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Mergers & Acquisitions and Corporate Governance Report

DECEMBER 2012

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CG represented **Dollar Thrifty Automotive Group** in connection with **Hertz Global Holdings**' $2.3 billion cash tender offer for Dollar Thrifty.

CG is representing **Stanley Black & Decker** in the $1.4 billion sale of its hardware and home improvement business to **Spectrum Brands** and in its acquisition of **Aeroscout**, the global market leader in Real-Time Location Systems (RTLS) for healthcare and industrial customers.

CG represented **Lafarge** in a $446 million divestiture of cement and concrete assets to **Eagle Materials.**

CG represented **3M Company** in its $860 million acquisition of **Ceradyne** through a cash tender offer.

CG represented **Oriental Financial Group** in its $500 million acquisition of **BBVA**'s Puerto Rico subsidiaries.

CG represented **América Móvil**, the leading provider of wireless services in Latin America, in connection with its €2.66 billion acquisition of an approximately 27.7% stake in **KPN N.V.**

CG represented **Conversus Capital** in the sale of its portfolio of third party private equity fund interests to **HarbourVest Partners** for $1.4 billion.

CG is representing **Bank of America Merrill Lynch** in the sale of its non-U.S. wealth management business to **Julius Baer Group.**

CG represented **General Mills** in connection with its acquisition of **Yoki Alimentos**, a Brazilian privately held food company, for approximately R$1.75 billion.

CG represented **TPG** in the acquisition, together with **Leonard Green & Partners**, of **Savers**, a thrift retailer, in a recapitalization transaction. CG also recently represented TPG portfolio company **PRIMEDIA** in its acquisition of eBay's **Rent.com**.

The Answer Is Blowing in the Wind: Chinese Lawsuit Highlights Expanding CFIUS Authority

A recent lawsuit challenging a decision by the Committee on Foreign Investment in the United States ("CFIUS") to prohibit an Oregon wind farm acquisition sheds light on two broader trends in CFIUS reviews: first, CFIUS challenges based simply upon the physical location of the acquired business, without regard to whether the acquired business itself has any national security implications, and second, CFIUS's assertion of authority to unilaterally impose any condition it sees fit upon a foreign acquisition of a U.S. business, whether or not the parties agree to it as a condition of CFIUS approval.

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The Answer Is Blowing in the Wind: Chinese Lawsuit Highlights Expanding CFIUS Authority

BY PAUL MARQUARDT

Mr. Marquardt is a partner at Cleary Gottlieb Steen & Hamilton LLP.

A recent lawsuit challenging a decision by the Committee on Foreign Investment in the United States ("CFIUS") to prohibit an Oregon wind farm acquisition sheds light on two broader trends in CFIUS reviews: first, CFIUS challenges based simply upon the physical location of the acquired business, without regard to whether the acquired business itself has any national security implications, and second, CFIUS's assertion of authority to unilaterally impose any condition it sees fit upon a foreign acquisition of a U.S. business, whether or not the parties agree to it as a condition of CFIUS approval.[1]

The Orders and Lawsuit

The lawsuit[2] was brought by Ralls Corporation, a U.S. wind farm development company owned by two executives of the Chinese Sany Group, against CFIUS in response to CFIUS's decision to require Ralls to divest a number of wind farm projects acquired from subsidiaries of Terna Energy SA, a publicly traded Greek company. CFIUS approached the parties to request a filing after the transaction closed and, following a review, issued an order imposing extensive restrictions on Ralls.

CFIUS's August 2 order, styled "interim mitigation measures," recites a conclusory determination that Ralls's acquisition of the wind farm projects from Terna is a "covered transaction" subject to CFIUS review and that there are "national security risks to the United States that arise as a result of the Transaction" and then orders a number of measures that purport to be enforceable by civil or criminal penalties:

- Ralls must immediately cease all construction and operations on the sites;
- Ralls must remove all stored items from the sites, and may not store additional items there or at any other site located near the U.S. government testing range at issue;
- Ralls must cease all access to the acquired sites;
- Ralls and Sany may not sell any item manufactured by Sany to any third party for use at the sites; and
- Ralls may not sell the project companies to any third party until all equipment has been demolished and CFIUS approves the buyer.

On September 28, President Obama issued a similarly conclusory order essentially ratifying and making permanent CFIUS's action, as well as formally requiring Ralls to divest the acquired companies.[3]

The lawsuit challenges CFIUS's action on a number of grounds. While an in-depth analysis of Ralls's legal claims is beyond the scope of this article, in essence, Ralls claims that CFIUS lacked authority to issue its interim order, CFIUS acted arbitrarily and capriciously by not explaining its order, and that CFIUS's order violated constitutional due process and equal protection issues, as well as that the President's order exceeded his statutory authority and raised the same constitutional issues. The government argues that CFIUS's order is moot, having been replaced by the President's order, and that the President's order is immune from judicial review under the language of the statute governing CFIUS and under the President's own constitutional authority.[4]

CFIUS Is Challenging Acquisitions Based Solely on Location of Facilities

The Ralls case confirms and underscores a recent trend in CFIUS cases resulting in the review and even prohibition of foreign acquisitions based on the physical proximity of their facilities to sensitive national security assets (which have not been defined), rather than on any national security characteristic of the target business. Moreover, "proximity" is a broad term; acquisitions that are 50-100 miles away from the facilities of apparent interest have been prohibited. No formal change in the CFIUS statute or regulations acknowledges or provides context or guidance regarding these principles, but the evolution clearly is taking place and has been acknowledged informally by Administration officials. To date, each of the publicly identified transactions appeared to have involved a Chinese acquiror and a military training or testing facility.[5]

In the Ralls case, it is clear from documents filed with the lawsuit that the issue was a military flight training range located near the wind farm projects. The range was identified in the FAA permitting process prior to the CFIUS review, and the Navy submitted comments requiring relocation of the wind turbines away from the range. CFIUS's subsequent review and prohibition took place despite the fact that the relevant permits were granted following the Navy's review. Provisions in the orders requiring that any interim activities take place no closer to the range than the existing facilities and requiring the permanent removal and/or demolition of all Sany-linked equipment make it clear that it is the location of the wind farm (rather than, for example, access to the power grid) that raised concern. Indeed, the government specifically noted in the Ralls litigation that other Ralls wind farms located elsewhere were not challenged.[5]

This conclusion is reinforced by two recent mining transactions. Also in 2012, CFIUS opened a post-closing investigation into the acquisition of a U.S. mining company still in the start-up phase, Nevada Gold Holdings, Inc. ("NGHI"), by a Chinese company, Far East Golden Resources Investment ("FERGI").[7] NGHI had no meaningful operating business of any kind; according to its 2011 annual report, NGHI had only permits and leases to conduct exploratory mining and a one-person exploratory staff. The CFIUS action was apparently based solely on NGHI's proximity to U.S. government facilities near Fallon Naval Air Station ("Fallon NAS"). FERGI was forced to divest its interest.[8] In an earlier review involving a Chinese acquisition of Firstgold Corp., which also owned a Nevada mine near Fallon NAS, CFIUS cited concerns about the mine's proximity to "sensitive and classified security and military assets that cannot be identified" in blocking the transaction.[9]

The use of location as a dispositive factor for blocking or unwinding U.S. acquisitions has the potential to seriously complicate efforts to conduct due diligence on potential transactions and assess whether a CFIUS notification is warranted. Moreover, the successful issuance of FAA permits in the Ralls matter following the Navy's review of the wind farms' location – precisely the matter at issue – underscores the fact that even explicit federal government review of an acquired facility does not provide reliable assurances that CFIUS will not later challenge a transaction. It is no longer enough to assess what the business to be acquired by a foreign purchaser does; one must also consider where its facilities are and what they're near. Unfortunately, the government has provided no real guidance as to which facilities are sensitive (or even what the particular facilities of interest were in the known cases) or what "near" means. Some of the facilities in targeted acquisitions were located nearly a hundred miles from the facility of apparent interest, but if one were to draw a 100-mile radius around every military facility in the United States, a significant percentage of the country would be covered.

In the absence of any meaningful public guidance from CFIUS or its member agencies, it is obviously difficult to assess risk. However, some principles appear to emerge from these cases (and from rumored additional cases of which we are aware). First, all of the acquirors have been Chinese entities. Although CFIUS proclaims its neutrality in evaluating acquirors from different countries, it seems unlikely that it would raise similar concerns regarding countries not thought to be a significant espionage threat (although it is worth noting that CFIUS routinely reviews and imposes mitigation measures on transactions from friendly countries where the target's business has national security implications). Second, the facilities in question have all involved flight testing ranges. It does not appear that CFIUS is challenging transactions because there is an office building or similar small-scale facility in the general area; rather, there are large-scale, outdoor activities involving training and testing with respect to current equipment and tactics. There are no guarantees that only such activities will trigger concerns in the future, but it seems reasonable to think that the potential ability to monitor ongoing activity in a test range or operational facility dealing with cutting-edge equipment and tactics is more likely to raise concerns than lower-priority facilities such as National Guard bases or office space.

Parties contemplating transactions involving the acquisition of U.S. assets by foreign persons need to take into account the risk that proximity to sensitive installations can lead to CFIUS reviews of transactions that otherwise have no tangible relationship to national security. While it may be very difficult to determine whether sensitive operations are located near the target's facilities or how sensitive those operations may be, foreign acquirors may wish to ask targets with U.S. operations whether they are aware of nearby military or other potentially sensitive facilities as part of their diligence. This is especially the case for acquirors with links to countries that might be considered threats to engage in espionage against the United

States. If potential issues are identified, the parties may wish to make a voluntary notification to obtain certainty that the transaction will not be challenged in the future. Finally, although there is not yet any reported instance of successful mitigation of these concerns (short of disposition of the facilities in question), parties to transactions that might raise concerns may want to consider whether it may be possible to mitigate concerns by maintaining separate, U.S.-managed operations at the location in question and restricting the installation of equipment and access by personnel linked to the foreign acquiror.

While post-closing investigations and forced divestitures are likely to remain rare, these recent cases illustrate a new and unpredictable risk to transactions involving businesses far outside the national security sphere.

CFIUS Is Asserting Authority to Impose Unilateral Measures on Transactions

When the CFIUS statute was amended in 2007, language was added permitting CFIUS to "negotiate, enter into **or impose**, and enforce **any agreement or condition** with any party to the covered transaction in order to mitigate any threat to the national security of the United States that arises as a result of the covered transaction."[10] Although this change was not the subject of much attention at the time, the Ralls matter makes clear that CFIUS believes that this exceptionally broad language means what it says: CFIUS has wide-ranging authority to impose legally binding orders on the parties to a transaction subject to CFIUS review (which encompasses a broad spectrum of acquisitions involving, directly or indirectly, foreign persons and operations in the United States), orders that may govern even activity that CFIUS would have no independent authority to review or restrict in the absence of a reviewable acquisition.[11]

CFIUS has long negotiated "mitigation agreements" with the parties when national security concerns arise in the course of a review. The purpose of the mitigation agreement is to provide assurances to CFIUS that any potential national security threats resulting from the acquisition will be addressed, by (for example) separating sensitive portions of the business from foreign control, instituting security procedures reviewed and monitored by U.S. government entities, or the like. These negotiations can be complex and contentious, and at the end of the day CFIUS always retains the threat that the transaction will be blocked unless a satisfactory agreement is reached. However, blocking a transaction is a significant step that requires an order from the President, and CFIUS is naturally reluctant to escalate a matter to the White House without a very good reason. Parties to a transaction thus have had some ability in negotiations to resist more burdensome and seemingly unnecessary measures – if the parties do not agree, there is a political cost to escalating the matter, and thus there is some incentive beyond simple reasonableness and goodwill (which should not be dismissed out of hand; the CFIUS staff and members are generally quite conscientious, although their perspective is not a commercial one) to come to an agreement on measures that all parties can accept.

The Ralls matter underscores, however, that CFIUS believes it has the authority to impose extensive conditions unilaterally. This raises questions both of scope and authority. With respect to scope, CFIUS believes that it can impose conditions in its review of a transaction that go beyond CFIUS's underlying authority to regulate generally foreign activity in the United States. The CFIUS order prohibited Ralls from selling any of the equipment intended for installation at the wind farm sites to any person, including any U.S. person. This order is clearly outside the scope of CFIUS's statutory authority to review transactions; it has no authority to review a decision by a U.S. person to procure equipment from a foreign supplier, nor to prevent a foreign supplier from selling into the United States. The order, if it is sustained, will have to be sustained as an exercise of the President's authority to "prohibit" a transaction after it has occurred – in other words, an attempt to restore the status quo ante in which no construction had yet taken place. Still, had this transaction never taken place, the same equipment could have been sold to a U.S. buyer intending to construct a wind farm in the same place, and so this does appear to be an expansion (at least in the context of a transaction reviewable by CFIUS) of CFIUS's authority to regulate transactions it would not otherwise have the right to review.

Perhaps the more significant implication for foreign acquirors arises from CFIUS's assertion of authority to impose whatever conditions it likes on a transaction without the need for the President's approval.[12] This is significant not so much for prohibited transactions (in which, one way or another, the transaction will not close or the acquired assets will be divested under close government supervision) but for approved transactions. While CFIUS cases approving transactions subject to conditions have, as noted, typically involved a set of requirements negotiated and agreed between the acquiror and the government, the Ralls transaction puts acquirors on notice that CFIUS does not believe that it needs the parties' agreement to conditions, even if they are burdensome and (reflecting the point above) even if they go outside the four corners of the transaction under review.

It remains to be seen how aggressive CFIUS will be in asserting this position in the context of transactions it clears; to date, it has not in fact imposed conditions willy-nilly on foreign acquirors without warning and negotiation. However, foreign acquirors of businesses with U.S. operations that might raise CFIUS concerns need to bear this risk in mind. The logical implication of CFIUS's position is that the acquirors' agreement to conditions on a transaction – no matter how onerous or broad the conditions, and even if they go beyond the transaction itself – is entirely optional and sought only as a matter of good faith. In the most extreme case, the acquiror of a U.S. business could find itself saddled with conditions so burdensome that the buyer would have abandoned the transaction rather than agree to them – yet the transaction is approved and remains legally binding. Foreign-controlled acquirors of U.S. businesses need to bear this in mind both when assessing the costs and benefits of CFIUS notification and when drafting their contractual obligations in transactions for which CFIUS review is possible.

Conclusion

The Ralls litigation is a rare and important challenge to the limits of CFIUS's authority, and much analysis is yet to come as the case wends its way through judicial review. Any definitive conclusions regarding the scope of CFIUS's authority are likely years of trial and appellate litigation away, however, there are immediate lessons to be learned. The new and (at least publicly) ill-defined focus on proximity to sensitive installations complicates the assessment of CFIUS risk in cross-border transactions, but it is clearly a significant factor that is unlikely to disappear. CFIUS's assertion of authority in the Ralls case also puts foreign acquirors on notice that CFIUS is, when pressed, willing to take assertive unilateral action in cases that do not present externally obvious core national security concerns.

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1 The Exon-Florio amendments to the Defense Production Act of 1950 (50 U.S.C. App. § 2170) and their implementing regulations (31 C.F.R. part 800) (together, "Exon-Florio") authorize the President to suspend or prohibit foreign acquisitions, mergers, or takeovers of U.S. businesses that threaten to impair the national security of the United States. CFIUS, which conducts reviews under Exon-Florio, is a committee of representatives from various government agencies and offices, including the Departments of Defense, Justice, State, Commerce, Energy, and Homeland Security, and is chaired by Treasury Department. Parties to an acquisition that could raise national security issues can file a voluntary notification of the transaction to CFIUS, thereby triggering a national security review. However, if no notification is made, CFIUS retains the right to review the acquisition in the future, before or after it closes. Following a national security review the Committee may approve the acquisition, require adherence to a security mitigation agreement, or recommend that the President block the acquisition.

2 *Ralls Corp. v. Obama*, Case no. 1:12-cv-01513-ABJ (D.D.C.).

3 "Regarding the Acquisition of Four U.S. Wind Farm Project Companies by Ralls Corporation," 77 Fed Reg. 60281 (Oct. 3, 2012).

4 *See* 50 U.S.C. App. § 2170(e) ("The actions of the President under paragraph (1) of subsection (d) of this section and the findings of the President under paragraph (4) of subsection (d) of this section shall not be subject to judicial review.") and 50 U.S.C. App. § 2170(d)(1) ("the President may take such action for such time as the President considers appropriate to suspend or prohibit any covered transaction that threatens to impair the national security of the United States.")

5 Because CFIUS provides no public analysis or reasoning justifying its decisions, it is not required to answer the question of why the acquisition of a U.S. business can or should be prohibited when alternative means of locating persons and equipment in substantially similar locations – renting a warehouse, for example – remain freely available.

6 In its response, Ralls claims that these transactions were not subject to CFIUS review; however, the signals that this challenge was location-based remain clear.

7 FERGI is a wholly owned subsidiary of Hybrid Kinetics Group Ltd., a Chinese-owned Bermuda company.

8 The parties declined to adopt a security mitigation plan that would have required NGHI to dispose of all its leases and claims in Tempo, NV, near Fallon NAS. FERGI and NGHI instead agreed that FERGI would dispose of its interest in NGHI to an approved buyer. Nevada Gold Holdings, Inc., Current Report (Form 8-K) (June 11, 2012).

9 Memorandum from Davis Graham & Stubbs LLP and Reed Smith LLP to Firstgold Corp. and Northwest Non-Ferrous Int'l Co. (Dec. 14, 2009) at 3, http://graphics8.nytimes.com/packages/images/nytint/docs/memo-regarding-the-sale-of-firstgold-corp/original.pdf.

10 50 U.S.C. App. § 2170(l)(1) (emphasis added).

11 Read literally, the language cannot constitutionally mean an unlimited delegation of power to CFIUS – it could not order the execution of the acquiring CEO. However, the limits are unclear.

12 That assertion of authority is under challenge in the Ralls litigation, but as a presidential order subsequently affirmed CFIUS's action, it is unclear whether the court will reach the question.

Runaway MAC Carve-outs

BY NEIL WHORISKEY

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The definition of "material adverse change" plays a critical role in public company merger agreements, effectively defining the situations in which a buyer may walk away from the transaction. There is significant case law defining what is (or, much more commonly, what is not) a material adverse change, but the case law only serves to interpret the agreed definitions. The agreed definitions, in turn, are typically very vague in defining what <u>is</u> a material adverse change (leaving lots of scope for judges), but explicit in listing the types of changes that may <u>not</u> be considered in evaluating whether a material adverse change has occurred. The use of these carve-outs to limit what may be considered a material adverse change has expanded significantly in recent years – arguably to a point where it may make sense for the pendulum to start to swing back.

It has been traditional for adverse effects attributable to changes in general economic conditions to be excluded in considering whether a material adverse effect has occurred, such that e.g., a loss of sales attributable to the great recession, no matter how severe, would not give buyer the right to terminate a merger agreement. This carve-out from the material adverse change definition can be grouped with others, such as carve-outs for downturns in the target industry, changes in law or accounting policies, acts of war, etc. – all of which shift to buyer the risks associated with the environment in which the target operates. What is notable is that over the last several years, not only has the percentage of deals that shift these "environmental" risks to buyer increased significantly, but MAC carve-outs that shift to buyer the risk of the deal, and (anecdotally at least) even the risk of running the business, have also increased markedly.

First, the empirical evidence, courtesy of the annual ABA Deal Points studies.[1] Listed below are various "environmental" MAC carve-outs, with the Deal Points calculation of how frequently these carve-outs appeared in 2004 deals (the year examined in the first Deal Points study) and in 2010 (the year examined in the last Deal Points study).

Carve-out	2004	2010
General Economy	92%	100%
Industry	75%	98%
Change in Law	43%	89%
Change in Accounting Principles	42%	94%
War/Terrorism	24%	90%

As can be seen, "environmental" risks in every category were more likely to be shifted to buyer in 2010 than in 2004. Risks associated with a downturn in the target industry were 30% more likely to be shifted to buyer in 2010. Adverse changes attributable to changes in law or accounting principles were more than twice as likely to be shifted to buyer in 2010. War and terrorism risks were almost four times as likely to be shifted to buyer. It is hard to conceive of a general rationale for buyers as a group to be more tolerant of these risks in 2010 than they were in 2004.

Risks associated with the deal itself also appear to have been, in the aggregate, assumed by buyer much more frequently than in the past. One indication of this is the increased prevalence of a carve-out for any adverse effects arising as a result of the announcement or pendency of the merger. This carve-out serves to protect the target from claims that a material adverse change has occurred due to, e.g., target's employees quitting en masse (because they don't want to work for buyer or see little chance that they will be retained after the merger), or customers defecting or shifting orders to a competitor as a result of the announcement. Leaving aside the question as to whether seller is in a better position than buyer to evaluate and mitigate these risks (a question that will have a different answer in each deal), it is clear that this carve-out has become more prevalent in recent years. In 2004, 69% of merger agreements for public company targets included this carve-out; by 2010, the percentage had increased to 90%, a 30% percent increase.

Moreover, while it is perhaps more anecdotal, other carve-outs that have the effect of shifting deal risk to buyer have also become popular – at least in targets' drafts. These include a carve-out from the material adverse effect definition for any adverse effects arising (or reasonably likely to arise) from the consummation of the transaction. While this sometimes defended as a temporal extension of the carve-out for adverse effects arising from the announcement or pendency of the merger (i.e., employees/customers/suppliers are likely to leave, but only if the deal is consummated), there are additional risks associated with the consummation of the merger. For example, consummation of the merger may trigger termination of a critical IP license, while the mere announcement of the merger would not. If buyer has accepted this carve-out, the effect of the termination of this critical license would not constitute (or even contribute to) a material adverse effect.[2] Even more directly, in one recent deal the target managed to insert not only a carve-out for changes arising from the consummation of the merger, but also a carve-out for adverse changes arising as a result of a failure to obtain any consents (regardless of whether those consents were identified by target as being necessary in connection with the transaction).

For further evidence of how far the pendulum has swung in favor of target, consider the increased prevalence of carve-outs that go beyond shifting deal risk, and actually shift the risk of running target business (pre-close) to buyer. In this regard, note that a carve-out for the failure of target to meet its projections was included in 15% of public merger agreements in 2004, increasing to 85% of deals in 2010 – an increase of almost sixfold. This may not be particularly probative, given that a large number of these clauses must have excluded from the carve-out any underlying causes that resulted in the failure to meet the projections – such that the carve-out merely excludes one forward looking measurement of the underlying adverse effect. However, that presumably might have been as true in 2004 as 2010, and the greater willingness of buyers to accept this carve-out is reflective of the broader trend of allowing more risk to be shifted to buyer via the MAC carve-outs.

Again somewhat anecdotally, we have noticed a number of target drafts where target attempts to carve out any adverse effects arising from actions taken with the consent of buyer. It is unclear why, under any circumstances, target should not take responsibility for its own actions, regardless of whether buyer has consented. Moreover, in certain circumstances buyer may be required to consent (e.g., if consent cannot be unreasonably withheld). Imagine a situation where target wants to sell of one of its less important operating subs in a jurisdiction in which buyer does not operate and does not wish to enter. Buyer happily consents. It turns out that the sub has a license to use and sublicense the target's critical and very marketable IP. Buyer has no walk right. Should the risk of diligencing the sale of the subsidiary be so fully on buyer?

Even more surprising are the attempts (accepted in at least one recent transaction) to carve-out any adverse effects arising from the <u>performance</u> of the merger agreement itself. As it is typically an obligation of the target to operate in the ordinary course of business, this carve-out would seem to exclude any adverse changes resulting from operating the business in the ordinary course!

So why have carve-outs run wild to such an extent? It is of course difficult to attribute these changes in the aggregate market to any single phenomenon. Maybe it has just been a long sellers' market. Maybe as the 2001 IBP v. Tyson case[3] has filtered into the market, buyers have become more and more convinced that they will never see a material adverse change that is unforeseen, sustained and severe enough to meet the standard set in that case – making the whole MAC concept close to useless.

Regardless of the cause, the material adverse change definition remains fundamental to the construct of public company merger agreements. If the target business deteriorates severely between signing and closing, or is in significantly worse condition than represented, the buyer has no remedy other than termination, and that remedy is triggered only by the occurrence of a material adverse change. When a buyer has been run through a tough auction process and paid top dollar for a company in the hope that it will continue to operate at the top of its game, every assumed risk should be carefully examined, whether it is an "environmental" risk (now almost universally shifted to buyer), deal risk, or risk of running the company. Buyers should ask whether they will be willing to part with as much cash as they have agreed to pay if, e.g., there is a severe downturn in the industry, or a change in law that will affect operating results. This is particularly true in deals where regulatory approvals or other factors will delay closing, allowing greater time for material adverse changes to develop. Hopefully we will see the pendulum swing back before a buyer's CEO is forced to tell his board that yes, there has been an unforeseen, sustained, and severe downturn in target's business, but we are still buying it.

* * *

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1 *See* ABA *2007 Strategic Buyer/Public Target Deal Points Study* (Nov. 5, 2007) and ABA *2011 Strategic Buyer/Public Target M&A Deal Points Study* (Dec. 29, 2011).

2 Note that this carve-out also indirectly has the effect of waiving certain breaches of representations by target. If target has breached its "material contracts" or "no consents" representations by failing to schedule the IP license as a material contract that required consent, the breach will not have a material adverse effect due to the carve-out. Termination rights for breaches of representations in a public company merger agreement generally arise only if the breach would give rise to a material adverse effect. (This was true in 100% of public deals in 2010; 87% in 2004.)

3 *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14 (Del. Ch. 2001).

Delaware Case Raises Question About Structuring Director Compensation

BY ARTHUR KOHN, JANET FISHER AND SAMUEL BRYANT.

Mr. Kohn and Ms. Fisher are partners and Mr. Bryant is an associate at Cleary Gottlieb Steen & Hamilton LLP.

A recent opinion of the Delaware Chancery Court, *Seinfeld v. Slager*,[1] addresses the legal standard applicable to directors' decisions about their own pay under Delaware law, an important topic as to which there is little prior law. In an opinion by Vice Chancellor Glasscock, the Court held that a derivative claim alleging that directors breached their fiduciary duties by granting themselves excessive compensation survived a motion to dismiss.[2] In so concluding, the Court also found that the directors' action did not have the protection of the business judgment rule and was instead subject to "entire fairness" review.

The Court's decision to require "entire fairness" review means that the claim of excessive compensation could proceed to a full evidentiary trial on the merits. Under Delaware law, a court will not second-guess business judgments of directors if the directors acted in good faith, exercised due care and were not conflicted in the matter. When the business judgment rule does not apply, the judgments may be subject to heightened scrutiny under the entire fairness standard. To meet this standard, the directors must demonstrate that both the process undertaken by directors and the amount of their compensation are fair to the company.

In analyzing the proper standard of review, the *Seinfeld* Court factually distinguished *Seinfeld* from a similar claim dismissed in *In re 3COM Corp. Shareholders Litigation*, a 1999 opinion by then-Vice Chancellor Steele (who is now, of course, Chief Justice of the Delaware Supreme Court).[3] Both cases involved stockholder-approved equity plans, but the plan in *3COM* included only narrow discretion granted to the directors to determine the size of their annual awards, whereas the plan in *Seinfeld* included only customary individual and aggregate limits on the size of awards.

How different were the plans? The aggregate number of shares authorized under the plan in *Seinfeld* was 10,500,000 shares, and the individual limit was 1,250,000 shares per year. The stock had a value of approximately $25 per share at the time that the contested *Seinfeld* awards were granted, so that the maximum annual stock grant for directors was, technically, in the range of $30 million at the time. Clearly, these were not intended to be guidelines for actual award levels; in fact, during the two years in dispute, the board in *Seinfeld* decided to grant themselves restricted stock units worth about $750,000 and $215,000, respectively. By contrast, under the *3COM* plan, directors were eligible to receive awards of options to purchase up to 60,000 shares (up 80,000 shares for the chairman, plus up to 24,000 shares for committee service) every two years. The *3COM* stock had a value of about $40 per share at the time the contested *3COM* awards were granted. The actual grants for one of the fiscal years at issue in *3COM* ranged from 22,500 shares to 70,000 shares per director, which the opinion states had a Black-Scholes value alleged to be at least $650,000 per director.

The limits in *Seinfeld* were not sufficient to overcome plaintiffs' assertion that the self-interest of directors called for heightened scrutiny. The *Seinfeld* Court found that the plan at issue "lacked sufficient definition" for the rule in *3COM* to apply, stating that "there must be some meaningful limit imposed by the stockholders on the Board for the plan to be consecrated by 3COM and receive the blessing of the business judgment rule, else the 'sufficiently defined terms' language of 3COM is rendered toothless. A stockholder-approved *carte blanche* to the directors is insufficient."[4]

Stockholder-approved equity compensation plans specifically for directors, such as the one at issue in *3COM*, were once much more common than they are today, in part because of SEC rule changes. Before 1996, directors who had received equity awards were nevertheless considered independent for purposes of the SEC's short-swing profit rules under Section 16 of the Securities Exchange Act of 1934, provided that the awards were granted under a non-discretionary "formula plan" and not changed more than once every six months, except to comply with changes in law.[5] Independent directors receiving only formulaic awards were in turn able to approve equity awards for executives that would be exempt from the short-swing profit disgorgement rules. In 1996, following changes to the SEC's Rule 16b-3, many companies ceased to maintain separate, formulaic director equity plans. While the SEC then put in place other safeguards to ensure the independence of directors administering stock plans, the Commission in its adopting release reminded issuers that "such grants would be subject to state laws governing corporate self-dealing."[6]

Directors now routinely set their own compensation[7] and, in the post-SOX era, director compensation has generally increased in line with director responsibilities.[8] *Seinfeld* suggests that for some companies additional care in making director compensation decisions may be appropriate to mitigate litigation risk in an area that inherently involves self-interested dealings. It also raises the obvious question of whether companies should adopt and seek shareholder approval of plans that specify, in sufficient detail to be likely to qualify for business judgment rule protection, the amount and type of compensation to be paid to their directors. That approach requires a judgment about the trade-off between the greater legal certainty to be obtained through shareholder approval against the loss of flexibility such approval entails, which judgment would be made against an historical backdrop of few shareholder claims alleging excessive director compensation. Regardless of the approach taken, board members should be aware of the scrutiny that their own compensation decisions could draw as compensation continues to be a focus for investors and governance gadflies.

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1 *Seinfeld v. Slager*, 2012 WL 2501105 (Del. Ch. Jun. 29, 2012).

2 The Court dismissed four other claims for corporate waste and breach of fiduciary duty in connection with executive compensation paid by Republic Services, Inc., the nominal defendant corporation. Plaintiffs did not make a demand on the board in respect of any of the claims. In respect of the excessive director compensation claim, demand futility was not argued by the defendants, presumably on the basis that the directors were clearly interested in the transaction. *See Aronson v. Lewis*, 473 A.2d 805 (Del. 1984).

3 *In re 3COM Corp. Shareholders Litigation*, 1999 WL 1009210, at 1 (Del. Ch. Oct. 25, 1999). For a similar claim involving cash, rather than equity-based, compensation, in which the Delaware Supreme Court also held that an entire fairness analysis would be applicable to directors' decisions about their own compensation, *see Telxon Corp. v. Meyerson*, 802 A. 2d 257, 265 (Del. 2002).

4 *Seinfeld*, at 12.

5 *Ownership Reports and Trading By Officers, Directors and Principal Security Holders*, Exchange Act Release No. 34-28869, 48 SEC Docket 234, 262-63 (Feb. 26, 1991).

6 *Ownership Reports and Trading By Officers, Directors and Principal Security Holders*, Exchange Act Release No. 34-37260, 61 Fed. Reg. 30,376, 30,381 (June 14, 1996).

7 *See* D.G.C.L. § 141(h) ("Unless otherwise restricted by the certificate of incorporation or bylaws, the board of directors shall have the authority to fix the compensation of directors."). *See also* NYSE Listed Company Manual § 303A.09, which provides that listed companies must adopt corporate governance guidelines that must address, among other things: "Director compensation. Director compensation guidelines should include general principles for determining the form and amount of director compensation (and for reviewing those principles, as appropriate). The board should be aware that questions as to directors' independence may be raised when directors' fees and emoluments exceed what is customary. Similar concerns may be raised when the listed company makes substantial charitable contributions to organizations in which a director is affiliated, or enters into consulting contracts with (or provides other indirect forms of compensation to) a director. The board should critically evaluate each of these matters when determining the form and amount of director compensation, and the independence of a director." We note also that director compensation has not so far been a significant factor in proxy advisory firm voting recommendations.

8 *See*, *e.g.*, Frederick W. Cook, Inc. 2011 Director Compensation: Non-Employee Director Compensation Across Industries and Size, at http://www.fwcook.com/alert_letters/2011_Director_Compensation_%20Non-Employee_Director_Compensation_Acr oss_Industries_and_Size.pdf ("As companies gain a better understanding of the increased responsibilities and perceived personal risk for directors, we anticipate that director compensation levels may increase at [a] more rapid pace over the next several years.").

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DECEMBER 2012

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