Lynn Toby Fisher

Partner
Corporate

Tracy A. Romano

Associate
Corporate

IN THIS ISSUE

Exclusive Forum Provisions in Charter Documents: Implications of the *Oracle* Decision

Expensive, time-consuming, multi-forum litigation has become increasingly common in intra-corporate disputes, particularly in connection with the sale of public companies. Following the 1972 U.S. Supreme Court decision *MS Bremen v. Zapata Off-Shore Co., 407 U.S. 1 (1972)*, courts generally recognize a contractual choice of forum clause, subject to "fundamental fairness" and public policy arguments. Recently, a spate of charter provisions has been adopted to mandate an exclusive forum for intra-corporate disputes. This is in response to *dicta* in a 2010 Delaware Chancery Court decision: "if boards of directors and stockholders believe that a particular forum would provide an efficient and value-promoting locus for dispute resolution, then corporations are free to respond with charter provisions selecting an exclusive forum for intra-entity disputes." *In re Revlon, Inc. Shareholders Litigation*, *990 A.2d. 940 (Del.Ch. 2010)*.

On January 3, 2011, the United States District Court for the Northern District of California issued a decision in *Galaviz v. Berg*, *763 F. Supp. 2d 1170 (N.D. Cal. 2011)*, declining to enforce an exclusive forum provision in a corporation's bylaws.

The Oracle Decision

The directors of Oracle Corporation ("Oracle") were sued in federal court in the Northern District of California for breach of fiduciary duty and abuse of control. The complaint alleges that between 1998 and 2006, Oracle made sales of software and licenses to the United States government through fraudulent and improper practices, resulting in millions of dollars of overcharges. In 2006, Oracle's bylaws were amended to add a forum-selection provision for derivative suits, providing that "[t]he sole and exclusive forum for any actual or purported derivative action brought on behalf of the Corporation shall be the Court of Chancery in the State of Delaware." This amendment was approved by Oracle's Board of Directors, without any action by Oracle's stockholders.

Oracle argued that this bylaw should be enforced as a permissible contract between the corporation and its stockholders. In a narrow opinion specifically crafted to the facts of the case, the court found the bylaw unenforceable under federal common law and denied the motion to dismiss for improper venue. The court emphasized that the Oracle bylaw was adopted by the unilateral action of the Board of Directors — and after the alleged wrong-doing. The stockholders did not consent to the forum-selection clause and the essential element of mutual consent, present in a contract, was not present. The court did not, however, go so far as to say that all forum-selection clauses in bylaws are invalid. The court specified that "were a majority of shareholders to approve such a charter amendment, the arguments for treating the venue provision like those in commercial contracts would be much stronger, even in the case of a plaintiff shareholder who has personally voted against the amendment."

The Practical Effect of the Oracle Decision

A board of directors must consider carefully whether it wants to restrict its stockholders' ability to "forum shop." Is the availability of multiple forums really a benefit to its stockholders, or is it principally a tool for the plaintiffs' bar to create diversion, together with multiple settlement (and fee) opportunities? Does the exclusive forum reduce litigation costs, and result in more expedited scheduling and certainty of outcome on the application of Delaware law — the very reason many corporations choose to incorporate in Delaware? Or does the availability of multiple forums provide a path to a quicker settlement and more certain outcome? What actions should be subject to the provision? Should there be exceptions to the exclusive forum provision? And if a decision is made that an exclusive forum provision is in the best interests of stockholders, how can you best ensure it will be enforced?

Although a board-approved bylaw mandating exclusive jurisdiction should be valid as a matter of Delaware law, the Oracle decision makes it clear that such a bylaw may not be enforced outside Delaware.

The law is still developing with respect to the enforceability of exclusive jurisdiction charter provisions and it is possible that a board-approved bylaw will be upheld by another federal district court facing different facts. Many newly public companies have included exclusive jurisdiction provisions in their IPO charter documents. For existing public companies, a stockholder-approved amendment to the bylaws or certificate of incorporation creates the greatest certainty that an exclusive jurisdiction provision will be enforced. But a board will want to carefully consider whether to submit such a charter amendment to a vote of stockholders — taking into account the likelihood of achieving a favorable vote, and any negative impact if the proposal is rejected. This spring, Institutional Shareholder Services ("ISS") recommended that stockholders vote AGAINST these proposals unless the company has in place significant "best-practice" governance features (an annually elected board, a majority vote standard in uncontested elections of directors, a meaningful special meeting right (generally a 10 percent demand level without onerous restrictions on topics and timing), and the absence of a poison pill, unless the pill was approved by stockholders). ISS is planning on reviewing this policy as part of its policy formulation process for the 2012 proxy season. As of mid-May 2011, for the spring 2011 proxy season, five proposals to amend organizational documents to include an exclusive jurisdiction provision were included in proxy materials by management, and four of these proposals were approved by stockholders. *Claudia H. Allen, "Forum-Shopping and Exclusive Forum Clauses: 'Anywhere But Delaware' or Only in Delaware?" 9 Corporate Accountability 23 at 3-4, June 10, 2011.*

Lynn Toby Fisher
lfisher@kayescholer.com

Tracy A. Romano
tracy.romano@kayescholer.com

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Diane Holt Frankle

Partner
Corporate

Lessons for Boards of Directors from In Re Del Monte Foods Company Shareholder Litigation

In Re Del Monte Foods Company Shareholder Litigation, 2011 Del. Ch. LEXIS 30 (Del. Ch. Feb. 14, 2011), presents a window into the world of investment banking and the pressures on bankers to generate transactions and the fees associated with those transactions. The case also provides some key lessons to target boards of directors managing M&A transactions.

In November 2010, Del Monte entered into a definitive merger agreement with affiliates of three private equity funds, Kohlberg, Kravis, Roberts & Co. ("KKR"), Centerview Partners and Vestar Capital Partners ("Vestar"), providing for a $5.3 billion acquisition. As has been widely reported, litigation was filed against the transaction in Delaware. Initially the plaintiffs in the *Del Monte* case challenged the board's decision to allow one bidder, KKR, to team up with Vestar, the high bidder in a previous solicitation, and the board's authorization of the board's financial advisor, Barclays Capital, to provide a portion of the buy-side financing to the bidder, KKR. As the court explained, further issues were revealed by discovery:

> Discovery revealed a deeper problem. Barclays secretly and selfishly manipulated the sale process to engineer a transaction that would permit Barclays to obtain lucrative buy-side financing fees. On multiple occasions, Barclays protected its own interests by withholding information from the Board that could have led Del Monte to retain a different bank, pursue a different alternative, or deny Barclays a buy-side role. Barclays did not disclose the behind-the-scenes efforts of its Del Monte coverage officer to put Del Monte into play. Barclays did not disclose its explicit goal, harbored from the outset, of providing buy-side financing to the acquirer. Barclays did not disclose that in September 2010, without Del Monte's authorization or approval, Barclays steered Vestar into a club bid with KKR, the potential bidder with whom Barclays had the strongest relationship, in violation of confidentiality agreements that prohibited Vestar and KKR from discussing a joint bid without written permission from Del Monte.

Del Monte, 2011 Del. Ch.LEXIS at *4. The court compared the situation to that in *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261 (Del. 1989), where the court found that "a board's lack of involvement in a sale process enabled management and their financial advisor to steer the deal to KKR, the preferred bidder." The court explained that "[d]espite the [MacMillan board's] independence, the directors failed adequately to oversee the process and permitted the conflicted management team and their financial advisor to exploit the opportunities it presented." *Id.* at 1280-81, 1284 n.32. The *MacMillan*

Although the Del Monte board is not likely to be subject to personal monetary liability, it goes without saying that no target board would want to subject itself to the deal disruption, intense scrutiny and unflattering portrayal found in Del Monte.

This decision by the board to permit Barclays to provide a portion of the financing created therefore a clear conflict of interest, where before the conflict was only potential.

court explains that "[w]hen corporate directors rely in good faith upon opinions or reports of officers or other experts 'selected with reasonable care,' they necessarily do so on the presumption that the information provided is both accurate and complete . . . . However, when a board is deceived by those who will gain from such conduct, the protections guarding the decision itself are voided." *Id*. at 1283-84.

The *Del Monte* court summarizes the deceptions as follows: "At a minimum, Barclays withheld information about its buy-side intentions, involvement with KKR, and its pairing of KKR and Vestar." *Del Monte*, 2011 Del. Ch. LEXIS at *59. The court concludes there was a fraud upon the Del Monte board. *Id*. One might have expected sympathy for the Del Monte board given the deception. Instead, the court holds that plaintiffs "established a reasonable likelihood of success on the merits of their claim that director defendants failed to act reasonably in connection with the sales process." *Id*. at *60. The Vice Chancellor explains that the directors breached their fiduciary duties to shareholders by "failing to provide the serious oversight that would have checked Barclays' misconduct[.]" *Del Monte*, 2011 Del. Ch. LEXIS at *5. The Del Monte court refers to the similar fact pattern in *MacMillan*, where the Delaware Supreme Court found that "[d]espite their independence, the directors failed adequately to oversee the process and permitted the conflicted management team and their financial advisor to exploit the opportunities it presented." *MacMillan*, 559 A.2d at 1280-81, 1284 n. 32. The Del Monte court explains that "[a]lthough the blame for what took place appears at this preliminary stage to lie with Barclays, ***the buck stops with the Board***. Delaware law requires that a board take 'an active and direct role in the sale process.'" *Del Monte*, 2011 Del. Ch. LEXIS at *57 (emphasis added).

Despite his determination that a finding of breach of fiduciary duty was likely, the Vice Chancellor explains that the board did not face a meaningful threat of monetary liability, absent any additional facts showing a breach of the duty of loyalty. The court notes that Delaware General Corporation Law Section 102(b)(7) would likely result in exculpation of liability, and Section 141(e) would likely provide protection for the board's reliance on qualified advisors chosen with reasonable care. "Unless further discovery reveals different facts, the one-two punch of exculpation under Section 102(b)(7) and full protection under Section 141(e) makes the chances of a judgment [against the directors] for money damages vanishingly small." *Del Monte*, 2011 Del. Ch. LEXIS at *6. (It is worth noting that the Vice Chancellor had a distinctly different view concerning the potential liability of the "self-interested aiders and abetters [KKR and Barclays].") In part because there were such strong defenses to monetary damages against the directors, the Vice Chancellor imposed injunctive relief. Thus, Del Monte was enjoined from proceeding with the stockholder vote on the merger for 20 days and all the deal protections, including the non-solicitation and match rights and termination fees provisions relating to topping bids, were enjoined during that 20-day period. After the injunction period ended, the transaction was approved by the Del Monte stockholders and was closed. Litigation is still ongoing in Delaware.

Although the Del Monte board is not likely to be subject to personal monetary liability, it goes without saying that no target board would want to subject itself to the deal disruption, intense scrutiny and unflattering portrayal found in *Del Monte*. Moreover, as again has been widely reported, the plaintiffs' counsel has been awarded $2.75 million in interim counsel fees by the Vice Chancellor. Thus, it is worth reviewing the lessons that boards might derive from the facts in *Del Monte* in providing oversight with respect to M&A transactions.

Ask up front about the bank's relationship with logical bidders, whether strategic or financial buyers.

As noted in *Del Monte*, investment banks regularly visit private equity shops as well as strategic acquirors, presenting possible transactions for consideration. This activity generates access to buyers and builds relationships helpful to transactions and is typically viewed as a positive. Thus, Barclays told Del Monte that Barclays was well-positioned to advise Del Monte because Barclays "knew many of the entities that might be an interested buyer." What wasn't offered, or apparently asked, was whether Barclays had earned significant fees from any of the logical bidders over the past few years. KKR had paid Barclays "over $66 million in fees" over the past two years and had worked with KKR on six projects in the consumer and retail space. *Del Monte*, 2011 Del. Ch. LEXIS at *11. To put this in perspective, Barclays was to earn "approximately $44.5 to $47.5 million . . . from its dual role" with Del Monte providing advice as a sell-side banker, while at the same time providing buy-side financing. *Id*. at *57. Barclays also didn't advise that it had pitched Del Monte to the very funds it was planning to solicit here and had a specific indication from KKR that it was "ready to take the next step." *Id*. at *11. The court found that "Barclays never disclosed to the Board its interactions with the private equity shops or its desire to provide acquisition financing." *Id*. at *50.

Although it is not reasonable for a board to expect a bank to disclose its secret motivations, of course, it seems that further inquiry by the board about ongoing relevant relationships and actual and potential conflicts of interest, like whether the bank had done substantial work for any of the likely bidders during the past two years, may have elicited sufficient information from Barclays at the outset to have caused the board to hire a different banker, or might at least the information may have caused the board to be more skeptical about the banker's advice, and more involved in decisions regarding the sales process. The court notes that "[i]f the directors had known at the outset of Barclays' intentions and activities the Board would have likely hired a different banker. . . . Even if the directors had decided to proceed with Barclays, the Board and its experienced counsel doubtless would have taken steps to protect the integrity of the process." *Id*. at *52.

Avoid having the target banker provide buy-side financing without a clearly demonstrated benefit to target, and before price negotiations are completed.

Barclays Capital's interest in obtaining additional fees from the transaction created the conflict for the banker vis-à-vis the target board. The court explains that

> [b]efore the Merger Agreement was signed and with price negotiations still on-going, Barclays sought and obtained a buy-side role and worked with KKR to develop financing. As a result, at the same time Barclays ostensibly was negotiating to get KKR to pay more, Barclays had an incentive as a well-compensated lender to ensure that a deal was reached and that KKR did not overpay.

Id. at *51. This decision by the board to permit Barclays to provide a portion of the financing created therefore a clear conflict of interest, where before the conflict was only potential. Moreover, there was "no deal-related reason for the request, just Barclays' desire for more fees. Del Monte did not benefit." *Id*. at *54-55. Barclays' participation in the buy-side financing in fact resulted in Del Monte being forced to spend an additional $3 million to hire a second bank to give a fairness opinion. The more troubling harm was, however, the obvious taint on the price negotiations. Where the conflict was so obvious it forced the hiring of a second sell-side banker, one would have expected some consideration by the Del Monte board of the impact of that conflict on the process, and to understand what, if any, benefit was being conferred.

The court finds that the Del Monte board failed to act reasonably. The board did not ask whether KKR could fund the deal without Barclays' involvement. "Without some justification reasonably related to advancing stockholder interests it was unreasonable for the Board to permit Barclays to take on a direct conflict when still negotiating price." *Id*. at *55. At a minimum, the board could have asked whether the financing was in fact critical to the deal getting done, and could have deferred giving Barclays permission until price negotiations were complete. The court explained that it is impossible to know the impact of the taint on the price negotiations, and that the burden of that uncertainty should rest on the fiduciaries who created the conflict.

The taint from the financing extends beyond the price negotiation. For example, the court noted that Barclays' desire to provide the buy-side financing led it to structure "a small private process that maximized the likelihood that it could provide acquisition financing." *Id*. at *50. Moreover, the court noted that the restrictions in the non-disclosure agreement that limited the buyers' right to contact debt sources without Barclay's permission was a way to put Barclays in the position to know about the financing needs of respective bidders, putting it in a particularly good position to offer financing. Moreover, as noted below, the buy-side financing resulted in a conflict for Barclays running the go shop process. Thus, the taint of the conflict from providing financing calls into question the entire sales process, without any demonstrable benefit from the financing delivered to the stockholders.

The Delaware courts have previously pointed out the conflicts inherent in a sell-side banker providing buy-side financing. Even where the merger agreement is already signed, the sell-side banker will be perceived to shift allegiance if the same bank is providing buy-side financing, since the buyer and seller simply have different motivations and perspectives on the transaction. *See In re Toys R Us, Inc. Shareholder Litigation*, 877 A. 2d 975, 1005-1006 (Del. Ch. 2005). It seems clear that a target board will do well to simply engage a separate banker to provide stapled financing, if it is deemed necessary, and simply decline to permit its sell-side advisor from providing financing on the deal. This policy would preserve the independence of the sell-side banker for purposes of running a process that would not be susceptible to second-guessing and allegations of conflict. Alternatively, the target board could engage two sell-side advisors and permit only one of them to offer financing to buyers. In any case, the board would be well advised not to allow the sell-side advisor to provide the buy-side financing without being able to point to a clear benefit for stockholders, and such financing should ideally not be offered until after price negotiations on the merger transaction are completed.

Seek to enforce anti-clubbing provisions in non-disclosure agreements; permit teaming only after consideration of the impact on deal process.

The *Del Monte* court explains that "what indisputably crossed the line was the surreptitious and unauthorized pairing of Vestar with KKR." Vestar had been the high bidder in the prior aborted process, and had indicated that it needed to pair with another buyer. It seems clear that Barclays could have teamed Vestar with a different sponsor in order to induce competition between KKR and another bidder. There was an anti-teaming provision in the process NDA, which contractually prohibited discussions between potential competing bidders. Barclays concealed its role in putting Vestar and KKR together. Nevertheless the court notes that "[t]he record does not reflect meaningful Board consideration or informed decision-making with respect to the Vestar pairing." *Id.* at *53. The minutes, for example, did not reflect a board discussion about how a pairing could affect competitive bidding or whether there were alternative pairings. It seems that although the Del Monte board could not have known of Barclays' actions to put the two bidders together, the board could certainly have objected to the pairing on the face of it, given the prior history with Vestar as the high bidder in the prior failed process and the desire to have a competitive process. The board could have requested an attempt to find another pairing to create some price competition. A key lesson from the *Del Monte* case is that the board in a merger transaction should not simply accept banker recommendations on process without considering the impact on the ultimate goal of the process to obtain the best available price and terms.

Manage the go shop process to maximize the likelihood of bids.

As noted above, the board allowed Barclays to participate in the buy-side financing. This participation by Barclays in the buy-side financing created an obvious conflict with respect to the "go shop" process, since banks providing financing for the deal would want the deal with KKR to be consummated so that they could obtain the financing fees, whether or not there was a superior deal available to Del Monte from a competing bidder. The Del Monte board apparently did not think about this conflict. *Id.* at *35. In light of this conflict, it would have been reasonable for the board to have selected another bank, perhaps the one providing the second opinion for the fairness of the transaction required due to that very conflict, to run the go shop process. Simply put, it is hard to have much confidence in a process run by a bank that has a clear conflict of interest against the process yielding any new bidders. Moreover, the court noted that the board "had no direct insight into how Barclays interacted with the parties it contacted." *Id.* at *57. "Barclays had a strong interest that a certain kind of buyer (private equity) acquire Del Monte, and a keen desire to see the deal close with KKR." *Id.* The court noted that it would have been highly unlikely that another bidder would have bid enough to replace the fees being paid for the financing with transaction fees.

The board could have dealt with this conflict by declining the initial request from Barclays to provide buy-side financing, or by hiring the second bank to run the go shop process, or at a minimum, by putting itself in an active supervisory role regarding the go shop process.

Ask questions and understand the process and the advice of advisors with the goal to develop a process to maximize stockholder value.

As noted above, one thing is clear from *Del Monte* — a target board should be directly engaged in the process, and at each stage the board should be asking questions, understanding the alternatives, and making decisions regarding the process in the best interests of stockholders, with the ultimate goal to maximize value. The board cannot simply rely without question on the banker to establish the process without at least considering the choices in light of the objective to maximize value and to assess the potential for conflicts, without risking embarrassment. The *Del Monte* court explains that experienced lawyers and financial advisors are critical to the protection of shareholder interests and guide sometimes inexperienced directors through a deal process. Nonetheless, the directors can ask questions to discern alternatives and information on the merits of the advice being offered. The board can thereby exercise its business judgment to develop a reasonable process designed to maximize stockholder value, considering the alternatives and the benefits and risks of each step toward that ultimate goal.

Diane Holt Frankle
diane.frankle@kayescholer.com

Claudia R. Higgins

Partner
Antitrust

Revisions to the Premerger Notification Rules under the Hart-Scott-Rodino ("HSR") Act are effective as of August 18, 2011, some of which will have important effects, particularly on private equity or investment funds.

The Remedies Guide is intended both to give guidance to the DOJ staff in their considerations of possible merger investigation settlements and to provide transparency for the public to understand the bases for the DOJ's enforcement decisions.

Significant Changes in U.S. Antitrust Enforcement Alter Merger Landscape

Recent weeks have seen significant changes in U.S. antitrust enforcement — retiring leadership and new nominations, revised premerger reporting rules, and new policy statements regarding merger remedies. First, Christine A. Varney, Assistant Attorney General for Antitrust at the Department of Justice ("DOJ") has resigned effective August 12, 2011; in a change for the Federal Trade Commission ("FTC"), the White House recently nominated a replacement for outgoing Commissioner William E. Kovacic. Second, important revisions to Hart-Scott-Rodino Act ("HSR Act") filing regulations will alter reporting requirements in ways that may affect many transactions quite significantly. Third, the DOJ has released new guidance regarding merger remedies for possible settlements with the DOJ.

New U.S. Government Antitrust Leaders

Sharis A. Pozen, currently Deputy Assistant Attorney General, has been asked to step in as Acting AAG of the Antitrust Division to replace outgoing AAG Varney who has held that post since early in the Obama administration. Pozen has worked closely with Varney for many years, not only as Chief of Staff at the Antitrust Division but also as a partner of Varney's in private practice, and, prior to that time, when Varney was FTC Commissioner and Pozen was her Attorney Advisor.

Most observers believe that Pozen is not likely to alter the enforcement policies put in place by Varney in any major ways. During the past two years, the DOJ has approved, albeit with some conditions, important high-tech mergers such as Comcast's acquisition of NBC Universal and Google's acquisition of the major airline software developer, ITA. Importantly, the DOJ is currently reviewing AT&T's proposed acquisition of T-Mobile USA, a transaction that is being closely watched by many.

At the other U.S. antitrust enforcement agency, the FTC, the White House recently nominated Maureen K. Ohlhausen to replace Commissioner William Kovacic, whose term expires this September. Ohlhausen, currently in private practice, directed the FTC's Office of Policy Planning during the George W. Bush administration. While Kovacic's background is predominantly in antitrust, Ohlhausen's focus has been more on the consumer protection side of the FTC's responsibilities, with practice specialties in the area of privacy and cybersecurity. Loss of the well-recognized antitrust expertise that Commissioner Kovacic has brought to this agency over the past several years will no doubt be sorely felt, but Ms. Ohlhausen is respected as a level-headed and skilled attorney in her own right.

New Hart-Scott-Rodino Regulations

Revisions to the Premerger Notification Rules under the HSR Act are effective as of August 18, 2011, some of which will have important effects, particularly on private equity or investment funds. Among the major revisions are: (1) a requirement that information be provided for companies under common management, rather than just for those under control of the ultimate parent entity; and (2) an expansion of the company documents that must be supplied with the filing pursuant to Item 4 of the HSR Form.

— **"Associate" Entities.** Formerly, the ultimate parents of the acquiring and target companies in a proposed transaction were required to report information in HSR filings only for the ultimate parent and the entities under their respective "control."[1] The new rules, however, define a new term, "Associate,"[2] and broaden the scope of disclosure to require information for the associate entities — essentially those that are under common management. HSR filings must now include information regarding the holdings and operations of each entity that is an "associate" of the ultimate parent entity if that associate reports revenues in the same six-digit NAICS code(s) as the target.

The effect of this change is of particular significance for private equity firms and other investment funds. Often, a fund sponsor manages a family of investment funds but does not have the right to receive more than 50% of the profits or assets upon dissolution from any of them. Under the former rules, each investment fund was its own ultimate parent entity, and its HSR filings did not need to identify holdings of other funds commonly managed. Under the new rules, these must be disclosed. Under the new rules, the sponsor itself and each of the other investment funds (and the portfolio companies that they control) are "associates" of the fund that is the acquiring person.

— **Additional Business Documents.** The rules add new Item 4(d), which requires that companies search for and submit three additional categories of documents in addition to those already called for under Item 4(c). Pursuant to Item 4(c), parties must provide competition-related documents that were prepared by or for an officer or director for the purpose of analyzing the transaction.[3]

New Item 4(d) requires in addition that companies produce:

- *All Confidential Information Memoranda (or documents of a similar type)*[4] *that were prepared within one year of the HSR filing and* ***that refer to the possible sale*** *of the target company*. This new requirement removes the limitations that an offering memorandum must be produced only if it (i) was prepared by or for an officer or director; (ii) was prepared for the instant transaction; and (iii) discussed competition-related topics such as market shares, competition, competitors, markets, potential for sales growth, or expansion into product or geographic markets.

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[1] Generally for purposes of HSR filings, control of an unincorporated entity is defined as the right to 50% or more of a company's profits or 50% or more of its assets upon dissolution. Control of a corporate entity is defined as holding 50% or more of the outstanding voting securities of an issuer or having a contractual right to designate 50% or more of the directors.

[2] "Associate" is defined in Rule § 801.1(d)(2):

> For purposes of Items 6 and 7 of the Premerger Notification and Report Form, an associate of an acquiring person shall be entity that is not an affiliate of such person but: (A) has the right, directly or indirectly, to manage the operations or investments decisions of an acquiring entity (a "managing entity"); or (B) has its operations or investment decisions, directly or indirectly, managed by the acquiring person; or (C) directly or indirectly controls, is controlled by, or is under common control with a managing entity; or (D) directly or indirectly manages, is managed by, or is under common operational or investment decision management with a managing entity.

[3] Item 4(c), which remains unchanged, requires parties to file "studies, surveys, analyses and reports which were prepared by or for any officer(s) or directors(s) . . . for the purpose of evaluating or analyzing the acquisition with respect to market shares, competition, competitors, markets, potential for sales growth or expansion into product or geographic markets. . . ."

[4] Although the new rules do not specifically define Confidential Information Memoranda, the FTC's Statement of Basis and Purpose announcing its final rules states that this term is "intended to capture offering memoranda," which it describes as "formal documents created in-house or by a third party that lay out the details of a company, or a part of a company, that is for sale" and "transaction-specific marketing presentation[s]." 76 Fed. Reg. 42471, 42474 (July 19, 2011).

- *Documents prepared within a year of the filing by investment bankers, consultants or other third-party advisors, if those documents were prepared for an officer or director for the purpose of evaluating or analyzing market shares, competition, competitors, markets, potential for sales growth, or expansion into product or geographic markets, and* ***refer to the possible sale*** *of the target company.* The documents required to be filed pursuant to this item include "pitch books" and similar materials prepared by investment bankers, consultants and other third-party advisors when seeking to be retained, if they include the specified information. Notably, this requirement is not limited to the transaction that is the subject of the filing at issue.
- *All studies or* analyses of synergies and/or efficiencies prepared by or for an officer or director to *evaluate the transaction*.

Overall, the additional documents that must be submitted under the new rules increase the burden of searching for documents. For example, the document search for an HSR filing may need to go back a year prior to the HSR filing, which may be before the transaction at hand was even contemplated. In addition, companies will even need to search the files of individuals who were not involved in the current transaction: officers and directors who have not worked on the transaction may have documents prepared by third-parties within the past year that discuss the possible sale of the target; and any individual in the company may have received offering memoranda that refer to the possible sale of the target. Both of these types of documents may be responsive to Item 4(d).

— Additional Changes. The new rules also require reporting of more detailed revenue information as well as disclosure of not only corporate voting securities but also non-corporate interests, such as partnership interests. In one limitation on disclosure, those ultimate parent entities who are natural persons will no longer be required to include personal balance sheets with HSR filings.

Changes in Policies for Merger Remedies

In addition to all of the above, earlier this summer the DOJ issued a new Policy Guide to Merger Remedies.[5]

[5] The DOJ Remedies Policy Guide can be found at: http://www.justice.gov/atr/public/guidelines/272350.pdf.

In many respects, the new Remedies Guide covers territory familiar to the M&A world. A possibly quite important addition appears, however, in that it specifically provides that both conduct, as well as structural remedies, will be considered for remedying anticompetitive problems — of course, with caveats that conduct remedies will be limited to appropriate circumstances.

The Remedies Guide is intended both to give guidance to the DOJ staff in their considerations of possible merger investigation settlements and to provide transparency for the public to understand the bases for the DOJ's enforcement decisions. The new Guides and recent merger settlements signal a shift in thinking at the DOJ regarding so-called "conduct" remedies. For decades, both the DOJ and the FTC strongly favored "structural" merger remedies, which usually involve divestiture of company divisions, product lines or asset packages sufficient to replace the competition lost as a result of the merger. In several more recent transactions, however, such as the Comcast / NBC Universal, Ticketmaster / Live Nation, and Google / ITA mergers, the DOJ has settled the merger issues by agreeing to remedies that include promises on the part of the acquiring company that it will in the ensuing years conduct certain of its business practices in a particular manner.

The new Guides do state that the DOJ will continue to pursue structural relief in most horizontal merger matters (those between competing companies) and that conduct relief will be reserved largely for vertical mergers (those between a supplier and its customer). Even with this limitation, however, the new position that has been taken in recent cases — and written into the Remedies Guide — represents an important departure from precedent at the agency.

Examples of the conduct remedies discussed include:

- Firewalls, such as that entered into in the Ticketmaster Entertainment / Live Nation merger that prohibits the merged firm from using information obtained in its ticketing business in the day-to-day operations of its promotions and artist management businesses;
- Non-Discrimination Requirements, such as those in the Comcast / NBC Universal settlement (which is still pending court approval in its Tunney Act proceeding); and

- Anti-Retaliation Requirements, such as those entered into in both the Ticketmaster / Live Nation and Comcast / NBC Universal settlements.

These settlements and the new Remedies Guide represent an invitation to propose more creative remedies to the DOJ than would have been entertained in prior years. Some deals that antitrust practitioners would have counseled as being too risky to pursue may now represent much less risk.

Importantly, the FTC did not join in this policy statement. The two antitrust agencies do not always release joint enforcement policies, and certainly are not required to do so. Nonetheless, when one of the two U.S. antitrust enforcement agencies issues a significant enforcement statement without the public concurrence from the other agency, that action typically signals a material rift between the enforcers.

Claudia R. Higgins
chiggins@kayescholer.com

KAYE SCHOLER LLP

Jeff London

Partner
Tax

Brian Witkowski

Associate
Tax

Negative "Say-on-Pay" Votes Lead to Litigation

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), enacted on July 21, 2010, requires nearly all publicly traded companies to hold an advisory "say-on-pay" vote. Although the Dodd-Frank Act expressly provides that the "say-on-pay" votes are non-binding, since July 2010 directors of no fewer than seven publicly traded companies have been sued by shareholders following negative "say-on-pay" votes. Boards and executives alike should be aware of the potential for shareholder backlash in response to a perceived disconnect between company performance and executive compensation, particularly in light of the apparent willingness of shareholders (and plaintiffs' law firms) to challenge executive compensation practices with costly litigation.

The companies that have been the subject of the lawsuits include Beazer Homes USA, Inc., Cincinnati Bell Inc., Hercules Offshore, Inc., Jacobs Engineering Group Inc., KeyCorp, Occidental Petroleum Corporation ("Occidental") and Umpqua Holdings Corporation. The allegations are by and large similar in each lawsuit: following a period of underwhelming shareholder returns and a negative "say-on-pay" vote, shareholders have brought derivative suits alleging that directors breached their fiduciary duties by approving excessive executive compensation packages and failing to adhere to purported pay-for-performance models. The lawsuits also include claims against directors and executive officers for corporate waste and unjust enrichment, and against executive compensation consultants for aiding and abetting the directors' breaches of fiduciary duties, among other claims.

Most practitioners believe that these lawsuits generally have little chance of succeeding on the merits. As an initial matter, the Dodd-Frank Act expressly provides that the "say-on-pay" votes are non-binding and do not impose any additional fiduciary duties on boards. Moreover, the business judgment rule provides directors (and officers) significant protection from shareholders who would argue that a breach of fiduciary duty has occurred as the result of an allegedly unwise business decision. As long as directors and officers make business decisions in good faith and with reasonable skill and prudence, and rely on the advice of experts reasonably selected, courts should apply the business judgment rule to insulate directors and officers from liability for any losses resulting from such decisions, including those relating to compensation. Similarly, courts are generally reluctant to recognize claims of corporate waste, unjust enrichment or aiding and abetting absent egregious wrongdoing.

Even though shareholders face an uphill battle in court, the two cases that have settled thus far are instructive as to the sensitivity of boards to shareholder concerns. Shareholders of KeyCorp, one of the nation's largest bank-based financial services companies, filed suit in July 2010 against KeyCorp's directors, executive officers and executive compensation consultant. According to the complaint, the suit arose from the board's "profligate spending on executive compensation" in light of KeyCorp's "simply awful" recent financial performance. Pursuant to a settlement agreement entered into in March 2011, KeyCorp agreed to pay $1.7 million in attorneys' fees to plaintiffs' counsel, and KeyCorp's board agreed to take a number of steps to reaffirm and clarify KeyCorp's pay-for-performance model. For example, KeyCorp's board or compensation committee will be required to consider whether to reduce future executive compensation to adjust for compensation that was excessive in 2009 and 2010, and will limit the number of consecutive years a director can serve on the compensation committee.

In 2010, three separate lawsuits were filed by shareholders of Occidental against its directors, executive officers and executive compensation consultant with allegations similar to those in the KeyCorp lawsuit. The parties settled the lawsuits in February 2011. Although the final settlement terms were not disclosed, Occidental's board announced significant changes to its structure and compensation policies in connection with the settlement. For example, the board agreed to create an Executive Chairman position and to submit to shareholder vote a proposal to amend Occidental's bylaws to split the Chairman and Chief Executive Officer roles. Occidental's board also agreed to reduce targeted and maximum compensation awards of Occidental's Chief Executive Officer to levels commensurate with peer group chief executive officers and to tie equity and equity-based awards to objective performance criteria (i.e., net income and shareholder returns relative to peer group shareholder returns).

In addition to considering whether pay is indeed tied to performance, recent lawsuits also highlight that boards should be careful to follow the objective terms of incentive compensation plans when granting awards. An example can be seen in a lawsuit filed in June 2011 by shareholders of The Bank of New York Mellon Corporation ("BNY Mellon") against its board. Even though BNY Mellon's "say-on-pay" vote received overwhelming shareholder approval, shareholders brought the suit alleging that BNY Mellon's board used subjective criteria to increase the value of awards under the company's incentive compensation plan in contravention of plan provisions providing that subjective criteria could only be used to decrease the value of awards.

Although the BNY Mellon case appears to be more fact-dependent than the lawsuits that have followed negative "say-on-pay" votes and raises different legal issues, it is further evidence of a trend of increased litigation concerning executive compensation and of boards' willingness to respond to shareholder concerns (or, at least, their willingness to respond to high-profile lawsuits). Given the emerging pattern of "say-on-pay" lawsuits being settled, it may be some time before a court renders a final decision on whether the claims have any legal merit. Even though we believe it is unlikely that directors would be held liable in these cases solely because executive compensation is, from the viewpoint of shareholders, excessive, boards should be mindful of the evolving risks associated with executive compensation practices and policies and pursue best practices to mitigate the risks of distraction and expense of shareholder litigation. Such best practices include the engagement of independent compensation consultants for the compensation committee and the use of tally sheets and performance-based bonuses and vesting criteria.

Jeff London
jlondon@kayescholer.com

Brian Witkowski
bwitkowski@kayescholer.com

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KAYE SCHOLER LLP

Diane Holt Frankle

Partner
Corporate

What Are the Board Duties in California and Delaware Regarding the Ability to Consider Competing Bids After A Merger Agreement Is Signed? Does Monty v. Leis Signal Different Rules for California Directors?

In *Monty v. Leis*, 193 Cal. App. 4th 1367, 123 Cal. Rptr. 3d 641 (Cal. Ct. App. 2011), the California Court of Appeals appropriately rejects a claim by two shareholders of a failing bank that the bank's board of directors breached its fiduciary duties to shareholders by failing to include in an investment agreement "a provision to back out of the deal if a better offer is made." In reaching this decision, the court reaffirms *Jewell, Inc. v. Payless Drug Stores Northwest, Inc.*, 741 F.2d 155 (9th Cir. 1984). In *Jewell*, the Ninth Circuit held that "under California law, a corporate board of directors may lawfully bind itself in a merger agreement to forbear from negotiating or accepting competing offers until the shareholders have had an opportunity to consider the initial proposal." 741 F.2d at 1564.

The investment agreement in *Monty* provided for the sale of preferred stock and common stock to obtain $500 million of much needed capital. The bank was under an order from the Comptroller of Currency and the Federal Reserve Board to improve its capital by a deadline expiring within about one month after the bank received a necessary approval of the Department of Treasury. This timeline did not permit a normal process to obtain shareholder approval of the transaction, and the bank received an exemption from NASDAQ from the stockholder approval requirements, asserting that the potential delay in obtaining shareholder approval would threaten the financial viability of the company. The terms of the preferred stock established by the board provided that the new preferred stock to be issued would be convertible into 2.275 billion shares of common stock. The bank's charter, not surprisingly, did not authorize sufficient shares of common stock to permit the conversion of the proposed new preferred, and shareholder approval would be required under California corporate law for an amendment of its articles to increase the authorized common. There was, however, sufficient common stock authorized to permit the issuance of the common stock being sold under the investment agreement. The bank, therefore, initially issued the common stock to the investor, which gave the investor a majority of the outstanding common stock. The investor then voted alone to amend the corporation's articles to increase the authorized common stock by the 2.275 billion required for the conversion of the preferred stock proposed to be issued under the investment agreement, and the preferred stock was thereupon also issued. The plaintiffs initially attacked the ability of the corporation to enter into the investment agreement without prior shareholder approval. The court properly held that the California Code does not require shareholder approval prior to entry by the corporation into such an investment agreement.

The plaintiff also argued in *Monty*, *inter alia*, that the bank directors breached their duty to the bank's shareholders by not including a provision allowing the bank to back out of the deal if a better offer were made. There was no allegation that a better deal was in fact available to the bank board. It appears instead that plaintiffs were objecting to the investment agreement without proposing or pointing to any alternative transaction.

One might have expected the plaintiffs to argue that the investment transaction was akin to a change of control transaction, since the agreement would result in the issuance of a controlling block of voting stock, even though it was not a business combination. Note that under Delaware law, once the Board has determined that a sale of control or breakup of the company is "inevitable," the duty of the directors is "the maximization of the company's value at a sale for the stockholders' benefit." *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986). California courts have yet to rule on whether so-called *Revlon* duties apply to directors of California companies. Even Delaware courts have held that a "stock for stock" merger, where a majority of the shares in the continuing entity will continue to be held after the merger by a "fluid aggregation of unaffiliated shareholders representing a voting majority," is generally not a sale of control triggering *Revlon* duties. This type of transaction is not considered a change of control because the target stockholders continue to have the opportunity to receive a control premium, even if the target stockholders will represent only a minority of the ongoing entity. *Paramount Communications, Inc. v. Time, Inc.* ("*Paramount*"), 571 A.2d 1140, 1151 (Del. 1989). This is true even when the target stockholders will represent only a very small percentage of the voting stock of the acquiror. *Arnold v. Society for Savings Bancorp*, 650 A.2d 1270, 1290 (Del. 1994). In a situation where a controlling block of stock is instead held by one shareholder following the business combination, however, Delaware courts have held that *Revlon* duties are triggered at the time of the consideration of such a transaction. *Paramount Communications v. QVC Network, Inc.* ("*QVC*"), 637 A.2d 34, 44 (Del. 1994).

Thus, under current Delaware law, the transaction considered in *Monty* might have subjected the directors of a Delaware corporation to enhanced scrutiny under *Revlon*, even though the transaction was not a business combination, and the current stockholders retained their later right to a change of control premium, given that the new stockholder would have a large majority of the voting power. It is interesting to note that in a recent transcript ruling, Vice Chancellor Laster considered a mixed cash and stock merger where the target stockholders end up with a 15% interest in the survivor of an "end stage" transaction from the standpoint of the target's stockholders and suggested that *Revlon* duties would apply, thus bringing into question earlier holdings that the ability to get a control premium as a stockholder of the buyer in the future would be sufficient for a transaction not to trigger *Revlon* duties, at least where the ongoing interest in the buyer is a relatively small minority interest. The Vice Chancellor noted that this transaction was the only opportunity for the fiduciaries to bargain as to how much of the future control premium their stockholders would get in the combined company. *Steinhart v. Howard-Anderson* (CA No. 5878- VCL) (Del. Ch. Jan. 24, 2011). *See also Reis v. Hazelett Strip-Casting Corp.*, 2011 Del. Ch. LEXIS 11 (Del. Ch. Jan. 21, 2011).

In any case, the court in *Monty* did not address an argument that the directors of the California corporation breached a duty akin to Delaware *Revlon* duties to obtain the best available price and terms. Even if plaintiffs had made that argument, however, as noted above, there is nothing in the reported facts to suggest that there was any alternative transaction, let alone one with superior terms, available to the bank — instead the impression left is that this transaction was one of last resort.[6] Nonetheless, the plaintiffs attempted to enjoin the transaction by arguing simply that the board should have retained the ability to back out of the investment agreement if a better deal did in fact come along. In rejecting the plaintiffs' argument, the California Court of Appeals reaffirmed the Ninth

[6] *See In Re Bear Stearns Litigation*, 23 Misc. 3d 447, 870 N.Y.S.2d 709, 2008 N.Y. Slip Op. 28500 (N.Y. Sup., Dec. 04, 2008) (distressed bank entered into an amended merger agreement pursuant to which JP Morgan, the buyer, was permitted to acquire a 39.5% interest in Bear Stearns, and Bear Stearns agreed to other deal protections including a no solicitation clause and an option for the sale of the headquarters building, and the court found that there was no evidence of a breach of the duty of loyalty and applied the business judgment rule, while also finding that if *Revlon* duties applied, the directors also met those duties). There the transaction passed with 71% of the vote, and the court noted that the transaction would have passed with 52% of the vote had the 39.5% interest acquired under the merger agreement been excluded.

Circuit's holding in *Jewell*. *Jewell*, where the Ninth Circuit applied California law, was decided before the Delaware Supreme Court issued its *Revlon* decision. It is therefore worth examining the implications of the *Jewell* and *Monty* cases to discern whether there is any divergence between the courts of Delaware and California as to the duties of directors with respect to the narrow issue raised in *Monty*, that is, the duty to retain an ability by the board to "back out" of a deal prior to shareholder approval, in the event that a better offer is made.

Contrary to plaintiff's assertion in *Monty*, Delaware courts do not impose a blanket requirement on directors of a Delaware corporation to retain a right to terminate a merger agreement in the period between signing and stockholder approval of a merger agreement. In fact, so long as a board of directors originally determines at the signing of the merger agreement that the transaction "is advisable," the board is permitted by Delaware statute to commit by contract to take the deal to the stockholders, even if the board later withdraws its recommendation or recommends against the transaction. Delaware General Corporation Law Section 146. This type of agreement is said to include a "force the vote" provision, although the "force the vote" impact results simply from the absence of the termination right on the part of the target company in the event of a superior proposal. Of course this structure is most powerful if the acquiror has voting agreements with stockholders representing a significant percentage of the voting stock of the target, and Delaware courts have cautioned that if the result of the provisions is that competing bids are precluded, the arrangements may breach the directors' duties to stockholders. *See Ace Limited v. Capital Re Corporation*, 747 A.2d 95 and fn. 55 (Del. Ch. 1999) (preclusive terms of a merger and stockholder agreement that locks up necessary votes may be unenforceable under *Unocal* test even in stock for stock transaction; "the result of the vote is foreordained because [the buyer] will no doubt prevail absent an out for the 33.5% holders."). In *Omnicare Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003), cited by the *Monty* plaintiffs, the Delaware Supreme Court held that the board of a Delaware corporation would breach its fiduciary duty by failing to negotiate a fiduciary termination right to terminate the merger agreement in the event of a superior proposal prior to stockholder approval, if there are in place voting agreements that commit a controlling voting block of shares to vote in favor of the merger. The *Omnicare* court reasoned that these voting agreements would effectively preclude a competing bid in light of the "force the vote" provision.

The court in *Monty* rejects the *Omnicare* case asserted by plaintiffs, without analyzing whether the holding is in fact applicable to the facts at hand. Thus, there were no preclusive voting agreements disclosed in *Monty*, nor was the transaction being approved a business combination. Instead, the transaction in question involved a two part transaction in which the investor legally obtained a majority of the voting power of the corporation by an investment of capital, and used that power to approve an increase in authorized common stock to support the issuance of additional preferred stock the investor intended to purchase; on the facts of the case both investments were made at what appeared to be fair market value. Given those distinguishing facts, it seems unlikely that *Omnicare's* holding had any application to the situation faced by the court in *Monty*. Plaintiff apparently simply asserted that directors were required to contract for a right to terminate the agreement pre-shareholder approval, although this is not a correct statement of the *Omnicare* holding nor consistent with Delaware law generally. Although the *Omnicare* ruling has been subject to significant judicial criticism, the *Monty* case simply did not present the opportunity for a rejection of its holding's application to California corporate law.

It is perhaps worth noting that Delaware courts have long held that a board of directors breaches its duty to stockholders in connection with a business combination transaction if the board contracts away its ability to consider information about competing deals prior to stockholder approval, through a so-called "no talk" provision. *Phelps Dodge Corporation v. Cyprus Amex Minerals Co.*, CA No. 17398, 1999 Del. Ch. Lexis 202 (Sept. 27, 1999). In *Phelps Dodge*, Chancellor Chandler held "the decision not to negotiate . . . must be an informed one," and that an agreement foreclosing all opportunity to discuss alternatives is "the legal equivalent of willful blindness." A "fiduciary out" to a no shop provision typically provides that the board has not only the right to consider a competing bid reasonably likely to lead to a superior proposal, but to discuss and negotiate the proposal, and to provide confidential information in connection with the proposal. This obligation to retain the right to consider a competing bid until stockholder approval can be distinguished from the separate right at issue in *Omnicare* to terminate a merger agreement prior to a stockholder vote in the event of a superior proposal. The Delaware courts' insistence on boards having a fiduciary out to a no talk provision seems linked logically to the board's duty of candor. Thus, a board in Delaware owes a duty to its stockholders to provide material information with respect to the matter being voted upon. In this context, "willful blindness" would prevent the board from satisfying that duty of candor to enable the stockholders to make an informed decision about the merger agreement being presented. *See also Ace Limited v. Capital Re Corporation*, 747 A.2d 95 (Del. Ch. 1999) ("No talk provisions . . . are troubling precisely because they prevent a board from meeting its duty to make an informed judgment with respect to even considering whether to negotiate with a third party.")

The Ninth Circuit similarly recognized in *Jewell* that under California law the board may not lawfully divest itself of its fiduciary obligations in a contract. 741 F.2d at 1563. The court in Jewel noted that the board may not, consistent with its fiduciary obligations to shareholders, withhold information regarding a potentially more attractive competing offer. Indeed, according to the Ninth Circuit decision in *Jewell*, the board may bind the corporation only temporarily and in limited areas pending shareholder approval. Shareholders remain free to accept or reject the merger proposal in light of another offer. *Id.* at 1564. Thus, *Jewell* does not support the right of a California board to agree to a "no shop" clause, which prevents the company from providing information to a competing bidder sufficient to permit the bidder to evaluate and formulate a competing bid, or to negotiate with a bidder offering a superior proposal. Further, the discussion in *Jewell* suggests that directors might be held to violate their fiduciary duties if they agreed to a merger agreement with break up fees that are triggered either on discussions with another party or a shareholder vote against the merger agreement. *See* 741 F.2d at 1563-1564. Further, it is clear that under California law the target board must retain its right to keep its shareholders fully informed of any competing bids. *Id*. Note, however, that *Jewell* does uphold a prohibition on negotiation as to a competing bid in the period between signing and closing, which could be viewed in the worst light as a limitation on the board's ability to be fully informed. The *Jewell* case makes clear, however, that the board has the duty to keep shareholders informed.

The issue of the board's right to consider alternative transactions is not typically raised in the context of a stock purchase or investment agreement, because following the board's decision to enter into the agreement, the board has the right to issue the stock without stockholder approval, absent the situation in *Monty* when insufficient authorized shares are available for the transaction. Where an investment is conditioned on stockholder approval for the increase in authorized capital, there is typically no contractual provision restricting the board's ability to consider other investment proposals. Indeed no such provision is alleged in *Monty*. The need for a stockholder vote in this context would typically be viewed as protecting the existing stockholders from dilution beyond the previously agreed upon authorized capital. In *Monty*, the board complied with the technical requirements under California corporate law for stockholder approval of the amendment, however, by using a two step investment, where the investor purchased sufficient shares to provide it with voting power to approve the increase in the authorized capital. There is nothing illegal about this two step transaction, and the facts do not suggest that the board otherwise acted improperly given the apparent lack of alternatives available to the bank.

It appears that in *Monty* the court reached the appropriate conclusion that the transaction for the sale of the common and preferred stock did not give rise to a breach of the directors' fiduciary duties. The board did not apparently contract away its right to consider a different and superior investment transaction (a "no-talk" provision which would have been illegal under Delaware law), and further there were no voting agreements in place with controlling stockholders that would have triggered *Omnicare* duties for a Delaware corporation. Instead, the board apparently approved the best investment deal available for the bank, and the fact that it was a two step transaction did not violate the board's fiduciary duties or California law. The *Monty* court's affirmation of the *Jewell* decision simply reaffirms that, just like Delaware directors, California directors are permitted to have corporations enter into binding agreements subject to stockholder approval and forego the right to terminate such agreements pending stockholder approval, at least so long as the California board retains the ability to consider new information and communicate any material change in facts to its shareholders in advance of a vote.

Diane Holt Frankle
diane.frankle@kayescholer.com

Steven Canner

Partner
Corporate

Konstantinos Yiannopoulos

Associate
Corporate

U.S. Court of Appeals for the Second Circuit Leaves More Questions than Answers in CSX Corporation v. The Children's Investment Fund Management (UK) LLP

The U.S. Court of Appeals for the Second Circuit issued its long-awaited opinion in *CSX Corporation v. The Children's Investment Fund Management (UK) LLP*. Those seeking clarity as to whether cash-settled equity swap agreements would trigger reporting requirements under Section 13(d) will continue to wait, as the Second Circuit declined to take the opportunity to resolve the issue. The Second Circuit did, however, weigh in on whether the defendants in the case formed a "group" as a result of their activities and whether "sterilization" (*i.e.*, elimination of voting rights) of the defendants' shares was an appropriate remedy.

In a cash-settled equity swap agreement, two parties attempt to replicate the positions of a long and a short investor in a particular stock, without transferring title to, or requiring a party to own, any shares. The "long party" receives from the "short party" cash in an amount equal to the increase in the value of the shares during a specified period plus any other amounts that would have been received by the long party had the long party owned the shares (such as dividends), while the short party receives from the long party interest accrued on an agreed notional amount plus the amount of any decrease in the value of the shares during such period. In order to hedge against potential risk of loss, the short party typically will (but is usually not required to) acquire shares of the stock.

The District Court bypassed the opportunity to directly rule on whether the defendants (the long parties in the cash-settled equity swap agreement at issue) would have beneficial ownership of the shares acquired by the short parties to hedge their positions. Similarly, on appeal, the Second Circuit did not opine on this issue, citing that the panel was divided on "numerous issues" surrounding the matter.

Judge Ralph Winter, however, in a concurring opinion, directly and clearly addressed the issue. Judge Winter found that the swap agreements, alone, did not convey to the long party beneficial ownership of the shares acquired by the short party to hedge its position. Judge Winter concluded that, absent an agreement obligating the short party to acquire the shares as a hedge, sell such shares to the long party at a given time or vote the shares as indicated by the long party, the long party lacked the investment power or voting power necessary to confer beneficial ownership.

Regarding the issue as to whether the defendants formed a "group" under Section 13(d) with respect to the CSX securities, the Second Circuit determined that the District Court's findings were insufficient for proper appellate review because the District Court did not find that a group was formed between the two long parties (*i.e.*, TCI and 3G) explicitly "for the purpose of acquiring CSX securities." Moreover, the Second Circuit noted that the District Court "did not distinguish in its group finding between CSX shares deemed beneficially owned by [TCI and 3G] and those owned outright by [TCI and 3G]." Thus, the Second Circuit remanded the case to the District Court for further findings on this issue solely with respect to the shares owned "outright" by TCI and 3G, and to reconsider the granting (and scope) of injunctive relief in the event the District Court held that a "group" existed and violated Section 13(d). The Second Circuit indicated that in order to determine if a group was formed, the District Court needed to focus on whether there was "sufficient direct or circumstantial evidence to support the inference of a formal or informal understanding between [members] *for the purpose of acquiring, holding, or disposing of securities*."

The Second Circuit affirmed the District Court's holding that "sterilization" of the CSX shares held by the defendants was not an available remedy. In affirming the ruling, the Second Circuit cited precedent and the intent of the Williams Act to allow public stockholders to have adequate information to make informed decisions with respect to their shareholdings and to make "disclosure . . . the preferred method of market regulation." Given that the defendants made Section 13(d) disclosure approximately six months prior to the CSX shareholders' meeting, the Second Circuit found that sufficient time was given for such shareholders to make an informed decision.

Unfortunately, the wait continues for the investment community to obtain clarity as to whether and when cash-settled equity swap agreements and similar instruments confer beneficial ownership upon the long party.

Steven Canner
scanner@kayescholer.com

Konstantinos Yiannopoulos
kyiannopoulos@kayescholer.com

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Chicago Office
+1.312.583.2300

Frankfurt Office
+49.69.25494.0

London Office
+44.20.7105.0500

Los Angeles Office
+1.310.788.1000

New York Office
+1.212.836.8000

Palo Alto Office
+1.650.319.4500

Shanghai Office
+86.21.2208.3600

Washington, DC Office
+1.202.682.3500

West Palm Beach Office
+1.561.802.3230