



Will Mandatory Shareholder Approval of Golden Parachutes Dull Their Luster?

By Kyoko Takahashi Lin, Bernice Grant, Ron Aizen and Jamila Diggs of Davis Polk & Wardwell LLP¹

The new Dodd-Frank Wall Street Reform and Consumer Protection Act includes a provision, added in the midst of conference committee negotiations, requiring public companies to seek shareholder approval of golden parachutes for named executive officers at the same time that shareholders are asked to approve a deal.² Golden parachutes are typically thought of as any compensation or benefits that are paid or provided in connection with a change in control of a company, such as deal bonuses, retention bonuses, severance, accelerated vesting of equity, continued health benefits, etc. Under the Act, public companies must disclose golden parachute arrangements with named executive officers in any proxy statement in which shareholders are asked to approve an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of the assets of a company. The total compensation that may be paid to the named executive officers in such a transaction, pursuant to golden parachute arrangements, must be included in this disclosure. These arrangements and compensation must be submitted for shareholder approval in a resolution separate from the vote to approve the underlying transaction. The golden parachute shareholder vote will be required of all public companies, but will not be binding on companies or their directors.

The New “Shareholder Approval of Executive Compensation” Requirement

The Act requires both a “say on pay” generally and a “say on golden parachutes” specifically. These requirements, which will apply to all public company shareholder meetings that occur at least six months after the Act’s enactment, are as follows:

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² Named executive officers of a company include (i) the principal executive officer; (ii) the principal financial officer; (iii) the three most highly compensated executive officers other than the principal executive officer and the principal financial officer who were serving as executive officers at the end of the last completed fiscal year; and (iv) up to two additional individuals for whom disclosure would have been provided but for the fact that the individual was not serving as an executive officer at the end of the last completed fiscal year.

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- **Say on Pay.** At least once every three years, at any annual or other meeting of shareholders for which proxy solicitation rules require compensation disclosure, companies must provide their shareholders with a non-binding shareholder vote to approve the compensation of executives as disclosed pursuant to SEC rules. At least once every six years, shareholders must also be provided with a non-binding shareholder vote to determine whether the say on pay vote will occur every one, two or three years.
- **Say on Golden Parachutes.**
 - **Disclosure of Arrangements and Compensation.** In any proxy or consent solicitation for a meeting at which shareholders are asked to approve an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of the assets of a company, the person making the solicitation must disclose, in a clear and simple form in accordance with regulations to be promulgated by the SEC, the following:
 - any agreements or understandings that such person has with any named executive officers of the company (or of the acquirer, if the company is not the acquirer) concerning any type of compensation (whether present, deferred or contingent) that is based on or otherwise relates to the transaction; and
 - the total of all such compensation that may (and the conditions upon which it may) be paid or become payable to, or on behalf of, the executive officer.
 - **Shareholder Vote.** In addition, the proxy must provide shareholders with a separate, non-binding vote to approve such agreements or understandings and compensation as disclosed, unless the agreements or understandings have been subject to a shareholder vote under the general say on pay requirement described above.

Given that the say on pay and say on golden parachutes provisions will apply to shareholder meetings that occur after the six-month anniversary of the date of enactment of the Act, the provisions will apply for the first time in the 2011 proxy season (at least for calendar year companies). The say on pay and say on golden parachutes provisions will not apply to foreign private issuers, since the provisions will be implemented through the U.S. proxy rules. Also, small issuers may be exempted if the SEC determines that they would be disproportionately burdened.

The say on golden parachutes provision will require SEC rulemaking with respect to the “clear and simple form” in which the golden parachute arrangements and compensation must be disclosed. Also, the exception to submitting golden parachutes to a shareholder vote if they have already been subject to a general say on pay vote appears to be available even if shareholders disapproved the company’s executive compensation during the general say on pay vote.

The Act will also require every institutional investment manager subject to the reporting requirements of Section 13(f) of the Securities Exchange Act of 1934 to disclose at least annually how it voted on any say on pay or say on golden parachutes vote (unless the SEC otherwise requires the vote to be reported publicly). In addition, since the national securities exchanges now prohibit broker discretionary voting in connection with executive compensation (among other matters), broker discretionary voting will not be permitted in connection with say on pay or say on golden parachutes.

A Historical Perspective

While the executive compensation provisions in the Act are aimed at promoting responsible compensation practices and corporate accountability, shareholder disclosure and approval of golden parachute arrangements is not an entirely new concept.

Existing Golden Parachute Disclosure Requirement for Proxy Statements

Item 5 of Schedule 14A (Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act) requires that proxies relating to M&A transactions include, in the section entitled “Interest of Certain Persons in Matters to be Acted Upon,” a brief description of any substantial interest, direct or indirect, by security holdings or otherwise, of any person who has been an executive officer or director since the beginning of the last fiscal year in any matter to be acted upon (other than elections to office). To satisfy this requirement, it has become the practice to disclose any golden parachute arrangements with executive officers or directors that will become payable in connection with an M&A transaction.

In addition, Item 8 of Schedule 14A requires that certain proxies, including annual proxies pursuant to which directors will be elected, include narrative and quantitative disclosure required by Item 402(j) of Regulation S-K regarding potential payments to named executive officers in connection with the termination of their employment or a change in control.

However, current proxy rules have been limited to *disclosure* to shareholders of golden parachutes, not shareholder *approval*. Under the proxy rules, shareholders' only recourse, if they disapprove of the golden parachutes, is to vote against the deal (in the context of a proxy for a transaction) or against the proposed directors (in the context of a proxy for an annual meeting at which directors will be elected). Under the Act, on the other hand, shareholders will be able to vote in favor of the deal but against the golden parachutes. That said, even under the Act, shareholder disapproval would be non-binding.

Case Law

Even though golden parachutes historically have not been subject to a shareholder approval vote, shareholders have, on occasion, voiced disapproval of golden parachute payments through litigation.

For example, in *In re Mony Group Inc. Shareholder Litigation*,³ shareholders brought a suit in the Delaware Chancery Court requesting a preliminary injunction to prohibit a shareholder vote to approve a stock-for-cash merger between a target company and the acquirer. Upon consummation of the merger, the target's senior management would be entitled to receive a total of \$120 million in golden parachute payments. Plaintiff shareholders argued that the disclosures made in the target's proxy statement regarding the change in control agreements with management were incomplete and misleading—specifically, that the target failed to disclose the percentage of the transaction value of aggregate payments to be made under the agreements as compared to payments in similar transactions. The court ruled in favor of the plaintiffs, stating that “the record supports the conclusion that there is a substantial likelihood that disclosure of the information would [be] viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available.”⁴ The court issued a preliminary injunction enjoining the shareholder vote on the merger pending the issuance of curative disclosures by the defendants. In addition, as part of the settlement, certain of the target's executives forfeited a total of approximately \$7.4 million in golden parachute payments.

Similar to *In re Mony*, in *Fisher v. Kanas*,⁵ a shareholder filed a suit in federal court in the District Court for the Eastern District of New York seeking to enjoin the payment of executive compensation in connection with a change in control of the defendant corporation, alleging that the defendants, North Fork Bancorporation, Inc. and its executives, violated Sections 14(a) and 20(a) of the Securities Exchange Act by misrepresenting executive compensation policies. According to the plaintiff, prior to an acquisition announcement, shareholders were unaware of change in control agreements that would result in a payment of approximately \$288 million in total to executives upon the change in control. The plaintiff alleged that proxy statements concerning the election of directors contained materially false statements because the defendants failed to disclose the potential magnitude of the payments under the change in control agreements. Unlike in *In re Mony*, the court dismissed the plaintiff's claims on the grounds that the allegations were insufficient to state a claim.⁶

Recently, in February 2010, Southern District of New York Judge Jed Rakoff reluctantly approved a settlement of a case regarding the nondisclosure and payment of bonuses to Merrill Lynch employees in connection with the acquisition of Merrill Lynch by Bank of America.⁷ In August 2009, the SEC filed a complaint against Bank of America in the District Court for the Southern District of New York alleging that Bank of America made a false statement in its proxy statement and “represented that Merrill Lynch had agreed not to pay year-end performance bonuses or other discretionary incentive compensation to its executives prior to the closing of the merger without Bank of America's consent [when] [i]n fact, contrary to the representation . . . , Bank of America had agreed that Merrill Lynch could pay up to \$5.8 billion—

³ *In re Mony Group Inc. S'holder Litig.*, 852 A.2d 9 (Del. Ch. 2004).

⁴ *Id.* at 35.

⁵ *Fisher v. Kanas*, 487 F. Supp. 2d 275 (E.D.N.Y. 2006).

⁶ The plaintiffs also filed a class action in the New York Supreme Court, Nassau County, citing a breach of fiduciary duty, but the state court dismissed the plaintiff's complaint on jurisdictional grounds. *Fisher v. Kanas*, 487 F. Supp. 2d 270 (E.D.N.Y. 2007).

⁷ New York Attorney General Andrew Cuomo has also filed a civil suit against Bank of America, its former CEO Kenneth D. Lewis and its former CFO Joseph L. Price regarding failure to disclose Merrill Lynch's bonuses and losses. *New York v. Bank of Am., et. al.* (N.Y. App. Div. 2009).

nearly 12% of the total consideration to be exchanged in the merger—in discretionary year-end and other bonuses to Merrill Lynch executives for 2008.”⁸ Judge Rakoff rejected the originally proposed consent judgment by which Bank of America, without admitting or denying the accusations, would be enjoined from making future false statements in proxy solicitations and would pay the SEC a fine of \$33 million because he thought it was not fair, reasonable or adequate. However, he reluctantly approved a revised proposed consent judgment that increased the fine to \$150 million and included specified prophylactic measures designed to prevent such nondisclosures in the future.⁹ He noted that the settlement essentially “transfer[red] \$150 million from all shareholders to those current Bank shareholders who were victimized by the non-disclosures. . . [and] serve[d] to renegotiate the price that Bank shareholders would have paid to Merrill shareholders for purchasing Merrill shares if the disclosures had been made.”¹⁰ Although Judge Rakoff found the outcome “far from ideal,”¹¹ he noted that the court must give substantial deference to the SEC as the regulatory body having primary responsibility for policing the securities markets, especially regarding transparency. He also expressed hope that the proposed remedial steps would foster a healthier attitude of “when in doubt, disclose.”¹²

These cases demonstrate the importance of adequate disclosure of golden parachutes and other bonuses in proxy statements for M&A transactions, especially in the face of challenges by shareholders or regulators.

Private Company Shareholder Approval of Golden Parachutes Under Section 280G

Beyond the shareholder *disclosure* requirement discussed above, shareholder *approval* requirements for golden parachutes are not entirely new either. For example, in the context of acquisitions of private companies, an excise tax that would otherwise be imposed on recipients of golden parachute payments under Section 4999 of the Internal Revenue Code will not apply, and a tax deduction that would otherwise be disallowed to the company under Section 280G of the Internal Revenue Code will be permitted, if shareholders approve the payments. This exemption is not applicable in the context of acquisitions of public companies, however.

Specifically, Section 280G of the Internal Revenue Code disallows a deduction for any “excess parachute payment” (*i.e.*, transaction-related payments and benefits that exceed one times the recipient’s historical taxable compensation, if the total transaction-related payments and benefits equal or exceed three times the recipient’s historical taxable compensation), and Section 4999 imposes on the recipient of such payment an excise tax equal to 20% of the amount of such payment. However, under Section 280G, for corporations whose stock is not readily traded on an established securities market, any payment to covered individuals is not a parachute payment if such payment is approved by more than 75% of the voting power of all outstanding stock of the corporation entitled to vote immediately before a change in ownership or control and if, before the vote, there was adequate disclosure to all persons entitled to vote of all material facts concerning all material payments that otherwise would be parachute payments with respect to a covered individual.¹³ The Section 280G regulations specify the requirements that must be met for such disclosure to be considered adequate.¹⁴

ISS Poor Pay Practices

Golden parachutes also receive the attention of shareholder advisory groups, such as ISS (formerly known as RiskMetrics Group). ISS has identified the following, among other practices, as constituting “poor pay” practices: “Change-in-control payments exceeding 3 times base salary and target bonus; change-in-control payments without job loss or substantial diminution of duties . . . ; new or materially amended agreements . . . under which an executive may voluntarily leave for any reason and still receive the change-in-control severance package . . . ; [and] new or materially amended agreements that provide for an excise tax gross-up”¹⁵ These practices may lead ISS to recommend to shareholders that they withhold votes or vote against compensation committee members and potentially the entire board of directors.

⁸ *S.E.C. v. Bank of Am. Corp.*, 653 F. Supp. 2d 507, 508 (2009) (citing Compl. ¶ 2).

⁹ The increased fine covered all nondisclosures that were material to the proposed merger because it also settled an additional case filed by the SEC against Bank of America regarding the alleged failure to disclose large losses at Merrill Lynch.

¹⁰ *S.E.C. v. Bank of Am. Corp.*, 2010 U.S. Dist. LEXIS 15460, 17-18 (S.D.N.Y. Feb. 22, 2010).

¹¹ *Id.* at 18.

¹² *Id.* at 13.

¹³ I.R.C. § 280G(b).

¹⁴ Treas. Reg. § 1.280G-1, Q&A (7)(c).

¹⁵ ISS 2010 U.S. Proxy Voting Guidelines Summary.

Legislative History Regarding Say on Golden Parachutes

Several members of Congress have attempted for several years to pass legislation that would provide shareholders with a say on golden parachutes. For example, in March 2007, Representative Barney Frank, Chairman of the House Financial Services Committee, introduced H.R. 1257, "The Shareholder Vote on Executive Compensation Act." The bill aimed to amend the Securities Exchange Act to require, among other things, a non-binding shareholder vote if a company awarded a new, previously undisclosed golden parachute package while negotiating the purchase or sale of the company. However, at the time, numerous members of Congress felt that requiring such a vote was an improper governmental intrusion into the private sector. The bill passed in the House, but it did not make it out of the Senate Committee on Banking, Housing and Urban Affairs.

After H.R. 1257 stalled, Representative Frank introduced H.R. 3269, the "Corporate and Financial Institution Compensation Fairness Act of 2009," which would have provided shareholders with a separate non-binding vote on golden parachutes. This bill passed in the House in July 2009 but, like Representative Frank's earlier bill, did not make it out of the Senate's Committee on Banking, Housing and Urban Affairs.

Subsequently, in 2009, Senators Charles Schumer and Maria Cantwell introduced the "Shareholder Bill of Rights Act of 2009," which proposed new corporate governance requirements, including a non-binding shareholder vote on golden parachutes. Senator Schumer viewed his proposed requirements as a way to provide a "greater voice to shareholders" and more board accountability following what he identified as a period of corporate governance failures in the United States, especially at financial institutions. The proposed provisions regarding executive compensation garnered overwhelming support from Democrats. Some, although not all, Republicans countered that government should not intervene in the private market and that passing such legislation would set a bad precedent.

Policy Considerations Regarding Say on Golden Parachutes

Although these legislative efforts did not become law, they paved the way for the current provision in the Dodd-Frank Act giving shareholders a say on golden parachutes. Originally, the legislation proposed by the Senate, and used as the base text for the Act, did not provide shareholders of public companies with a say on golden parachutes, whereas the legislation proposed by the House did. As a result of negotiations led by Representative Frank, House leaders prevailed in maintaining the say on golden parachutes provision. Ultimately, Congress may have been persuaded by some of the following arguments provided by academics at the House Financial Services Committee's hearing on Compensation Structure and Systemic Risk or in other settings:

Arguments for Regulating Golden Parachutes

- Golden parachutes encourage management to favor proposed takeovers that might not be in the best interests of shareholders.
- Golden parachutes simply transfer wealth from shareholders to management, as they remove the discipline imposed by the market for corporate control.
- While golden parachutes were created to align executives' interests with those of shareholders during mergers, they have grown in ways that may not be consistent with the long-term value of a company.
- Golden parachutes are economically inefficient and unfair from a social policy standpoint, especially in light of the recent financial crisis and high unemployment rates.

Those who argue against regulating golden parachutes often advance the following arguments:

Arguments against Regulating Golden Parachutes

- Golden parachutes provide management with incentives to pursue value-maximizing corporate transactions that are in the best interests of the company and its shareholders without the fear of a substantial loss of income from being terminated after the closing of such transactions.
- Golden parachutes help ensure that management remains focused on the business during a period of inherent uncertainty.

- The government has tried to regulate golden parachutes in the past through the tax code (e.g., Sections 280G and 4999 of the Internal Revenue Code, as discussed above), with arguably unintended results. For example, some companies have increased the size of golden parachutes to an amount just below the safe harbor under Section 280G (i.e., Section 280G may have created a presumption that payments within the safe harbor are reasonable) or made additional payments to executives to gross up the 20% excise tax.

The Road Ahead

Although shareholder disclosure and approval of golden parachute arrangements is not entirely a new requirement, the Act mandates, for the first time, that shareholders of all public companies have the right to vote on golden parachute arrangements and payments. Moreover, the requirements described above regarding the disclosure of votes by institutional investment managers and the prohibition of broker discretionary voting could have an impact on say on golden parachutes in a way that the mere disclosure and approval aspects of the rule do not (i.e., by reducing the number of votes that might have been cast with the company in favor of the golden parachutes).

Whether mandatory shareholder approval will dull golden parachutes' luster, and the impact, if any, shareholder disapproval will have on golden parachutes, remains to be seen. However, given that the proxy rules already mandate disclosure of golden parachutes, and that the shareholder vote on golden parachutes mandated by the Act is non-binding and required only if golden parachutes have not already been subject to the general say on pay vote, it seems unlikely that the new rule will dramatically change the prevalence or magnitude of golden parachutes.

What to Do Now: Complying with New Executive Compensation Requirements

Anticipating the passage of the Dodd-Frank Act, Dave Lynn just put the finishing touches on a special "Summer 2010" issue of *Compensation Standards* that lays out a number of **action items** that you should be considering now to comply with the new executive compensation provisions in the Act. This print newsletter is a part of a CompensationStandards.com membership.

Act Now: Try our "Rest of '10 for half price" no-risk trial to gain immediate access to this important issue. If you need assistance, contact us at 925-685-5111 or info@compensationstandards.com.

How to Prepare for Mandatory Say-On-Pay: Ahead of our package of two full-day Conferences on the executive pay provisions of the Dodd-Frank Act—coming up in just two months - we have just announced a special July 29th pre-conference webcast to help you start taking the actions you need to be taking now. Dave Lynn, Mark Borges and Mike Kesner headline this webcast: "The New Pay Legislation: Action Items." If you are not yet registered for the Conferences, register now so you won't miss this critical webcast.

Note that we already have a record number of members signed up for the pair of the conferences to be held from September 20-21 in Chicago and via video webcast: "Tackling Your 2011 Compensation Disclosures: The 5th Annual Proxy Disclosure Conference" & "7th Annual Executive Compensation Conference."

Among others, these panels from this pair of Conferences will help you prepare:

- "How to Draft Disclosure for 'Say-on-Pay'"
- "The Proxy Advisors & Investors Speak: Their Hot Button Issues and Say-on-Pay"
- "Five Hot Button Compensation Fixes: In Light of Say-on-Pay and More"
- "This Coming Year's Grants: How to Deal with Last Year's Inadvertent Gains"
- "The Big Roundtable: Consultants, Directors and Top HR Heads"
- "Directors Speak Their Minds on Executive Compensation"

Register Now: Don't wait any longer, register now or contact us at info@thecorporatecounsel.net or 925-685-5111. Remember that last year, these Conferences sold out a month before the event.

Mini-Tender Offers: More Frequent—No Less Troubling

By Dennis Garris and Sean Whittington of Alston & Bird LLP¹

Mini-tender offers appear to be on the rise. In particular, there appears to be an increase in these tender offers for non-listed REITs given that a number of those REITs have suspended or terminated their share redemption programs. Mini-tender offer bidders seem to be exploiting concerns about liquidity and real-estate market fears in rationalizing their below market offers. These bidders are employing troubling tactics that are similar to those the Securities and Exchange Commission addressed ten years ago in a series of regulatory and enforcement actions.

What is a Mini-Tender Offer?

Generally, a mini-tender offer is a tender offer that is subject only to limited regulation under the federal securities laws because it is an offer to purchase only a small percentage of outstanding securities. Upon consummation of a mini-tender offer, the bidder would beneficially own less than five percent of the class of securities subject to the offer. This includes the percentage of securities already owned by the bidder. Mini-tender offers are generally structured as such to avoid the filing, disclosure and procedural requirements of Section 14(d) of the Securities Exchange Act of 1934.

The regulation of third-party tender offers is divided into two groups:

(1) Fully regulated tender offers are those that are for five percent or more of a class of equity securities registered under Section 12 of the Exchange Act. These offers are subject to both Sections 14(d) and 14(e) of the Exchange Act (“14(d) tender offers”); and

(2) Section 14(e)-only tender offers include offers for equity securities that are not registered under the Exchange Act (e.g., private company or class), offers for non-equity securities and offers for Section 12 equity that would result in the bidder owning less than 5% of the class (*i.e.*, mini-tender offers). Section 14(e) is the anti-fraud section for tender offers and contains only limited procedural requirements, but it applies to ALL tender offers.

How Are 14(d) Tender Offers Regulated?

These tender offers are governed by Regulation 14D, which requires far greater procedural protections than mini-tender offers, including: withdrawal rights; pro rata acceptance if the offer is for less than all of the securities of the class; the requirements that the offer is open to all security holders of the subject class and the highest price paid for any tendered shares will be paid to all participants; and, the requirement that the target make a recommendation (*i.e.*, accept, reject or remain neutral) to its security holders regarding the offer within ten business days after the offer is commenced.

14(d) tender offers are also subject to significant disclosure and filing requirements. Regulation 14D sets out specific substantive disclosure items, such as: a summary term sheet in plain English; subject company information; specific identity and background information of the bidder including identifying control persons, executive officers, directors and general partners; past contacts, transactions, negotiations and agreements between the bidder and the target; purpose of the offer and plans of the bidder with respect to the target; source and amount of funds to be used for the offer; identity of persons and experts retained to solicit or make recommendations; financial statements of the bidder, if material; and the target must make a recommendation regarding the offer and disclose its specific reasons for the recommendation.

14(d) tender offers are often reviewed by the SEC staff in the Office of Mergers and Acquisitions in the Division of Corporation Finance because these tender offers are required to be filed with the SEC.

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How Are Mini-Tender Offers Regulated?

Unlike 14(d) tender offers, there are no specific disclosure and dissemination requirements for mini-tender offers. Section 14(e) is the anti-fraud provision for all tender offers and prohibits fraudulent, deceptive or manipulative practices in tender offers. Under Regulation 14E, the only significant procedural provisions are that the tender offer must be open for at least 20 business days; the offer must remain open for ten business days following a change in the offering price or the percentage of securities being sought; the bidder must promptly pay for or return securities when the tender offer expires; the target must state its position about the offer within ten business days after the offer is commenced; and, in tender offers for equity securities, the bidder is restricted from purchasing the subject securities outside the tender offer. As mini-tender offers are not required to be filed with the SEC, the SEC staff typically does not have an opportunity to review the disclosures.

The lack of specific regulation of mini-tender offers led to abuses in the 1990s causing the SEC to bring enforcement actions,² issue an interpretive release,³ and issue an investor alert⁴ to address the problems.

Why is the SEC Concerned With Mini-Tender Offers?

As noted above, the purpose behind a mini-tender offer is typically to avoid the heightened filing, disclosure and dissemination requirements associated with 14(d) tender offers. Mini-tender offers became popular for listed securities in the 1990s when fraudsters discovered that they could catch security holders off-guard with misleading offers given the lack of regulation of these offers. In recent years, mini-tender offers have been very common for non-listed REITs.

In response to the problems in the 1990s, the SEC issued the Mini-Tender Offer Guidance in 2000 setting out its views on the types of disclosures that are necessary in mini-tender offers to avoid fraudulent offers. The SEC was concerned that the substance of the disclosure in many of these offers was not adequate, that bidders were not properly disseminating the disclosure to security holders, and that many bidders were not paying for securities promptly at the expiration of the tender offer.⁵

The Mini-Tender Offer Guidance notes several types of activity that the SEC considers misleading or fraudulent, such as bidding below market value without disclosing this fact, bidding above market value with the intention to hold the tendered shares until the value of the shares increases while the holder is unable to withdraw, and not disclosing that certain fees will be deducted from the offer price rendering the purchase price below market value.

In addition, the Mini-Tender Offer Guidance notes troubling dissemination and procedural activity, including offers that operate on a first come, first served basis without disclosing the process, and bidders failing to promptly pay for tendered securities but instead waiting until they receive proceeds from reselling the securities, often waiting 30 days or more to pay the original holder.

What Does the SEC's Mini-Tender Offer Guidance Say?

As there are no specific disclosure rules for mini-tender offers, the Mini-Tender Offer Guidance is critical because it is the only binding SEC authority on the tender offer antifraud provisions. The SEC recommends that bidders in mini-tender offers consider the following disclosure issues.

Offer Price: Bidders should clearly indicate if the price is below market price and include the market price (or the bid and ask prices) on the day of commencement or the most recent practicable date. Other considerations for disclosures related to offer price include:

- If there is no liquid market for the securities, the bidder should disclose, if known, the latest price at which the security sold, including the date of sale, or the latest bid and ask prices, even when there is no established market. The bidder should summarize how the offer price was determined;

² See *In the Matter of IG Holdings, Inc.*, Exchange Act Release No. 41759 (August 19, 1999); *In the Matter of Peachtree Partners*, Exchange Act Release No. 41760 (August 19, 1999); *In the Matter of City Investment Group, LLC*, Exchange Act Release No. 42919 (June 12, 2000).

³ *Commission Guidance on Mini-Tender Offers and Limited Partnership Tender Offers*, Release No. 34-43069, 64 FR 46581 (July 24, 2000) ("Mini-Tender Offer Guidance").

⁴ *Mini-Tender Offers: Tips for Investors*, at <http://www.sec.gov/investor/pubs/minitend.htm> (last visited June 28, 2010).

⁵ See Mini-Tender Offer Guidance, *supra* note 3, at 46583.

- If the bidder prepared a valuation, it should disclose the value along with the basis for the value. If the bidder decided not to perform a valuation, investors may want to know why. The bidder should disclose any liquidation value that was calculated; and
- The bidder should disclose, if applicable, that the price may be reduced by any distributions or fees and the amount, if known. If the bidder changes the price, the tender offer must be extended for ten business days.

This price information should be prominently disclosed in the beginning of any letter or document sent to shareholders.

Withdrawal Rights: The disclosure should clearly state whether shareholders have the right to withdraw their tenders. If withdrawal rights are not available, the disclosure should clearly state that if the bidder extends the offer, the shares tendered before the extension cannot be withdrawn and may be held through the end of the offer until payment. If withdrawal rights do exist, the disclosure should explain fully the procedures for withdrawing tendered shares.

Pro Rata Acceptance: The bidder should disclose clearly whether tendered securities will be accepted on a pro rata basis if the offer is oversubscribed and, if not, the consequences to shareholders. For example, if the offer has no pro rata provision and no withdrawal rights, the offer can, in effect, be open for less than 20 business days because shares may be purchased on a first come, first served basis.

Identity and Ability to Finance Offer of Bidder: The bidder should completely and accurately disclose its identity, including its control persons and promoters as well as any affiliation between the target and the bidder. The bidder should clearly disclose whether it has the funds necessary to consummate the offer or whether it cannot buy the securities until it obtains financing. These disclosures provide security holders with insight regarding financial resources, capacity to pay for tendered securities and historic business practices.

Plans or Proposals: The bidder should disclose its plans or proposals regarding future tender offers of the securities of the same target, the bidder's plans for the issuer, and whether or not the bidder intends to continue to acquire the securities in the future until control is obtained. It is not uncommon for these bidders to conduct multiple offers.

Conditions to the Offer: A tender offer can be subject to conditions only where the conditions are based on objective criteria outside the bidder's control, otherwise the offer is considered illusory and may constitute a "fraudulent, deceptive or manipulative" practice within the meaning of Section 14(e). The bidder should disclose all material conditions to the offer and how they operate.

Extensions of the Offer: A bidder's ability and intent to extend the offer period is material information, especially when there are no withdrawal rights. The initial disclosure materials should state whether the offer could be extended, whether the bidder intends to extend the offer, under what circumstances the bidder would extend and, if the bidder intends to extend, the anticipated length of any extension. If the offer is extended after the initial disclosure materials are provided to security holders, the bidder should publicly announce this fact.

Target Recommendation: Security holders should be advised, before an investment decision is made, that additional material information will come from the target company. The bidder should disclose that if the target is aware of the offer, the target is required to make a recommendation to security holders regarding the offer within ten business days of commencement. The SEC encourages bidders to send the offering document to the target at the commencement of the tender offer so the target can make a recommendation regarding the tender offer.

Prompt Payment: Regulation 14E requires the bidder to pay the consideration offered, or return the tendered securities, promptly after the termination or withdrawal of the tender offer. In most cases, current settlement practices constitute prompt payment. Payment may be delayed where the transfer of the interest must be processed by the issuer, as the bidder has no control over the transfer. The bidder should disclose the anticipated time frame for payment.

Limited Partnership Issues: Tender offers for limited partnership interests raise certain additional disclosure issues unique to limited partnerships that the SEC addressed in the Mini-Tender Offer Guidance.

How Do Issuers Become Aware of a Mini-Tender Offer?

In many instances the issuer will not know that a mini-tender offer has been commenced for its securities and it is often difficult to locate a copy of the offer documents. The SEC encourages bidders to provide a copy of the offer document to the issuers, however, this does not always happen. Issuers may learn of a mini-tender offer when the bidder requests a shareholder list but this is not a consistent practice.

Issuers may also learn about an offer through shareholders complaining to the issuer that they have been approached by a bidder with a below market offer. Shareholders may call the issuer's investor relations department asking questions about the bidder's identity, whether the issuer is conducting the offer itself, what the offer actually is and what the issuer's position is with respect to the offer. Issuers that receive notice of these tender offers through their shareholders should ask the shareholder for a copy of the offer documents.

Where issuers learn about an offer through other means such as a press article, they should investigate further but be careful not to inadvertently publicize the offer if they contact their shareholders to inquire whether the shareholders have received an offer. Some mini-tender offer bidders are in the business of conducting these offers (including bidders who were the subject of SEC enforcement actions) and have websites that list their offers. For certain issuers it may be worthwhile monitoring these sites in order to determine whether a mini-tender offer is active in their securities.

What Should an Issuer Do in Response to a Mini-Tender Offer?

Issuers have an obligation under Section 14(e) and Regulation 14E to let their shareholders know within ten business days of the tender offer whether the issuer recommends accepting, rejecting or is remaining neutral. If the issuer learns about the offer after the tenth business day, it should respond within a reasonable amount of time. These recommendations often take the form of a letter or postcard to shareholders. The issuer should take the opportunity in its recommendation to address certain issues such as the comparison of the offer price to the most recent market prices; any known problems with the bidder, such as past violations of the federal securities laws; any structural issues with the tender offer that would tend to add pressure or confuse shareholders, such as the lack of withdrawal rights and first come, first served provisions; and make reference to the SEC's investor alerts regarding mini-tender offers.

Regulation 14E is not clear on how the issuer is supposed to disseminate its response. Some issuers mail postcards or short letters to their shareholders. A press release may be sufficient, but because it is not sent directly to shareholders, it may unnecessarily publicize the mini-tender offer and may actually benefit the bidder by extending their reach to shareholders that would not otherwise have known of the offer. The best approach is one that takes into account the particular nature of the issuer's shareholders.

Issuers should always consider addressing problems in any particular mini-tender offer directly with the SEC staff. This can be done by way of a formal complaint in writing or informally by telephone to the Office of Mergers and Acquisitions in the Division of Corporation Finance. It is important to keep in mind that this is often the only notice the SEC staff will have of the mini-tender offer. The SEC staff generally will not disclose what they will do with the complaint but the staff will often contact the bidder directly to discuss disclosure or structural concerns and may require changes to the offer. The SEC staff is very receptive to these types of complaints and this avenue is often the only practical way of dealing with abusive mini-tender offers.

Poor disclosure and provisions used to pressure shareholders or to catch shareholders off-guard are quite common in mini-tender offers. Typical problems that can be raised with the SEC include the following:

- the bidder fails to fully disclose their identity
- the below market price is not made clear
- recent prices above the offer price are not disclosed
- withdrawal rights are not adequately explained
- anticipated delays in payment or undisclosed fees that will be deducted from the offer price
- the conditions to the offer are not explained
- the dates of the offer are unclear
- misleading, confusing or untrue statements about the issuer's business

- Schedule 13D disclosure issues
- Schedule 13D group issues where different bidders join together to make the offer without disclosing the group
- a bidder may miscalculate its beneficial ownership and incorrectly determine it does not need to comply with Regulation 14D

What Should the SEC Do Now?

The Mini-Tender Offer Guidance is now ten years old. We have learned in those ten years that mini-tender offers continue to pose a real risk to investors. Some bidders make minimal effort to comply with the spirit of the guidance while other bidders simply ignore the guidance. Although the SEC currently has a full plate of regulatory proposals, given the continuing use of fraudulent practices in mini-tender offers, the SEC should consider codifying the Mini-Tender Offer Guidance and additional protections under the antifraud provisions of Section 14(e). The SEC should also consider bringing more enforcement actions in this area when appropriate. With an aggressive enforcement program and specific disclosure requirements, mini-tender offer bidders may go out of business.

Latest Developments in Use of Top-Up Options

By John Grossbauer, a Partner of Potter Anderson & Corroon LLP

Top-up options have grown in use over the years and have become an accepted part of two-step acquisition transactions. The use of a top-up is seen as a “win-win” for both parties. The buyer gets to close the back end of a merger more efficiently, and the seller’s stockholders who do not tender get cash in their hands more quickly. However, several lawsuits have been filed recently raising objections to the use of top up-options.

Specifically, plaintiffs have argued that the use of a top-up option, particularly an option for which payment is made via a note (as is also customary), results in a dilution of the value of target shares in any appraisal and is therefore coercive, and that the alleged dilutive effect has not been properly disclosed to stockholders of the target corporation who are asked to decide whether to accept the negotiated deal price or to seek an appraisal of their shares.

This issue came to a head most recently in connection with the acquisition of eV3, Inc. by Covidien Group, S.a.r.l. In *Olson v. eV3, Inc.*, Vice Chancellor Laster agreed to schedule an expedited injunction hearing focused on plaintiff’s claims that the top-up option granted by eV3 was coercive and the disclosure related to it was inadequate, and that the Board had not acted in accordance with the requirements of the Delaware General Corporation Law in agreeing to accept a note as consideration for the issuance of the top-up shares. The alleged problems with top-up options (which Vice Chancellor Laster characterized as a “potential unintended consequence”) stem from the fact that a top-up option requires that a large number of shares be issued at the merger price—an amount equal to 10% of the outstanding shares for every 1% by which the offer falls below the 90% threshold needed to accomplish a short-form merger under Section 253 of the Delaware General Corporation Law.

Because these shares will be outstanding on the date the back end merger closes, as a technical matter, those shares, and the consideration paid for them, normally would be considered in an appraisal proceeding under Section 262 of the General Corporation Law. If the shares are paid for with cash, the effect on appraised value may be neutral or even positive if the appraisal value is otherwise below the deal price. However, if, like most top-up options, the option consideration may be paid for with an unsecured note, plaintiffs argued that the note could be worth substantially less than the merger price on a per share basis. This possibility, coupled with an alleged lack of disclosure about the mechanics of the top-up option, allegedly results in stockholders being coerced to tender into the deal, or at least not to elect to exercise appraisal rights.

The eV3 case settled before the Vice Chancellor had an opportunity to rule on these issues. As part of the settlement, the parties agreed to an amendment to the merger agreement that (i) makes it clear that

guaranteed delivery shares are excluded from the purchaser's ownership until delivered in settlement, (ii) provides that the top-up purchase price will be paid partly in cash (for the aggregate par value of the shares to be issued) with the remainder to be paid either in cash or by a promissory note, and (iii) sets forth the terms for such promissory note (including the interest rate).

On the disclosure front, the revised Schedule 14D-9 accompanying the settlement and amendment added disclosure concerning the board's consideration of the amendment to the merger agreement, the terms and effect of such amendment, and the board's approval of the draft promissory note. The Schedule 14d-9 also adds the following disclosure on the appraisal dilution point:

For avoidance of doubt, the Company, Parent and Purchaser have acknowledged and agreed that, in any appraisal proceeding described herein, the fair value of the Shares subject to the appraisal proceeding shall be determined in accordance with the DGCL without regard to the Top-Up Option, any Shares issued upon exercise of the Top-Up Option or the Promissory Note.

The approach taken here of expressly agreeing to exclude the top-up option shares from consideration in an appraisal proceeding was suggested in an article that Vice Chancellor Laster wrote last January before joining the bench in which he argued that merger partners should be able to address the issue by adding language in the merger agreement providing that the parties agree that any shares issued per the top-up option won't be considered for purposes of the appraisal. (The article did not, however, expressly suggest that such an agreement also provide that the value contributed for the shares to be issued should be excluded from the appraisal analysis, as was done in eV3.)

The eV3 case and other similar challenges suggest a need for a change in deal practice in two-step mergers. Merger agreements should include a provision that expressly addresses how the shares to be issued and the consideration to be paid is to be treated in an appraisal proceeding. In addition, adding broader disclosure about the top-up option and its potential impact on appraised value in the tender offer materials is warranted in order to blunt any claims of inadequate disclosure about the top-up option and its effect (or lack thereof) on appraisal valuation.

Blood in the Water? Use of Delaware's Two-Record Date Statute May Provide Flexibility, But Can Also Expose a Weak Hand

by Mike Verrechia, John Ferguson, Joe Mills and Dennis Mensch of Morrow & Co.

Last year's amendment to Section 213(a) of the Delaware General Corporation Law—which allows the use of separate notice and voting record dates for stockholder meetings—is receiving a new round of attention from securities attorneys and other M&A advisors since its enactment. The statute had previously been the subject of commentary primarily regarding its intended effect of reducing “empty voting.”

Now that separate record dates have been used in a highly publicized transaction—the recent stockholder meeting of On2 Technologies in its acquisition by Google in a stock swap—the focus has shifted to the effectiveness of its practical application.

Proxy solicitations, particularly involving M&A transactions with significant trading, have always been vulnerable to the loss of votes from stockholders who held shares as of the record date but sold them before the meeting. Once a holder sells his shares, he usually no longer has an economic interest in the outcome of the meeting and often will not vote. In a merger vote, or any other transaction requiring the affirmative support of at least a majority of the outstanding shares, a failure to vote has the effect of an “against” vote.

Using a notice record date for mailing the proxy statement, and a second record date much closer to the meeting for determining who has the right to vote, should limit the amount of post-voting record date selling, and presumably, the amount of votes lost thereby. DGCL 213(a) allows the voting record date to be as late as the meeting date itself, although use of such a late date would make a proxy mailing to the new record date holders impossible, and would likely be impermissible under existing SEC rules and interpretations as well as the policies of the various exchanges.

The availability of a two-record date solicitation raises immediate questions. Is it really needed? Is it a signal to the street that a solicitation is expected to be more difficult than normal, and therefore, more likely to fail or be particularly vulnerable to disruption? Are there cases where it could backfire and end up hurting more than helping? If we make the assumption that at times the use of a later record date for voting could make the difference between a successful and unsuccessful proxy solicitation, it becomes important to consider a few of the logistical and regulatory issues that can affect the solicitation.

Broadridge, Timing and the SEC

Broadridge Financial Solutions controls the proxy voting of almost all street-name shares, and therefore the timing and logistics of every meeting will be subject to customary street-name mechanics. Broadridge needs three business days from any proxy record date to merge its records. In mailings to new voting record date holders, Broadridge will have to take the additional step of sorting its list to break out those voting record date holders who were not holding shares as of the original notice date, which will add at least an additional day to the process. In its normal practice, Broadridge will take at least an additional two business days to complete a mailing; in proxy season, Broadridge often takes more than two business days to mail.

With this timeline, it can take between ten calendar days to two weeks from the voting record date for the proxy materials to actually reach the new street-name holders. The use of electronic delivery and the Proxy Edge system for institutions, as well as overnight delivery, may cut one or two days off the delivery time. This makes the strategy of setting a voting record date close to the meeting date less feasible, purely on mechanical grounds. Broadridge's ability to convert the tabulation from the earlier to the later record date is also subject to delay, so an issuer would not even know what its actual vote total was until at least the fourth or fifth business day after the voting record date.

Joseph Connolly, a senior M&A partner at Hogan Lovells LLP and one of the lead attorneys for On2 in its merger with Google, related to us that SEC considerations played a significant role in determining the timing and mechanics ultimately used in conjunction with DGCL 213(a). Mr. Connolly, who had several pre-filing discussions with SEC staff, stated that the SEC's overriding concern was ensuring that the new holders who held shares as of the voting record date received full disclosure about the proposed merger in a timely manner that allowed them to make an informed voting decision.

- Mr. Connolly stated that in light of the SEC's concerns, On2 ultimately set the voting record date as of the close of business on December 3, 2009, for a meeting to be held at 4 p.m., New York time, on December 18, 2009. The company set the close of business on October 20, 2009, eight weeks before the meeting date, as the notice record date, leaving approximately six weeks between the two record dates for stock trading. Experience with such transactions would lead one to expect that arbitrageurs and hedge funds would be doing most of the buying between the two record dates.
- In its initial mailing of the proxy statement/prospectus to the On2 stockholders as of the notice record date, On2 and Google were able to incorporate by reference various documents previously filed with the SEC, such as 10-Ks, 10-Qs, and 8-Ks, without enclosing them separately, since the proxy statement/prospectus was being mailed more than 20 business days prior to the meeting date.

However, due to instructions in Form S-4 that permit such incorporation by reference only when the mailing is made no later than 20 business days before the meeting date, they had to send to the new On2 stockholders as of the voting record date a package that included all such documents and committed in the original proxy statement/prospectus to also send "any other documents that are filed with the SEC and incorporated by reference into this proxy statement/prospectus between the notice record date and the voting record date." In its conversations with the SEC staff, On2 also committed to distribute via overnight delivery the package of proxy materials to the new On2 holders as of the voting record date (bearing in mind the time required by Broadridge to compile and sort the list of new holders as of the voting record date).

- As disclosed in the proxy statement/prospectus, Google agreed to pay for the printing and mailing of the proxy statement/prospectus to all On2 holders as of both the notice record date and

the voting record date, as well as the documents originally incorporated by reference that were required to be sent separately to the new voting record date holders.

- According to Mr. Connolly, the SEC staff also requested that On2 supplementally provide an opinion of counsel to support On2's position that proxies could be valid under Delaware law even if they were signed and dated prior to the voting record date. The proxy statement/ prospectus stated to On2 holders: "By executing the proxy, you will authorize the proxy holders to vote (i) all shares of On2 Common Stock owned by you as of the date of execution of the proxy, excluding any shares that you sell or transfer between the execution of the proxy and the voting record date and (ii) any shares that you acquire between execution of the proxy and the voting record date."

Consequences for Dissidents?

Almost all of the discussion of DGCL 213(a) has centered on stockholder meetings that are planned and called by the issuer. What about stockholder meetings requested by dissidents? One of the most popular and successful stockholder proposals presented by governance activists in recent years has been the proposed bylaw amendment allowing holders of ten percent of an issuer's outstanding shares to call a special meeting. It should be expected that dissident calls for special meetings will occur from time to time at Delaware corporations.

Assuming that the decision for setting a record date and meeting date in such cases still rests with the board, how would the discretion of a board to use or not use separate notice and voting record dates impact the vote on the dissident proposal? Could management be accused in certain scenarios of attempting to manipulate the voting machinery in its favor? For example, what if a board, required to call a special meeting by a dissident, decides to set a much later voting record date, and just before that date, engages in a transaction that places a substantial amount of shares in hands friendly to management? What if the board sets a voting record date so close to the meeting date that it creates mechanical difficulties for the dissident in rounding up voting record date proxies for the meeting?

Mr. Connolly is confident that the SEC will apply strong oversight to the timing of a separate voting record date in any meeting insofar as it impacts the ability of the new holders to receive their proxy material in a timely manner that allows them to make an informed voting decision. He also believes that Delaware law adequately governs directors' actions and obligations in connection with controlling the proxy machinery in meetings requested by stockholders.

Should the use of two record dates become more common, Mr. Connolly believes the SEC will take a more visible position on timing and disclosure issues. The various exchanges also could possibly weigh in with rules of their own. The question remains how widespread its use will become.

Why Use Two Record Dates?

How big a contributor is post record date selling to the failure of a board-recommended proposal? It is rarely cited as a standalone factor leading to the defeat of a merger or other matter being voted on. More important factors include organized or public opposition by a major holder or group, a negative recommendation by ISS, negative press, or, in a merger, the belief that a higher offer may be forthcoming, which boosts the stock price above the merger price before the meeting date (which in turn may also lead to more selling).

Even in situations where there is no publicly announced hostility, a board-recommended M&A transaction can face tough sledding. A heavily retail stockholder base of a company that has lost a large portion of its market value will often not respond favorably to a premium merger price that still leaves the holders' investments underwater. (This apparently was the case with at least part of the On2 stockholder base.) In cases that may involve other proposals, a substantial retail stockholder base that cannot be contacted personally can also present a problem of voter apathy. A sizable population of foreign accounts that never vote can also create difficulties for a solicitation unless the turnout from the remaining stockholder base is better than usual.

It is when negative factors such as those mentioned above come into play, and the margin of success becomes very slim, that the loss of support due to post record date selling can mean the difference

between success and failure. That would seem to be a likely time for an issuer to consider the use of two record dates. But it remains difficult to predict in any challenging or contentious situation whether new buyers of shares who gain voting rights through the issuer's use of a separate voting record date will be supportive of, or opposed to, management. As two record dates will only be used in difficult solicitations, there will always be the chance that an aggressive, unfriendly stockholder will sense vulnerability and take the opportunity to shake things up.

The negative effect of post record date selling can be overestimated at times. Some holders may sell only a portion of their position after the record date and still vote the full position, others will sell after they have voted and some others may vote despite the fact that they sold.

On2 adjourned its original stockholder meeting in December 2009 in order to solicit additional proxies, and ultimately stockholders approved a sweetened offer from Google two months later on February 17, 2010. For the final adjourned meeting, On2 updated its separate notice and voting record dates with a single record date for voting and notice of January 15, which was a more traditional five weeks prior to the meeting date. At the adjourned meeting on February 17, On2 was able to include in its vote total proxies from stockholders as of the original voting record date that had remained in the stock through the new record date.

Mr. Connolly commented: "With On2's large retail stockholder population, at least part of which had bought shares in the past at prices higher than the merger consideration, we recognized that obtaining the affirmative vote of a majority of the outstanding shares was going to require a very thorough solicitation. We believed using two record dates was the best approach in this case since it gave us six weeks for the solicitation from the mailing of the original proxy statement/prospectus while also enfranchising holders of shares that were bought in time to be part of the voting record date list fifteen days prior to the meeting. Moreover, we anticipated that any holders purchasing shares between the two record dates would be arbitrageurs and hedge funds and that these holders would likely vote in favor of the transaction."

Calculating the Risk

As stated previously, a major risk in using two record dates is that it may signal to the street that the issuer considers the vote a difficult one, which requires help beyond the traditional meeting logistics. Sharks can smell blood in the water, and the possibility will always be present that aggressive unfriendly investors will sense weakness and will buy in at what they consider an opportune time to gain leverage over management.

DGCL 213(a) does not give the issuer the benefit of waiting until it is well into its solicitation before deciding to use a new record date for determining voting rights. The statute requires the board to decide on whether to use a later voting record date at the time it fixes the notice record date. On2 disclosed in its preliminary proxy that it intended to use a separate voting record date, and it disclosed the actual date of the voting record date in its definitive proxy. DGCL 222(a) requires that notice of a stockholder meeting shall state "the record date for determining the stockholders entitled to vote at the meeting, if such date is different from the record date for determining stockholders entitled to notice of the meeting...." However, the board can set a new record date, as On2's board did for its readjoined February 17th meeting.

The mailing of the merger proxy statement will usually not occur for at least one to two months after the initial announcement of the transaction, which in most cases allows "friendly" arbitrageurs and hedge funds time to buy in to support the merger long before any record date need be set. By that time, if the stockholder profile contains a strong hostile element or some other problematic group, the board may believe its best chance for success is with the hope that new holders will continue buying in to be supportive as of a later voting record date, regardless of any hint of vulnerability. In the end it may simply come down to the board believing that the situation is difficult enough that it has not much to lose and something to gain by using two record dates.

Once management converts the vote totals from the original notice record date to the new voting record date, it may find that it has support from substantially less shares, as holders who had previously voted subsequently sell out or reduce their positions. If one large holder sells out and the shares are bought by numerous smaller ones, it may be difficult to track all of the new buyers. One of the most important aspects of a two record date approach will be the ability to track and identify the new holders buying

in for the voting record date so that they can be contacted directly and promptly about voting their shares.

In some cases, the loss of votes from selling holders may be balanced by gains from holders who increased their positions between the two record dates. The plan, of course, is to make up for any lost shares and add additional support with the votes of the holders who recently purchased. But that assumes the new holders are friendly and they will all vote promptly in the short time remaining before the meeting. That remains to be seen.

Leveraged Acquisitions: A New Post-Credit Crisis Structure

By Andrew Nussbaum, Gregory Ostling and Eric Rosof, Partners of Wachtell Lipton Rosen & Katz

In the current uncertain and fast-moving financing environment, recent transactions demonstrate that acquirors and targets, sharing a desire to complete a deal, can move beyond the pre-credit crisis leveraged deal model involving financing commitments, to develop a new paradigm for allocating financing risk.

Financing commitments today, when obtainable, often are more conditional than the terms agreed between the principals. They may also be of shorter duration than what is needed to consummate the transaction and have pricing and other “flex” terms allowing the banks to alter terms to facilitate selling-off the debt. While pre-credit crisis leveraged deals generally required buyers to draw down committed financing even if the lenders flexed pricing and covenants to the maximum allowed, buyers may not be prepared to accept that result based on the condition of the financing commitment market today. In short, commitments may no longer “match” deal terms, making them a less helpful tool in persuading the seller that the buyer is in fact committed to complete.

While banks are understandably cautious about bridging the signing-to-closing period with certain funds, corporate and private equity buyers can sometimes obtain superior financing terms simply by going to the capital markets immediately prior to closing. To mitigate financing risk, sellers can require covenants that ensure that the buyer will go to market, and will borrow funds subject to agreed (or better) terms. In effect, the financing term sheets that would have been attached to the bank commitment instead become a schedule to the purchase agreement. An appropriate “financing failure” termination fee and rigorous obligation to obtain financing subject to the expressed terms can provide the seller with extensive comfort that the deal is not an option for the buyer.

A recent example is the May 2010 acquisition of Tommy Hilfiger by Phillips-Van Heusen. Phillips-Van Heusen committed to close the transaction if it obtained financing meeting minimum terms (including weighted average cost of capital) agreed between the parties. Post-signing, both parties promptly worked to complete the financing, which included bank lending, as well as a note offering, an equity offering and a private placement of preferred stock. The transaction closed approximately 45 days later. This structure is also being used in the pending merger between Mirant Corporation and RRI Energy, Inc.

Which transactions may be the best candidates for this approach? Deals with short time periods between signing and closing that afford greater visibility of the financing markets. Sellers with an in-depth understanding of the capital markets are more likely than others to be comfortable that they can “keep the buyer honest.” Ultimately, which buyers and sellers will accept this approach and the risk of an announced deal that does not complete will depend on how compelling the transaction is for the parties.

Dealmakers can hope that bank commitments will one day return to some reflection of their former selves; in the meantime, sophisticated acquirors and targets can digest financing risk and use deal creativity to reach an optimal result.

Delaware Protects Attorney-Client Privilege for Investment Banker Communications

By Herbert Wachtell, Peter Hein, David Gruenstein and David Katz, Partners of Wachtell Lipton Rosen & Katz

A recent Delaware Court of Chancery decision explicitly acknowledges that Delaware employs a “broader rule” of attorney-client privilege protection for communications between a corporate client and its lawyers that involve an investment banker, particularly in the context of a corporate transaction. This decision also held that Delaware law, with its broader application of privilege, should be applied even to communications between a corporate client and its counsel in another jurisdiction where the parties to the ultimate transaction had selected Delaware law as the governing law and chose Delaware as the exclusive forum for resolving any dispute and the dispute in fact was litigated in Delaware. *3Com Corporation v. Diamond II Holdings, Inc.*, C.A. No. 3933 - VCN (Del. Ct. Ch. May 31, 2010) (Noble, V.C.).

The *3Com* case arose out of a dispute over application of the termination provision of a merger agreement. The Court noted that the communications at issue took place largely in Massachusetts and that Massachusetts courts have taken a more limited approach than Delaware courts when assessing whether communications made to, or in the presence of, third parties (such as investment bankers) are protectable under the attorney-client privilege.

Specifically, the Court noted that a recent Massachusetts Supreme Judicial Court decision (in the context of communications involving a tax accountant) had ruled that disclosure to a third party would result in the loss of attorney-client privilege unless the third party’s involvement was “necessary” for “effective consultation” between client and attorney (such as when the third party acts in effect as an interpreter or translator), and that, in the view of the Massachusetts Court, it would *not* suffice that the involvement of the third party was simply “useful and convenient” and improved the attorney’s ability to represent the client.

By contrast, Delaware Vice Chancellor Noble harkened back to the leading Delaware decision by Chancellor Allen in *Jedwab v. MGM Grand Hotels, Inc.* as support for Delaware’s “broader rule,” which reflects Delaware’s recognition of the practical necessity of involving non-legal advisors, such as investment bankers, in meetings and written communications relating to the provision of legal advice in what are often fast-paced corporate transactions.

The *3Com* decision highlights both differences between jurisdictions in approach to the scope of the protections of the attorney-client privilege and the potential impact on the availability of privilege of the parties’ selection of governing law and forum provisions. Although counsel should continue to take appropriate precautions to protect privilege even in corporate transactions for which Delaware law is expected to govern, *3Com* shows that, at least in Delaware courts, privilege should not be lost simply because an investment banker was included in the communications.

Delaware Court of Chancery Announces New Rules for Controlling Shareholder Freeze-Out Transactions

By Stephen Radin, a Partner of Weil Gotshal & Manges LLP

Delaware Vice Chancellor J. Travis Laster’s recent decision in *In re CNX Gas Corp. Shareholders Litigation*, C.A. No. 5377 (Del. Ch. May 25, 2010), adopts new rules for Court of Chancery treatment of going private transactions that “freeze out” minority shareholders. These new rules create new and powerful incentives—and disincentives—for controlling shareholders and their advisors to consider in structuring going private transactions and balancing transaction certainty and litigation risk. These new rules also provide independent directors serving on special committees new leverage in their dealings with controlling shareholders. A request for an immediate appeal is pending.

Briefly, and as also summarized in the chart following this article:

- *Going private transactions accomplished by tender offer followed by short-form merger:* Until CNX, there was no requirement that controlling shareholders offer minority shareholders a fair price in this form of transaction. CNX announces a fair price requirement—but provides business

judgment rule protection *if both* the tender offer is approved by a special committee empowered as described below *and* a majority of minority shareholders tender.

- *Going private transactions accomplished by one-step merger:* Delaware law before *CNX* requires that controlling shareholders offer minority shareholders a fair price in this form of transaction. *CNX* proposes (but does not yet explicitly adopt) the same possibility of business judgment rule protection for mergers that *CNX* provides tender offers—*i.e.*, if the merger is approved by both a special committee empowered as described below and a majority of the minority shareholders.
- *Special committee empowerment:* In either case, the special committee must be granted the full power of the controlled corporation's board with respect to the transaction, including the power to negotiate, seek strategic alternatives, and, if the special committee deems it appropriate, deploy a "poison pill" rights plan against the controlling shareholder. *CNX* rejects prior Court of Chancery precedent to the contrary, and describes "director primacy" as "the centerpiece of Delaware law, even when a controlling stockholder is present."

While *CNX* is, of course, just one decision by one Court of Chancery judge, members of the Court of Chancery rarely decline to follow each other's decisions, and can be expected to adhere to the broad principles—if not all the details—stated in *CNX* until the Supreme Court speaks on these issues. The Supreme Court may or may not do so in the near future. If it does, it may or may not agree with the course the Court of Chancery has taken.

Going Private Before CNX

Until *CNX*, two separate lines of Delaware cases governed controlling shareholder freeze-outs, depending on the freeze-out mechanism involved. Cases such as *Kahn v. Lynch Communication Systems, Inc.*, 638 A.2d 1110 (Del. 1994), governed going private transactions involving merger agreements, which require shareholder approval (a forgone conclusion where there is a majority shareholder). Cases such as *In re Siliconix Inc. Shareholders Litigation*, 2001 WL 716787 (Del. Ch. June 19, 2001), governed going private transactions involving tender offers followed by short form mergers (which allow the controlling shareholder to act without board approval if, following the tender offer, the controlling shareholder has reached 90% ownership).

Under *Lynch*, a 1994 Supreme Court decision, the merger price must be fair—and is tested in a court challenge by the entire fairness test, with the controlling shareholder bearing the burden of showing fair price and fair dealing. The business judgment rule, a presumption that directors are faithful to their fiduciary duties and pursuant to which a business judgment is upheld unless it cannot be attributed to a rational business purpose, never applies. The burden of proving fairness or unfairness may shift to the plaintiff *if either* the merger is approved by a special committee of disinterested and independent directors *or* by a majority of minority shareholders. The majority of the minority is based on all outstanding shares, not just shares that are voted, according to the Court of Chancery's 2009 decision in *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, 2009 WL 3165613 (Del. Ch. Oct. 2, 2009).

Under *Siliconix*, a 2001 Delaware Court of Chancery decision, the tender offer and short-form merger price need not be fair—and, unlike a *Lynch* transaction, is not tested in court by the entire fairness test. Judicial relief requires false or misleading disclosure or wrongful coercion—*i.e.*, conduct forcing shareholders to tender "for some reason other than the merits of the transaction"—and even then is typically limited to injunctive relief. (Appraisal also is available, but that alternative is typically disfavored by minority shareholders, because it cannot be pursued by class action and shareholders must forgo payment until the proceeding is complete and bear the risk of an appraised value below the transaction consideration.)

In re Pure Resources Shareholders Litigation, 808 A.2d 421 (Del. Ch. 2002), a 2002 Court of Chancery decision involving a tender offer and short-form merger, expanded *Siliconix*. Under *Pure*, a tender offer is coercive unless it includes (1) a non-waivable majority of the minority tender condition, (2) a promise of an immediate short-form merger at the same price offered in the tender offer if the tender offeror achieves 90% ownership, and (3) no threats of retribution (*e.g.*, by seeking delisting) if the tender offer fails. The controlling shareholder also must allow independent directors sufficient time to retain financial and legal advisors, make a recommendation to minority shareholders, and provide minority shareholders the information they need to make an informed decision concerning the tender offer.

GOING PRIVATE TRANSACTIONS		
	Pre-CNX	Post-CNX
Tender Offer/ Short-Form Merger	<p>No duty to offer fair price, under <i>Siliconix</i></p> <p>No need for business judgment rule protection</p> <p>Non-coercion requires</p> <ul style="list-style-type: none"> • non-waivable majority of the minority tender condition • promise of short-form merger at same price as tender offer if 90% obtained • no retributive threats • controlling shareholder must allow special committee sufficient time to react to tender offer by hiring its own advisors, providing a recommendation to non-controlling shareholders and disclosing adequate information to allow non-controlling shareholders an opportunity for informed decision making <p>No requirement that controlling shareholder give special committee all power board would have if dealing with third party offeror</p>	<p>Must offer fair price, under <i>CNX</i></p> <p>Business judgment rule protection if <i>both</i></p> <ul style="list-style-type: none"> • special committee approval <i>and</i> • majority of minority approval <p>Non-coercion requires</p> <ul style="list-style-type: none"> • non-waivable majority of the minority tender condition • promise of short-form merger at same price as tender offer if 90% obtained • no retributive threats • controlling shareholder must allow special committee sufficient time to react to tender offer by hiring its own advisors, providing a recommendation to non-controlling shareholders and disclosing adequate information to allow non-controlling shareholders an opportunity for informed decision making <p>Controlling shareholder must give special committee all power board would have if dealing with third party offeror, including the power to negotiate, seek strategic alternatives, and, if the special committee deems it appropriate, deploy a “poison pill” rights plan against the controlling shareholder</p>
One-Step Merger	<p>Must offer fair price, under <i>Lynch</i></p> <p>No business judgment rule protection</p> <p>Burden of proving fairness shifts if <i>either</i></p> <ul style="list-style-type: none"> • special committee approval <i>or</i> • majority of minority approval 	<p>If <i>Lynch</i> not overruled, same as pre-CNX one-step merger</p> <p>If <i>Lynch</i> overruled, same as post-CNX tender offer/short-form merger</p>

The New CNX Rule

The Court of Chancery’s May 2010 decision in *CNX*, another case involving a tender offer and a short-form merger, questions the wisdom of different tests for different forms of freeze-outs, concluding that there is no good reason for different rules to govern economically similar transactions (a conclusion previously stated in *Pure*). The court in *CNX* determined to adopt a new “unified” rule first suggested by Vice Chancellor Leo E. Strine, Jr. in 2005 in dictum (in a decision on an attorneys’ fee award dispute) in *In re Cox Communications, Inc. Shareholders Litigation*, 879 A.2d 604 (Del. Ch. 2005). The unified rule would govern both forms of freeze-outs—mergers and tender offers followed by short-form mergers.

Under the new *CNX* rule, going private transactions effectuated by tender offer, like going private transactions effectuated by merger in the past, must offer minority shareholders a fair price—and money damages

may be sought where a shareholder believes the price is unfair. However, the business judgment rule will apply when the tender offer is conditioned on *both* the affirmative recommendation of a special committee *and* the approval of a majority of the unaffiliated shareholders. Also under the new *CNX* rule, special committee approval is effective only if the special committee is granted authority comparable to what a board would possess in a third-party transaction—including the power to negotiate, seek strategic alternatives, and deploy rights plans.

CNX is called a “unified” rule intended to “unify” the *Lynch* and *Siliconix* lines of cases, but *CNX*’s application in merger cases is uncertain: no such transaction was before the court in *CNX* and, even if it were, *Lynch* is a Supreme Court decision and the Court of Chancery cannot overrule the Supreme Court.

The new *CNX* rule is not good news for controlling shareholders seeking to effectuate going private transactions by tender offer. Under *CNX*, minority shareholders will have a legal right to a fair price enforceable in an action for money damages unless both special committee approval (with the committee empowered in a way special committees have not necessarily been empowered in the past) and majority of the minority approval are obtained. This right was triggered in the *CNX* case, because the special committee in that case took no position on the tender offer and was not granted the required authority.

The new *CNX* rule, if ultimately adopted in the *Lynch* merger context, is better news for controlling shareholders seeking to effectuate going private transactions by one-step merger. Controlling shareholders under this scenario would have the option of structuring a freeze-out in a manner that would provide them business judgment rule protection rather than require them to prove entire fairness, as under *Lynch*. Controlling shareholders presumably no longer would have the option, as under *Lynch*, of shifting the burden of proving fairness (thus requiring plaintiffs to prove unfairness) by securing special committee or majority of the minority approval.

One final wrinkle about remedies. The new availability of money damages for unfairness in tender offer transactions provides shareholders a remedy that may make injunctive relief less likely in cases involving disclosure or coercion violations where the controlling shareholder has the wherewithal to pay the potential damage award if the price is proven at trial to be unfair. The court in *CNX*, for example, stated its concern about the effectiveness of the majority of the minority tender condition in *CNX* and considered the possibility of an injunction requiring modification of the provision. The court concluded, however, that injunctive relief that might have been granted before *CNX* was unnecessary because the tender offer would be tested pursuant to the entire fairness standard and money damages would be awarded if the tender offer price was found to be unfair.

An Immediate Appeal?

On May 26, 2010, the plaintiffs in *CNX* sought immediate appellate review, and the Court of Chancery certified an appeal to the Supreme Court with respect to the appropriate standard of review. Vice Chancellor Laster readily agreed that “I absolutely believe that the Delaware Supreme Court needs to weigh in and decide *Siliconix* versus *Lynch* versus *Cox Communications*.”

Plaintiffs withdrew their appeal, however, after the Court of Chancery declined to enjoin the transaction pending the appeal and ruled that a \$15 million bond (5% of the court’s estimate of the \$300 million premium provided by the offer) would be required if the Supreme Court granted a stay pending the appeal.

On June 4, 2010, the controlling shareholder responded by seeking certification of its own immediate appeal, rather than face what it describes as “expensive and burdensome litigation that the trial court has decided at the outset will be resolved under the most plaintiff-friendly standard known to our law (entire fairness with no burden shift).” Neither Vice Chancellor Laster nor the Supreme Court has yet ruled on this application.

If an immediate appeal is denied, the case will proceed through discovery and a trial with respect to the fairness of the tender offer challenged in the case.

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