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IN THIS ISSUE

In Re El Paso Corporation Shareholder Litigation Demonstrates the Risks of Serious Management and Financial Advisor Conflicts and the Value of Effective Board Supervision of Acquisition Transactions

A recent Delaware Chancery Court decision reminds us yet again of the risks to deal consummation posed by serious conflicts of interest of management and financial advisors, as well as the critical role played by a board of directors in managing such conflicts of interest. *In Re El Paso Corporation Shareholder Litigation*[1], addresses the conflicts arising in the sale of El Paso Corporation (El Paso), a publicly held corporation, to Kinder Morgan.

Chancellor Strine noted a number of conflicts of interest raised by this transaction, including:

- The CEO of El Paso, who was the key negotiator for El Paso in the merger transaction approved by the Board, had disclosed to the El Paso Board neither his interest in developing a bid with others in his management team to buy from Kinder Morgan the El Paso exploration and production (E&P) business which the El Paso Board had proposed to spin off, nor his contacts to Kinder Morgan's CEO about this proposed separate transaction;
- The El Paso Board relied on advice from Goldman Sachs, knowing that Goldman owned 19 percent of Kinder Morgan (a $4 billion investment) and controlled two Kinder Morgan Board seats; and
- A second investment bank, Morgan Stanley, was engaged by the El Paso Board in light of Goldman's known conflicts noted above, but:
    - Goldman Sachs continued to advise on strategic alternatives, and provided advice on the El Paso proposed spinoff of the E&P business, including valuation analyses used in evaluating the Kinder Morgan deal;
    - Goldman Sachs intervened in the negotiation of the terms of the second bank's engagement to assure that Morgan Stanley only received compensation if El Paso chose the Kinder Morgan deal; and
    - The lead Goldman Sachs banker did not disclose that he personally owned approximately $340,000 of Kinder Morgan stock.

[1] *In Re El Paso Corporation Shareholder Litigation*, 2012 Del. Ch. LEXIS 46 (Del. Ch. Feb. 29, 2012)

Chancellor Strine noted that the record shows a number of debatable negotiating and tactical decisions which nonetheless, absent a conflict of interest, would not have raised concerns. Given that the CEO and Goldman Sachs, the Board's long-time and trusted financial advisor, had serious conflicts of interest, the decisions by each of the CEO and Goldman Sachs were viewed as potentially "compromised by the conflicting financial incentives of these key players." Although Chancellor Strine declined to grant a preliminary injunction, he found that plaintiffs had a reasonable likelihood of success on the merits in proving a breach of the duty of loyalty, thus potentially exposing the defendants to claims for damages post-closing. The decision not to enjoin was based on the Chancellor's conclusion that the stockholders had a choice to turn down the merger and the Chancellor's unwillingness to remove a premium bid from the stockholders, given that no alternative bid on the table existed.

The record provides some examples of the types of decisions made by the negotiators which were subject to serious second-guessing in light of the conflicts by the CEO and Goldman Sachs:

- Kinder Morgan made what appeared to be an attempt at a preemptive bid for El Paso following El Paso's announcement of an intent to sell the E&P business and then threatened to go public, but instead of calling Kinder Morgan's bluff and permitting a public auction to develop, El Paso's CEO entered into negotiations with Kinder Morgan.

- The El Paso Board knew, in failing to shop the deal, that Kinder Morgan was attempting to prevent competition for El Paso in a normal sales process, and that there could be a number of bidders for the E&P business or the balance of the El Paso business, but no likely bidders for El Paso as a whole, but did not contact alternative buyers for either of the businesses to see if there was any significant interest in, and possibly more attractive bids, from those other possible buyers.

- Kinder Morgan then backed off its price, asserting that it had relied on aggressive analyst projections. El Paso did not call its bluff, settling for a lower price for El Paso without any significant pushback.

- The parties negotiated a no-shop clause that prevented El Paso from entertaining any proposal for the E&P business, while continuing as an independent company, despite the fact that this sale and continuation of the balance of El Paso was the previously announced strategy of the Board, and the only realistic alternative to the transaction with Kinder Morgan.

- The Board allowed the CEO to pursue the merger negotiations without close supervision by independent bankers or directors.

- The Board concluded that the deal proposed by Kinder Morgan, although for a lower amount than the original deal proposed, was still more favorable than the one originally proposed by itself—the previously announced spinoff of El Paso's E&P business. The Board's conclusion was based in large part on a valuation analysis by the conflicted banker, Goldman Sachs, on the value of the spinoff.

Although Chancellor Strine declined to grant a preliminary injunction, he found that plaintiffs had a reasonable likelihood of success on the merits in proving a breach of the duty of loyalty, thus potentially exposing the defendants to claims for damages post-closing.

Lessons for Boards of Directors Today

- If a board entrusts a CEO as sole or key negotiator for a merger deal, consider carefully that CEO's reasonably anticipated potential conflicts of interest. Inquiries as to such conflicts should take place at the beginning of the deal negotiations. Keep in mind that management is virtually certain to have conflicts arising in any sale of control, resulting from its employment status or agreements governing compensation in a change of control. Here, beyond those employment-related conflicts, the Board apparently never asked the CEO if he was interested in buying the spun-out E&P business, although it seems reasonably anticipated that management would have some interest in taking over that business.

- To address the conflicts of interest, the Board could have interposed a Morgan Stanley banker and/or an independent director or committee to review the proposed deal and the full range of strategic and tactical decisions in the negotiations, such as the appropriate response to Kinder Morgan's puzzling reduction of its initial preemptive proposal. Goldman encouraged the El Paso Board to avoid a hostile situation with Kinder Morgan, but not only did Goldman have conflicts, but the CEO also had undisclosed incentives not to negotiate the highest price for El Paso, including his interest in leading a management buyout of the E&P business. An independent board or banker could have pushed harder to consider alternative strategies.

If a board entrusts a CEO as sole or key negotiator for a merger deal, consider carefully that CEO's reasonably anticipated potential conflicts of interest. Inquiries as to such conflicts should take place at the beginning of the deal negotiations.

- If a conflict of interest with a trusted bank advisor arises, and a second bank is engaged, shift the board's attention and allegiance to the second, unconflicted bank and negotiate engagement terms that provide incentives for unconflicted advice. In this case, the Board could have attempted to negotiate away Goldman's exclusivity, or could have paid Morgan Stanley a fee if the spinoff transaction was chosen, or could have agreed to pay a flat advisory fee credited against the transaction fee if the sale to Kinder Morgan was the alternative chosen.

- If a bank has a conflict of interest causing it to favor a particular transaction, the board should view the bank's advice about alternatives to such deal with skepticism. Thus, the advice Goldman gave about the value of the spinout to El Paso stockholders has to be judged in light of what Goldman stood to gain if the Kinder Morgan deal was chosen.

- Ask banks about individual banker conflicts. Here, the Goldman banker likely would have disclosed his personal interest in Kinder Morgan if he had been asked.

If a bank has a conflict of interest causing it to favor a particular transaction, the board should view the bank's advice about alternatives to such deal with skepticism.

- Negotiate deal lockups with an eye to the most likely alternative transactions. Although the formulation of the definition of superior proposal was not "off market" in requiring a proposal for a majority of the stock or assets of the company to be the subject of such proposal, the alternative actively being considered by the El Paso Board was a spinoff of slightly less than 50% of the El Paso business. It made little sense to prohibit El Paso from talking to bidders about a deal for the E&P business as that was the most likely alternative transaction considered by the El Paso Board.

The El Paso decision, while not resulting in an injunction, provides useful lessons for boards of directors dealing with conflicts of interest.

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The question of whether an officer performs "policy-making functions" is a factual one and companies should carefully analyze which officers fits into this category.

What's In A Name? The Disclosure Implications of Being an "Officer," "Executive Officer" or "Named Executive Officer" Under SEC Rules

The rules and regulations of the Securities and Exchange Commission (SEC) require specific disclosures for officers of a company who are "Executive Officers." There are additional requirements for those officers who are deemed "Named Executive Officers" or those officers deemed "Officers" under Section 16 of the Securities Exchange Act of 1934, as amended (the Exchange Act). Further, the SEC imposes Form 8-K reporting obligations for events involving certain principal officers.

When companies have numerous officers (for example, several vice presidents), they need to carefully consider into which of these categories these individuals fit to ensure that proper disclosures are made for each officer. This article serves as a quick primer on the definitions of each of these officer classifications, along with the disclosure implications of each classification.

Section 16 "Officers"

Definition. The term "Officer" is defined in Rule 16a-1 of the Exchange Act as a company's president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice president of the company in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions for the company. The question of whether an officer performs "policy-making functions" is a factual one and companies should carefully analyze which officers fit into this category. It is also important to note that Rule 16a-1 specifies that officers of the company's parent(s) or subsidiaries shall be deemed officers of the company if they perform such policy-making functions.

Rule 16a-1(f) provides that persons designated as Section 16 "Officers" by the board of directors of the company are presumed to be the only company officers subject to Section 16. Boards of directors should take advantage of this presumption by affirmatively deciding (at least annually) who their Section 16 "Officers" are. More importantly, a board resolution naming Section 16 "Officers" is an effective tool for the company's legal team to help ensure compliance with SEC reporting requirements.

Disclosure Implications. Individuals that are deemed Section 16 "Officers" are subject to that section of the Exchange Act, and are required to file Forms 3, 4 and 5 to report their beneficial holdings in the company regardless of how many shares they own.

"Executive Officers"

Definition. The definition of "Executive Officer" is found in Rule 3b-7 of the Exchange Act. That term tracks the definition of Section 16 "Officers" but does not specifically define the principal financial officer and the principal accounting officer/controller of the company as an "Executive Officer." Many companies will find that their lists of "Executive Officers" and "Officers" are identical; however, some companies may determine that the principal accounting officer does not have a policy-making function and, therefore, is not considered an "Executive Officer."

Please note that "Executive Officers" and "Named Executive Officers" lists will generally not match and most companies typically have more "Executive Officers" than "Named Executive Officers."

Disclosure Implications. Companies are required to disclose biographical information about their "Executive Officers" in Part III of their Annual Report on Form 10-K,which can be incorporated by reference to the company's proxy or information statements for its annual meetings of shareholders. Specifically, a company must disclose, pursuant to Item 401 of Regulation S-K:

- The names and ages of all their executive officers and all persons chosen to become executive officers;
- All positions and offices with the company held by each executive officer;
- The term of office of each executive officer and the period during which he or she has served as such;
- Any arrangement or understanding between any executive officer and any other person(s) (naming such person) pursuant to which such executive officer was or is to be selected as an officer; and
- Each executive officer's business experience during the past five years, including (a) his or her principal occupations and employment; (b) the name and principal business of any corporation or other organization in which such occupations and employment were carried on; and (c) whether such corporation or organization is a parent, subsidiary or other affiliate of the company.

"Named Executive Officers"

Definition. The most narrow of the three definitions is that of a "Named Executive Officer." For companies that are not Smaller Reporting Companies, Item 402(a)(3) of Regulation S-K defines "Named Executive Officers" as:

- All individuals serving as the company's principal executive officer or acting in a similar capacity during the last completed fiscal year (PEO), regardless of compensation level;
- All individuals serving as the company's principal financial officer or acting in a similar capacity during the last completed fiscal year (PFO), regardless of compensation level;
- The company's three most highly compensated executive officers other than the PEO and PFO who were serving as executive officers at the end of the last completed fiscal year; and
- Up to two additional individuals for whom disclosure would have been provided pursuant to the above bullet point but for the fact that the individual was not serving as an executive officer of the company at the end of the last completed fiscal year.

Most companies are aware that the appointment, termination, resignation or retirement of an executive officer is a reportable event and requires the filing of a Form 8-K, generally within four business days. However, what can be overlooked is that the Form 8-K reportable event is not limited to events involving "Executive Officers."

The definition of a "Named Executive Officer" for Smaller Reporting Companies, found in Item 402(m)(2) of Regulation S-K, is narrower. It does not specifically include the PFO and only encompasses two of the most highly compensated executive officers. Practically speaking, a PFO is usually still a Named Executive Officer for a Smaller Reporting Company because he or she is usually one of the two most highly compensated executive officers of the company.

Please note that "Executive Officers" and "Named Executive Officers" lists generally not match and most companies typically have more "Executive Officers" than "Named Executive Officers."

Disclosure Implications. Pursuant to Item 402 of Regulation S-K, companies are required to disclose their Named Executive Officers' compensation information in Part III of their Annual Report on Form 10-K (which can be incorporated by reference to the company's proxy or information statements for its annual meetings of shareholders). These disclosures include:

- A summary compensation table, disclosing the compensation of each "Named Executive Officer" for the past three years;
- A table disclosing grants of awards made to any "Named Executive Officer" in the last completed fiscal year under any plan;
- A narrative description of any material factors necessary to understand the information disclosed in the above two tables;
- A table disclosing unexercised options, stock that has not vested and equity incentive plan awards for each "Named Executive Officer" outstanding as of the end of the company's last completed fiscal year;
- A table disclosing each exercise of stock options, SARs and similar instruments, and each vesting of stock, including restricted stock, restricted stock units and similar instruments, during the last completed fiscal year for each of the "Named Executive Officers" on an aggregated basis;
- A table disclosing pension benefits and a table disclosing nonqualified defined contributions and other nonqualified deferred compensation plans of the "Named Executive Officers";
- Potential payments to the "Named Executive Officers" upon termination or a change of control; and
- In certain situations, a table disclosing golden parachute compensation of the "Named Executive Officers."

Please note, Smaller Reporting Companies are not required to disclose all of the above-listed items due to scaled-back compensation disclosure requirements.

Form 8-K Principal Officers

Definition and Disclosure Implications. Most companies are aware of that the appointment, termination, resignation or retirement of an executive officer is a reportable event and requires the filing of a Form 8-K, generally within four business days. However, what can be overlooked is that the Form 8-K reportable event is not limited to events involving "Executive Officers." Specifically, Item 5.02(b) of Form 8-K requires disclosure of the termination, retirement or resignation of a company's principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or any person performing similar functions, or any "Named Executive Officer." Item 5.02(c) of Form 8-K requires disclosure of the appointment of a new principal executive officer, president, principal financial officer, principal accounting officer, principal operating officer, or any person performing similar functions.

Because Form 8-K uses a combination of all three definitions, whenever a Section 16 "Officer," "Executive Officer" or "Named Executive Officer" is hired or terminated, or if he or she retires or resigns, an analysis must be conducted to determine whether a Form 8-K must be filed.

Because Form 8-K uses a combination of all three definitions, whenever a Section 16 "Officer," "Executive Officer" or "Named Executive Officer" is hired or terminated, or if he or she retires or resigns, an analysis must be conducted to determine whether a Form 8-K must be filed.

Conclusion

The analysis of which officers of a company are Section 16 "Officers," "Executive Officers" and "Named Executive Officers," and which officers will trigger Form 8-K filings, is complicated and impacts the accuracy of a company's filing obligations. The determinations are not solely based on title and the definitions, while they relate to one another, have subtle differences of which one must be cautious. As a matter of good corporate governance, the board of directors of a company should annually determine which officers are Section 16 "Officers," "Executive Officers" and "Named Executive Officers" after careful consideration of each definition. An annual determination will help ensure continued compliance with the company's SEC reporting obligations.

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While the upcoming elections will usher in a new Congress and determine whether President Obama serves a second term, the faces of the regulators in Washington have already begun to shift — as so often occurs in the 18 months prior to an election.

Elections, Transitions, and Antitrust: What Can Companies Expect from US Antitrust Enforcement Between Now and Mid-2013?

Election years bring major upheaval in Washington, DC, and these changes can materially affect businesses. Often, companies feel the most direct impact from leadership changes at government regulatory agencies than from the politicians standing for election. While the upcoming elections will usher in a new Congress and determine whether President Obama serves a second term, the faces of the regulators in Washington have already begun to shift—as so often occurs in the 18 months prior to an election.

Presidential appointees, such as Cabinet members and officials ranking one or two steps below agency heads, rarely serve for an entire administration. Appointees exit through the revolving door to private enterprise—typically after only two or three years in their positions—and new leaders are appointed, often in an "acting" capacity. The Antitrust Division of the US Department of Justice (DOJ) is no exception to this normal course of events.

What will the changes at the DOJ mean for businesses?

In the summer of 2011, Christine Varney resigned as Assistant Attorney General for Antitrust at the DOJ to return to private practice. Her deputy, Sharis Arnold Pozen, stepped in as Acting AAG for Antitrust; at the end of April 2012, Pozen too resigned and another Deputy AAG, Joseph Wayland, stepped in to assume the Acting AAG role. In the meantime, on February 6, 2012, President Obama nominated a well-known and highly respected antitrust attorney, William J. Baer, to assume leadership of the Division. While Baer awaits confirmation, the election season is in full swing and few anticipate new appointees to be confirmed for positions such as the Antitrust AAG. At present, most in Washington agree that Baer's confirmation will turn on the start of a new Congress in 2013; if Obama is not re-elected, another president will seek confirmation of his own nominee.

In terms of antitrust enforcement, what do these many changes portend for the upcoming twelve months? What should businesses anticipate as they make decisions over the next year? How will November's presidential and congressional elections affect businesses in the months post-election?

The answer is probably more of the same, even if the electorate ushers in a new administration. Post-election appointments and confirmations take time, and rarely are new appointees able to exercise immediate control over their organizations. Businesses therefore can anticipate that until this time next year, the Division's leadership will carry on much as it has in the hands of current Acting AAG Wayland. An experienced antitrust litigator, Wayland most recently led the Antitrust Division to its first successful court challenge of a merger in 10 years, blocking H&R Block's proposed acquisition of its rival do-it-yourself tax preparation company, TaxAct.

So, what will Wayland's leadership mean in terms of real terms for antitrust enforcement?

Two major antitrust enforcement decisions made during 2012 provide object lessons for what to expect during the rest of this year and the first several months of 2013.

Wayland is expected to apply standards much like those we have seen over the past year. Two major antitrust enforcement decisions made during 2012 provide object lessons for what to expect during the rest of this year and the first several months of 2013. The first of these is the DOJ's decision not to challenge significant transactions that involved patents:

- the acquisition of Motorola Mobility Holdings Inc. by Google; and
- the acquisition of certain Nortel Networks Corporation patents by a consortium of Apple, Microsoft and Research In Motion.

The second is the DOJ's decision not to challenge the acquisition of T-Mobile by AT&T. A significant break from past antitrust enforcement in the communications industry, this bold action surprised many. These key decisions point to how antitrust enforcement may proceed in the next 12 months. The Antitrust Division can be expected to make bold decisions, sometimes in favor of proposed business transactions and sometimes against, whether the election brings about the re-election of President Obama and Baer's confirmation, or the inauguration of a President Romney brings about the nomination of a different Antitrust AAG .

Patent Acquisition Decisions. In February of this year, the Antitrust Division cleared Google Inc.'s $12.5 billion purchase of Motorola Mobility Holdings Inc. On the same day, the Division also announced that it would not challenge the purchase by an Apple-led consortium of the trove of patents owned by the bankrupt Canadian company Nortel. The Division concluded, after a serious investigation, that the transactions would not "significantly change existing market dynamics."

The Division explained its decisions in a closing statement that described its investigations of the two transactions as focusing on the acquiring firms' potential ability and incentives to use the patents to foreclose competitors. The Division recognized that patents have become a major source of contention and legal disputes in the telecom field, a factor that it would presumably extend to other high technology industries as well.

In its closing statement, the Division determined that the parties had addressed concerns about the "potential anti-competitive use" of the patents that were to be acquired by making commitments to license the patents on fair and reasonable terms. "The division took into account the fact that during the pendency of these investigations, Apple, Google and Microsoft each made public statements explaining their respective SEP licensing practices."[1] The decision not to challenge the Google and Apple-led transactions apparently was coordinated closely with officials in the European Union, who announced several hours ahead of US authorities that they too had approved the patent transactions.[2]

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The transactions approved by the Division in February were not without their opponents. For example, some believed antitrust regulators feared that Google's vertical integration, using its Android software and Motorola's hardware, could allow it to limit other hardware manufacturers that currently license Google software. Others countered this concern by pointing out that the Android software is

[1] Statement of the Department of Justice's Antitrust Division on its Decision to Close its Investigations of Google Inc.'s Acquisition of Motorola Mobility Holdings Inc., and the Acquisitions of Certain Patent rights by Apple Inc., Microsoft Corp. and Research In Motion ltd., February 13, 2012, available at: http://www.justice.gov/atr/public/press_releases/20120280190.htm. DOJ did not require the SEP practices be codified in a consent decree.

[2] Google had attempted to buy the Nortel Networks wireless patents but had lost out to the Apple consortium. Google's CEO Larry Page later announced that Motorola's patent portfolio would offer its Android protection, presumably from companies such as Apple.

open source and therefore not subject to such exclusionary limitations. Nonetheless, Google's prominence—particularly with respect to its search engine—no doubt had raised the anxiety of regulators, a factor that had to be addressed by Google to defend the transaction. In the same way, the Apple-led consortium raised similar issues of possible market power on the part of the consortium members in their respective industry spaces. By agreeing to license the patents on reasonable terms, the consortium allayed the Division's concerns.

AT&T/T-Mobile

The Antitrust Division's challenge of the AT&T/T-Mobile transaction was a significant break from the past and a courageous decision. When AT&T finalized its $39 billion acquisition plan for T-Mobile in 2010, its announcement was accompanied by a full-court press relations enterprise orchestrated to show positive attributes of the combination and widespread support for the deal—with expressions of support from unions to congressional leadership as well as other organizations. AT&T had agreed to a multi-billion dollar break-up fee if the deal did not go through, suggesting its confidence in bringing the deal to a close, despite antitrust and Federal Communications Commission regulatory hurdles ahead. Although not all antitrust pundits agreed, many expressed similar confidence that the deal would ultimately work its way through the government processes so that the parties could consummate the transaction.

> *The Antitrust Division's challenge of the AT&T/T-Mobile transaction was a significant break from the past and a courageous decision. When AT&T finalized its $39 billion acquisition plan for T-Mobile in 2010, its announcement was accompanied by a full-court press relations enterprise orchestrated to show positive attributes of the combination and widespread support for the deal.*

Over time, however, the initial political support for the deal withered, the Antitrust Division filed suit to enjoin the acquisition, and the FCC remained unwilling to give its approval. AT&T ultimately abandoned the transaction in August 2011.

The DOJ's analysis of the AT&T/T-Mobile transaction differed significantly from the manner in which it had analyzed prior cell phone service provider transactions. In connection with earlier mergers in the industry, the DOJ had based its analysis upon regional, rather than national geographic markets, which allowed the parties to those transactions to argue that local cell phone service providers were important competitors. In contrast, in the AT&T/T-Mobile transaction, the DOJ looked nationally. It recognized that enough customers needed national, rather than regional coverage, and that providers of cell services really had to offer nationwide coverage. This new market definition—national vs. regional—spelled the downfall of the AT&T transaction. Nationwide, too few competitors would remain post-merger for the DOJ to stand by and allow the transaction to proceed without challenge.

The DOJ's opposition to the merger was not without political peril. AT&T and T-Mobile had significant political allies—and politicians could harm the DOJ's funding. While most antitrust counselors advise that regulators do not base their decisions upon political pressure, for particularly momentous transactions such as the AT&T/T-Mobile deal, this maxim may not be entirely accurate. Line staff attorneys will not necessarily feel political pressures, but their superiors just may—particularly as they watch threats to agency funding in connection with major transactions. Agency heads anger politicians at the peril of their agencies.[3] Despite these possible difficulties, Acting AAG Pozen accepted the risk.

> *AT&T and T-Mobile had significant political allies — and politicians could harm the DOJ's funding.*

Ultimately, as we now know, the early public and congressional support for the transaction waned over time. The FCC balked at approving the transaction, and the DOJ filed suit to block the transaction. In lieu

[3] For example, when the FTC brought suit in February 2000 to enjoin BP-Amoco from acquiring Atlantic Richfield, the agency's then-Chairman Robert Pitofsky faced a scathing, public rebuke from Senator Ted Stevens (R-AK) during testimony delivered soon after the suit was filed. The litigation, according to Stevens, had a direct effect on revenues for Alaska, and the Senator threatened the FTC's budget in no uncertain terms.

of continuing to fight for the deal, AT&T and T-Mobile abandoned it. The DOJ win became the agency's first significant merger victory in almost a decade, and it changed the manner in which the telecommunications industry is analyzed.

The DOJ win became the agency's first significant merger victory in almost a decade, and it changed the manner in which the telecommunications industry is analyzed.

Both of these actions—one not to challenge and one to challenge—represent significant decisions for the Department of Justice and involve important, rapidly-evolving, high-technology industries. While the Antitrust Division has evidenced its approval of certain types of patent acquisitions, recognizing the fluidity of intellectual property, it will not stand by and allow an established market leader to consummate an acquisition that allows it to cement its position for the longer term.

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All these changes "had the effect of making the NDA stronger in the sense of broadening the information subject to its restrictions and limiting the permissible uses and disclosures of the covered information."

Chancellor Strine Upholds Confidentiality Agreement in *Martin Marietta Materials, Inc. v. Vulcan Materials Company*[1], While Providing Incentives to Draft NDAs More Carefully

This case involves, in Chancellor Strine's words, "two rock stars in the aggregate industry," Martin Marietta Materials, Inc. (Martin Marietta) and Vulcan Materials Company (Vulcan). The parties had engaged in friendly merger discussions at the urging of Vulcan, with Martin Marietta the reluctant target. Why was Martin Marietta reluctant? Its two CEOs during the relevant time period, first Zelnack and later Nye, were worried about being put in play, in Nye's words, "whether by Vulcan or otherwise" at a time and on terms not of Martin Marietta's Board's choosing.

Martin Marietta's GC, understanding her CEO Nye's worry about being put in play (and let's face it, potentially ultimately losing his job), was asked to send out an NDA to cover discussions of a possible merger with Vulcan. She made a number of changes to a form of NDA previously used by the parties for an asset swap before sending the draft NDA to Vulcan to start the discussions. All these changes "had the effect of making the NDA stronger in the sense of broadening the information subject to its restrictions and limiting the permissible uses and disclosures of the covered information." Changes proposed by Martin Marietta to the previously used NDA included:

- A change in the definition of "Transaction" from "a possible transaction involving [Martin Marietta] and Vulcan" to one "between" the companies, a word Chancellor Strine noted is "more easily read than 'involving' to require joint agreement of the two parties themselves"

- Broadening the requirement to keep confidential the fact that the parties were discussing a transaction, from the initial prohibition that discussions "are taking place" to include the fact that discussions "have [been] taking place," thus "preventing disclosure... in the event that discussions terminated without any agreed-upon Transaction," and further, suggesting that the parties agreement to enter into the NDA itself be confidential

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[1] *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, 2012 Del. Ch. LEXIS 93 (Del. Ch. May 4, 2012).

- Providing that a paragraph in the NDA prohibiting disclosure of the fact that “any Evaluation Material has been made available hereunder, that discussions or negotiations have or are taking place concerning a Transaction or any of the terms, conditions or other facts with respect thereto (referred to as Transaction Information,)” except as “legally required,” would be subject to another paragraph, which defined “legally required” as responses to external demands for the information, and set forth the required procedures in the event of such an external demand for disclosure of information by a third party (termed the “Notice and Vetting Process” by the Chancellor)

- Entering into a JDA covering discussions relating to antitrust issues, and defining a Transaction as “a potential transaction being discussed by Vulcan and Martin Marietta...involving the combination or acquisition of all or certain of their assets or stock.” This definition is not identical to that used in the NDA. Confidential materials are only to be used in aid of the Transaction as defined.

The parties never discussed a standstill which would have explicitly prohibited them from making an unsolicited tender offer or launching a proxy contest.

The parties never discussed a standstill which would have explicitly prohibited them from making an unsolicited tender offer or launching a proxy contest. The talks proceeded in 2010 under the working assumption that Vulcan would be the acquiror. Unfortunately for Vulcan, Vulcan’s stock price was adversely affected by its concentration in markets affected by the burst housing bubble and “other factors,” resulting in a share of Vulcan declining against a share of Martin Marietta. Vulcan then cooled to (the?) combination given the dilution that would result from a stock deal at the then-current trading prices. However, in April 2011, Martin Marietta began contemplating an acquisition of Vulcan using Martin Marietta’s own strengthening stock as currency. Vulcan’s CEO told Nye in June 2011 that he was no longer interested in a transaction. Martin Marietta sent a public bear hug on December 12, 2011, filed an S-4 for an exchange offer and, in January, launched a proxy contest. The SEC documents discussed the history of Martin Marietta’s negotiations with Vulcan at length, in what Chancellor Strine described as a “detailed, argumentative S-4.” Martin Marietta also disclosed evaluation material in investor calls and presentations.

Although Martin Marietta made arguments to the contrary, Chancellor Strine concluded that Martin Marietta made use of both the synergies information delivered under the NDA and the antitrust information delivered under the JDA in formulating a hostile bid for Vulcan. Chancellor Strine further concluded that Martin Marietta disclosed evaluation information and the transaction (i.e., the deal) information in the exchange offer and proxy contest and proceeded to evaluate whether these uses were a breach of the two agreements.

The violations alleged by Vulcan were as follows:

- Martin Marietta could not use evaluation material in support of a hostile acquisition of Vulcan because the agreement limited the use only for a business combination transaction “between” the two companies, and that didn’t include a hostile, non-negotiated transaction

- Even if Martin Marietta had the right to use the evaluation material to evaluate a hostile bid, it was not permitted to disclose the information or the fact of the parties’ merger negotiations; the exception for “legally required” disclosure did not apply to legal requirements generated by Martin Marietta’s voluntary actions—like filing the Exchange Offer—but only applied if there was a third party request and only after following the Notice and Vetting Process

- Even if Martin Marietta was legally required to disclose information, the disclosure made went far beyond any legal requirements

- The disclosure in investor calls and other investor communications was not in any case legally required.

After lengthy analysis of both the language of the contract (which Chancellor Strine concluded could reasonably support either side’s position) and extrinsic evidence of the parties’ actions (which, Chancellor Strine concluded, supported Vulcan’s position that the contract provisions were being breached), Chancellor Strine ultimately held that Martin Marietta had violated both the terms of the

NDA and the JDA in each of the ways noted above. Accordingly, he granted an injunction against moving forward either with the exchange offer or the proxy contest for at least four months (the minimum duration of the breach), which would be from the launch of the exchange offer through the expiration of the NDA. This remedy prevented Martin Marietta from presenting its slate of directors at its June 1, 2012 annual meeting.

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Lessons for Practitioners

In considering the facts and holdings of this case, practitioners can derive several key lessons:

- **Words in contracts matter, as do negotiations and parties' behavior relating to the subject matter of the contract.** The case analyzes in extraordinary detail the words chosen by Martin Marietta for the new confidentiality agreement served up for the potential merger discussions. As an example, the fact that the parties inserted "between" instead of "involving" was deemed meaningful as a sign of a desire to limit the use to consensual combinations. Similarly, Chancellor Strine analyzes whether the term "business combination transaction" itself signals that the use of the confidential information in connection with a hostile bid is intended to be prohibited. The close textual reading of the agreement by Chancellor Strine reinforces the valuable work that lawyers do in choosing the particular words to limit or expand a contractual provision. Note, however, that when the Chancellor concluded that two possible interpretations of the intent behind the express words were reasonable, he turned to extrinsic evidence — the parties' actions — and actions by Martin Marietta demonstrated an intent to limit the use and expand the application of the confidentiality agreement. Any lawyer worth his salt would rather that the words, rather than the parties' behavior, control the outcome scripted or not.. See below for further discussion of some of the core principles a party to a confidentiality agreement will want to be sure to make clear to avoid this risky result where behavior controls outcome.

- **A form of confidentiality agreement used in a prior unrelated transaction may not be the best starting point for an agreement in a major transaction.** Here, the parties had done an asset swap deal previously and the GC just marked up the old agreement. Given the large amount of ink spilled by the court in analyzing the interpretive questions raised by the resulting NDA, and the fact that the language of the agreement was viewed as potentially ambiguous with two possible readings on every interpretive issue raised by the plaintiff, it might have made more sense to start with an NDA designed for the sale of the entire company. A good NDA would have inserted "negotiated" in front of "transaction" in the use restriction paragraph—which, although counter to Martin Marietta's ultimate desire, was exactly what appeared to be their intent at the time the NDA was being prepared. It would also have made crystal clear that the term "legally required" was intended to only mean response to external demands for information through subpoena or court discovery. Thus, we generally advise clients to start with a good form of an M&A NDA in an important transaction and to not just mark up the last deal's NDA. These agreements should be reviewed with an eye to the parties' overall goals—not just getting a few quick changes in from the last deal. The value of a well drafted NDA can also be seen in the recent Delaware Supreme Court decision, RAA Management LLC v. Savage Sports Holdings Inc., Del., No. 577,2011 (May 18,2012). See our recent client alert about this case, which addresses a different issue arising in NDAs relating to the efficacy of non-reliance and waiver clauses.

- **There are many resources available to the draftsperson working on a confidentiality agreement.** In particular, Chancellor Strine noted the ABA Model Confidentiality Agreement (2011) published by its M&A Committee. A common issue in confidentiality agreements is the standard under which otherwise prohibited disclosures are permitted as being "legally required." Some agreements provide that only disclosure required by "external demands" such as a government subpoena or discovery would be "legally required," and only after vetting the external demand with the disclosing party. Other agreements define "legally required" to include generally applicable legal requirements, such as federal securities law or listing requirements. The agreement between Vulcan and Martin Marietta, like many other confidentiality agreements, was less clear about the standard for "legally required" that applied to the deal information (the fact that a deal was under discussion) than it was about the definition of "legally required" that applied to the evaluation material (the information disclosed in the diligence process, such as customer lists and contracts). Parties are, however, able to draft to make clear which standard of legal compulsion will permit disclosure, and the resources cited by Chancellor Strine provide a variety of techniques to make clear which standard applies. This case makes clear that leaving the term "legally required" undefined introduces ambiguity, and may allow a contracting party to voluntarily take an action that subjects it to a legal requirement to disclose under the federal securities laws at least the deal information. This could be quite an unpleasant surprise for a client who has not recognized such an ambiguity! Alternatively, as Strine noted, "restricting the scope of legally required disclosures to those that arise in the context of some sort of discovery obligation or affirmative legal process may have the effect of creating a backdoor standstill provision."

- Perhaps most obviously, if a party wants to limit the ability of a counterparty to launch a hostile tender offer, it is better not to rely on subtleties like the difference between "between" and "involving," the use of the term "business combination transaction," or the definition of "legally required." At a minimum, parties should use the word "negotiated" to describe the use limitation (e.g., defining a "Transaction" as a "possible *negotiated* transaction.") However, note that **if it is a key goal of at least one of the parties to eliminate the right of a counterparty to use the information to launch a hostile bid against the counterparty, the traditional way to effect that goal is through a well-drafted standstill.**

The close textual reading of the agreement by Chancellor Strine reinforces the valuable work that lawyers do in choosing the particular words to limit or expand a contractual provision. Any lawyer worth his salt would rather that the words, rather than the parties' behavior, control the outcome, scripted or not.

- **A standstill is a direct prohibition of such activity as an unsolicited tender offer or a proxy contest. It is not ambiguous.** If a standstill is offered by one side, the counterparty has an opportunity to negotiate for meaningful exceptions or "lapse" provisions. Although some practitioners will choose to rely on the use limitation for "negotiated" transactions—in some cases because they do not want to risk delaying the start of the deal at hand with preliminary and sometimes frustrating negotiations over a standstill—the facts in the *Vulcan v. Martin Marietta* case are evidence that parties change their minds as to whose ox is gored by a provision, and the meaning of provisions short of a standstill are up for interpretation. Publicly traded targets should seriously consider including a well-drafted standstill provision in the NDA to avoid the type of questions raised here.

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- **Martin Marietta might have improved its legal position by imposing a "clean team" to pursue the hostile tender offer**, although they would have had to deal with the taint from the knowledge gained by CEO Nye and the CFO in the diligence process. If a company is in the position of analyzing how to avoid breaching confidentiality agreement provisions due to exposure to confidential information, it should consider the use of individuals without such exposure. A company thinking about a hostile transaction would also be well advised to be judicious as to what confidential information of the other party it chooses to review, and to consider separating the diligence team up front from senior management who might be involved in a decision about a hostile transaction.

- **Martin Marietta might have also improved its position by limiting the disclosure of the evaluation material in the SEC filings for the transaction.** The court was clearly troubled by the expansive and argumentative use of the evaluation material in the S-4 and investor disclosures, compared to a much more limited disclosure of the limited facts absolutely required by the disclosure rules. The Chancellor noted, "Martin Marietta disclosed far more than was legally required, in a plain attempt to cast Vulcan in a bad light through a debatable and selective disclosure of Transaction Information and Evaluation Material." The moral of this story is that if a company risks a breach, flaunting the breach is not the way to get the court on one's side.

- **The Delaware courts believe in the parties' ability to contract and will enforce those contracts.** These contracts should be thoughtfully negotiated given the courts' penchant to enforce them as drafted.

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The Wal-Mart scandal already offers valuable lessons to multinational companies struggling with the complexities and costs of real-world global anti-corruptions compliance challenges.

Early Lessons From The Wal-Mart Scandal

We are only learning now of the allegations of widespread bribes by Wal-Mart de Mexico and questions surrounding decisions by senior management at the US parent company to limit the probe. Much is being written about the debacle—including the potential for a widespread, global investigation of Wal-Mart's compliance with anti-corruption laws, criminal prosecutions in the United States and Mexico, civil enforcement actions, sharp decline in Wal-Mart share value and market cap, possible shareholder derivative lawsuits, and even legal challenges by competitors—and more is sure to come. Although the scandal will continue to unfold as new facts emerge and the legal wrangling begins, it already offers valuable lessons to multinational companies struggling with the complexities and costs of real-world global anti-corruption compliance challenges.

The US government's aggressive enforcement of the Foreign Corrupt Practices Act (FCPA), the US statute prohibiting overseas bribery of foreign officials to win or retain business, is nothing new. Companies around the world have taken note of the price of non-compliance and the astronomical costs associated with some highly publicized investigations. However, these cases—while attention-grabbing for anyone who reads them—have created new risks for companies and their boards. In the absence of a mandatory reporting requirement, amnesty programs or clear guidance regarding penalty reductions for voluntary disclosure and cooperation, companies now regularly assess whether the risk of disclosure and prolonged, expensive investigations is outweighed by other options.

Although many facts remain unclear and we should be careful not to prejudge the company, the Wal-Mart scandal brings to the fore the proverbial "fork in the road" companies face when presented with serious compliance problems, and the balancing act of mitigating competing risks without stepping over the line.

- **Senior Management and Directors must set the standard for compliance and ensure that compliance professionals have the tools and support to implement practical and compliance "best practice" rules to effectively limit risk.** Without strong "Tone at the Top" and financial investment from business leadership and the Board, compliance programs will be of limited value. Companies that cut too many corners on the compliance infrastructure will pay for it later. But a balance has to be struck. Unrealistic compliance programs can impose unnecessary costs and breed contempt for the law.

- **Enforce your own rules.** Companies must be able to show regulators that they do more than talk or write about compliance. They must show action. Officers and employees must know that they will be rewarded for compliance and sanctioned for violations. If a company fails to live up to its own ethical standards or allows misconduct to go unpunished, its legal, reputational and business risks will multiply.

Without strong "Tone at the Top" and financial investment from business leadership and the Board, compliance programs will be of limited value. Companies that cut too many corners on the compliance infrastructure will pay for it later. But a balance has to be struck. Unrealistic compliance programs can impose unnecessary costs and breed contempt for the law.

- **Every global company has to deal with compliance transgressions and wrongdoing by employees.** How a company responds to these matters will set the stage for how effectively it will weather the storm if the worst happens. If allegations of potential wrongdoing surface, develop a plan to thoroughly and credibly investigate the allegations. The integrity and quality of the investigative process will be critical to regulators, stakeholders and the public. Outside counsel will be important if the allegations involve senior managers, pervasive misconduct, or significant illegal conduct.

- **It is better for the company to uncover and address problems on its own than have them exposed by others.** Companies naturally struggle with the rising costs of investigations and how far they need to go to root out problems. In practice, the government understands these challenges and is receptive to arguments around reasonable limits. Make sure there is a justifiable rationale for investigative limitations. If a company decides to arbitrarily limit an investigation to save money or avoid discovery of problems, it faces greater legal peril and future costs - including having to re-do tainted or incomplete investigations later to assuage the government.

- **Carefully weigh disclosure considerations, remediation and contingency planning.** Get advice from outside counsel to understand when disclosure is required or advisable. Carefully weigh the risks of either action. Regardless of any disclosure decision, companies should remediate wrongdoing or control gaps. Stop the problematic conduct, deal with employees or third-party offenders, and fix compliance weakness. Companies should view remediation as an opportunity to showcase management's commitment to compliance and the effectiveness of its program. If the matter is discovered later, these steps will go a long way to support the company's arguments for leniency. Finally, don't be caught flat-footed. Prepare contingency strategies in the event the matter is discovered to get out ahead of the crisis and minimize collateral damage.

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Produced by Kaye Scholer's Corporate Department, and edited by Palo Alto Partner Diane Frankle, the M&A and Corporate Governance Newsletter is published quarterly. Designed for corporate clients of all sizes and industry areas, articles are chosen for their practical application to issues that corporations confront on a regular basis, timeliness, and diversity of perspectives. Reader feedback or suggested article ideas can be sent to diane.frankle@kayescholer.com.

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