached their fiduciary duties because the board was not disinterested or independent as to the merger and because the board's conduct throughout the sales process constituted bad faith.[16] Even if the board's conduct did not amount to bad faith, plaintiffs maintained, the directors' actions constituted a breach of the duty of care.[17] Defendants argued that, because the merger was approved by a disinterested majority of the stockholders, the business judgment rule should apply to plaintiffs' claims under the reasoning of Chancellor Bouchard's *KKR* opinion.[18] The Court stated that, if it were to apply the reasoning

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of *KKR*, the presumption of the business judgment rule would " 'insulate[] the [merger] from all attacks other than on the grounds of waste.' "[19]

But the *Zale* Court disputed a key tenet of *KKR*—namely, that a statutorily required vote would have the effect of invoking the business judgment rule—and therefore instead conducted its review of the directors' conduct under *Revlon* intermediate scrutiny.[20] The Court also noted that, regardless of which standard applied, it would reach the same conclusion on all of the defendants' motions to dismiss, except for Merrill Lynch's.[21] As to Merrill Lynch's motion, the Court stated that, if the merger vote had no cleansing effect, the plaintiffs conceivably could prove their claim that Merrill Lynch was liable for aiding and abetting a breach of the director defendants' duty of care.[22]

In reviewing plaintiffs' price and process claims, the Court found that the "the only deficiency that conceivably could constitute a breach of the duty of care" was plaintiffs' allegation that one of the members of the financial advisor team representing Zale also was a member of the team that had made a pitch to represent Signet in the acquisition.[23] The fact that Merrill Lynch had made a pitch to Signet only emerged when the proxy statement was being prepared, after the merger agreement had been executed. Due to the belated disclosure of the financial advisor's buy-side (but ultimately unsuccessful) pitch, the Court concluded it was reasonably conceivable that the directors did not act in a fully informed manner.[24] While the plaintiffs' complaint acknowledged that the board had considered generally potential conflicts involving its financial advisor, that fact alone was not sufficient, on a motion to dismiss, for the Court to conclude that plaintiffs could not conceivably prove that the directors breached their duty of care.[25]

The Court ultimately ruled that, because Zale's certificate of incorporation included an exculpatory provision under Section 102(b)(7), whether the directors could have breached their duty of care was relevant only for purposes of determining whether Signet or Merrill Lynch could be liable for aiding and abetting those breaches.[26] As there were no allegations in the complaint supporting an inference that Signet knowingly participated in the board's duty of care breach, the aiding and abetting claim against Signet was dismissed. But the Court found it was reasonably conceivable that Merrill Lynch knowingly participated in the breach.[27]

Third Opinion: The Supreme Court Affirms *KKR*

On appeal, the Delaware Supreme Court affirmed the "well-reasoned" Chancery *KKR* opinion, adding that "[f]or sound policy reasons, Delaware corporate law has long been reluctant to second-guess the judgment of a disinterested stockholder majority that determines that a transaction with a party other than a controlling stockholder is in their best interests."[28] Noting that plaintiffs had not argued for the *Revlon* standard in the Court below, the Supreme Court stated that it need not "delve into whether the Court of Chancery's determination that *Revlon* did not apply to the merger is correct for a single reason: it does not matter."[29] The effect of the stockholder vote, the Court held, "is outcome-determinative, even if *Revlon* applied to the merger."[30]

In other words, "the business judgment rule is invoked as the appropriate standard of review for a post-closing damages action when a merger that is not subject to the entire fairness standard of review has been approved by a fully informed, uncoerced majority of the disinterested stockholders."[31] The Court emphasized the policy basis for its holding, stating that when the stockholders, "the real parties in interest," can protect themselves through their voting power, "the utility of a litigation-intrusive standard of review promises more costs to stockholders in the form of litigation rents and inhibitions on risk-taking than it promises in terms of benefits to them."[32]

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Fourth Opinion: *TIBCO* Does Not Address *KKR*

After the Delaware Supreme Court affirmed his *KKR* decision, Chancellor Bouchard decided *In re TIBCO Software Inc. Stockholders Litigation* without wrestling with the *KKR* issues.[33] The stockholder-plaintiff in *TIBCO* challenged the per-share merger consideration that private equity buyer Vista Equity Partners paid to the former holders of TIBCO Software Inc. in an all-cash merger.[34] The merger agreement provided that the TIBCO stockholders would receive $24 per share. Based on the number of fully diluted outstanding shares reflected in the merger agreement, that per-share consideration implied a transaction value of approximately $4.144 billion. In negotiating the merger agreement, however, Vista and TIBCO had operated under the mistaken belief that the aggregate equity value implied by the transaction was approximately $4.244 billion, which would have resulted in per-share merger consideration of $24.57. The mistaken belief was the result of the double-counting of shares included in a spreadsheet that TIBCO's financial advisor had prepared. That spreadsheet was furnished to Vista, and it formed the basis of the financial advisor's initial fairness opinion to the TIBCO board.[35]

The error in the capitalization table was discovered when the parties were preparing the proxy statement, and it was disclosed in the preliminary proxy statement.[36] Following that disclosure, the plaintiff moved to enjoin the transaction, but the Court denied the injunction.[37] Following the closing, the plaintiff asserted various other claims, including claims for reformation and for breach of fiduciary duty.[38] With respect to the fiduciary duty claims, the Court found that the complaint stated a claim for a breach of the directors' duty of care, due to their alleged failure to inform themselves adequately as to "basic matters one rationally would expect a board to explore to properly assess its options" after learning of the share count error.[39] Despite the finding, the directors, as in *Zale*, were protected by an exculpatory provision under Section 102(b)(7); thus, the claims for breach of fiduciary duty against them were dismissed.

Nevertheless, as in the initial *Zale* opinion, the claims against the directors formed the basis of the aiding and abetting claim against TIBCO's financial advisor. Accepting plaintiff's well-pled allegations as true, the *TIBCO* Court found that there was "a sufficiently wide gulf between what was done and what one rationally would expect a board to do" after learning of the share-count error.[40] As a result, the Court found that it was reasonably conceivable that the plaintiff would be able to meet the "gross negligence" standard.[41]

Turning to the aiding and abetting claims against the financial advisor, the Court noted that the plaintiff was required to prove the existence of a fiduciary relationship, a breach of fiduciary duty, and the non-fiduciary financial advisor's knowing participation in the breach. Having found that the plaintiff adequately alleged a breach of the duty of care, the Court focused on whether the financial advisor "knowingly participated" in the alleged breach. On that front, the Court noted that the financial advisor had allegedly concealed material information regarding the share-count error from TIBCO's board, and found it was reasonably conceivable that the alleged concealment created an "informational vacuum" at a critical juncture of the board's considerations of its options.[42] Moreover, the Court credited the allegation that the financial advisor was motivated by a sizable fee, almost all of which was contingent on the consummation of the transaction, in combination with other allegations, as sufficient to show at the motion to dismiss stage that the financial advisor knowingly and intentionally created the informational vacuum. Accordingly, the Court denied the financial advisor's motion to dismiss.[43]

Interestingly, although the Court had requested supplemental briefing on the *KKR* issues, the *TIBCO* opinion did not expressly

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address the effect of the stockholder vote (which followed a proxy disclosure of the financial advisor's mistake).

Fifth Opinion: *Zale* Reconsiders on Reargument

After the Supreme Court's affirmance in *KKR*, Merrill Lynch submitted a motion for reargument.[44] The *Zale* Court granted the motion, noting that, as a result of *KKR*, it had "misapprehended the law regarding the cleansing effect of a fully informed, statutorily required vote by a disinterested majority of stockholders in the circumstances of the *Zale* case."[45] The Court stated that the misapprehension was "material and potentially outcome-determinative as to Merrill Lynch's aiding and abetting liability," as the Court had "applied *Revlon* rather than [business judgment review]" in determining whether plaintiffs' complaint had adequately alleged that the directors breached their fiduciary duties.[46]

Reexamining the claims in light of *KKR*, the Court stated that,

> when reviewing a board of directors' actions during a merger process after the merger has been approved by a majority of disinterested stockholders in a fully informed vote, the standard for finding a breach of the duty of care under [the business judgment rule] is gross negligence.[47]

The Court noted that, in its initial opinion, it had employed an intermediate level of scrutiny, reviewing the directors' alleged conduct under a reasonableness standard. Under that standard, plaintiffs' allegations were sufficient to state a claim for breach of the duty of care—and Merrill Lynch, unprotected by the exculpatory provision covering the director defendants, could not prevail on its motion to dismiss.[48]

Under the business judgment rule, however, for Merrill Lynch to remain in the case, it would have to be reasonably conceivable that the directors "breached their duty of care by acting in a grossly negligent manner."[49] Absent such a showing, the Court stated, "there would be no predicate fiduciary duty breach for Merrill Lynch to have aided and abetted, and Merrill Lynch's motion to dismiss would be granted."[50] Applying the business judgment rule, the Court found that it was not reasonably conceivable that the directors were grossly negligent, as their conduct was not the result of "reckless indifference or a gross abuse of discretion" and the facts did not "suggest a *wide* disparity between the process" they used and one that "would have been rational."[51]

Implications

The result in *Zale* following reargument suggests that *KKR* is not the final word in a third-party merger approved by a fully informed, uncoerced majority of the disinterested stockholders. In that situation, *KKR* would state that the business judgment rule applies to the merger. One might think that, once the business judgment rule applies, the entire case—including all claims for breach of fiduciary duties and for aiding and abetting that breach—would be dismissed.[52] But as the analysis in *Zale* on reargument demonstrates, this is not necessarily the case.

> ***Practitioners should be aware that the cleansing KKR vote may not guarantee a dismissal.***

Instead, these cases suggest that the business judgment rule applied under *KKR* is subject to rebuttal, just as is the business judgment rule in non-merger cases. Accordingly, even after the cleansing stockholder vote, plaintiffs apparently may prevent dismissal by pleading sufficient claims of breaches of the duty of care (or, presumably, the duty of loyalty).[53] It remains to be seen whether the Delaware Supreme Court approves this "weak" application of the post-*KKR* business

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judgment rule or whether the Delaware Supreme Court instead holds that the post-*KKR* business judgment rule results in an automatic dismissal in the absence of waste. Until that question is answered, practitioners should be aware that the cleansing *KKR* vote (and potentially even the *MFW* protocol) may not guarantee a dismissal, and certainly not for officers or advisors without protection under Section 102(b)(7).

Notes

1. — A.3d —, 2015 WL 5772262 (Del. Oct. 2, 2015).
2. In *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110, 1117 (Del. 1994), the Court held that "the exclusive standard of judicial review in examining the propriety of an interested cash-out merger transaction by a controlling or dominating shareholder is entire fairness." Later, in *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635, 645 (Del. 2014), the Delaware Supreme Court held that the business judgment standard of review could be applied to a controlling stockholder transaction subject to entire fairness *ab initio* "*if and only if*: (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." Accordingly, before the Delaware Supreme Court's decision in *KKR*, controlling stockholder buyouts potentially could be reviewed under the favorable business judgment rule, while third-party mergers not involving a controller were subject to intermediate scrutiny under *Revlon*.
3. *See, e.g.*, *In re Zale Corp. S'holders Litig.*, 2015 WL 5853693, at *11 (Del. Ch. Oct. 1, 2015) ("While the intermediate level of *Revlon* enhanced scrutiny is 'more exacting than the deferential rationality standard applicable to run-of-the-mill decisions governed by the business judgment rule, at bottom *Revlon* is a test of reasonableness; directors are generally free to select the path to value maximization, so long as they choose a reasonable route to get there.' In that regard, the questions before me are: (1) whether the decision making process employed by the Director Defendants, including the information on which they based their decisions, was adequate; and (2) whether the Director Defendants' actions were reasonable in light of the circumstances then existing." (footnote omitted)); *In re PLX Tech. Inc. S'holders Litig.*, C.A. No. 9880-VCL, at 23 (Del. Ch. Sept. 3, 2015) (TRANSCRIPT) ("Let's start with the sale process claims. Enhanced scrutiny is the governing standard of review. In my view, it is reasonably conceivable that the plaintiffs could prove at trial that the board's actions fell outside the range of reasonableness. The complaint therefore states a claim for breach of fiduciary duty.").
4. *See Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53, 64 (Del. 1989) ("The business judgment rule is an extension of the fundamental principle 'that the business and affairs of a corporation are managed by and under the direction of its board.' The rule operates as both a procedural guide for litigants and a substantive rule of law. As a rule of evidence, it creates 'a presumption that in making a business decision, the directors of a corporation acted on an informed basis [i.e., with due care], in good faith and in the honest belief that the action taken was in the best interest of the company.' The presumption initially attaches to a director-approved transaction within a board's conferred or apparent authority in the absence of any evidence of 'fraud, bad faith, or self-dealing in the usual sense of personal profit or betterment.' The burden falls upon the proponent of a claim to rebut the presumption by introducing evidence either of director self-interest, if not self-dealing, or that the directors either lacked good faith or failed to exercise due care. If the proponent fails to meet her burden of establishing facts rebutting the presumption, the business judgment rule, as a substantive rule of law, will attach to protect the directors and the decisions they make." (internal citations omitted)).
5. *See Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 371 (Del. 1993) ("A breach of either the duty of loyalty or the duty of care rebuts the presumption that the directors have acted in the best interests of the shareholders, and requires the directors to prove that the transaction was entirely fair.").
6. *See In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 74 (Del. 2006).
7. Section 102(b)(7) of the Delaware General Corporation Law permits a corporation to include in its certificate of incorporation a provision that eliminates the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty, other than (i) for breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law; (iii) under Section 174 of the DGCL (relating to unlawful dividends or stock repurchases or redemptions); or (iv) for any transaction from which the director derived an improper personal benefit. 8 *Del. C.* § 102(b)(7). Essentially, directors of corporations with such a provision may not be held personally liable for breaches of the duty of care.
8. *See, e.g.*, *In re Zale*, 2015 WL 5853693, at *19-20 (finding that the complaint alleged facts from which it was reasonably conceivable that the plaintiffs could demonstrate the directors had breached their duty of care, but granting the director defendants' motion to dismiss due to the Section 102(b)(7) provision, while denying the board's financial advisor's motion to dismiss plaintiffs' claims for aiding and abetting breach of fiduciary duty); *In re PLX*, C.A. No. 9880-VCL, at 5-6 (dismissing

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claims against certain of the director defendants while denying the motion to dismiss of certain officers and the board's financial advisor).

9. Notably, the Chancery Court's opinion in *KKR* could be construed to suggest that the Court was invoking the "substantive" incarnation of the business judgment rule, as the Court stated: "plaintiffs do not disagree with defendants' position that the legal effect of a fully-informed stockholder vote of a transaction with a non-controlling stockholder is that the business judgment rule applies and insulates the transaction from all attacks other than on the grounds of waste, even if a majority of the board approving the transaction was not disinterested or independent." *In re KKR Fin. Hldgs. LLC S'holder Litig.*, 101 A.3d 980, 1001 (Del. Ch. 2014), *aff'd*, — A.3d —, 2015 WL 5772262 (Del. Oct. 2, 2015). That construction, however, is at odds with the analyses in the *Zale* and *TIBCO* opinions discussed below.

10. *In re KKR Fin. Hldgs.*, 101 A.3d at 983.

11. *Id.* at 990.

12. *Id.* at 993-96.

13. *Id.* at 983.

14. 2015 WL 5853693, at *1 (Del. Ch. Oct. 1, 2015).

15. *Id.*

16. *Id.* at *8.

17. *Id.*

18. *Id.*

19. *Id.* at *10. This statement suggests that the "substantive" incarnation of the business judgment rule was in play. *See supra* note 9. As will be seen, the *Zale* Court seemed to change positions on reargument. *See infra* note 49.

20. Unlike the *KKR* Court, the *Zale* Court adopted a different interpretation of the Supreme Court's opinion in *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009), regarding the doctrine of stockholder ratification. The *Zale* Court interpreted *Gantler* as holding that enhanced scrutiny could not be "pared down to the business judgment rule as a result of a statutorily required vote." *Zale*, 2015 WL 5853693, at *10.

21. 2015 WL 5853693, at *10.

22. *Id.*

23. *Id.* at *18.

24. *Id.* at *19.

25. *Id.*

26. *Id.* at *18.

27. *Id.* at *22.

28. *KKR*, 2015 WL 5772262, at *1. The Supreme Court also affirmed Chancellor Bouchard's ruling that KKR was not a controlling stockholder. *Id.* at *2-3.

29. *Id.* at *3. The Supreme Court also noted that the concepts of intermediate scrutiny under *Unocal* and *Revlon* were designed principally with an eye toward injunctive relief and were therefore ill-suited to a post-closing damages case. *Id.* at *6 ("First, *Unocal* and *Revlon* are primarily designed to give stockholders and the Court of Chancery the tool of injunctive relief to address important M & A decisions in real time, before closing. They were not tools designed with post-closing money damages claims in mind, the standards they articulate do not match the gross negligence standard for director due care liability under *Van Gorkom*, and with the prevalence of exculpatory charter provisions, due care liability is rarely even available.").

30. *Id.* at *3.

31. *Id.* at *1.

32. *Id.* at *6

33. 2015 WL 6155894 (Del. Ch. Oct. 20, 2015).

34. *Id.* at *1.

35. *Id.*

36. *Id.*

37. *Id.*

38. *Id.* at *2.

39. *Id.*

40. *Id.* at *23.

41. *Id.*

42. *Id.* at *25.

43. *Id.* at *26.

44. *In re Zale Corp. S'holders Litig.*, 2015 WL 6551418, at *1 (Del. Ch. Oct. 29, 2015). At the time of publication, plaintiffs had filed a notice of appeal of this decision.

45. *Id.* at *2.

46. *Id.*

47. *Id.* at *3.

48. *Id.*

49. *Id.* Cognizance of allegations regarding the duty of care—rather than waste—suggests that the *Zale* Court was, on reargument, treating the "procedural" incarnation of the business judgment rule. *See supra* note 9.

50. 2015 WL 6551418, at *3.

51. *Id.* at *4.

52. *Cf. Swomley v. Schlecht*, 2015 WL 7302260 (Del. Nov. 19, 2015) (ORDER) (affirming the dismissal of a controlling stockholder buyout that was conditioned on negotiation by an independent special committee and a majority of the minority vote in conformity with the *MFW* construct).

53. Interestingly, in *Gantler v. Stephens*, the Delaware Supreme Court arguably referenced the "procedural" incarnation of the business judgment rule in addressing "classic ratification," stating that, "[w]ith one exception, the 'cleansing' effect of such a ratifying shareholder vote is to subject the challenged director action to business judgment review, as opposed to 'extinguishing' the claim altogether (*i.e.*, obviating all judicial review of the challenged action)." 965 A.2d at 713.

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