

Recent Delaware Cases Involving Controlling Stockholders

BY WILLIAM D. REGNER AND DMITRIY A. TARTAKOVSKIY

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Most publicly traded U.S. companies do not have controlling stockholders. Those that do generate a disproportionate amount of stockholder litigation, given the potential for the interests of controlling stockholders to diverge from those of other stockholders. In three recent cases, the Delaware Court of Chancery had the opportunity to dilate on some of the issues that often arise in transactions involving companies and their controlling stockholders.

***Krieger v. Wesco*: What is the Applicable Standard of Review?**

Under Delaware law, the legal standard applicable to going-private transactions depends on the transaction structure and the role of the controlling stockholder. For Delaware targets, a going-private merger with a controlling stockholder generally is subject to review under the entire fairness standard, with the burden of proving entire fairness shifting to the plaintiff if appropriate procedural protections are in place—namely, approval of the transaction by a special committee of independent directors

or, alternatively, conditioning the deal on approval by holders of a majority of the stock not held by the controlling stockholder.¹ In a series of cases, the Delaware Court of Chancery has explored whether going-private mergers subject to more robust procedural protections, as well as unilateral, non-coercive tender offers by controlling stockholders, should be reviewed under the more deferential business judgment rule.²

In his 2010 decision in *In re CNX Gas Corp. S'holder Litig.*,³ Vice Chancellor

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From the EDITOR

An Antic Antitrust Season

The collapse of the \$39 billion AT&T/T-Mobile USA merger in December surprised few, as it had seemed for some time that AT&T was increasingly wary of going head-to-head with the Department of Justice, which was intent on blocking the deal. The prospect of spending more than a year in court while having to get the Federal Communication Commission's approval as well ultimately proved to be a deal-killer.

Along with the DOJ's recent victory in stopping H&R Block's proposed acquisition of rival TaxAct, the failure of the AT&T deal signaled that we're in the most vigorous antitrust environment in over a decade. Should President Obama be re-elected in the fall, the 2010s could well be marked by a tough and aggressive DOJ, which could mean that the next four years will be a questionable environment for big-ticket mergers with antitrust issues.

That said, some analysts and lawyers have found that a pattern has emerged in terms of antitrust enforcement. The DOJ is typically concentrating on challenging "horizontal" deals like the proposed AT&T/T-Mobile merger, in which one competitor buys another major competitor in a fairly closed industry. Thus the prominence of AT&T and T-Mobile, the second- and fourth-ranked companies in the mobile phone sector, made their merger (which would have created the largest mobile phone provider in the U.S.) a ripe target for the DOJ, which was planning to argue that the deal would result in reduced competition and higher costs for consumers.

However, the DOJ has so far been fairly favorable to "vertical" deals, in which a company purchases a target in another industry as a strategic expansion. For example, last year the DOJ allowed Google's purchase of travel software mak-

er ITA Software as well as the merger of concert promoter Live Nation with Ticketmaster.

The implications of a long-term aggressive antitrust effort at the DOJ could reverberate in the M&A market for years, especially if the President is re-elected. To take just one example, the state of reverse termination fees could be substantially altered. According to Fried Frank's David Shine and Abigail Bomba, in their article this issue examining such fees, AT&T/T-Mobile USA's deal included a fee payable by AT&T to the seller of up to approximately \$6 billion in value (consisting of cash, spectrum rights and other assets) in the event that antitrust approvals for the deal were not obtained, or about 15% of the transaction size. "This became payable in December when AT&T terminated the proposed transaction due to the strong stance taken against the transaction by the Department of Justice," they wrote.

However, if there is to be an aggressive DOJ for the foreseeable future, today's historically high average of reverse termination fees seem unsustainable. After all, as the authors write, "extravagant promises, like chickens, only become an issue when they come home to roost. To date there have been no legal challenges to these fees, but the result of the AT&T transaction may cause dealmakers to rethink these provisions."

I hope that all of our readers had a great holiday season, and best of luck to you all in 2012.

CHRIS O'LEARY
MANAGING EDITOR

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Travis Laster, reviewing a going-private tender offer by CONSOL Energy, Inc., the holder of approximately 83.5% of the common stock of CNX Gas Corporation, to acquire the remaining shares of CNX Gas, articulated a “unified standard of review,” holding that the business judgment rule applies to a going-private transaction involving a controlling stockholder—whether the transaction is structured as a tender offer or a negotiated merger—provided the transaction is conditioned on both (1) the affirmative recommendation of a special committee empowered to negotiate the transaction and (2) the approval by holders of a majority of the shares held by unaffiliated stockholders. If either prong is not satisfied, the transaction is subject to entire fairness review.⁴ In reaching his holding, Vice Chancellor Laster expressly declined to follow prior Delaware cases and suggested that the choice among the applicable lines of cases implicates fundamental issues of Delaware law that should be resolved by the Delaware Supreme Court.

In *Krieger v. Wesco Financial Corp.*,⁵ Vice Chancellor Laster again visited the question of the standard of review applicable to going-private transactions involving controlling stockholders. The transaction in *Krieger* was structured as a negotiated merger, rather than a tender offer. Vice Chancellor Laster again applied the “unified standard of review” announced by him in *CNX Gas*, holding that the transaction should be reviewed under the business judgment rule.

The *Krieger* case arose from a merger in which Berkshire Hathaway, the holder of 80.1% of Wesco’s common stock, sought to acquire the remaining common shares of Wesco in exchange for cash or Berkshire stock, at the election of Wesco stockholders. The merger was negotiated and approved by a duly empowered and independent special committee of the Wesco board, and the merger agreement contained a non-waivable majority-of-the-minority stockholder approval condition.

The Court of Chancery denied a request to preliminarily enjoin the merger, holding that the transaction was subject to the business judgment rule because it satisfied both prongs of the unified standard. The court also held that the majority-of-the-minority approval was not tainted by the

inclusion of Wesco’s largest minority stockholder, who held 5% of the stock and was also a member of the special committee, stating that there was no evidence that the interests of the large minority stockholder were not aligned with those of the other minority stockholders.

Southern Peru: What is the Role of the Special Committee?

It is well settled under Delaware law that a transaction in which a company acquires an asset from its controlling stockholder is subject to the entire fairness standard of review. In *In re Southern Peru Copper Corp. S’holder Deriv. Litig.*,⁶ the Delaware Court of Chancery awarded \$1.26 billion in damages in an entire fairness lawsuit arising from Southern Peru Copper Corp.’s over \$3 billion stock-for-stock acquisition from Grupo Mexico, Southern Peru’s controlling stockholder, of Grupo Mexico’s 99.15% equity interest in Minera Mexico. Although the transaction had been approved by a special committee of Southern Peru’s independent directors, the court held that the process followed by the special committee in negotiating and approving the transaction was not entirely fair and did not result in the payment of a fair price.

The decision, by Delaware Chancellor Leo Strine, criticized Southern Peru’s special committee for, among other things, having from the outset a narrow conception of its mandate, limited to “evaluating” a transaction proposed by the controlling stockholder and not including the power to explore alternatives. Moreover, Chancellor Strine found that the special committee and its financial adviser went to “strenuous lengths” to equalize the values of the Southern Peru and Minera shares by valuing them on a relative basis when using Southern Peru’s market value would have suggested that Southern Peru was overpaying—an approach that, according to Chancellor Strine, resulted in a “manifestly unfair” transaction. The court also was critical of the special committee’s failure to consider whether it should change its recommendation in favor of the transaction at the time of the Southern Peru stockholder vote. Southern Peru was issuing a fixed number

of shares to Grupo Mexico in the transaction, and, as a result of Southern Peru's stronger-than-expected business performance, those shares had substantially increased in value between the signing of the merger agreement and the stockholder vote.

In light of these deficiencies in the special committee process, as well as his finding that Southern Peru stockholders had not been fully informed at the time of the merger vote, Chancellor Strine held that the defendants bore the burden of demonstrating the entire fairness of the merger and were not entitled to shift the burden of persuasion to the plaintiff. However, the Chancellor noted that the issue of burden shifting was not outcome determinative—or even important—because the evidence on the issue of fairness was not at equipoise. According to Chancellor Strine, regardless of who bore the burden of persuasion, the merger was unfair.

The court also focused on the role of one member of the special committee, nominated by Southern Peru minority stockholder Cerro, who was active in negotiating the deal while Cerro simultaneously negotiated with Southern Peru for registration rights to sell its Southern Peru shares. Ultimately, Chancellor Strine found that this conflict compromised the director's effectiveness, but that it did not rise to the level of a breach of the duty of loyalty.

OPENLANE: Can a Controlling Stockholder Lock Up the Deal?

One power of a controlling stockholder is its ability to deliver deal certainty to an acquirer of the company. The practical utility of this power was called into question by the Delaware Supreme Court's 2003 decision in *Omnicare, Inc. v. NCS Healthcare, Inc.*,⁷ which appeared to impose a bright-line requirement for a fiduciary out. Post-*Omnicare*, some parties seeking increased deal certainty have attempted to shorten the period between signing the merger agreement and obtaining stockholder approval of the merger. In its 2008 decision in *Optima Int'l of Miami, Inc. v. WCI Steel, Inc.*,⁸ the Delaware Court of Chancery upheld a merger agreement that permitted

the acquirer to terminate the agreement if target stockholder approval was not obtained within 24 hours after the merger agreement was signed. In *Optima*, the merger agreement was approved by the target's board of directors on the day of signing and was adopted by written consent of the target's stockholders later that day.

The Delaware Court of Chancery recently had the opportunity to revisit this issue in *In re OPENLANE, Inc. S'holders Litig.*,⁹ in which the court declined to enjoin the proposed acquisition of OPENLANE, Inc. by KAR Auction Services, Inc. The merger agreement required the target to obtain stockholder approval of the merger within 24 hours after signing but allowed the target board to terminate the agreement without paying a termination fee if stockholder approval was not obtained within that period. The merger agreement was adopted by written consent of holders of a majority of the target's shares within 24 hours after signing.

The plaintiff, an OPENLANE stockholder, argued that the no-solicitation provision in the merger agreement, which did not contain a fiduciary out, and the fact that the target's management held more than 68% of its outstanding stock, constituted an impermissible lock-up of the merger in violation of *Omnicare*. However, Vice Chancellor Noble found that there was no stockholder voting agreement to approve the merger and that the record merely suggested that holders of a majority of the target's shares quickly consented to the merger after it was approved by the board. In addition, the court noted that the no-solicitation provision in the merger agreement was "of little moment" because the target board was allowed to terminate the agreement without paying a termination fee if stockholder approval was not obtained within 24 hours. Accordingly, the court concluded that, unlike in *Omnicare*, the merger was not a "fait accompli."

The court also rejected the plaintiff's more general *Revlon* claim that the OPENLANE board engaged in a flawed sales process because, among other things, it failed to perform an adequate market check, contacted only three potential buyers, did not receive a fairness opinion and relied on scant financial information in approving the merg-

er. Although Vice Chancellor Noble observed that “the Board’s decision-making process was not a model to be followed,” he found that there was sufficient evidence that the board made a reasonable effort to maximize shareholder value.

Reaffirming the notion that, under Delaware law, “there is no single path that a board must follow in order to maximize stockholder value,”¹⁰ the court excused the OPENLANE board’s failure to undertake an extensive market check or to obtain a fairness opinion on the grounds that the board had “impeccable knowledge” of the company’s business and thus was in a position to judge the limited offers that were obtained, and the company’s business prospects, without taking these steps. Vice Chancellor Noble also noted that the target was a small company and that extensive market checks and fairness opinions are expensive. Although, according to the Vice Chancellor, “small companies do not get a pass just for being small,” if the small company is managed by a board with an “impeccable knowledge” of the company’s business, the size of the company may be taken into account in determining what is reasonable and appropriate. The court also excused the OPENLANE board’s failure to solicit bids from any financial sponsors, on the grounds that two of the target directors were private equity professionals and thus “were likely to know whether financial buyers would be interested in OPENLANE and approximately how much those buyers would be willing to pay.”

A footnote in the opinion seemed to imply that, even after the deal had been approved by holders of a majority of the target company’s shares, the transaction might still somehow be vulnerable to a higher bid. After quoting statements in *Omnicare* and *QVC* suggesting that every merger agreement must contain a fiduciary out, the court observed that it made no sense to enjoin a transaction when no superior offer had in fact emerged. According to the court, although the circumstances and the deal protection provisions may have discouraged potential buyers, sophisticated potential competing bidders likely would have understood that, “if a materially better offer were to be made, judicial relief might have been available” and would “recognize the capacity of

equity, when properly called upon, to fashion an appropriate remedy.”

NOTES

1. *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994) (“an approval of the transaction by an independent committee of directors or an informed majority of minority shareholders shifts the burden of proof on the issue of fairness from the controlling or dominating shareholder to the challenging shareholder-plaintiff”). See also *In re Pure Resources, Inc. S’holders Litig.*, 808 A.2d 421 (Del. Ch. 2002); *In re PNB Holding Co. S’holders Litig.*, 2006 Del. Ch. LEXIS 158 (Del. Ch. Aug. 18, 2006); *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929 (Del. 1985).
2. See *Pure Resources*, 808 A.2d at 421-22 (citing *Solomon v. Pathe Communications Corp.*, 672 A.2d 35, 39 (Del. 1996)). See also *Pfeffer v. Redstone*, 965 A.2d 676 (Del. 2009); *In re Cox Communications, Inc. S’holders Litig.*, 879 A.2d 604 (Del. Ch. 2005); *Next Level Communications, Inc. v. Motorola*, 834 A.2d 828 (Del. Ch. 2003); *Aquila, Inc. v. Quanta Services, Inc.*, 805 A.2d 184 (Del. Ch. 2002); *In re Siliconix Inc. S’holders Litig.*, Del. Ch. LEXIS 83 (Del. Ch. June 19, 2001).
3. 2010 Del. Ch. LEXIS 119 (Del. Ch. May 25, 2010).
4. The “unified standard” was first suggested by then-Vice Chancellor Strine in *In re Cox Communications, Inc. S’holders Litig.*, 879 A.2d 604 (Del. Ch. 2005). In that case, Vice Chancellor Strine expressed the view that a going-private merger that is negotiated with and approved by an independent special committee and is conditioned upon the approval of a majority of the publicly held shares should be reviewed under the business judgment rule. In *CNX Gas*, Vice Chancellor Laster tightened the test proposed in *Cox Communications* in a small but important manner, requiring that the special committee affirmatively approve the transaction rather than merely not recommend against it, as had occurred in the transaction reviewed by Vice Chancellor Strine in *Cox Communications*.
5. C.A. No. 6176-VCL (Del. Ch. May 10, 2011).
6. C.A. No. 961-CS (Del. Ch. Oct. 14, 2011).
7. 818 A.2d 914 (Del. 2003).
8. C.A. No. 3833-VCL (Del. Ch. June 27, 2008).
9. C.A. No. 6849-VCN (Del. Ch. Sept. 30, 2011).
10. *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989).

Reverse Termination Fees Gone Wild: Legal Limits or Sky's the Limit?

BY DAVID SHINE AND ABIGAIL BOMBA

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Followers of the deal press know that last year featured some strategic transactions with eye-popping antitrust reverse termination fees. In March, AT&T announced its agreement to acquire T-Mobile USA, which included a fee payable by AT&T to the seller of up to approximately \$6 billion in value (consisting of cash, spectrum rights and other assets) in the event antitrust approvals for the deal were not obtained. This potential fee represented approximately 15% of the transaction size and became payable in December when AT&T terminated the proposed transaction due to the strong stance taken against the transaction by the Department of Justice. In addition, over the summer Google announced its agreement to acquire Motorola Mobility. That transaction features a cash antitrust reverse termination fee of \$2.5 billion which represents about 20% of the transaction size.¹

The use and size of forward termination fees (which a target pays to an acquirer in order, for example, to accept a higher offer) are constrained by a well-established body of law. Although there is no specific formula for determining the reasonableness of forward fees and they are evaluated in the context of the entire package of deal protection provisions,² forward fees have infrequently strayed from the 3-4% range.³ And, for a time, the size of reverse fees and forward fees were linked. But targets have realized that there is no

logic to linking the size of these fees. A reverse termination fee is intended to compensate the target for the potential impact of a failed transaction, such as the loss of key customers or employees or the possible marketplace view of the target as “damaged goods,” and should constitute an appropriate price to be paid by the acquirer for its “option.”

During the height of the credit crisis, concerns about the availability of financing drove financing reverse termination fees to levels well beyond those of customary forward termination fees.⁴ More recently, expectations of more robust antitrust enforcement under the current administration appear to have contributed to the ballooning of antitrust reverse termination fees.⁵ However, at the time these transactions were signed no out-sized reverse termination fee (either for antitrust failure or financing failure) had become payable. Extravagant promises, however, like chickens, only become an issue when they come home to roost. To date there have been no legal challenges to these fees, but the result of the AT&T transaction may cause dealmakers to rethink these provisions. This article will explore whether there are legal arguments that could be asserted to challenge unusually large reverse termination fees and, if so, the likelihood of those arguments succeeding.

State Law Restrictions on Penalty Payments

The first line of argument that could be asserted in seeking to set aside the payment of an outsized reverse termination fee is that the fee is a penalty payment which, under applicable state law, is unenforceable. A claim like this would, presumably, be made as a derivative claim by shareholders of the acquirer. However it is not always easy to distinguish a payment that seeks to penalize nonperformance (and which could, therefore, be unenforceable) from a payment in the nature of liquidated damages based on an agreement in advance as to the compensation payable to an aggrieved party in the event a contract is breached (and which would generally be enforceable).

Under Delaware law, a liquidated damages provision will not be enforced if it coerces performance by making a breach unreasonably expensive. While a liquidated damages provision, by its nature, exerts pressure on a party to perform, such a provision will not be disturbed “where the damages are uncertain and the amount agreed upon is reasonable.”⁶ This standard was applied to a forward termination fee in *Kysor Industrial Corp. v. Margaux, Inc.*⁷ In connection with its proposed acquisition by Kysor, Margaux agreed to pay a forward termination fee representing approximately 2.8% of the purchase price if it failed to consummate the transaction under certain circumstances. Margaux subsequently terminated the Kysor agreement to pursue a transaction with another acquirer and refused to pay the termination fee on the grounds that it was an unenforceable penalty. The Court reasoned that the estimation of damages in acquisitions of companies is inherently uncertain because the opportunity costs incurred in pursuit of such transactions are difficult to measure. It then examined the market for termination fees and noted the general consensus that fees in the 1-5% range of acquisition price are reasonable. Finding that the damages were uncertain and that the fee was reasonable, the Court held that the termination fee was enforceable. The Delaware Supreme Court expanded on this line of analysis in *Brazen v. Bell Atlantic Corp.*⁸ Addressing a shareholder challenge to a mutual termination fee representing 2% of a merger’s transaction size, the Court stated that the evaluation of a fee’s reasonableness should be guided by the difficulty of calculating the anticipated loss should the transaction not occur. Specifically, as the difficulty of calculation increases, more leeway should be given by the courts when determining a fee’s reasonableness. The Court then cited the difficulty of calculating the opportunity costs of pursuing a merger in a rapidly consolidating industry and noted the multitude of considerations that went into arriving at the specified fee before ultimately upholding the fee as an enforceable liquidated damages provision.

Whether an outsized reverse termination fee could be set aside as an unenforceable penalty would depend on the extent to which the dam-

ages resulting from termination are uncertain or incapable of calculation, and whether the fee is “reasonable.” In a public acquisition involving two sophisticated entities represented by experienced legal and financial advisors, it seems highly unlikely that under Delaware law a negotiated reverse termination fee could be held to be an unenforceable penalty payment. Nevertheless, targets may want to include in the merger agreement the type of language that often accompanies forward termination fees to the effect that the fee constitutes liquidated damages in a reasonable amount in light of the facts and circumstances rather than a penalty, noting that the calculation of damages is inherently uncertain.

Acquirer Waste

A second possible line of argument that could be asserted against an outsized reverse termination fee is that the fee constitutes corporate waste. This type of claim could be made by shareholders of the acquirer who believe that the approval of a proposed transaction did not constitute a valid exercise of business judgment by the acquirer’s board.

Under Delaware law, a board of directors generally enjoys the protections of the business judgment rule, which creates a presumption that in making a business decision the directors acted on an informed basis, in good faith and in the belief that the action was in the best interests of the company. In order to overcome the business judgment rule in the context of a claim of corporate waste, the facts must lead to a reasonable inference that the defendants “authorized an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration.”⁹ The test requires plaintiffs to show that “the board’s decision was so egregious or irrational that it could not have been based on a valid assessment of the corporation’s best interests.”¹⁰ Because there is such an onerous burden on plaintiffs, successful claims of corporate waste are few and far between.

Two high profile examples of corporate waste cases that have been unsuccessful in Delaware are

*In re The Walt Disney Company Derivative Litigation*¹¹ and *In re The Goldman Sachs Group, Inc. Shareholder Litigation*.¹² Disney involved a corporate waste challenge to the \$140 million severance package payable to former Disney president Michael Ovitz following his termination without cause just 14 months after being hired. Although the Court of Chancery noted that the Disney board “fell significantly short of the best practices of ideal corporate governance,” it ultimately rejected the corporate waste claim finding that the board had acted in good faith. More recently, in *Goldman Sachs*, plaintiffs alleged that Goldman’s directors committed corporate waste by utilizing a compensation structure tied to net revenue that resulted in excessive bonus payments. The Court of Chancery acknowledged that Goldman’s compensation levels were higher than other comparable firms but stated that this alone was insufficient to overcome the business judgment rule and dismissed the corporate waste claim.

In the context of an acquisition transaction, by negotiating reverse termination fees buyers are expressly limiting potentially enormous exposure in the event of a financing failure or an antitrust failure. Former Chancellor Allen stated in *Lewis v. Vogelstein* that “[if] there is *any substantial* consideration received by the corporation, and if there is a *good faith judgment* that in the circumstances the transaction is worthwhile, there should be no finding of waste, even if the fact finder would conclude *ex post* that the transaction was unreasonably risky. Any other rule would deter corporate boards from the optimal rational acceptance of risk...”¹³ Where an acquirer’s board has carefully evaluated the transaction and engaged in a thoughtful, informed decision-making process, the determination to commit to a reverse termination fee is unlikely to be deemed “wasteful” regardless of the size.

Possible Effect as an Impermissible Lockup

A third possible line of argument against a very large reverse termination fee could be that the fee, depending on the circumstances of the transac-

tion, impermissibly locks up the transaction for the acquirer. Companies in the so-called *Revlon* mode generally cannot agree to deal protection provisions that would make it impossible to accept a higher offer from another bidder. And in a non-*Revlon* stock-for-stock transaction, a well informed target board may provide its preferred acquirer with a significant bidding advantage.¹⁴ As a result, forward break-up fees, clearly a form of deal protection, are structured in transactions to navigate the judicial landscape of *Revlon* and its progeny.¹⁵

It is generally difficult to see how a large reverse termination fee could be construed as an impermissible form of deal protection.¹⁶ A well informed board, utilizing a deliberate process could certainly determine that obtaining a large antitrust reverse termination fee from a preferred acquirer is in the best interests of the target’s shareholders. However, one could envision scenarios where an outsized reverse termination fee, say, in a *Revlon* transaction, could arguably have the effect of making it nearly impossible for a higher offer to emerge.

For example, consider a transaction where there are two likely strategic buyers of a target—one buyer with few apparent antitrust hurdles and the other buyer with major hurdles. And, in the transaction, the buyer with few hurdles is offering a lower price. The target board could certainly accept the lower price if it believes that the antitrust hurdles of the higher bidder are so great that the transaction would be at significant risk.¹⁷ But what if, in order to try to avoid having to confront a renewed offer from the higher bidder, the lower bidder (with little antitrust risk) offered to include a substantial reverse termination fee? That way, any renewed bid from the higher bidder that did not match the fee would arguably not be “superior” and so would not require pursuit by the target. The higher bidder could, of course, persuasively argue that in such a circumstance the reverse fee is illusory since almost certain to never become payable, and so not a necessary component of a “superior” offer.

While this scenario may be unlikely, it does demonstrate that there may be circumstances in which the use of a large reverse termination fee

could arguably have a defensive effect and, if so, could be subject to the *Unocal* enhanced scrutiny standard.¹⁸ How the court would find in such a case would of course depend on the totality of the facts, but it is possible such a case could survive a target's motion for summary judgment.

Conclusion

Because the permissible scope of forward termination fees has been long debated and is now reasonably well defined, some may also question whether there are legal limitations on the permissible size of reverse termination fees. As discussed above, there may be plausible arguments that can be asserted seeking to invalidate a reverse termination fee. And the strength of these arguments may be in direct proportion to the size of the reverse fee in question. However, in the absence of unusual facts or a court of equity exerting unusual authority, these arguments are likely to remain just that.

NOTES

1. We note, however, that these fees may be deductible to the acquirer and so in the event of payment their net cost to the acquirer may be substantially less.
2. Arthur Fleischer, Jr. and Alexander R. Sussman, *Takeover Defense: Mergers and Acquisitions* § 14.05[E], at 14-178 (successor ed. to *Takeover Defense*, 6th ed. 2010).
3. See, e.g., *In re Dollar Thrifty Shareholder Litigation*, C.A. Cons. No. 5458 (Del. Ch. Sept. 8, 2010) (upholding a termination fee representing 3.9% of the transaction price); *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975 (Del. Ch. 2005) (upholding a termination fee representing 3.75% of the transaction price). But see, e.g., *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.* 1999 Del. Ch. LEXIS 202, at *5 (Del. Ch. Sept. 27, 1999) (noting that a termination fee representing 6.3% of the transaction price is probably outside of the range of reasonableness).
4. For example, Pfizer agreed to pay a reverse termination fee representing approximately 6.6% of the transaction size if Pfizer was unable to obtain the financing necessary to complete its acquisition of Wyeth. Similarly, the Merck-Schering-Plough merger agreement provided for a reverse termination fee representing approximately 6.0% of the transaction size if Merck was unable to obtain financing.
5. Interestingly, notwithstanding such expectations, there is no reverse termination fee in Express Scripts' proposed acquisition of Medco despite the apparent antitrust hurdles posed by the transaction.
6. *Lee Builders, Inc. v. Wells*, 103 A.2d 918, 919 (Del. Ch. 1954).
7. 674 A.2d 889 (Del. Super. Ct. 1996).
8. 695 A.2d 43 (Del. 1997).
9. *In re Citigroup Shareholder Derivative Litigation*, C.A. No. 3338-CC, 2009 Del. Ch. LEXIS 25 (Feb. 24, 2009) (quoting *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000)).
10. *White v. Panic*, 783 A.2d 543, 554 n.36 (Del. 2001); *In Re The Goldman Sachs Group, Inc. Shareholder Litigation*, C.A. No. 5215-VCG (Oct. 12, 2011).
11. 731 A.2d 342 (Del. Ch. 1998).
12. C.A. No. 5215-VCG (Oct. 12, 2011).
13. *Brehm*, 746 A.2d at 263 (quoting *Vogelstein*, 699 A.2d 327, 336) (emphasis in original) (citations omitted).
14. Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 *Bus. Law.* 919, 940 (2001).
15. See *In re Cogent, Inc. S'holder Litig.*, 7 A.3d 487, 503 (Del. Ch. 2010) (noting that termination fees representing approximately 3% of the transaction price are generally considered acceptable).
16. However, a very large fee payable by an acquirer in a stock-for-stock transaction in the event the acquirer's stockholders vote down the deal may be subject to set-aside as an impermissible intrusion on the stockholder franchise. See *Brazen v. Bell Atl. Corp.*, 695 A.2d 43, 49-50 (Del. 1997); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 659-60 (Del. Ch. 1988).
17. See, e.g., *Dollar Thrifty*, C.A. Cons. No. 5458 (rejecting plaintiffs' claims that Dollar Thrifty's board of directors failed to satisfy their fiduciary duties under Revlon in circumstances where the board rejected an interloping bid that offered a higher price per share but did not provide certainty of closing on antitrust issues (the bid did not contain an antitrust reverse termination fee or commit to a level of divestitures sufficient to obtain antitrust approval)).
18. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985) (stating that defensive measures are subject to enhanced scrutiny and will be upheld only if such measures are in response to a legitimate threat to corporate policy and are reasonable in relation to the threat posed).

IRS Issues Regulations Regarding the Valuation of Stock- Based Consideration Packages in M&A Transactions

BY DAVID B. STRONG

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On December 19, 2011, the IRS finalized prior temporary regulations and issued additional proposed regulations regarding the valuation of stock-based consideration packages for purposes of the “continuity of interest” requirement applicable to most tax-free reorganizations under Section 368 of the Internal Revenue Code. In general, the continuity of interest requirement dictates that a minimum percentage of a consideration package *by value* must be in the form of the acquiring corporation’s stock (generally assumed to be about 40%). In addition, if the value of the acquiring corporation’s stock is measured as of the closing date, the possibility of price fluctuations between signing and closing can make the tax treatment of a transaction uncertain. In order to address this issue, the final regulations define the circumstances under which the acquiring corporation’s stock will be valued as of the last business day before the day on which a deal is signed (referred to as the “signing-date rule”). As a result, pursuant to the signing-date rule, a transaction may still qualify as tax-free even if the relative value of the acquiring corporation’s stock declines between signing and closing.

The following basic example illustrates the signing-date rule contained in the final regulations:

- On January 3 of Year 1, an acquiring corporation (“X”) and a target corporation (“T”) sign a binding contract pursuant to which T will be merged with and into X on June 1 of Year 1.
- Pursuant to the contract, the T shareholders will receive 40 X shares and \$60 cash in exchange for all the outstanding stock of T.
- On January 2 of Year 1, X stock is worth \$1 per share. On June 1 of Year 1, T merges with and into X pursuant to the terms of the contract and as of that date X stock has declined in value and is worth only \$.75 per share.

Under the final regulations, and despite the decline in the value of X stock between signing and closing, the transaction will satisfy the continuity of interest requirement and will have the ability to qualify as a tax-free reorganization. Specifically, pursuant to the signing-date rule, the value of the X stock to be delivered to the T shareholders will be deemed to represent 40% of the total consideration package (40 X shares * \$1 per share = \$40). By comparison, if the closing-date value for X stock was used, the transaction may not qualify as a tax-free reorganization because the value of the X stock to be delivered to the T shareholders would represent only approximately 33% of the total consideration package (40 X shares * \$.75 per share = \$30).

Shareholder Election Mechanisms

The final regulations adopt prior temporary regulations that were originally issued in 2007, and that later expired in 2010, with only a few minor changes. One of the changes in the final regulations clarifies that certain “shareholder election” mechanisms, whereby a target corporation’s shareholders can make individual elections regarding the desired mix of stock and cash to be received in connection with a transaction, will not prevent the application of the signing-date rule. This change effectively provides acquiring cor-

porations with enhanced flexibility in situations where the shareholders of a target corporation may have different ongoing investment objectives or tax profiles.

Price Protection Mechanisms

In addition to the final regulations, related proposed regulations create entirely new rules that are designed to address certain types of price protection mechanisms (such as “variable-ratio stock collars” and cash “top-up” or “top-down” arrangements). Previously, such price protection mechanisms would have prevented the use of the signing-date rule. However, if the same general concepts set forth in the proposed regulations are eventually reflected in final regulations, the parties to a transaction may be able to utilize price protection arrangements and apply a special variation of the signing-date rule that utilizes the underlying “floor” or “ceiling” price for the acquiring corporation’s stock.

As an illustration of a price protection mechanism that may qualify for the proposed special variation of the signing-date rule, consider the following example, which is based on an example contained in the proposed regulations:

- On January 3 of Year 1, an acquiring corporation (“X”) and a target corporation (“T”) sign a binding contract pursuant to which T will be merged with and into X on June 1 of Year 1.
- Pursuant to the contract, the T shareholders will receive 50 X shares and \$50 cash in exchange for all the outstanding stock of T, subject to a price adjustment mechanism whereby the amount of cash will be adjusted depending upon the closing-date value of X stock.
- Under the terms of the price adjustment mechanism, if the average price of X stock over the five-day period preceding the closing date exceeds \$1, the amount of cash will be reduced by 50 times the excess of that price over \$1 (subject to an aggregate minimum of \$40).
- At the same time, and again under the terms of the price adjustment mechanism, if the average price of X stock over the five-day period preceding the closing date is less than \$1, the amount of cash will be increased by 50 times the excess of \$1 over that price (subject to an aggregate maximum of \$60).
- On January 2 of Year 1, X stock is worth \$1 per share. On June 1 of Year 1, T merges with and into X pursuant to the terms of the contract and as of that date X stock has declined in value and is worth only \$.75 per share (with the preceding five-day average price of X stock also equaling \$.75 per share).
- Upon the closing of the transaction, and due to the decline in the price of X stock, the T shareholders receive aggregate consideration of \$97.50, in the form of \$60 cash and 50 shares of X stock with an aggregate closing-date value of \$37.50.

Based on the terms of the price adjustment mechanism, the T shareholders are certain to receive aggregate consideration with a value of \$100 on the closing date as long as the value of X stock is between \$.80 and \$1.20 per share (with a “floor” mix of \$60 cash and \$40 X stock and a “ceiling” mix of \$40 cash and \$60 X stock). Furthermore, utilizing the approach of the proposed regulations, the transaction can satisfy the continuity of interest requirement and qualify as tax-free reorganization based on the relative value of X stock and cash as determined using the lower “floor” value for X stock of \$.80 per share. As a result, 40% of the consideration package (or \$40) will be deemed to be received by the T shareholders in the form of X stock and the continuity of interest requirement will be satisfied (despite the aggregate closing date value of \$37.50 for the 50 shares of X stock).

Effective Date; Additional Considerations

The final regulations apply to all transactions that occur pursuant to binding contracts entered into after December 19, 2011. In addition, parties

to transactions should take care to note that the final regulations are not elective and the signing-date rule will apply in all cases that fit within the defined parameters of the regulations. This could potentially prevent a transaction from qualifying as a tax-free reorganization if, for example, the continuity of interest requirement was not satisfied as of the signing date and the share price of the acquiring corporation's stock subsequently increased between signing and closing.

Finally, parties to transactions should also be aware that the final regulations contain rules that address a variety of special situations, including cases where:

- a contract is subsequently modified by the parties after the original signing date;
- an acquisition is conducted in the form of a tender offer;
- a portion of the consideration package may be placed in escrow;
- a contingent adjustment may occur to the consideration package; or
- the acquiring corporation alters its capital structure between signing and closing.

Delaware Court Applies Step Transaction Doctrine to 'Ensure Fulfillment of Parties' Expectations' in Merger Agreement

BY ROBERT REDER, ROLAND HLAWATY, DAVID SCHWARTZ AND HANNAH DWORKIS

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In *Coughlan v. NXP b.v.*,¹ the Delaware Court of Chancery recently applied the step transaction doctrine in determining that a series of actions related to the formation of a joint venture “were part and parcel of the same transaction,” thereby triggering provisions of a merger agreement requiring the acceleration of certain post-closing contingent payments.² However, because the joint venture assumed performance obligations of one of the parties related to the contingent payments—although not the specific obligation to make the contingent payments if earned—the Court ruled that acceleration of the contingent payments was not required under the terms of the merger agreement.

Background

In December 2007, GloNav, Inc., “a developer of GPS-related semiconductors,” entered into a merger agreement with NXP b.v., “a semi-

conductor company based in the Netherlands.” Upon consummation of the merger on January 23, 2008, GloNav stockholders received cash in exchange for their GloNav shares and GloNav survived as a wholly-owned subsidiary of NXP. The merger agreement designated Elaine Coughlan as the “Stockholder’s Representative” for the former GloNav stockholders.

In addition to the cash payments to be made at closing, the merger agreement provided for contingent payments to the former GloNav stockholders if GloNav achieved “certain revenue and product development targets” post-closing (collectively, “Contingent Payments”). In furtherance of the Contingent Payments obligations, the merger agreement obligated NXP “to develop an operating plan for the GloNav business that was ‘aligned with the achievement of the [targets]’ and to provide GloNav with the tools...and other support needed to achieve the targets.” Additionally, the merger agreement provided that, in the event of certain “change of control” transactions involving a sale of (i) “a majority of the outstanding stock of or other equity interests in [GloNav],” (ii) “all or substantially all the assets of [GloNav]” or (iii) “a portion of the assets of NXP in which all or substantially all of such assets consist of all or substantially all of the assets of [GloNav],” any remaining Contingent Payments would be accelerated unless the acquirer agreed to “assume all of NXP’s remaining obligations under” the section of the merger agreement governing the Contingent Payments.

Then in April 2008, NXP entered into a joint venture with STMicroelectronics, “a French semiconductor company,” whose purpose was to “combine[] the companies’ wireless businesses.” Pursuant to the terms of the JV agreement, NXP transferred various assets—including the assets constituting the GloNav business—to the joint venture in a two-step transaction. In the first step, NXP contributed its non-Dutch wireless businesses, including the GloNav assets, to a newly-formed subsidiary. In the second step, NXP transferred all of the shares of this subsidiary to the joint venture in return for a 20% stake in the joint venture and a cash amount, which was contributed by ST along with certain of its wireless assets.

ST received an 80% stake in the joint venture in consideration of its contributions. Although NXP retained its obligation to make the Contingent Payments if they were earned, the JV agreement assigned NXP’s related performance obligations under the merger agreement to the joint venture.

Following formation of the joint venture, NXP continued to make Contingent Payments as the GloNav business achieved the relevant targets. However, as a result of the 2008 financial crisis, the milestones for the final \$5 million in Contingent Payments were not met. In an effort nevertheless to obtain the remaining Contingent Payments, Stockholder Representative Coughlan filed suit in the Court of Chancery in October 2009, claiming that the remaining Contingent Payments had been accelerated by virtue of (i) the transfer by NXP of GloNav’s assets to the joint venture and (ii) the failure of the joint venture to assume NXP’s obligations to actually make the Contingent Payments under the merger agreement.

In response to Coughlan’s summary judgment motion, NXP argued that none of the triggering events for acceleration had occurred because (i) the *first step*, which involved NXP’s transfer of GloNav assets to a wholly-owned subsidiary, was an “exempt” transfer for purposes of the merger agreement, and (ii) the *second step*, involving the transfer of shares of the subsidiary to the joint venture, was not an acceleration triggering event under the merger agreement. Further, NXP argued that the joint venture’s assumption of NXP’s performance obligations under the merger agreement was sufficient to negate acceleration even if a triggering event was deemed to have occurred. On this basis, NXP cross-moved for summary judgment.

The Court’s Analysis

The Court granted summary judgment to NXP, concluding that although a change of control of the GloNav business had occurred by virtue of the formation of the joint venture, acceleration of the remaining Contingent Payments was not triggered because the joint venture had assumed NXP’s performance obligations with respect to

the Contingent Payments for purposes of the merger agreement.

Application of the Step Transaction Doctrine

To determine whether, as Coughlan claimed, the two seemingly separate steps used to effectuate NXP's transfer of GloNav assets to the joint venture constituted a change of control of GloNav that triggered acceleration of the Contingent Payments, the Court invoked the step transaction doctrine. This was required because neither step, taken alone, literally was a transaction that could trigger acceleration. According to the Court, the "[step transaction] doctrine treats the 'steps' in a series of formally separate but related transactions involving the transfer of property as a single transaction if all of the steps are substantially linked. Rather than viewing each step as an isolated incident, the steps are viewed together as components of an overall plan."³

Next, the Court delineated the "three different analyses in applying the step transaction doctrine": (1) the "*end result test*," under which a series of transactions is aggregated "if the 'separate transactions were prearranged parts of what was a single transaction, cast from the outset to achieve the ultimate result,'" (2) the "*interdependence test*," under which a series of transactions is aggregated "if the steps are not interdependently significant and [have] meaning only as part of the larger transaction," and (3) the "*binding commitment test*," under which a series of transactions is aggregated "if, at the time the first step is entered into, there was a binding commitment to undertake the later steps."

The Court determined that all three tests were satisfied and, therefore, under the step transaction doctrine, "although neither of the two transactions alone were Triggering Events," "the two transactions that resulted in the Joint Venture's ownership of GloNav's assets were part and parcel of the same transaction." While acknowledging, as NXP argued, that "a court should refrain from applying the step transaction doctrine to interpret a contract if doing so would contravene the parties' intent," the Court observed that "there is

nothing in the Merger Agreement's drafting history that suggests that the acceleration was not meant to occur upon a series of interdependent transactions that, when analyzed substantively rather than hyper-technically, clearly fits within the transactions enumerated in" the merger agreement provisions triggering acceleration. In the Court's view, "[t]o allow NXP to circumvent the protections of...[the acceleration provisions] simply by using a subsidiary to transfer the assets of GloNav to the Joint Venture would render those protections meaningless." Further, "[i]t is well settled in Delaware that our courts 'will not read a contract to render a provision meaningless or illusory.'"⁴

NXP also argued that the step transaction doctrine had its origins in, and should not be applied outside the context of, the tax treatment of asset transfers and fraudulent conveyances. The Court rejected this argument as well, noting that Delaware courts previously had "extended the doctrine to partnership agreements, warrant agreements, and recapitalization transactions," all on the basis that "transactional formalities will not blind the court to what truly occurred. Indeed, 'it is the very nature of equity to look beyond form to the substance of an arrangement.'"⁵ And just in case an appellate review might result in a finding that "the step transaction doctrine did not apply in this case," the Court went on to rule that it "would still consider the two transactions together as a matter of equity" because "equity regards substance rather than form."⁶

Assumption of Contingent Payment Obligations

Next, the Court turned to the question whether the joint venture's assumption of NXP's performance obligations in respect of the Contingent Payments, but not its payment obligations, prevented triggering of the acceleration provisions. Rejecting Coughlan's claim that the joint venture had assumed neither NXP's performance nor payment obligations, the Court concluded that various provisions of the JV agreement, "read as a whole...plainly indicate that the ST Joint Venture assumed NXP's Performance Obligations

and that NXP retained its Payment Obligations.” Because “the record is clear that the Joint Venture provided GloNav with the resources it needed to continue to meet the product development milestones” and that NXP “continued to make Contingent Payments as the relevant milestones were reached,” the Court concluded that the former GloNav stockholders “got exactly what they bargained for: contingent payments when the relevant milestones were reached.”

Thus, even though “the word ‘all’...could be read to require...that the ST Joint Venture assume both the Performance and Payment Obligations of NXP,” the Court viewed its “role” as requiring it “to derive meaning from the contractual language chosen by the parties *as a whole*, through which the parties set forth their respective obligations.” As a result, the Court did “not find it relevant which entity...was required by the terms of the JV Agreement to be the source of the funds that NXP was required to deliver...under the terms of the Merger Agreement.” Either way, “the Contingent Payments continued to be paid...following a change in control of GloNav—precisely as contemplated in the Merger Agreement.”

Conclusion

The *Coughlan* Court’s application of the step transaction doctrine to negate the desired impact of formally separating an asset transfer into two separate steps demonstrates that, for purposes of Delaware contract interpretation, “transactional creativity” employed by clever dealmakers and lawyers in structuring a transaction “should not affect how the law views the substance of what truly occurred.” Though the step transaction doctrine was historically used primarily in tax and bankruptcy courts, it is important for contracting parties to be aware that Delaware courts will utilize the doctrine in interpreting general business contracts. No matter how heavily negotiated a contract or how sophisticated the parties, the *Coughlan* ruling teaches that the Court of Chancery will look beyond “technical formalities” in

order “to ensure the fulfillment of parties’ expectations”

NOTES

1. 2011 WL 5299491 (Del. Ch. November 4, 2011).
2. For a discussion of a recent Delaware Supreme Court decision (applying New York law) refusing to apply the step transaction doctrine to the interpretation of an indenture’s successor obligation provision, see *Bank of New York Mellon Trust Company, N.A. v. Liberty Media Corp.*, 2011 WL 4376552 (Del. Supr., Sept. 21, 2011), *aff’g Liberty Media Corp. v. Bank of New York Mellon Trust Company, N.A.*, No. 5702-VCL (Del. Ch. Apr. 29, 2011).
3. *Citing Noddings Inv. Group, Inc. v. Capstar Commc’ns, Inc.*, 1999 WL 182568 (Del. Ch. Mar. 24, 1999).
4. *Citing Osborn v. Kemp*, 991 A.2d 1153 (Del. 2010).
5. *Citing Gatz v. Ponsoldt*, 925 A.2d 1265 (Del. 2007).
6. *Citing In re Cencom Cable Income Partners, L.P.*, 2000 WL 130629 (Del. Ch. Jan. 27, 2000).

Corporate Governance Feature: Investors Differ on Proxy Access Standards

BY TED ALLEN

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While many governance observers expected to see just a handful of proxy access proposals at 2012 corporate meetings, institutional investors and retail shareholders have filed at least 16 access resolutions so far with four variations in ownership thresholds and holding periods.

Several months ago, many observers were predicting just a few proposals that were modeled on the Securities and Exchange Commission’s uni-

versal access rule, Rule 14a-11. The rule, which was invalidated by a federal court, would have required investor groups to hold at least a 3% stake for three years to nominate board candidates, and would have imposed a 25% cap on the number of board seats available to access nominees. However, some retail activists objected to this approach and have filed access proposals with lower thresholds that would make it easier for smaller shareholders to participate.

During ISS' recently concluded comment period on its draft voting policies, shareholders offered varying views on the types of access provisions that they would support. Overall, ISS received more than 50 comments from investors, issuers, and other market participants on access, pay for performance, and other key U.S. and international governance issues.

The U.S. Proxy Exchange, an advocacy group for retail activists, argued in its comments that the 3% ownership threshold in Rule 14a-11 was too high and would disenfranchise "all individual shareowners and all but the very largest of institutional shareowners, at least at medium or large corporations."

Glyn A. Holton, the group's executive director, said U.S. Proxy Exchange is developing a model proxy access proposal to "provide a reasonable—but not necessarily easy—means for most long-term shareowners to participate in nominating directors. It will impose no hard cap on the total number of shareowner proposals, although it will provide safeguards that obstruct parties seeking a change of control through proxy access."

James McRitchie, a shareholder activist and a member of U.S. Proxy Exchange, noted: "We are leaning toward thresholds of 1% held for at least one year or 50-100 shareowners who have all held \$2,000 of stock for a year to be able to nominate up to 20% of the board."

In addition to the model proposal, Holton said: "We hope that shareowners will also submit completely different proposals of their own design. The success of proxy access depends on experimentation to find what works."

In the United Kingdom, groups of 100 shareholders may place shareholder proposals (including director nominations) on the ballot of

a company's annual meeting, provided that the investors own shares worth at least 100 British pounds (\$160) on average. However, director nominations from such investor groups are quite rare. Investors also can submit agenda items or request an extraordinary meeting if they own a 5% stake.

If investors were to widely support a 100-shareholder mechanism for access and some companies (or the SEC) were to adopt such an approach in the future, there may be disputes over the eligibility of those shareholders. Dozens of companies each year now challenge the ownership evidence provided by individual shareholder proponents and presumably would scrutinize the eligibility of any 100-investor access groups.

Institutional Investors' Views on Access

However, it appears that some institutional investors are not ready to support more permissive access standards. During client roundtables hosted by ISS, some participants still were undecided on their approach or expressed concerns over access. Some institutional investors said they could support carefully targeted proposals with similar requirements as SEC Rule 14a-11.

In comments submitted to ISS, Donna Anderson, a global corporate governance analyst with T. Rowe Price, noted that T. Rowe has not yet established its 2012 voting policies on access proposals, but agrees that certain restrictions on access are reasonable and necessary.

"Such restrictions, in our view, should include a reasonable minimum ownership standard, a maximum number of seats, and an exclusion on filers seeking a change in control. We are less inclined to believe that a lengthy holding period is necessary," she said. She added that the provisions in the Rule 14a-11 are "a good general reflection of institutional shareholders' expectations with regard to such limits and requirements."

Anderson said T. Rowe Price also believes that "proponents should have a strong rationale for targeting a particular company," given the potential disruption that an access provision could cause. "In this regard, proponents should be re-

quired to demonstrate a long-term commitment to creating shareholder value and not have a personal agenda or ‘axe to grind’ with the company,” she said.

However, Runa Urheim, a senior corporate governance analyst with Norges Bank Investment Management (NBIM), argued that access proposals “should be supported regardless of the governance profile and financial performance of the company,” and that those resolutions should be used “to establish a *de facto* market standard.” NBIM also favors lower thresholds than set forth in Rule 14a-11. “Our preferences are thresholds of one year and 1%, and 25% of the board seats,” Urheim wrote in comments to ISS.

The California State Teachers’ Retirement System said it would support access proposals unless the terms were “unreasonable.”

“We could be more lenient on the terms if the proposal is precatory and the company’s past actions make the need for access more desirable,” wrote Philip Larrieu, an investment officer with CalSTRS. “We have not set specific limits to holdings percentage or duration. They will be evaluated on the need for access at the company, and reasonableness of the requested limits.”

Likewise, the CPP Investment Board, which oversees the assets of the Canada Pension Plan, expressed general support for access. “We generally support proxy access shareholder proposals subject to sufficient requirements regarding share ownership, to be determined based on the need for access at each company,” said Michael Ma, a corporate governance analyst with CPP. “We believe that all shareholders meeting the ownership requirements, including 13D filers seeking a change in control, should be able to place candidates on ballots.”

Corporate Views

Most corporate advocates didn’t address proxy access in their comments to ISS. One exception was Kenneth A. Bertsch, president and CEO of the Society of Corporate Secretaries and Governance Professionals, who said that shareholder proposals should include the various protections of Rule 14a-11.

In addition to a three-year holding period and a commitment not to seek a change in control, Bertsch said an access proposal “should provide that nominees be independent of the nominating shareholder and of the company under existing SEC and listing exchange rules . . . [and] no such candidates should be put forth in a year when a company is already subject to a proxy contest.”

Likewise, Time Warner said shareholder proposals should at least include those protections and the 3% for three years threshold of Rule 14a-11. In considering whether to support an access proposal, investors should consider “a company’s broader governance provisions for Board accountability, including annual elections of all directors, a majority-vote standard, and overall governance profile,” the media company said in comments to ISS.

However, the Center for Legal Policy at the Manhattan Institute, a corporate advocacy group, warned that access proposals modeled on Rule 14a-11 would “run the risk of empowering” labor pension funds “to extract benefits from the company at the expense of the broader group of shareholders.” The group warned that those resolutions would “effectively [limit] the engagement of vulture investors, private equity investors, or hedge funds that might take advantage of a proxy access rule to facilitate the takeover of an underperforming company, since such investors will not normally hold shares for a three-year period.”

The State of the Field in Late 2011

As of mid-December 2011, investors have reported that they filed proxy access proposals at four more U.S. companies: Hewlett-Packard, Nabors Industries, Goldman Sachs and Chiquita Brands International. Overall, investors have publicly announced 15 access resolutions for the 2012 U.S. proxy season.

The HP and Nabors proposals are the third “private ordering” variation on proxy access so far this season, and are the first proposals submitted by the U.S. public and labor pension funds. This variety of proposals will complicate proxy voting decisions for institutions and will help en-

sure that proxy access is one of the most closely watched issues of 2012.

The proposal at HP was filed by the Amalgamated Bank, a labor-affiliated investor. The non-binding proposal asks the technology giant's board to adopt a bylaw that is similar to the Securities and Exchange Commission's marketwide access rule, Rule 14a-11, which was struck down by a federal appeals court in July. The shareholder resolution seeks an access bylaw that would require investors to hold a 3% stake continuously for three years, with a 25% limit on the number of board seats that investors could nominate candidates for.

The HP resolution was filed in early October, and the company did not ask the SEC staff for permission to omit the proposal before the no-action deadline, said Cornish Hitchcock, a lawyer for Amalgamated Bank.

It appears that this proposal should fare well at HP, which has experienced significant CEO and board turnover in recent years. In 2007, investors filed a similar access resolution at the technology company, which received 43% support. HP traditionally holds its annual meeting in March, so the company would be the first test of the popularity of proxy access in 2012.

In its supporting statement, Amalgamated said the "need for a significant shareholder role in the nomination process remains compelling" and cited these reasons:

- A decline in total shareholder return of 49% for the three years ending in September 2011, compared to S&P's Technology & Hardware Equipment Industry index (up 26%), and Information Technology Sector (up 25%);
- An erratic business strategy, marked by a decision—quickly amended—to terminate HP's new tablet, as well as months of uncertainty about whether HP will remain in the personal computer business;
- Three abrupt CEO departures in under seven years; and
- A 52% "no" vote on HP's compensation report at the 2011 annual meeting.

Meanwhile, public pension funds from California, Connecticut, North Carolina, Illinois, and New York City have filed an access proposal at Nabors Industries. The proposal asks the Bermuda-based oil drilling contractor to adopt an access bylaw that is based on SEC Rule 14a-11. The funds collectively own about 1.7 million of Nabors' 288 million shares.

"Nabors has a long history of poor governance, including a board that has consistently been unresponsive to shareholder concerns," Janet Cowell, state treasurer of North Carolina, one of the proponents, said in a Dec. 13 press release.

Nabors, which has its operations headquarters in Houston, has faced significant investor dissent in recent years. At its annual meeting in June, the company received more than 57% opposition during its say-on-pay vote. Nabors is one of 41 U.S.-listed companies that have reported failed advisory votes this year, according to ISS data. In addition, a director received majority opposition this year after Nabors' board failed to adopt a majority-supported board declassification proposal in 2010. (The company has since said that it will put a declassification proposal on the ballot in 2012.)

Shareholders also have been angered by the company's announcement in October that Chairman Eugene Isenberg would receive \$100 million for giving up his chief executive title. Nabors also faces a SEC probe into executive perks.

Retail Investors' Proposals

The proposal at Goldman Sachs was filed by shareholder activist Jim McRitchie and is based on the model resolution drafted by the U.S. Proxy Exchange (USPX), which calls for a 1% threshold for two years. That proposal also would allow access nominees from groups of 100 or more investors who each hold at least \$2,000 in company stock for one year.

In his supporting statement, McRitchie criticizes the investment banking firm for a "pay-for-performance disconnect," a 45% share decline over the year that ended Nov. 25, and a loss in the third quarter of this year.

The Chiquita proposal, which is also based on the USPX resolution, was filed by shareholder activist John Chevedden. The food products company didn't face significant investor opposition at its last two meetings. In 2009, three compensation committee members received more than 40% dissent after entering into new change-in-control severance agreements that contained excise tax gross-up provisions. In November 2009, the compensation committee approved management's recommendation to eliminate tax gross-up provisions for any new change-in-control agreements.

In his supporting statement, Chevedden objects to a potential \$21.3 million exit payment for CEO Fernando Aguirre, and contends that the executive "appears incentivized to seek a change in control, rather than improving performance." Chevedden also criticizes Chiquita's long-term performance, noting: "During the last decade our stock has lost about 20%, while the broader market has gained about 40% in value."

Another retail investor activist, Ken Steiner, has filed similar USPX proposals at five other companies. In addition, Norges Bank Investment Management has filed six proposals that call for a 1% ownership stake for at least one year.

How Will Investors and Companies Respond?

While HP did not challenge the access proposal through the SEC's no-action process, it appears likely that other firms will do so. While the SEC has repealed a 2007 rule that allowed companies to exclude all access-related shareholder proposals, issuers still can raise other substantive objections (such as impermissibly vague or misleading, or contrary to state or federal law), or seek to challenge a proponent's evidence of ownership.

Many U.S. institutional investors still are formulating their voting policies on 2012 proxy access resolutions. While many institutions have expressed support in the past for the SEC's marketwide standards, it remains to be seen how many institutions actually will vote for shareholder proposals on this topic, especially those resolutions that call for lower ownership thresholds than in

Rule 14a-11. Proposals with one-year holding periods may have difficulty winning broad support, given that public and labor funds have generally preferred at least a two-year period to limit the potential use of access by hedge funds.

In addition, some institutions may not be comfortable with supporting 1% or 2% ownership thresholds, except perhaps at mega-cap firms with well-known governance controversies. The three access proposals in 2007—at UnitedHealth Group, HP and micro-cap Cryo-Cell International—that received broad investor support all called for at least a 3% stake. The SEC's 2009 draft access rule called for sliding scale of ownership thresholds of 1%, 3%, and 5%, depending on market cap, but the agency abandoned that approach when it decided on a universal 3% standard in its final rule.

At this point, it appears unlikely that any more companies will voluntarily adopt proxy access provisions before the spring proxy season. Just a handful of issuers have approved access bylaws, and most have called for a 5% ownership threshold. In 2007, Converse Technology adopted a proxy access bylaw (which required a 5% stake for two years) as part of a package of governance reforms. At the time, the company was recovering from a stock-option backdating scandal and faced a proxy fight. American Railcar Industries, which is controlled by Carl Icahn, now has proxy access after reincorporating to North Dakota in 2009. The state's 2007 governance law, which companies may opt into after moving there, has an access provision with a 5% for two years standard. Apria Healthcare adopted a proxy access policy (also with a 5% stake for two years) in 2003; the company was acquired in 2008 by Blackstone.

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