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Summer 2014

M&A and Corporate Governance Newsletter

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Zillow and Trulia Juggle Antitrust Risks Raised by Proposed Acquisition

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On July 28, 2014, Zillow Inc. announced that it plans to acquire Trulia Inc. for $3.5 billion. If consummated, the transaction will combine the two largest online real estate listing companies in the United States. Mergers and acquisitions involving major competitors usually prompt antitrust enforcers at the U.S. Department of Justice or the Federal Trade Commission to investigate the proposed deal before approving it. Facing such a possibility, parties typically pay close attention to negotiating antitrust risk-allocation provisions in their purchase agreements. The Zillow and Trulia M&A agreement contains a number of such provisions, along with clauses that govern the conduct of their respective businesses during the interim period before closing. These aspects of their agreement bear examination.

The two companies together would hold a significant share of the Internet home-listing website visits; over 70 percent of all visitors to [the] real estate category.

First, just how and why do parties decide on one or another provision for allocating or shifting antitrust risks from one party to another? Many M&A agreements include a breakup fee, paid by the buyer to the seller in the event the buyer abandons the deal. For example, when AT&T and T-Mobile entered their ill-fated merger agreement in 2011, AT&T agreed to pay T-Mobile a breakup fee of $4 billion if the transaction could not be consummated. Trulia is entitled to a breakup fee of $150 million. This represents approximately 4.3 percent of the purchase price, which is about average for these types of fees as a percentage of deal value. The magnitude of the breakup fee is one sign of each party's assessment of the risk of a government antitrust challenge and the party's willingness to accept that risk.

Second, what are the appropriate limitations on business conduct in the period between signing a purchase agreement and closing the deal? Trulia has agreed to significant limitations on how it conducts its business, and is bound by those limitations for nearly the next year and a half.

The Zillow/Trulia Transaction

As is usually the case in antitrust analysis, the factual background for the transaction is of considerable importance. There are four leading players in the market for Internet home-listing services. The two largest are Zillow and Trulia. The next largest is Realtor.com, which is owned by the National Association of Realtors and operated by Move Inc. Homes.com ranks a distant fourth.

Online listing services differ significantly from Multiple Listing Services, which are typically regionally based and owned and operated by real estate brokers and agents working collectively to share their respective listings with one another. Realtors finance their MLS themselves, while Internet home-listing services, including Zillow and Trulia, raise revenues by selling online advertising.

Commentators have pointed out that the two companies together would hold a significant share of the Internet home-listing website visits; according to ComScore, the two sites had over 70 percent of all visitors to its real estate category. According to *Bloomberg* the deal "would create a dominant search website for U.S. house hunters." Others emphasize that the competition to offer these Internet services takes place in a rapidly evolving sphere in which small companies face few constraints on growth and also in which other services, such as a realtor's MLS and other forms of real estate advertising, compete as well. The competitive threats these factors represent may force even a dominant firm to compete vigorously. Such arguments would be put to the test if either the DOJ or the FTC investigates the proposed transaction.

What Is Driving the Antitrust Risk Allocation for This Transaction?

When competitors are negotiating a deal, they need to know early on whether and to what extent a proposed transaction would provoke an antitrust challenge. After assessing the likelihood of an antitrust investigation, each party can negotiate for terms that allocate antitrust risk according to its best interest. How the parties allocate that risk will be an important factor in their agreement.

Sometimes, parties agree that they will be bound by their transaction "come hell or high water," meaning the companies will fight an antitrust challenge up until the termination date of the agreement. Often the best case scenario for a seller in a cash deal is a guarantee that the buyer will come to closing and pay the agreed-upon purchase price as of a particular date, period. The best case for a buyer, on the other hand, often is to have the flexibility to walk away from the deal if an antitrust hurdle emerges that is too great for its liking. The buyer may agree to pay the seller a breakup fee for this privilege. There are a myriad of other ways in which parties can share the antitrust risks that their deal may face. Buyers may agree to make the purchase even if divestitures are required by government enforcers to settle antitrust disputes without litigation. In those instances, the M&A agreement typically specifies either that only a certain portion of the target company may be divested to satisfy the enforcers or that any such divestiture is acceptable only if it does not have a material adverse effect on the overall acquisition value or the combined company, or the buyer or target, standing alone. The buyer, therefore, has assumed antitrust risk, but has done so with a cap on the magnitude of the risk. The parties may agree that they will use "reasonable best efforts" to obtain government approvals, and may expressly agree to litigate, or may be silent or exclude litigation from their efforts covenant.

The 18-month time frame provided for in the Zillow/Trulia acquisition, during which neither party may abandon the deal, suggests that the parties are committed to responding to a lengthy government inquiry and even litigating an agency's decision to block it.

The termination date set by the parties plays a pivotal role in these antitrust risk-shifting negotiations. A provision that allows the parties to walk away from the deal after only three or four months from signing implies that the parties do not contemplate pursuing their deal in the face of an in-depth government inquiry. That time frame may be sufficient for the parties to convince the DOJ or FTC to close an investigation. But it does not allow enough time for the parties to produce extensive documents and information, as is typically required by an in-depth government investigation, such as when an agency issues a Second Request. Of course, a short time frame also eliminates any possibility of engaging in a court battle with antitrust enforcers. Thus, a short time frame until closing most often means that the parties have agreed to share the antitrust risks. They will work to convince the agencies to allow the merger without significant investigation, but if they are unsuccessful, they intend to walk away from the proposed transaction.

By contrast, the 18-month time frame provided for in the Zillow/Trulia acquisition, during which neither party may abandon the deal, suggests that the parties are committed to responding to a lengthy government inquiry and even litigating an agency's decision to block it. The agreement requires the parties to use their "reasonable best efforts" to meet the various requirements of the Hart-Scott-Rodino Act (HSR Act) and to defend the transaction in the event the government sues to enjoin its closing. Having agreed to a termination date that allows ample time for antitrust review, the parties are, through the agreement, expressing confidence that, in the end, they will be able to consummate their transaction.

Finally, the allocation of antitrust risk will be an important factor as parties negotiate a purchase price and breakup fees. The Zillow/Trulia M&A agreement provides that Zillow will pay Trulia a $150 million breakup fee in the event that the deal is blocked by antitrust enforcers. This fee is in part intended to encourage Zillow's efforts to resolve antitrust issues, and to compensate Trulia for distraction and lost opportunities if the transaction is not completed.

Will the Zillow/Trulia Merger Agreement Trigger Gun-Jumping Concerns?

Under the Clayton Act, Zillow and Trulia may not close their transaction until it has cleared the federal government's merger review process. In the meantime, they must navigate uncertain waters. Although they are permitted to cooperate and plan for an orderly transition, they must remain independent competitors until the transaction closes. Any cooperation beyond integration and transition planning is almost certainly circumscribed by the antitrust laws. In short, they must compete vigorously even while planning to combine.

In this context, parties must be careful to avoid transferring or ceding control of any business functions to their merger partner before the deal closes. The Clayton Act imposes fines of up to $16,000 per day for engaging in such "gun jumping." Moreover, the parties risk violating the conspiracy provisions of Section 1 of the Sherman Act that prohibit anticompetitive agreements if they exchange competitively sensitive information or agree to coordinate their competitive activities.

Despite these serious potential penalties, the DOJ and FTC have not issued guidelines or established policies addressing the limits of acceptable practices during the waiting period. A few consent decrees and public statements by agency leadership offer some limited guidance, but for the most part, parties must rely on counsel who have developed a sense of the government's views over the course of their practice in front of the agencies. The area is made more difficult because what may be competitively sensitive (and therefore proscribed from pre-closing coordination) will often differ from industry to industry.

Zillow and Trulia must show the government that under their particular circumstances, the limitations serve a legitimate purpose while being unlikely to have any significant adverse effects on Trulia's competitiveness.

The merging parties must not, in the words of FTC General Counsel Blumenthal, "prematurely combine significant aspects of their day-to-day operations and manage themselves as one." As a general rule, they may not limit actions normally taken in the course of their businesses or require actions not normally so taken. Moreover, as competitors, they may not coordinate business operations or collaborate with respect to their relationships with any vendor or customer in a way not otherwise permissible under US antitrust laws. As competitors they should avoid coordinating pricing, marketing or advertising strategies. Nor should they coordinate R&D programs, production and distribution practices, or business development efforts.

As in any merger agreement, the Zillow/Trulia merger agreement imposes operating covenants on Trulia. For example, Trulia may not acquire another business entity or any business's assets; it may not borrow money; it may not make capital expenditures above a certain maximum; it may not initiate a legal action regarding intellectual property; and it may not enter into an employment agreement involving compensation higher than $275,000 or a title of vice president or higher, except to replace a departing employee (in which case the successor cannot receive more than 110 percent of the predecessor's compensation).

These prohibitions may be intended to preserve Trulia's value so that Zillow will get the benefit of its bargain—certainly an important and legitimate business interest. At the same time, the nature and extent of the limitations, particularly given the long period for antitrust review contemplated by the drop dead date here, may prompt government enforcers to examine their competitive implications, both for the interim period and long-term, if the deal were blocked. Zillow and Trulia must show the government that under their particular circumstances, the limitations serve a legitimate purpose while being unlikely to have any significant adverse effects on Trulia's competitiveness.

For example, enforcers may ask Trulia and Zillow to defend the requirement that Trulia not incur any new debt or issue any debt securities, while Zillow may borrow up to $250 million and issue debt securities of up to $400 million. They may question whether this restriction unduly restrains Trulia's ability to invest in its software or make other reasonable acquisitions during the merger review period, while Zillow is less constrained. Similarly, enforcers may question the restrictions on Trulia's ability to hire senior management or commence intellectual property actions during the lengthy period contemplated by the agreement. Approaching limitations such as these with a skeptical eye, the antitrust enforcers may ask the parties to show that they are reasonable means of preserving the value for which Zillow negotiated without unduly harming the ongoing business potential of Trulia should the transaction not be consummated. Quite possibly, Trulia has significant resources and need not resort to borrowing to maintain its competitive capabilities. The restrictions on intellectual property actions and hiring of management also may not present significant restrictions given Trulia's business outlook. The length of the time over which the operating covenants may apply will be relevant to the discussions the parties will have with the regulators to the extent the operating covenants receive scrutiny.

Conclusion

The antitrust bar will no doubt watch closely as the government responds to the proposed Zillow/Trulia transaction. The government's course of action with respect to gun-jumping issues will provide guidance for future deals whether the agencies object or demur. The context of the particular business operations and industry will always be critical in determining the boundaries between permissible and prohibited pre-closing restrictions on business operations. Further, M&A transactions will continue to present parties with a range of choices regarding the allocation of antitrust risk.

Therefore, it is paramount that parties seek antitrust expertise early on in the deal process so that the parties can fully evaluate the choices they face. As always, it is far better to incur the relatively minor costs of antitrust counsel up front rather than bearing the brunt of a government enforcement action that could result in potential civil fines, the imposition of a consent decree and ongoing government monitoring.

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Seal No Longer Required in Delaware for Contract Survival Periods of More Than Three Years—Avoids Trap for the Unwary in M&A Deals

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As we wrote in our Winter 2012 *M&A and Corporate Governance Newsletter*, Delaware courts have held that the three-year statute of limitations applicable to general contract claims trumps contractual language that purports to apply a longer survival period. For example, the typical merger agreement applies a survival period of between one and two years for most breaches of representations and warranties, but provides that others, such as fundamental representations and warranties or those relating to tax matters, survive much longer than three years, or indefinitely. Delaware courts have held that these types of survival provisions cannot extend the three-year statute of limitations applicable to general contract claims under Section 8106 of Title 10 of the Delaware Code[1]. An acquirer of a business that attempts to bring an indemnity claim for breach of a tax representation six years after closing, to pick a typical example, is therefore likely to be foreclosed from bringing that claim. In order to benefit from a 20-year statute of limitations instead of the three-year statute of limitations under Section 8106, the parties would need to have the contract executed under seal. As noted in our prior newsletter, there are various steps that can be taken, depending on whether a party is an individual or a corporate entity, in order to achieve this result.

To benefit from the extended statute of limitations, the contract must therefore involve at least $100,000 and specify another "period" within which claims must be made.

Effective August 1, 2014, a seal is no longer required in most cases. Section 8106 has been amended by adding a new paragraph (c), which provides that "an action based on a written contract, agreement or undertaking involving at least $100,000 may be brought within a period specified in such written contract, agreement or undertaking provided it is brought prior to the expiration of 20 years from the accruing of such cause of action." To benefit from the extended statute of limitations, the contract must therefore involve at least $100,000 and specify another "period" within which claims must be made. The synopsis accompanying the amendment provides that examples of a "period" would include, without limitation, "(i) a specific period of time, (ii) a period of time defined by reference to the occurrence of some other event or action, another document or agreement or another statutory period and (iii) an indefinite period of time."

1 See *GRT Inc. v. Marathon GFT Technology, Ltd. and Marathon Oil Company,* 2011 WL 2682898 (Del. Ch. July 11, 2011).

For M&A practitioners, new Section 8106(c) provides welcome relief from a rule that was at best an oddity, and at worst a potential source of embarrassment in the future. The text of Section 8106(c) and the accompanying synopsis indicate that the Section should be interpreted broadly and will be easy for parties desiring a survival period longer than three years to comply with. Nonetheless, out of an abundance of caution, it would be prudent to phrase survival language in agreements in terms of provisions surviving or claims being able to be brought "for a period of X years" after closing, instead of "for X years." Parties should also make sure that there is no scenario under which their contracts could be interpreted as not "involv[ing] at least $100,000." An acknowledgement as to value in a recital or survival paragraph could, in an appropriate case, be beneficial.

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MOFCOM's Decision to Block P3 Highlights China's Importance for Global Transactions

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On June 17, 2014, the Anti-Monopoly Bureau of China's Ministry of Commerce (MOFCOM) published its decision to block the formation of a strategic alliance between the world's largest ocean container shipping companies—Denmark's A.P. Møller–Mærsk, Switzerland's Mediterranean Shipping Company (MSC) and France's CMA CGM (collectively P3). In the six years since China implemented its antitrust pre-merger notification rules in 2008, and out of approximately 900 transactions notified in China so far, this was MOFCOM's second blocking decision after its prohibition of Coca-Cola's $2.5 billion acquisition of Chinese juice and beverage company Huiyuan Juice Group in 2009.

MOFCOM's ban on P3 comes a year after the three container carriers announced their long-term operational vessel-sharing agreement on the east-west trades called the P3 Network. After implementation, P3 would be able to reduce the number of vessels the partners deployed in the main east-west trades to about 250 ships from approximately 350 under operation in 2013. The container ships they would have deployed would have been their largest and most fuel-efficient vessels, which would have cut their slot costs to enable them to possibly offer lower freight rates.

This was MOFCOM's second blocking decision after its prohibition of Coca-Cola's $2.5 billion acquisition of Chinese juice and beverage company Huiyuan Juice Group in 2009.

The parties proposed to jointly create a limited liability partnership under the laws of England and Wales, to operate a joint vessel operation center and to coordinate their container shipping fleets in the world's three major shipping routes: Europe–Asia, trans-Atlantic and trans-Pacific. To avoid antitrust scrutiny, the parties had structured the transaction to assure each shipper would retain its separate identity, as well as have fully separate and independent sales, pricing and marketing functions. The plan was to coordinate capacity, but not to fix prices or allocate customers, markets or territories. They would still compete against each other. The parties intended to implement an operational, not a commercial, cooperation.

The US and the EU Clear P3

On March 24, 2014, the US Federal Maritime Commission (FMC) decided, with only Commissioner Richard A. Lidinsky, Jr. dissenting, to allow the P3 alliance to become effective in the US. The FMC determined that the alliance would not be likely to cause a reduction in competition at the time. Going forward, however, the FMC ruled that the alliance would be subject to certain reporting

requirements with the FMC, because circumstances could arise in the future that would allow the alliance to raise prices or reduce services unreasonably.

On June 3, 2014, the European Commission decided not to open an antitrust investigation into P3. Because the proposed alliance was not a merger, nor a joint venture to pool the parties' businesses, a formal merger control notification was not required.

Three weeks later, on June 24, 2014, the European Commission announced it would extend the validity of the maritime consortia block-exemption regulation No. 906/2009 exempting liner shipping companies from EU antitrust rules beyond 2015, by another five years, until April 2020. These block-exemption rules allow carriers with a combined market share of below 30 percent to enter into cooperation agreements to provide joint cargo transport services, so called consortia. Agreements covered shall allow carriers to rationalize their activities and to achieve economies of scale. If such consortia face sufficient competition, do not fix prices or share the market, customers are usually able to benefit from improvements in productivity and service quality. Reportedly, the Hong Kong Shipowners Association is planning to seek an industry-wide, block-exemption regulation for its shipping industry similar to the one from the EU.

MOFCOM's Blocking Decision

MOFCOM's blocking decision occurred on the very last day of MOFCOM's quite lengthy review process. Because the proposed alliance was not structured as a merger, initially it was unclear whether the P3 alliance would have to notify MOFCOM or if the parties should instead consult with China's price-related antitrust authority, the National Development and Reform Committee (NDRC). MOFCOM confirmed its own jurisdiction, because in their view the P3 alliance would not create just a "loose" shipping alliance but, instead, a "tight consortium," a "close joint venture," which qualified as a merger under Chinese antitrust rules.

On September 18, 2013, the P3 parties submitted a draft notification with MOFCOM. After certain pre-notification discussions and amendments, MOFCOM accepted the formal notification three months later on December 19, 2013. Subsequently, MOFCOM entered into an extended Phase II review. Because MOFCOM does not have the ability to extend the review period beyond the 180-day deadline in a Phase II procedure, MOFCOM either had to obtain satisfactory commitments from the parties or block the transaction. The P3 parties tried to negotiate remedial measures for several rounds, and submitted a final remedy proposal on June 9, 2014. However, these remedy plans could not resolve MOFCOM's competition concerns and on the very last day MOFCOM rejected the alliance.

MOFCOM further mentioned a lack of evidence that the proposed cooperation's benefits would outweigh its harm to competition or that the proposed alliance was in line with the public interest.

MOFCOM said the P3 alliance would certainly boost the market power that the alliance partners would have—actually the three biggest market players on those trades already—and increase market concentration. Further, P3

would create considerable barriers to new competitors entering this market, so clearing P3 would have harmed competitors as well as giving the carriers more leverage over Chinese customers and port operators. MOFCOM also mentioned high market shares of the alliance parties, a combined 46.7 percent share on the Asia–Europe route. These antitrust concerns would not be resolved by the remedy proposals submitted by the P3 participants. (Among the approximately 900 transactions notified with MOFCOM, only 23 have been given conditional remedies.) MOFCOM further mentioned a lack of evidence that the proposed cooperation's benefits would outweigh its harm to competition or that the proposed alliance was in line with the public interest.

More details and transparency would certainly provide helpful guidance for antitrust experts and industry players, helping them to structure transactions and remedy plans, and to streamline the notification process in China.

Mærsk and MSC's Proposed 2M Could Succeed

After the failure of P3, Møller–Mærsk and MSC announced a 10-year vessel sharing agreement without CMA CGM on July 10, 2014, regarding the Asia–Europe, trans-Atlantic and trans-Pacific trades. This vessel sharing agreement, known as 2M, encompasses approximately 185 ships deployed on 21 routes. The proposed 2M agreement differs from the P3 alliance, and the parties hope that 2M will receive approval in China as well. The combined market share of 2M is much smaller now without CMA CGM, probably around 35 percent (if the 47 percent share for P3 was correct). Further, 2M is only based on a pure vessel-sharing agreement—a joint venture entity is not being put in place this time to coordinate the operational business.

Comments

MOFCOM's rejection was a surprise to many transaction and antitrust experts who widely anticipated that MOFCOM would conditionally approve the P3 alliance in light of the bureau's general reluctance to block cross-border transactions. Regarding the P3 decision, there are reasons which suggest that the protection of Chinese competitors played some role in the decision-making process. It would be very helpful, though, if MOFCOM would render more details about its antitrust analysis and why it reached the conclusions it did. More details and transparency would certainly provide helpful guidance for antitrust experts and industry players, helping them to structure transactions and remedy plans, and to streamline the notification process in China.

Regarding the planned 2M, it has to be seen whether it will catch antitrust scrutiny around the world. Since the EU Commission did not object to P3, the 2M parties could feel comfortable to self-assess their proposed agreement without contacting the Commission's staff, which is possible under EU competition rules. To be on the safe side, however, the 2M parties may want to contact the Commission's case team again to inform them about the new deal. For the US authorities, another clearance may be expected as well.

China is able, and becoming more willing, to impose conditions or even block transactions outright based on its own assessment, even where they have been unconditionally cleared in other well- established antitrust jurisdictions like the EU or the US.

But China's antitrust regulators could again take a close look at the 2M alliance, in particular if Chinese carriers and other market players again strongly raise objections and concerns as they did with P3. It is unclear whether MOFCOM must be notified regarding 2M again, because this time 2M does not plan to use an entity to coordinate their operations. In case it is rather a "traditional loose shipping alliance" under Chinese rules as well, MOFCOM may not have jurisdiction over 2M. In such a scenario, perhaps the 2M parties will consult with the NDRC instead. In addition, 2M will have to register with China's Ministry of Transport, which may have objections as well.

The P3 case once again demonstrates the independence and importance of MOFCOM in merger reviews of global cross-border deals. China is able, and becoming more willing, to impose conditions or even block transactions outright based on its own assessment, even where they have been unconditionally cleared in other well-established antitrust jurisdictions like the EU or the US. For this reason, Germany-based Hapag-Lloyd's pending takeover of the cargo container shipping business of Chilean shipping company Compañía Sud Americana de Vapores (CSAV)—which, after closing, would make Hapag-Lloyd the fourth largest international shipping carrier in the world—will be worth watching. The transaction needs antitrust clearance at least in the EU, US and China. The US FMC provided antitrust clearance (early-termination) on July 31, 2014, and EU notification was submitted on July 23, 2014, so it will be interesting to see what position MOFCOM takes.

It is quite prudent for companies in all industry sectors to review and discuss their existing and planned cooperation agreements and alliances with antitrust experts to ensure such plans and activities do not violate antitrust laws in one or more jurisdictions. International cross-border deals must be prepared carefully, not only if they require MOFCOM pre-consummation approval. Antitrust counsel should be pulled in as early as possible to assess the substantive antitrust issues. And parties should be on notice that a merger control review in China may involve significant time and efforts.

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Executive Compensation Landscape Continues to Change: "Say on Pay" Effect on Golden Parachutes and Equity Vesting

Jeffrey L. London Partner and **Kathleen Wechter** Counsel

As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act, public companies generally are required to seek a nonbinding "say on pay" vote periodically and on certain changes in control. Shareholder scrutiny of these arrangements has become more intense, and institutional investors are now challenging—and sometimes rejecting—provisions in senior executive employment arrangements that had been viewed as fairly standard in the recent past. Since shareholder "say on pay" vote is often highly publicized in the press, companies face embarrassment at having compensation voted down even though the vote is not binding. In some cases, this signals possible adverse results for future votes on new compensation packages and even for routine votes for directors. Companies are increasingly concerned about the percentage approval by shareholders decreasing on "say on pay" proposals over time (for example, from 90 to 75 to 60 percent) because it calls corporate governance into question even if the "say on pay" vote continues to "pass."

After a few proxy seasons of "say on pay" votes, more institutional investors, advisory firms and proxy firms are using their votes to register increased concern about, and rejection of, executive compensation.

Institutional shareholders acknowledge that employment agreements are necessary to recruit and retain top executive-level talent, and those packages typically include equity awards to align executives' interest with that of shareholders. Historically, on the termination of an executive's employment following a change of control, payments were often based on (i) a multiple of the number of years of base salary and bonus, and (ii) payout of deferred compensation and other amounts accumulated over time (often awards that had been earned and vested years before). Stock awards were typically vested on the change-of-control event. While this may result in a large payout being disclosed in a proxy statement as a result of a change of control (some at the time of a change of control and some if and when the executive's employment is terminated by the purchaser), these amounts may represent compensation for the loss of the executive's job after a lifetime career and for the appreciation of stock granted many years before.

The trend in executive compensation over the past several years has seen far fewer payouts on a change of control for executives whose employment is not terminated (so-called "single trigger agreements"). After a few proxy seasons of "say on pay" votes, more institutional investors, advisory firms and proxy firms are using their votes to register increased concern about, and

rejection of, executive compensation. In our experience, many advisory firms and proxy firms have a negative view of provisions such as:

- Payments for golden parachute excise tax gross-ups;
- Accelerated vesting of stock options on a change of control; and
- Severance upon "retirement."

Excise-Tax Gross-Ups

Golden parachute gross-ups have become far less common among newly hired executives as companies face concerns from shareholders in adding new benefits for executives. Many advisory firms and proxy firms are putting increased pressure on companies to replace gross-ups with a "best net" provision under which the executive receives the better of (i) the total unreduced payments or (ii) the maximum payments that would not be subject to the excise tax on parachute payments.

Vesting of Equity

Stock awards such as stock options and restricted stock usually vest either (i) at a specified date if the executive remains employed ("Service-Based Vesting"), (ii) on the attainment of specified performance goals either related to the executive or the company, or a combination ("Performance-Based Vesting"), or (iii) based on a combination of Service-Based Vesting and Performance-Based Vesting. It is fairly common for equity awards of public companies to provide for accelerated vesting on a change of control, especially in the case of Service-Based Vesting. But given the scrutiny of "say on pay" votes, shareholders are more frequently objecting to accelerated vesting prior to the executive's termination of employment (either without cause or for "good reason"). This may be, in part, because of the immediate cost to the company and partly because the vesting takes away the incentive for the executive to continue with the purchaser if offered a position.

While shareholders have long been focused on the costs of golden parachute gross-ups, the increase in Performance-Based Vesting stock awards, together with the shareholders' ability to cast a "say on pay" and (in the case of a change of control) "say on parachute" vote, has resulted in an increase in proposals attempting to eliminate automatic vesting of those awards on a change of control. *The Wall Street Journal* discusses four proposals submitted by organized labor groups that passed in 2014. These proposals would prevent the automatic vesting on a change of control of stock awards that would otherwise vest based on future performance, but the proposals are not binding on the companies.

As noted above, companies are also required to include a nonbinding "say on parachute" vote by stockholders on change-of-control compensation in connection with a meeting of stockholders considering a merger or other change-of-control transaction. Interestingly, all but one of the 58 "say on parachute" proposals that has gone to vote so far in 2014 has been approved. Shareholders are so far focusing on the "say on pay" mechanism and the votes on compensation committee members nominated for board seats to express their concerns about compensation, but there is also a risk of "failed" parachute votes in cases where the companies have gross-ups or accelerated vesting being realized as part of the change-of-control transactions.

Severance on "Retirement"

Employment agreements generally provide for the same computation of severance (often based on a multiple of base salary and bonus), regardless of the age at which the executive's employment is terminated. Some advisory firms are urging companies to consider adding an age limit to the computation of the severance, so that, for example, the computation of the severance payment would be capped based on the number of years and months until the executive attains age 65. The stated rationale for this is that the executive would not be likely to continue working as an employee after age 65 and so, regardless of the reason for his termination, he will not need severance payments as a bridge until he can find a new position.

Executives may be willing to renegotiate certain provisions in their employment agreements, but companies should expect that they will have to offer some additional enhancements in order for an executive to give up a negotiated right.

New Arrangements Versus Existing Arrangements

Companies should consider the view of shareholders, advisory firms and proxy firms in entering into new employment agreements and change-of-control arrangements *before* those arrangements are adopted or granted. But many companies are bound to long-term employment agreements that they cannot terminate without either making large payments to executives or triggering a "good reason" for the executive to resign and be paid under the agreement. These employment agreements may well include gross-up provisions that had been included at a time when these provisions were viewed more favorably by shareholders (and may have been necessary to retain or attract the executive in that market). Similarly, stock options with acceleration of vesting on a change of control may have been granted up to 10 years before. With respect to any such provisions, it is important that the compensation committee describe in the proxy statement (i) the reality that those plans and awards cannot be changed in the near future and (ii) the provisions that the company is including in more current agreements and grants. Executives may be willing to renegotiate certain provisions in their employment agreements, but companies should expect that they will have to offer some additional enhancements in order for an executive to give up a negotiated right.

The Take-Away

Engaging with shareholders continues to be a crucial part of the corporate governance process, and it is important to understand the current positions of a company's major institutional investors and proxy firms on relevant compensation policies. Public companies will want to make sure that they understand the current view of their shareholders and take that into account in granting new awards and agreements.

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Motive Matters: Good Process in Merger Transactions and Contemporaneous Minutes Reflecting Reasons for Process Decisions May Protect Directors and Officers From Breach of the Duty of Loyalty and Self-Dealing Claims

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Two recent Chancery Court decisions, *Houseman v. Sagerman*, 2014 WL 1478511 (CA No. 8897-VCG) (Del. Ch. April 16, 2014) and *Chen v. Howard-Anderson*, 87 A.3d 648 (Del. Ch. April 8, 2014), remind us of the value of both good process *and* preserving a good record of that process when boards are considering the sale of a company. In each case, the board of the target company was alleged to have breached the duty of good faith because of alleged failures to conduct a sales process reasonably. As is typical, both companies had an exculpatory clause in their corporate charters protecting directors from personal liability other than for a breach of the duty of loyalty, which includes the duty to act in good faith.

In *Houseman*, the main allegation of a defect in the process was a decision by the board not to obtain a fairness opinion, which we discuss below in further detail. Vice Chancellor Glasscock notes that "the Universata Board did not conduct a perfect sales process, but, neither did it utterly fail to undertake any action to obtain the best price for stockholders." Quoting from *Lyondell*, Vice Chancellor Glasscock explains that "only if [the directors] *knowingly and completely failed* to undertake their responsibilities would they breach their duty of loyalty." *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 243-44 (Del. 2009).

Thus, although the court identified possible process imperfections, the court determined that the board had not failed utterly to undertake actions to obtain the best price. The motion to dismiss the complaint as to these claims was granted.

The question was not whether the board had utterly failed to undertake its responsibilities or "consciously disregarded" its known duties, but rather whether the board acted from improper motivations.

In *Chen*, however, Vice Chancellor Laster determined that "there was a reasonable inference that the Board favored one bidder at the expense of generating greater value through a competitive bidding process or by remaining a stand-alone company and pursuing acquisitions," that it was unreasonable both to give a competing bidder a 24-hour ultimatum to make a bid with no reason for such a short deadline and to rely on a banker's 24-hour, July 4 market check. Here, the question was not whether the board had utterly failed to undertake its responsibilities or "consciously disregarded" its known duties, but rather whether the board acted from improper motivations.

Improper Motivation Is a Separate Ground for Bad Faith

As Vice Chancellor Laster explained, Delaware courts have held that "[a] failure to act in good faith may be shown … where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation," *Chen, citing In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 67 (Del. 2006). "Greed is not the only human emotion that can pull one from the path of propriety; so might hatred, lust, envy, revenge … shame or pride. Indeed any human emotion may cause a director to place his own interests, preferences or appetites before the welfare of the corporation." *Chen, citing In re RJR Nabisco, Inc. S'holders Litig.*, 1989 WL 7036, at *15 (Del. Ch. Jan. 31, 1989). The vice chancellor held that "[t]he plaintiffs can defeat summary judgment by citing evidence which when evaluated under the Rule 56 [motion for summary judgment] standard, supports an inference that the directors made decisions that fell outside the range of reasonableness for reasons other than pursuit of the best value reasonably available which could be no transaction at all."

Nevertheless, in *Chen*, the court determined the plaintiffs had not offered "evidence sufficient to create a dispute of material fact about the outside directors' pursuit of the best value reasonably available." He explained that "[a]t the summary judgment stage, speculation about motives is not enough." He noted that one cannot reasonably infer that directors would act against their own economic interests. This was not a foregone conclusion in this case, however. One of the directors had multiple conversations with the favored bidder. Vice Chancellor Laster observed with respect to that director, that "[f]or obvious reasons, the inference that [the director] provided confidential information about [the target company] to a competitor and potential acquirer presents one of the more troubling aspects of the case." Nevertheless, the vice chancellor found that plaintiffs simply failed to offer any plausible improper motive. He therefore granted the motion for summary judgment in favor of the independent directors.

It is worth noting that the officer defendants in *Chen* were not so lucky, because the exculpatory clause did not apply to them *qua* officers. Thus, the process defects identified by Vice Chancellor Laster would require further legal proceedings—if the case proceeds to trial, the officers will have to justify their actions and demonstrate that they had no improper motive. The vice chancellor observed that there was competing evidence supporting the reasonableness of the process decisions by the board, and both the director defendants and the officer defendants would have been well served by a clear record in the minutes of the reasons for the process decisions, demonstrating a proper motive on the face of it.

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Chen is certainly not the first or the last Delaware decision in which the breach of the duty of loyalty claim focused on improper motives. See, e.g., *In re Answers Corporate Shareholders Litigation*, 2012 WL 1253072

(Del. Ch. 2012) (liquidity "has been recognized as a benefit that may lead directors to breach their fiduciary duties;" alleged breach of duty of loyalty where directors who were employees of a large stockholder desiring liquidity approved a merger where the company's improving financial results had not been disclosed). Indeed, Vice Chancellor Glasscock also considered the possibility of bad motivations for the alleged defects in process in *Houseman*. Like the directors in *Chen*, the directors in *Houseman* had a substantial economic interest in the company, and the plaintiffs did not attempt to "suggest what could have caused these directors with substantial economic interests in the Company to utterly abandon their responsibilities to maximize value in selling the Company." Future plaintiffs will take note of the need to plead facts that would at least permit an inference of bad motive, and one can expect ever more aggressive discovery to uncover hidden motives.

Process decisions and the reasons for them should be reflected in the minutes of the board meeting, contemporaneously prepared, to assure the board the defense that they had made a reasonable business judgment.

Failure to Obtain a Banker Fairness Opinion Does Not Constitute Bad Faith *Per Se*

In *Houseman*, Vice Chancellor Glasscock considered the failure of the board of a privately held company to obtain a fairness opinion allegedly costing at least $250,000. The board had concluded that hiring the investment bank for the limited purpose of assisting in diligence, shopping the company and providing an informal opinion as to whether an offer was within the range of reasonableness was in the stockholders' interests. The court noted that "the board did undertake *some* process aimed at achieving the best price for stockholders, and considered and rejected, obtaining a fairness opinion based on cost. That is not bad faith."

Note that in this case, it was helpful to the defendant directors that the plaintiff's complaint demonstrated the board consideration of the relative value of the fairness opinion. Obviously, a director cannot assume that a plaintiff will know what happened in the boardroom, nor include the information critical to demonstrating the board's consideration of an issue in the plaintiff's complaint. Therefore, these process decisions and the reasons for them should be reflected in the minutes of the board meeting, contemporaneously prepared, to assure the board the defense that they had made a reasonable business judgment.

Failure to Receive Value for Litigation Assets May Give Rise to a Colorable Claim Against Directors

In *Houseman*, plaintiffs also argued that "the merger consideration was insufficient in that it failed to account for the value of litigation claims that could have been brought against the directors," and that the plaintiffs should recover for the value of those litigation assets. The three board decisions at issue were decisions made by the board on the date the

merger was approved—decisions to amend the target company's equity plan to treat equity under the plan as common stock, to vest outstanding "in the money" warrants and to honor parachute payments under an officer's employment agreement. The defendant directors successfully argued that these derivative claims are not the type that give rise to liability post-merger under *In re Primedia, Inc. S'holders Litig.*, 67 A.3d 455, 476 (Del. Ch. 2013),[1] because the claims came into existence only on the day the merger was approved and, therefore, the board could not have negotiated a price that included consideration for those litigation assets.

The plaintiffs argued, however, that this would permit the board to engage in self-dealing without consequence. Vice Chancellor Glasscock notes that "directors' unfair acts of self-dealing throughout the course of a merger transaction should not be immune from stockholder challenge." He notes that case law[2] supports the right of stockholders to challenge payments to directors who wrongfully take off the table consideration that otherwise would have been shared by stockholders on a pro rata basis.

Vice Chancellor Glasscock concluded that plaintiffs had stated a conceivable claim for diversion of merger consideration here, noting that to survive a motion to dismiss, plaintiffs must plead facts supporting an inference that the side payment was an improper diversion, and absent impropriety, the consideration would have gone to the stockholders. He found that the pleadings could be understood to allege that certain warrants arose in a self-dealing context, the board caused the warrants to vest rather than lapse, constituting further self-dealing and that the value was material in the context of the consideration at issue.

Primedia and the self-dealing cases raise additional dangers of personal liability for boards considering related party transactions like compensation and vesting of equity in the context of a change-of-control transaction. It is important for the board to undertake a careful process with independent directors to consider any related-party transactions after full consideration and to establish a defensible record of their deliberations and decisions.

Conclusion

These cases demonstrate that plaintiffs not only have to plead sufficient facts to state a claim against directors for breach of *Revlon* duties, but also must plead a breach of the duty of loyalty. In pleading bad faith, plaintiffs will rarely survive a motion to dismiss on a theory that directors utterly failed to observe

1 A plaintiff claiming standing to challenge a merger for failure to obtain value for an underlying derivative claim must meet a three-part test: the plaintiff must plead an underlying derivative claim that has survived a motion to dismiss or states a claim under which relief could be granted, the value of the derivative claim must be material in the context of the merger and the complaint must support a pleading-stage inference that the acquirer would not assert the underlying derivative claim and did not provide value for it. The standard is premised on the idea that prior to a merger, stockholders own, as an asset, the value of any derivative claim that could be asserted; after a merger, the right to bring a derivative action passes via merger to the surviving corporation and the stockholders are entitled to recover consideration for the transfer of the asset. *In re Primedia*, 67 A.3d at 476-77.

2 See *Kramer v. Western Pacific Industries, Inc.*, 546 A.2d 348 (Del. 1988); *Parnes v. Bally Entertainment Corp.*, 722 A.2d 1243 (Del. 1999), and *Golaine v. Edwards*, 1999 WL 1271882 (Del. Ch. Dec. 21, 1999).

their *Revlon* duties. The alternative theory requires plaintiffs to plead facts giving rise to an inference of improper motivation. Plaintiffs will therefore be aggressive in seeking to find facts that demonstrate bad motives to create pressure on director defendants. It is important to create a good contemporaneous record of process decisions showing proper motivation. This will also help in defending officers for process defects under *Revlon*, as officers are personally liable for a simple breach of the duty of care. Directors should also take care to avoid self-dealing transactions and have any related party transactions approved by independent directors, after careful deliberations with a good contemporaneous record.

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Conflict Minerals Disclosures

Round 1: Some Initial Observations

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Now that June 2, 2014 has come and gone, and the first wave of Form SDs and Conflict Minerals Reports has been filed, a few common themes have emerged.[1]

Product Descriptions

Notwithstanding the April 29, 2014 statement from the SEC's Division of Corporation Finance that issuers would not be required to describe their products as "DRC conflict free," having "not been found to be DRC conflict free" or "DRC conflict undeterminable," many issuers nonetheless disclosed that their necessary conflict minerals were "DRC conflict undeterminable." It appears that for such issuers, the desire to report that despite their reasonable country of origin inquiry and due diligence efforts, they were unable to adequately trace the origin of their necessary conflict minerals, outweighed any first amendment concerns (at least with respect to the "undeterminable" category).

Reasonable Country of Origin Inquiry (RCOI)/Due Diligence

As there appeared to be overlap between many issuers' RCOI and due diligence efforts, a discussion of both was often included in filed Conflict Minerals Reports.

With respect to the RCOI, the template developed by the Electronic Industry Citizenship Coalition (EICC) and the Global e-Sustainability Initiative (GeSI), which was created to facilitate disclosure and communication of information regarding smelters or refiners (SORs) relevant to a company's supply chain, was widely adopted by issuers this reporting period. Among other things, the template includes questions about the origin of conflict minerals included in the supplier's products and suppliers' due diligence efforts. Many issuers noted that survey responses were analyzed for completeness, to ascertain whether information regarding SORs was provided and to determine the "conflict-free" certification status (from independent third parties) of identified SORs.

Notwithstanding the reported efforts of issuers to narrow the list of their suppliers to those "in scope" for the Conflict Minerals Rule, the widespread use of the EICC-GeSI template, and multiple follow-up attempts with respect to unresponsive suppliers, few issuers

1 This article discusses filed Form SDs. Note that with respect to the application of the rule itself, Keller and Heckman LLP, on behalf of ten industry associations, participated in a telephone conference with the SEC staff concerning whether nonmetallic forms of tin qualify as conflict minerals under the final rule. According to their follow-up letter, which was recently published, the SEC staff represented that companies using chemical compounds derived from a 3TG to manufacture products are not required to conduct any inquiry into the country of origin associated with these compounds and are not otherwise required to submit any report to the SEC, but alloys containing a 3TG would remain subject to the rule, as would companies that use a 3TG in its raw metal form to manufacture a chemical compound. The Elm Consulting Group has said that it reconfirmed some of this informal oral advice directly with the SEC staff. Elm has written that "the staff has determined that the disclosure requirements only apply to metallic forms of tin, including alloys containing tin that is intentionally added. It does not appear that the staff will issue any written documentation of this new interpretation…." Elm has subsequently confirmed that the informal guidance relates to all 3TG.

disclosed a 100 percent supplier response rate (a range of 40–85 percent was not uncommon for those issuers who disclosed the response rates to their supplier inquiries). As a result, many issuers noted their intention to focus on improving supplier response rates for subsequent reporting periods.

Many issuers stated they would attempt to improve their due diligence in subsequent reporting periods by working with suppliers to obtain certifications tailored to a particular issuer's end products, as opposed to blanket company-wide certifications.

In addition, many disclosures noted that the responses received from suppliers were provided at the supplier level, instead of being specific to the products sold to the issuer, such that even where SORs were identified by suppliers, it was often impossible for an issuer to determine which SORs were used to produce such issuer's particular products (especially where a large number of SORs were identified by one supplier). Many issuers therefore concluded that they did not have sufficient information to identify either the country of origin of their necessary conflict minerals or the particular SORs that processed them. In addition, a number of issuers noted that the SORs identified by the suppliers were not listed on any certified smelter or refiners lists, and could therefore not be confirmed as actual SORs.

In light of the foregoing, many issuers stated they would attempt to improve their due diligence in subsequent reporting periods by working with suppliers to obtain certifications tailored to a particular issuer's end products, as opposed to blanket company-wide certifications.

Additional Common Themes

In addition to low supplier response rates, complex and multi-tiered supply chains, and company-wide supplier responses, many issuers reported that they were unable to determine whether their necessary conflict minerals originated in the relevant countries or, if so, whether they were from scrap or recycled sources, or directly or indirectly benefitted or financed armed groups (as defined in the Conflict Minerals Rule) as a result of:

- Difficulties in obtaining information from entities distant from the issuer in the supply chain;
- The issuer's resulting inability to determine definitively the country of origin of its necessary conflict minerals; and
- The early stage of smelter certification processes.

Conclusion

Although issuers devoted a substantial amount of time and resources to compliance with the Conflict Minerals Rule, and disclosed that their due diligence efforts followed the framework provided by the Organisation for Economic Co-operation and Development (OECD) Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas, this initial reporting period has demonstrated that conflict minerals supply chains are still far from transparent. As a result, despite the stated goals of many issuers to achieve determinable "conflict-free" supply chains, it is apparent that more time and work are needed to convert this intention into reality.

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