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SEC Guidance on Unbundling in M&A Context

When Merger Parties Must Include Unbundled Vote on Amendment to Acquiror's Organizational Documents

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On October 27, 2015, the SEC issued new Compliance and Disclosure Interpretations (the 2015 C&DIs) regarding unbundling of votes in the M&A context. The 2015 C&DIs address the circumstances under which either a target or an acquiror in an M&A transaction must present unbundled shareholder proposals in its proxy statement relating to provisions in the organizational documents of the public company that results from the deal. The 2015 C&DIs replace SEC guidance given in the September 2004 Interim Supplement to Publicly Available Telephone Interpretations (the 2004 Guidance). According to public

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statements of the SEC, and contrary to perceptions created by the news media,[1] the 2015 C&DIs represent a slight change from, and clarification to, the 2004 Guidance. The following is a brief overview of the unbundling rules, a summary of key differences between the 2015 C&DIs and the 2004 Guidance, and some observations about the practical implications of the changes.

Background of Unbundling

The unbundling proxy rule, Rule 14a-4(a)(3) under the Securities Exchange Act of 1934, as amended (the Exchange Act), requires that the form of proxy "identify clearly and impartially each separate matter intended to be acted upon." Rule 14a-4(b)(1) under the Exchange Act requires that the form of proxy provide a means for shareholders "to specify by boxes a choice . . . with respect to each separate matter" to be voted on. This means, for example, that issuers seeking shareholder approval for charter amendments need to consider whether the amendments can be bundled together in one proposal, or need to be broken out into different proposals.

The unbundling proxy rule, Rule 14a-4(a)(3) under the Securities Exchange Act of 1934, requires that the form of proxy "identify clearly and impartially each separate matter intended to be acted upon."

The unbundling proxy rule was adopted by the SEC in 1992, in part in response to the wave of dual class recapitalizations being undertaken as a defense against hostile takeovers. Management would obtain shareholder approval for recapitalizations that were implemented in order for management to obtain high voting stock. Charter amendment proposals, which were required in order to create the high vote stock, were often bundled with various sweeteners, such as increased cash dividends to shareholders, if the proposals were adopted.

2004 Guidance

In 2004, the SEC published guidance on application of the unbundling rule to M&A transactions. The 2004 Guidance was intended to "assist companies in determining when charter, bylaw or similar provisions need to be set out separately on the form of proxy in the context of mergers, acquisitions, and similar transactions." For illustrative purposes, the 2004 Guidance can be considered in the context of two scenarios: triangular mergers (reverse or forward), and double dummy mergers, where the parties form a new publicly-traded holding company (holdco) and the two merging companies become subsidiaries of holdco.[2] For triangular mergers, the 2004 Guidance involved a two-step approach. The first step involved looking to see whether the acquiror in the transaction required an unbundled vote on an amendment to its organizational documents. Consistent with the SEC's guidance in the non-M&A context,[3] if the amendment to the acquiror's

[1] See, e.g., Steven Davidoff Solomon, Regulators Unbundle Some Attractions of Mergers, N.Y. Times (Nov. 3, 2015) (describing the 2015 C&DIs as the SEC's reaction to a number of inversion transactions, including that of Mylan Inc., which resulted in Mylan obtaining a governance structure that helped it to thwart a hostile takeover attempt by Teva Pharmaceutical Industries Ltd.).

[2] This article discusses triangular mergers and double dummy mergers for illustrative purposes only. There are other structures, such as transactions involving asset transfers or schemes of arrangement, where the unbundling rules may also apply.

[3] The SEC clarified its general approach to unbundling in C&DIs issued in 2014. These C&DIs came in the wake of a federal court decision in *Greenlight Capital, L.P. v. Apple, Inc.*, 2013 WL 646547 (S.D.N.Y. Feb. 22, 2013), where the court enjoined Apple from combining four charter amendments into a single shareholder proposal. In its 2014

organizational documents involved provisions that were immaterial (or the acquiror was not amending its organizational documents in the deal), then no unbundled acquiror shareholder vote would be required. In that case, the target also would not require a vote of its shareholders on the amendment to the acquiror's organizational documents.[4]

If an unbundled acquiror shareholder vote was required under the 2004 Guidance, then, as the second step, a comparison had to be made of the new provisions in the acquiror's organizational documents to the provisions of the target's organizational documents. If the new provisions were not contained in the target's organization documents, and state law, stock exchange rule or the target's organizational documents would require shareholder approval if the provisions were presented on their own, then an unbundled target shareholder vote on the provisions was also required. If, on the other hand, the new provisions (or comparable provisions) were already contained in the target's organizational documents, then no target shareholder vote on the provisions was required. A target shareholder vote was also not required if the target's shareholders were only receiving cash in the merger.

This two-step approach was fairly easy to understand and plan around for triangular mergers. Moreover, most triangular mergers proceed without any shareholder approval-required amendment to the acquiror's organizational documents. The main exception to this general rule is an amendment to the acquiror's charter in order to authorize shares to be issued in the transaction. But the SEC has generally carved this out from application of the unbundling rules.[5]

Based on a review of SEC comment letters, more issues appear to have arisen in the application of the test to double dummy mergers. Under the 2004 Guidance, the SEC has applied the test separately to each party. Each party's pre-merger organizational documents were compared to those of holdco. For each party, if there were no differences between the material provisions of that party's organizational documents and those of holdco (or if the provisions were comparable), then no shareholder vote on the provisions was required. If, on the other hand, there were

C&DIs, the SEC clarified, among other things, that while proposals on separate matters generally need to be unbundled:

- Immaterial matters may typically be bundled with a material matter. For example, charter amendments to change the par value of common stock and eliminate provisions relating to preferred stock that is no longer outstanding may ordinarily be bundled with amendments to declassify a board. (In a nod to the *Apple* decision, the SEC cautioned that if management knows or has reason to believe that an immaterial amendment is nonetheless one on which shareholders could reasonably be expected to want an unbundled vote, the vote should be unbundled.)
- Multiple matters that are "inextricably intertwined" do not need to be unbundled. For example, a charter amendment that both reduces the dividend rate of preferred stock and extends its maturity date does not need to be unbundled into two proposals.

[4] The 2004 Guidance lists "corporate governance-related and control-related provisions" as the type of organizational document provisions that generally would need to be unbundled. Unbundling would not be required in a number of situations, such as for bylaw provisions that can be amended by the board of directors, name changes, restatements, mere technical changes to organizational documents, and changes to implement a nonvoting class of securities that would be issued as part of the merger consideration. In SEC comment letters, the SEC has also created an exception to the unbundling requirement, in the context of double dummy mergers, with respect to provisions in holdco's organizational documents that are required by law in the jurisdiction of holdco's formation. The SEC has included such an exception in the 2015 C&DIs.

[5] The 2015 C&DIs specify that an amendment to increase the number of authorized shares of the acquiror's equity securities will not be subject to the unbundling requirement, provided that the increase is limited "to the number of shares reasonably expected to be issued in the transaction."

such differences, and state law, stock exchange rule or that party's organizational documents would require shareholder approval if the provisions were presented on their own, then an unbundled vote of that party's shareholders on the provisions was required.

Based on a review of SEC comment letters, more issues appear to have arisen in the application of the test to double dummy mergers.

The greater number of issues in connection with double dummy mergers may be due in part to some ambiguities in the text of the 2004 Guidance. It is possible to conclude, based solely on the text of the 2004 Guidance, that the SEC applied the test for double dummy mergers in a way different from that described above. Another possible reason for the greater number of issues arising in connection with double dummy mergers is that they are more likely to involve changes to organizational documents. When parties undertake a double dummy merger, they are creating a new entity to serve as the resulting publicly-traded entity. There may be a sense among practitioners that they are less constrained by the existing provisions of the deal parties' organizational documents than is the case for triangular mergers. Moreover, holdco's charter is typically adopted before the deal closes, at a time when holdco has no shareholders to consider.

The test under the 2004 Guidance also appears more likely to trigger the need for an unbundled vote with respect to double dummy mergers, compared to triangular mergers. Under the 2004 Guidance, in a double dummy merger, if one deal party had a staggered board and the other did not, and holdco had a staggered board, then the deal party without a staggered board required an unbundled staggered board proposal. However, if the transaction was structured as a reverse triangular merger, and the party with the staggered board was the acquiror, then neither party required an unbundled staggered board proposal. If no unbundled shareholder vote was required, then questions under the 2004 Guidance were less likely to arise.

The 2015 C&DIs

The 2015 C&DIs clarify and supersede the 2004 Guidance. There appear to be two main differences from the 2004 Guidance. Pursuant to C&DI 201.01, only the first step in the old two-step approach for triangular mergers is undertaken, and the second step has been discarded. In other words, an inquiry is made into whether an unbundled shareholder vote of the acquiror is required (or would be required if the acquiror were conducting a proxy solicitation). If it is, then an unbundled shareholder vote of the target's shareholders is also required. If it is not, then no unbundled shareholder vote of the target's shareholders is required.

There appear to be two main differences from the 2004 Guidance. Pursuant to C&DI 201.01, only the first step in the old two-step approach for triangular mergers is undertaken, and the second step has been discarded.

This change simplifies the test for triangular mergers, but can produce a different outcome from the 2004 Guidance. For example, to go back to the staggered board example, the target's shareholders may now need an unbundled vote on a staggered board proposal

even if the target's charter already provides for a staggered board. The fact that the target's charter already provides for a staggered board is simply not factored into the analysis.

The SEC's perspective, as set forth in C&DI 201.01, is that the change to the acquiror's charter "is a term of the transaction agreement that target shareholders are being asked to approve, [and] would effect a material change to the equity security that target shareholders are receiving in the transaction. Target shareholders should have an opportunity to express their views separately on these material provisions that will establish their substantive rights as shareholders, even if as a matter of state law these provisions might not require a separate vote." In other words, the SEC looks at what the target's shareholders are receiving under the merger agreement, and if it involves acquiror securities, the terms of which are being materially amended, then the target's shareholders are entitled to a vote on the amendment unbundled from their vote on the merger agreement. This rationale also has implications for the voting standard, as described under "Voting Implications for Target's Unbundled Proposal", below.

The second difference from the 2004 Guidance is double dummy mergers are now treated similarly to triangular mergers, with "the party whose shareholders are expected to own the largest percentage of equity securities of the new entity following consummation of the transaction" being considered the acquiror for purposes of the analysis.

The second difference from the 2004 Guidance is set forth in C&DI 201.02. Under that C&DI, double dummy mergers are now treated similarly to triangular mergers, with "the party whose shareholders are expected to own the largest percentage of equity securities of the new entity following consummation of the transaction" being considered the acquiror for purposes of the analysis.[6] In other words, an inquiry is made into whether an unbundled shareholder vote of the deemed acquiror is required. If it is, then an unbundled shareholder vote of the deemed target's shareholders is also required. If it is not, then no unbundled shareholder vote of the deemed target's shareholders is required. This C&DI clearly sets out the new test, and thus should resolve some of the confusion arising under the 2004 Guidance with respect to double dummy mergers.

Outcomes May Differ Between the 2004 Guidance and the 2015 C&DIs

The table included on Annex A compares the outcome under the 2015 C&DIs with the outcome under the 2004 Guidance. It assumes that the public entity resulting from the merger (i.e., either parent in a triangular merger or holdco in a double dummy merger) has a staggered board, and looks at whether an unbundled vote would be required of either the acquiror's shareholders or the target's shareholders, where either, both, or neither of the merging parties has a staggered board prior to the merger. Three points stand out from the table:

- First, application of the new test may produce different results from the old test. For a triangular merger, it may require an unbundled target shareholder vote where

[6] Parties in transactions involving multiple classes of stock may need to seek additional clarification from the SEC on the meaning of the phrase "largest percentage of equity securities."

none was required before. For a double dummy merger, it produces a different result in several scenarios.

- Second, for each deal structure under both the 2004 Guidance and the 2015 C&DIs, there remains an equal number of "Y" entries as "N" entries. Thus, the new test does not appear to require unbundled votes in a greater percentage of scenarios than in the past.
- Third, in the case of double dummy mergers where the target's shareholders are expected to hold the majority of holdco's equity after closing, the target's shareholders will get an unbundled vote if the target does not have a staggered board prior to closing. This is true under both the old test and the new one. This is the situation most implicated by inversion transactions, which are often structured as double dummy mergers. Thus, the likelihood of requiring an unbundled vote for the US company's shareholders in an inversion transaction does not appear to change under the new test.

Voting Implications for Target's Unbundled Proposal

At first blush, one of the oddities about requiring a vote of the target's shareholders on an amendment to the acquiror's charter is that such a vote is unlikely to be required under the charter amendment provisions of the corporation law of the acquiror's jurisdiction of formation. The target's shareholders will not become shareholders of the acquiror until after completion of the transaction, which is after the vote will have taken place. Questions also arise as to what the appropriate voting standard is, and what the consequences are of the target's shareholders not approving the amendment.

For example, consider again a reverse triangular merger in which the acquiror, a Delaware corporation, is amending its charter to implement a staggered board. The vote required of the acquiror's shareholders will be a majority of the outstanding shares entitled to vote (assuming no higher vote is required under the acquiror's charter). But what vote will be required for the corresponding unbundled proposal of the target's shareholders on the acquiror's charter amendment? Whatever that vote is, what if the target's shareholders do not approve the proposal? Will it mean that the acquiror's amendment is invalid?

The SEC has not addressed these questions in either the 2004 Guidance or the 2015 C&DIs. According to its public statements, the SEC views questions about the voting standard as involving applicable corporation law and not the federal proxy rules. However, the SEC has been clear in its public statements that it does not view the target shareholder vote obligation as arising under the charter amendment provisions of the applicable corporation law. Instead, it views the obligation as arising under the merger agreement, which typically sets forth the acquiror's obligation to obtain the charter amendment.[7]

If the charter amendment is not unbundled at the target shareholders' meeting, the target's shareholders will be voting to approve the charter amendment when they vote to adopt the merger agreement. Therefore, according to this view, when the charter amendment is

[7] In its public statements, the SEC has made clear that the vote on the acquiror's charter amendment is being unbundled from the vote on the merger. The proxy rules do not provide the SEC with authority to require a vote on a matter on which the target's shareholders are not already voting. The unbundling rules simply provide for unbundling a proposal from an existing proposal on which the target's shareholders are already voting.

unbundled, it remains subject to the same approval requirement as the merger agreement, that is, for a Delaware target corporation, approval of a majority of the outstanding shares entitled to vote. Note, however, that there are plenty of examples of mergers that the SEC has reviewed where the targets took the view that the appropriate standard was the default voting standard under Delaware law and the target's bylaws (which is generally easier to satisfy than a majority of outstanding shares). The SEC has not pressed the issue in the past, and nothing in the 2015 C&DIs suggests that it is likely to do so in the future.

"The SEC has recently publicly stated that it . . . would not object if a target company took the position in its proxy statement that the [unbundled] vote was precatory."

A separate issue is what the consequences are of failure of the target's shareholders to approve the charter amendment. In comment letters, the SEC has required targets to describe the consequences in the proxy statement. Targets appear to have generally addressed the issue by including language in the proxy statement to the effect that the acquiror will not proceed with the charter amendment if the target's shareholders do not approve it. It is theoretically possible for a target company to state in the proxy statement that it views the vote as precatory and nonbinding on the acquiror, and that the acquiror will be free to implement the charter amendment if the target's shareholders do not approve it. The SEC has recently publicly stated that it views this issue as arising under state law, and would not object if a target company took the position in its proxy statement that the vote was precatory.

Conditioning Completion of the M&A Transaction on Approval of Unbundled Proposals

The SEC has made clear under both the 2004 Guidance and the 2015 C&DIs that completion of the M&A transaction can be conditioned on shareholder approval of the unbundled proposals. This simplifies the analysis regarding the voting implications for the target's unbundled proposals because it leaves the transaction in the same position, from a target shareholder approval perspective, as would be the case if the proposals were bundled. If the proposal were bundled, then the target's shareholders would simply be voting on a proposal to adopt the merger agreement, which, assuming Delaware law, would typically require approval of holders of a majority of the outstanding shares entitled to vote. If the charter amendment were unbundled and subject to the same voting standard, then it would be rational for shareholders to approve the charter amendment (even if they were not in favor of it), if they wanted the merger to be completed and understood that failure to approve the charter amendment would mean the merger would not be completed.

If, as a result of cross conditioning, the unbundling rules do not make shareholder approval of a transaction any more difficult to obtain, then who do the rules benefit? The SEC has repeatedly stated, including in both the 2004 Guidance and the 2015 C&DIs, that the unbundling rules are intended to provide shareholders a means to communicate their views to the board of directors. It will not be lost on boards of directors that activist shareholders and proxy advisory firms may also be beneficiaries of the unbundling rules, given the new platform it affords them.

Practical Implications

The 2015 C&DIs do not introduce any significant new hurdles to obtaining shareholder approval in M&A deals. They should, however, provide greater clarity for those deals where the unbundling issue may arise. For practitioners, this will make it easier to structure transactions where the need for an unbundled proposal can be factored in at the outset. This will spare practitioners from the embarrassment of first learning of the issue in an SEC comment letter. Greater clarity could also potentially lead to greater deal certainty. For example, if a target were unaware of the need to include an unbundled vote on an acquiror charter amendment at the time of signing the merger agreement, it could result in a breach of its representations under the merger agreement regarding the shareholder approval required to complete the deal. If the deal were to go south, the acquiror could attempt to use the breach as leverage in trying to get out of, or renegotiate, the deal.

The 2015 C&DIs also shine a spotlight on an area that could attract activists. In the non-M&A context, unbundling was recently used by an activist, Greenlight Capital, in its campaign against Apple, Inc. It would, therefore, not be a surprise to see it appear more frequently in the activists' toolkit in those M&A campaigns (albeit small in number) to which the 2015 C&DIs apply. Note, however, that if activists do agitate, the parties may be able to diffuse the situation by dropping the charter provision that is driving the need for an unbundled vote (as many deal parties have done in navigating the SEC comment process under the 2004 Guidance).

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Annex A
Comparison of Outcomes Under 2004 Guidance and 2015 C&DIs

	2004 Guidance				2015 C&DIs					
	Triangular Merger		Double Dummy		Triangular Merger		Double Dummy (A)		Double Dummy (T)	
	Unbundled vote?		Unbundled vote?		Unbundled vote?		Unbundled vote?		Unbundled vote?	
	A	T	A	T	A	T	A	T	A	T
Pre-merger status										
A(staggered) + T(staggered)	N	N	N	N	N	N	N	N	N	N
A(staggered) + T(non-stag.)	N	N	N	Y	N	N	N	N	Y	Y
A(non-stag.) + T(staggered)	Y	N	Y	N	Y	Y	Y	Y	N	N
A(non-stag.) + T(non-stag.)	Y	Y	Y	Y	Y	Y	Y	Y	Y	Y

Explanation:

The above table illustrates the different outcomes between the 2004 Guidance and the 2015 C&DIs with respect to triangular mergers and double dummy mergers where the public company that results from the deal (i.e., the parent entity in a triangular merger and holdco in a double dummy merger) has a staggered board. Four scenarios are considered, as indicated by the labels in the first column: where both the acquiror and the target have staggered boards before the merger, where neither party has a staggered board, and where one party does but the other does not. In the case of double dummy mergers under the 2015 C&DIs, two scenarios are considered: one where the acquiror is the party whose shareholders are expected to own the largest percentage of holdco's equity securities (Double Dummy (A)), and the other where the target is expected to own the largest percentage of holdco's equity securities (Double Dummy (T)). The letter "Y" indicates that unbundling is required, and "N" indicates that it is not required.