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Mergers & Acquisitions and Corporate Governance Report

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CG is representing **Standard Microsystems Corporation (SMSC)** in its acquisition by semiconductor manufacturer **Microchip Technology** for a total equity value of approximately $939 million.

CG is representing **GlaxoSmithKline** in its pending unsolicited tender offer to acquire **Human Genome Sciences** for approximately $2.59 billion in cash.

CG is representing **Biomet** in its offer to acquire the global trauma business of **DePuy Orthopaedics**, a Johnson & Johnson company, for approximately $280 million.

CG is representing **Barclays Capital** in a complex transaction that is intended to result in **Burger King Worldwide Holdings** being listed on the New York Stock Exchange. As part of the transaction, shareholders of **Justice Holdings** will receive an approximately 29% stake in the combined company in exchange for approximately $1.4 billion in cash. Affiliates of **3G Capital Partners**, Burger King's current private equity owner, will receive an approximately 71% stake in the combined company.

CG is representing **Royal DSM** in its acquisition of **Kensey Nash Corporation**.

CG is representing **GlaxoSmithKline** in its acquisition of additional shares of **Theravance** for $213 million. GlaxoSmithKline currently owns 18.3% of Theravance and will increase its stake to 26.8% following the acquisition.

CG is representing **Bausch + Lomb** in its proposed acquisition of **Ista Pharmaceuticals**.

CG represented **Asahi Kasei** in its offer to acquire through a cash tender offer all of the outstanding common stock of Massachusetts-based **ZOLL Medical** for approximately $2.21 billion.

CG is representing **Goldman Sachs Asset Management** in its acquisition of **Dwight Asset Management Company**, a stable-value money manager, from **Old Mutual Asset Management**.

"*Vulcanize – To improve the strength, resiliency, and freedom from stickiness and odor . . .*" American Heritage Dictionary

"*But, upon a close review of these model [confidentiality] agreements and other leading treatises, I cannot conclude that the use of a standard structure has led to a corresponding lack of ambiguity about important issues*." Martin Marietta Materials, Inc., v. Vulcan Materials Company. **[Read More]**

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The ongoing battle between Floyd, Virginia-based Cardinal Bankshares Corporation and activist investor Douglas Schaller raises interesting questions with respect to whether an activist shareholder entity can wage a proxy contest to replace a majority of directors on the board of a bank holding company (BHC) without the activist entity being considered a BHC under the Bank Holding Company Act. **[Read More]**

The Federal Reserve Board last week approved for the first time a controlling investment by a Chinese bank in a U.S. bank, opening the door for future Chinese acquisitions and investments in the U.S. banking sector. In approving an 80% equity investment by the Industrial and Commercial Bank of China Limited in The Bank of East Asia (U.S.A.) N.A., as well as branch openings by the Bank of China Limited and the Agricultural Bank of China Limited, the Federal Reserve determined that each of the three Chinese banks is subject to comprehensive consolidated supervision or "CCS" – the first time such determinations have been made with respect to a Chinese bank. **[Read More]**

Vulcanizing Your Confi

BY NEIL WHORISKEY

Neil Whoriskey is a partner at Cleary Gottlieb Steen & Hamilton LLP.

"Vulcanize – To improve the strength, resiliency, and freedom from stickiness and odor . . ." American Heritage Dictionary

"But, upon a close review of these model [confidentiality] agreements and other leading treatises, I cannot conclude that the use of a standard structure has led to a corresponding lack of ambiguity about important issues." Martin Marietta Materials, Inc., v. Vulcan Materials Company.[1]

On December 12, 2011, Martin Marietta Materials, Inc. sued Vulcan Materials Company in Delaware Chancery Court, seeking declaratory judgment that the non-disclosure agreement between them (the "NDA") did not prohibit Martin Marietta from making a hostile offer for the shares of Vulcan. The initial reaction of many deal professionals at the time was – well, if the parties wanted to agree to a standstill preventing a hostile offer, the firms involved certainly knew how to draft one.[2] However, it seems as if the idea of a standstill was not even discussed by the parties – leading perhaps to the several ambiguities found by the court in its opinion. The ambiguities, of course, required that the court resort to extrinsic evidence to determine the intent of the contracting parties. The court found that virtually all of the extrinsic evidence supported Vulcan's contention that the parties intended the NDA to serve as a back-door standstill.

The two most significant questions examined by the court, both resulting from contractual ambiguities, were the following:

1. Whether restricting the use of confidential information to evaluation of a "Transaction" effectively prohibited the use of the confidential information for the purpose of evaluating an unsolicited transaction?
2. Whether the exception to confidentiality, permitting the disclosure of confidential information as "legally required," permitted disclosure of confidential information "legally required" to be disclosed solely as a result of Martin Marietta's own decision to launch a hostile offer?

Confidential Information Was Disclosed in the Hostile Offer

Before answering these questions, the court first found as a factual matter that Martin Marietta had indeed used confidential information in evaluating and launching its hostile exchange offer. Most substantively, the court found that confidential information was used to prepare Martin Marietta's estimates of cost synergies, which cost synergies were then disclosed in Martin Marietta's S-4.[3] It is worth pausing on this factual finding for a minute, because it is clear that a synergies estimate customarily would be disclosed in the context of a hostile exchange offer, and arguably, but not necessarily, would be legally required as a disclosure matter. And regardless of whether such cost synergies were disclosed, it seems inevitable that they would be used in evaluating whether to make a hostile bid.

The court also found that Martin Marietta's S-4 contained confidential information regarding the views of the Vulcan CEO on synergies, alternative deal structures and tax leakage, as well as the views of the parties' antitrust counsel regarding the antitrust impediments to a merger.[4] The court seemed particularly annoyed by these last disclosures, which in its view were made as a result of "a tactical decision, influenced by [Martin Marietta's] flacks,"[5] in an "approach to disclosure that seems more designed to impugn the motives of Vulcan management than to address a topic in a balanced way."[6] This tactic prejudiced the court against Martin Marietta's claim, discussed below, that all of its disclosure was "legally required;" however, these disclosures were not decisive, as the court also found that the disclosure of cost synergies was also not "legally required" in the narrow sense that term was used in the NDA.

The practical question remains as to whether a hostile offer can ever be evaluated and made without the use of material and relevant confidential information received from the target. It would seem to be very difficult to "unring the bell" in cases where material and relevant confidential information (like the synergies estimates in this case) has been learned and materially affected the bidder's decision to bid.

"Transaction" Means a Negotiated Transaction

Having decided that confidential information had been disclosed, the court analyzed whether the use of that information in evaluating and making a hostile offer constituted a breach. The court focused first on the question of whether the term "Transaction", defined as "a possible business combination transaction between" the parties,[7] limited the use of confidential information to consensual transactions, or if a hostile bid could also fit within the definition of "Transaction". Generally, as a drafting matter, deal lawyers concerned about a subsequent hostile approach will insert the word "negotiated" before the words "business transaction", clearly limiting the use of confidential information to consensual deals. However, had the word "negotiated" appeared in that particular spot in the NDA, this would not have been an interesting aspect of the case, as it would have eliminated the ambiguity that the court found in the definition of "Transaction." While the court's analysis of the ambiguity of the phrase "business combination transaction" and of the word "between" goes on for a learned 22 pages, all that we need to say about it here is that the court found the phrase "business combination transaction" not to necessarily include or exclude deals consummated by way of hostile offer, and that the word "between" while it probably does mean a transaction consensually entered into between the two parties, and not a transaction entered into by one party and the shareholders of another party, in this context is ambiguous as it was not preceded by the word "negotiated."

Having found this ambiguity, the court then turned to extrinsic evidence,[8] and found that the trial testimony and drafts of the NDA exchanged between the parties demonstrated that the parties intended to preclude the use of the confidential information in evaluating or making a hostile offer. In fact, in an ironic twist, it turned out that Martin Marietta, the hostile bidder, was the party that had initially most feared a hostile approach, and as a result had made changes to the NDA that ultimately weakened their position in the litigation – for example, changing the definition of "Transaction" from "a business combination <u>involving</u>" to "a business combination <u>between</u>" the parties.[9] (As this is now the second case involving a backdoor standstill that turned, in part, on the use of the word "between", the court did not find this change to be insignificant).[10]

Accordingly, the court found that the hostile bid did not constitute a "Transaction" as defined in the NDA, and that Martin Marietta, by using confidential information "in deciding upon, formulating and selling its" hostile bid,[11] had breached its obligation to use the confidential information "'solely' for the purpose of 'evaluating' a 'Transaction'."[12]

"Legally Required" Does Not Include Self-Imposed Legal Requirements

Vulcan additionally argued that, even if the confidential information could be used for evaluating a hostile bid, the confidential information was still confidential information and so could only be disclosed if "legally required" – the ambiguity here being whether "legally required" should include self-imposed legal requirements, such as those that arose when Martin Marietta launched its bid.

The precise words giving rise to the ambiguity here were of the ever treacherous "subject to" variety. In this case "Subject to Section 4," was inserted (by Martin Marietta) at the very beginning of Section 3 of the NDA. Section 3 is the core confidentiality provision in the NDA – the one that says, that the parties will not disclose any confidential information, "other than as legally required." As the court notes, "Without any qualifying language, the degree of compulsion necessary for something to be 'legally required' may be construed broadly."[13] Here, the qualifying language was provided by the reference to Section 4.

Section 4, entitled "Required Disclosure" is the standard paragraph that tells the parties what to do if they are "requested or required (by oral questions, interrogatories, requests for information or documents in legal proceedings, subpoena, civil investigative demand or other similar process) to disclose any of the other party's" confidential information. In short, in these circumstances, the disclosing party is required to notify the other party, permit the other party to seek a protective order, and limit any disclosure to the minimum that its counsel advises is legally required – these procedures are what the court called "Notice and Vetting" procedures. By making Section 3, the general non-disclosure obligation, "subject to" Section 4, Vulcan argued that the parties had limited "legally required" disclosure to the type of disclosure required under Section 4 – i.e., disclosure required pursuant to a legal proceeding – and made such disclosure subject to the "Notice and Vetting" provisions of Section 4. Oversimplifying for brevity, Martin Marietta essentially argued that "subject to Section 4" was there to clarify that "legally required" disclosures of the type specified in Section 4 were subject to the limitations in Section 4, but that any other "legally required" disclosures were not. So that a self-imposed legal requirement, not arising from a legal proceeding, but rather from a need to file an S-4 without any material misstatements or omissions, was not subject to the limitations of Section 4.

To make a long story short, the court again found ambiguity, turned to external evidence, found (again ironically) that Martin Marietta had requested the insertion of "subject to Section 4" in order to provide "maximum confidentiality"[14] and that accordingly "legally required" disclosures were intended to be limited to disclosures of the type described in Section 4 and subject to the Notice and Vetting provisions of Section 4.

Absent this limiting language, which was both unclear and somewhat uncommon, the court may well have "construed broadly" the "legally required" disclosure exception to confidentiality – but it is unclear whether "legally required" would have been construed to be so unambiguous as to prevent recourse to extrinsic evidence. Accordingly, the question lying dormant in thousands of confidentiality agreements across the country – does the "legally required" exception include self-imposed legal requirements – while answered in this case, remains more generally unanswered.

Remedy

The court granted a four month injunction against Martin Marietta's hostile bid. The four month period roughly matched the period between the date when the hostile offer was launched (December 12, 2012) and the expiration of the NDA (May 3, 2012), meaning that the hostile offer was stayed by during a period equivalent to the period during which the hostile offer was in violation of the NDA. The four month stay also precluded Martin Marietta from running its slate of directors at Vulcan's June 1, 2012 annual meeting. The court emphasized that the four month stay, which was the relief sought by Vulcan, could have been longer, given the "pervasiveness of Martin Marietta's breaches."[15] It is hard not to wonder whether an injunction would have been issued if Martin Marietta had prevailed on its argument that all of its disclosure was legally required, and the only breach had been the use of material confidential information in evaluating the hostile bid.

Vulcanizing Your Confi

Perhaps the first lesson to be learned here is that, if your client wants a standstill, you should raise the topic and ask for a standstill, even if deemed to be impolite. The standstill will cost a lot less than the litigation. The second lesson is that if your client wants to retain the option to make an unsolicited offer, you should ask for a standstill with a clear end date, and a clear right to use confidential information for your bid as soon as the standstill ends (and to disclose the confidential information to the extent required by law or disclosure principles). While you could instead simply try to sign up a confidentiality agreement with a broad definition of Transaction (e.g., any business combination or purchase transaction involving the parties, their assets, subsidiaries or shareholders), and a broad definition of "legally required" (e.g., any disclosure required or customarily made in connection with any legal process or Transaction), it is unlikely that, after this case, you will get any points for candor in taking this approach. However, given that clients often discount the possibility of making an unsolicited approach, and, particularly in merger of equals contexts, often loathe to raise the subject, the most practical approach may be to simply try to limit the confidentiality obligation to one year, assuming that a backdoor standstill of that duration would be acceptable.

* * *

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1 *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, No. 7102-CS, slip op. at 111 (Del. Ch. May 4, 2012).

2 The parties' respective general counsels were asked to draft the NDA, but it is unclear in the opinion whether either consulted outside counsel.

3 *Id* at 49.

4 *Id* at 49-50.

5 *Id* at 50.

6 *Id* at 51-52.

7 Note that the case involved two confidentiality agreements, a non-disclosure agreement and a joint defense agreement entered into in connection with the analysis of antitrust concerns. The joint defense agreement had a different definition of "Transaction" – it meant "a possible transaction being discussed by" the parties. Since it was clear that the parties were not discussing the possibility of a hostile bid (not even daring to broach the topic of a standstill), it was significantly easier for the court to find a breach of the confidentiality provisions of the joint defense agreement. As a result, the joint defense agreement is a good bit less interesting for purposes of this article, which will focus just on the non-disclosure agreement.

8 It is interesting to speculate as to how the court would have resolved these ambiguities in the absence of the ample extrinsic evidence present here.

9 *Martin Marietta*, at 83.

10 *Id* at 75.

11 *Id* at 89.

12 *Id* at 88.

13 *Id* at 113.

14 *Id* at 105.

15 *Id* at 137.

The El Paso/Kinder Morgan Opinion: Further Delaware Guidance on Sell-side Conflicts

BY VICTOR LEWKOW, DAVID LEINWAND AND ETHAN KLINGSBERG.

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In its recent decision regarding the acquisition of El Paso Corporation by Kinder Morgan, Inc.,[1] the Delaware Chancery Court concluded that El Paso's sale process may have been tainted by conflicts of interest affecting the company's CEO and financial advisors. The court nevertheless denied plaintiffs' request for a preliminary injunction on the grounds that enjoining the deal in the absence of a competing bid would pose a significant risk for El Paso shareholders who would have their own chance to judge the merits of the deal at a shareholder meeting. The opinion, authored by Chancellor Strine, provides guidance, and simultaneously raises a number of questions, regarding how to approach relationships and interests that risk giving rise to conflict of interest allegations against directors, officers and financial advisors involved in a sale of control.

The Opinion

After El Paso announced that it would spin-off its exploration and production ("E&P") business and retain its pipeline business, it received an unsolicited bid for the entire company from Kinder Morgan. In the course of the subsequent negotiations, the El Paso board made numerous decisions that, based on a preliminary record, Chancellor Strine found "could be seen as questionable." These included the failure to shop the company or either of its two businesses after receiving the Kinder Morgan bid; the failure to forcefully reject the initial overture and force Kinder Morgan to go public with its bid; charging El Paso CEO Doug Foshee with handling all the negotiations without close supervision by an independent director or legal advisor; continuing to negotiate after Kinder Morgan lowered its bid from a preliminarily agreed upon price; agreeing to deal protections that prohibited accepting an alternative bid for less than 50% of El Paso's assets thereby precluding a separate sale of the E&P business; agreeing to matching rights; and agreeing to a break-up fee that, in the context of a hypothetical sale of El Paso to an interloper interested in the pipeline business alone, would likely represent a relatively high percentage of the purchase price in such a transaction. Chancellor Strine noted, however, that these decisions alone would not provide the basis for enjoining the merger as Delaware law does not permit courts to second guess reasonable, even if debatable, steps taken by a board to obtain the highest value available.

But on his review of the preliminary record, the Chancellor concluded that plaintiffs had established a reasonable likelihood of success on their claim that the deal was tainted by breaches of fiduciary duty. The basis for this conclusion was his determination that there was evidence that Mr. Foshee and El Paso's financial advisors had conflicts of interest which may have led to the board's "questionable" tactical decisions.

In particular, the opinion focuses on the fact that Foshee never informed the El Paso board that he was considering bidding for El Paso's E&P business after the closing of an acquisition of the entire company by Kinder Morgan. Although Foshee did not mention his interest in the E&P business to Kinder Morgan until after the merger agreement was executed, he had discussed it with other members of El Paso management during the negotiation of the deal. This led Chancellor Strine to conclude that Foshee may not have been motivated to get the highest price from Kinder Morgan as that would tend to cause Kinder Morgan to seek a higher price from any subsequent purchaser of the E&P assets, and he may not have vigorously negotiated as "a fist fight . . . might leave a bloodied Kinder unreceptive to a bid from Foshee and his team." The Chancellor noted that, at the very least, Foshee should have disclosed his interest in a post-acquisition purchase of the E&P assets to the El Paso board.

The court also found, based on a preliminary record, potential conflicts relating to the board's financial advisors. Goldman Sachs & Co. was El Paso's long-time financial advisor and had been advising El Paso on the spin-off. When the Kinder Morgan bid was made, an issue arose because private equity funds affiliated with Goldman Sachs owned approximately 19% of Kinder Morgan and had two representatives on the Kinder Morgan board. The El Paso board was fully aware of these circumstances, and several steps were taken by the board and

Goldman to address the situation: Morgan Stanley & Co. was retained by El Paso as an independent advisor for the potential Kinder Morgan transaction; Goldman Sachs put a firewall in place between the El Paso advisors and the individuals responsible for the Kinder Morgan investment; the Goldman affiliated directors on the Kinder Morgan board recused themselves from the transaction; and the El Paso board and Goldman agreed that Goldman would not advise the board on the Kinder Morgan deal. The Chancellor, however, found that these remedial measures may have been insufficient. He noted that, despite the attempt to wall Goldman off from the Kinder Morgan transaction, Goldman advised the El Paso board regarding the offer in the first days after it was made, including recommending, as is quite common, that the board take steps to avoid a potentially expensive and disruptive hostile bid by Kinder Morgan. In addition, as a result of its continuing advice regarding the E&P spin-off, the primary alternative to a sale of the company, the Chancellor concluded that Goldman necessarily had an impact on the board's view of the relative merits of the Kinder Morgan deal. Finally, the court expressed concern that the El Paso board was unaware that the senior Goldman banker working on the spin-off transaction owned an interest in approximately $340,000 of Kinder Morgan stock.

The court also questioned whether the retention of Morgan Stanley cured Goldman's potential conflict. In particular, the Chancellor found that the structure of the agreement between El Paso and Morgan Stanley regarding Morgan Stanley's fee may have created a distinct conflict of its own. According to the court, because Morgan Stanley would not receive a fee if the El Paso board decided to pursue the spin-off instead of the Kinder Morgan deal, Morgan Stanley -- brought on for the purpose of remedying any potential effect of Goldman's interest in Kinder Morgan -- may itself have been biased toward seeing that the Kinder Morgan deal was completed.

Despite finding that there was sufficient evidence in the preliminary record to support a reasonable likelihood plaintiffs would succeed on their fiduciary duty claims, the court denied plaintiffs' request that it grant a preliminary injunction modifying the merger agreement to allow El Paso to pursue alternatives for a specified period while still requiring Kinder Morgan to acquire El Paso in the event such pursuit proved fruitless. Chancellor Strine concluded that it would be inequitable for Kinder Morgan to remain bound by the terms of the merger agreement while El Paso was freed from the bargained-for deal protections. More importantly, he noted that, although the process may have been flawed, an injunction would have put the deal -- which was at a substantial premium -- at risk. It was a risk he was unwilling to take in light of the ability of the El Paso stockholders to decide whether to approve or reject the Kinder Morgan deal at the upcoming shareholder meeting.

Implications for Boards and Financial Advisors

While differing facts and circumstances will undoubtedly affect the analysis in any particular transaction, the opinion has several significant implications for companies and their advisors in change of control transactions:

- The opinion serves as a reminder to boards and executives that potential conflicts of interest faced by directors and senior management should be explored at the outset of the transaction process and, if necessary, remedial measures should be implemented. In addition, if circumstances that may give rise to allegations of conflicts subsequently arise they should promptly be brought to the attention of the board and its counsel. Instructive in this regard is Chancellor Strine's oft repeated assertion that the El Paso board may have approached the negotiations differently had the directors known of Foshee's interest in buying the E&P assets from Kinder Morgan.
- It is not entirely clear from the opinion, which was based on a preliminary record, how closely Foshee's negotiations were supervised by the El Paso board. In any event, if management is tasked with leading negotiations on behalf of the board, as Foshee did for El Paso, the board or a subset of the board including independent directors, should consider implementing a mechanism for regularly monitoring the course of the negotiations. This may be as simple as receiving regular updates from management as the process unfolds.
- If one of the principal alternatives to a sale of control is a break-up of the company, the board should carefully consider whether a "fiduciary out" in a transaction agreement should provide the flexibility to accept an alternative "superior" transaction that involves the sale of separate businesses and/or a spin-off of certain businesses to shareholders. In this regard it is instructive that in *El Paso* Chancellor Strine found it "questionable" that the board did not have a "fiduciary out" to accept an alternative

transaction that involved a separate sale of the E&P assets. In addition, he implied that the magnitude of the break-up fee should be evaluated not only relative to the purchase price for the entire company, as is customarily done, but also relative to the purchase price for the separate business that a topping bidder might want to acquire.

- At the beginning of a sale process, a board should ask its financial advisor about interests it may have in potential bidders, and financial advisors should be instructed to keep the board updated during the transaction process. However, as Vice Chancellor Parsons observed in *In re Micromet Shareholders Litigation*,[2] issued on the same day as the *El Paso* decision, not all such interests of the target's financial advisor in an acquiror are of a "size and nature" that "would be likely to impede [the financial advisor's] ability effectively and loyally to perform its assignment." In addition, due to institutional informational barriers, the holdings and interests of many parts of an investment bank will, by necessity, be unknown by the team providing financial advice. Although boards should make inquiries about a financial advisor's interests in potential bidders, *El Paso* should not be read in most situations to require concern about holdings and interests that fall below the thresholds required for public filings and that the financial advisory team would be unaware of due to firewalls.
- The *El Paso* opinion suggests that, in addition to inquiring into its financial advisor's investments, the board should also consider inquiring as to whether the senior bankers who will be advising the board have significant ownership stakes in potential bidders. Again, however, not all such interests will be material or raise potential conflicts, and the board should recognize that there may be legitimate practical limitations on the ability to conduct such an inquiry.
- A board should carefully consider the incentives created by the fee arrangements agreed to with its financial advisor. Certainly, as the Chancery Court has repeatedly recognized, there are legitimate reasons for a board to agree to a pure success-based fee or for an engagement to provide that no fee or perhaps a nominal fee be payable in the event a transaction is not consummated. Many potential transactions are explored with the assistance of financial advisors, and no board wants to pay a substantial fee if a transaction is not completed. However, in circumstances in which a second financial advisor is retained to address a potential conflict, *El Paso* counsels that a board should be particularly mindful of the potential impact of fee arrangements agreed to with that financial advisor.
- For financial advisors, already on guard after Vice Chancellor Laster's opinion last year in the *Del Monte* case, the *El Paso* opinion counsels continued caution in considering sell-side conflicts. The Delaware Chancery Court judges appear to be subjecting financial advisors' potential conflicts and the customary measures used to address those potential conflicts to increased scrutiny. It is therefore important that a financial advisor carefully vet potential conflicts with its own counsel and keep its counsel updated on developments in the transaction process. In addition, at the outset or in advance of an engagement, financial advisors and their counsel should work with boards and their advisors to put the financial advisors' relationships and interests in perspective and to permit appropriate and well-informed deliberation by the board with the objective of arriving at sensible and practical approaches to the engagement.

* * *

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1 *In re El Paso Corporation Shareholder Litigation*, C.A. No. 6949-CS (Del. Ch. February 29, 2012).

2 C.A. No. 7197-VCP (Del. Ch. February 29, 2012).

The Bank of Floyd – Shareholder Activism and the Bank Holding Company Act

BY JOHN MCGILL

John McGill is a senior attorney at Cleary Gottlieb Steen & Hamilton LLP.

The ongoing battle between Floyd, Virginia-based Cardinal Bankshares Corporation (Cardinal) and activist investor Douglas Schaller raises interesting questions with respect to whether an activist shareholder entity can wage a proxy contest to replace a majority of directors on the board of a bank holding company (BHC) without the activist entity being considered a BHC under the Bank Holding Company Act (BHCA).

Background

Cardinal is the holding company of the Bank of Floyd, which provides banking services in five counties of Virginia. Cardinal is publicly-traded and has a market capitalization of approximately $22 million.

In a February 7, 2011 Schedule 13D filing with the Securities and Exchange Commission (SEC), entities associated with Douglas Schaller (Schaller Equity Partners, Schaller Equity Management, Inc. and Schaller Investment Group Incorporated) disclosed an 8.3% ownership stake in Cardinal. Over the following 12-month period the Schaller entities filed several amended Schedule 13Ds, reflecting an ownership stake in Cardinal that eventually increased to 9.8%. Beginning in June 2011, Schaller and Cardinal engaged in a war of words, largely carried on in open letters and in the press. Schaller first pushed for Cardinal to explore a sale and later appeared to back off that position, instead arguing for management changes. Cardinal resisted Schaller and has maintained that Schaller is only interested in selling Cardinal. While the letters between Schaller and Cardinal are not the focus of this article, they make for interesting reading and can be found in SEC filings by Schaller and Cardinal.

At Cardinal's next annual shareholders meeting, which is scheduled to occur on May 22, 2012, all six of Cardinal's directors are to be elected. In a proxy statement filed in March 2012, the Coalition to Improve the Bank of Floyd (Coalition) filed preliminary proxy materials to solicit proxies in favor of five of its board nominees, all whom are described as independent of Schaller and associated entities. The Coalition consists of Schaller and associated entities, together with several individual Cardinal shareholders and a special purpose vehicle formed to hold and vote proxies.

In April 2012, the Coalition amended its proxy statement to decrease the number of its nominees from five to three. In the amended filing, the Coalition explained that it was reducing the number of nominees because the staff of the Federal Reserve Board (FRB) had taken the position that the leadership role of Schaller Equity Partners (SEP) in soliciting proxies to elect a majority of Cardinal directors could cause SEP to be considered a BHC under the BHCA. The FRB staff reportedly based its position on Section 2(a)(2)(B) of the BHCA, which is triggered by the ability of a "company" to "control in any manner" the election of a majority of the board of a BHC. According to the Coalition, the FRB staff held the view that because SEP was an entity rather than an individual, its leadership role in the proxy solicitation would trigger Section 2(a)(2)(B). The Coalition noted that the FRB staff took this position even though the proxies are revocable until Cardinal's annual meeting and expire at the end of the annual meeting.[1] The FRB staff did not provide written confirmation of its position to the Coalition. The FRB staff reportedly indicated that SEP's participation in a solicitation to elect less than a majority of Cardinal's board would not be a problem under FRB staff interpretations of Section 2(a)(2)(B).

Despite the Coalition's decision to reduce the number of its Cardinal board nominees from five to three (i.e., 50% of Cardinal's board) in response to concerns raised by the FRB staff under Section 2(a)(2)(B), a May 4, 2012 proxy filing by the Coalition reported that, in subsequent discussions with the FRB, the FRB staff expressed concern that SEP's involvement in soliciting proxies for the election of three directors might constitute SEP's exercise of a "controlling influence" over the management or policies of Cardinal. Under Section 2(a)(2)(C) of the BHCA, if such a controlling influence were found to exist, SEP could be considered a BHC. While SEP disagreed with the FRB staff's position, it and the Coalition nominees proposed entering into the FRB's standard passivity commitments, which are designed to alleviate any FRB concerns that SEP will have a controlling influence over Cardinal.[2] The Coalition nominees (all of whom are independent of Schaller and associated entities) committed not to take any action to cause (or otherwise do anything that assists or facilitates) SEP to take the actions specified in SEP's passivity commitments. In the filing, the Coalition indicated that the FRB staff had not yet responded to the proposed passivity commitments.

In its proxy filings, the Coalition indicated its suspicion that Cardinal's public statements about Schaller and the Coalition may have contributed to questions from the FRB staff relating to the intentions of SEP if the Coalition's proxy solicitation is successful. However, there is no indication in public materials that Cardinal raised BHCA issues with the FRB staff as a means to defeat the Coalition's proxy challenge. Nonetheless, it is not uncommon, particularly in the hostile takeover context, for the target of a proxy contest to use BHCA control concerns as a defensive tactic (e.g., by arguing to the FRB that the potential acquirer cannot solicit proxies without prior FRB approval).

Cardinal Proxy Contest and BHCA Issues

Section 2(a)(1) of the BHCA defines a BHC as "any company which has control over any bank or over any company that is or becomes a bank holding company . . ." An investment fund such as SEP would typically not want to be regulated as a BHC because of, among other things, the restrictions imposed on a BHC's non-banking and investment activities, limitations on leverage, the requirement to serve as a "source of strength" to any controlled banks, and FRB and other regulatory examination and reporting requirements.

Under Section 2(a)(2)(B) of the BHCA, a company has control over a bank or any BHC if "the company controls in any manner the election of a majority of the directors . . . of the . . . company." As indicated above, the FRB staff initially expressed concern that SEP's involvement in soliciting proxies for a majority of Cardinal directors might cause SEP to be considered a BHC under the BHCA. As reported by the Coalition, the FRB staff took the view that SEP was potentially subject to Section 2(a)(2)(B) because it is an entity but would not be subject to Section 2(a)(2)(B) if it were an individual. This result, while consistent with the language of Section 2(a)(2)(B), which specifically refers to "companies" having control, creates a potential impediment to the participation in proxy solicitations of any shareholders that, like SEP, are entities. Shareholders that are entities could participate in a proxy solicitation in the sense of granting proxies to others who are soliciting them, but the FRB staff's reported position in the Cardinal matter appears to caution against such shareholders taking a leadership role.[3]

It should be noted that there is a relevant statutory exception in Section 2(a) of the BHCA to the definition of a BHC. Recognizing that the definition of a BHC in Section 2(a) would not allow the formation of a bona fide stockholders' committee or similar organization for the purpose of soliciting proxies in order to gain control of voting rights of shares (until the proxy contest is terminated), Section 2(a)(5)(C) of the BHCA was adopted to provide for an exception to the BHC definition in the context of a proxy solicitation. Section 2(a)(5)(C) provides that "[n]o company formed for the sole purpose of participating in a proxy solicitation is a bank holding company by virtue of its control of voting rights of shares acquired in the course of such solicitation." Absent such an exception, a company formed to solicit and hold proxies that acquires temporary control over the voting rights of 25% or more of a banking organization could find itself within the definition of a BHC. However, since the Section 2(a)(5)(C) proxy exception is focused on the entity formed for the purpose of holding and voting proxies (in the case of the Coalition's proxy solicitation, Coalition Proxy Holding and Voting SPV, Inc.) and not other proxy solicitation participants, the FRB staff likely viewed this exemption as unavailable to SEP.

Under Section 2(a)(2)(C) of the BHCA, a company has control if the FRB "determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies" of the banking organization. As indicated in the Coalition's May 4 proxy filing, despite previously decreasing the number of its board nominees from five to three in response to the position taken by the FRB staff under Section 2(a)(2)(B), the FRB staff apparently expressed concern that SEP's involvement in the solicitation of proxies to elect three directors might be seen as the exercise of a controlling influence over the management and policies of Cardinal, causing SEP to be considered a BHC. The Coalition's nominees are local businessmen in the Floyd, Virginia area and are independent of Schaller. Nonetheless, there appeared to be concern on the FRB staff's part that Schaller and associated entities would exercise influence over the nominees and thereby over Cardinal if the nominees were elected to the Cardinal board. This same concern was expressed by Cardinal in public statements made in opposition to the Coalition's proxy solicitation.

In its proxy filings, the Coalition indicated that SEP does not believe the Coalition's solicitation of proxies should cause SEP to be considered a BHC on any basis under the BHCA. The Coalition reasoned that proxy solicitation and trying to influence the voting of other shareholders through reasoned argument is not the exercise of a controlling influence, but is instead participation in shareholder democracy. The Coalition argued that even if the Coalition is successful in securing votes to effect a one-time change in the board, that success does not give SEP the ability to exercise a controlling influence over Cardinal. Instead, according to the Coalition, Cardinal would have several new board members who are not controlled by or committed to SEP.

Schaller and his associated entities own a minority 9.8% interest in Cardinal, which is greater than the 5% threshold below which a company is presumed not to control a BHC. In the FRB's 2008 policy statement on equity investments in banks and BHCs, the FRB provided guidance on questions under Section 2(a)(2)(C) that are raised by minority investments in banking organizations. In particular, the FRB provided guidance in the policy statement on the extent to which a minority investor's communications with a banking organization's management would be consistent with a noncontrol determination. The policy statement notes that in previous cases, minority investors have committed to the FRB not to solicit proxies on any matter from other shareholders of the banking organization. While the policy statement indicates that a minority shareholder is permitted to advocate for changes in a banking organization's policies, operations and management (including recommending alternative management), the FRB did not indicate any acceptable participation in proxy solicitations, other than allowing its shares to be voted by proxy in connection with another shareholder's proxy solicitation. The FRB cautioned minority investors not to accompany its management communications with explicit or implicit threats to sponsor a proxy solicitation as a condition of action or non-action by the banking organization or its management. While the policy statement does not explicitly state that leading a proxy solicitation is inconsistent with a noncontrol determination, one is left with that impression.

The policy statement provides useful guidance with respect to the extent of board representation and communications with management that a minority investor may have, but this guidance is better suited to negotiated transactions in which an investor acquires a stake in a banking organization and negotiates for board representation and other rights. What remains less clear is how an activist investor can effect change at a banking organization through a proxy contest. In light of the Cardinal matter, the involvement in a BHC proxy contest of an activist investor in the form of an investment fund or other entity (even if the activist forms a special purpose vehicle like Coalition Proxy Holding and Voting SPV, Inc. to hold and vote proxies) may raise issues for the activist fund under Section 2(a)(2)(B) of the BHCA, or other provisions of Section 2(a)(2), since the fund would not be an entity formed solely for the purpose of participation in a proxy solicitation, and seems to be unable, based on the FRB's reported views, to take advantage of the exception to the definition of a BHC provided by Section 2(a)(5)(C) of the BHCA.

From what has been reported about the Cardinal matter, it is not clear whether or how the size of SEP's stake in Cardinal affected the positions taken by the FRB staff under Sections 2(a)(2)(B) and 2(a)(2)(C). Although the size of Schaller's stake is above the 4.9% level where a presumption of non-control exists, it is below thresholds that, when considering only the investment amount, typically raise control concerns under the BHCA and related regulations and guidance. The FRB's concerns could have been affected by the existence of the minority stake. However, based on the reported concerns, a potential conclusion as a regulatory matter could be that, whether an activist investment fund holds 0.1%, 5% or, like Schaller, 9.8% of a BHC, the fund could risk potential classification as a BHC under Sections 2(a)(2)(B) and 2(a)(2)(C) if it had a leading role in the BHC proxy contest to elect a majority (or less) to the board of the BHC.[4]

If the Coalition is successful in obtaining the election of its reduced three-person slate of nominees to Cardinal's board, the Coalition nominees will have "negative control" over board decisions because they constitute 50% of the board seats (assuming Cardinal's three continuing directors do not resign, as they have threatened to do if any of the Coalition's nominees are elected). However, the Coalition nominees would not have "positive control" to effect changes to policies, operations or management at the board level because they would not be able to carry a vote by themselves.

1 The Coalition may have highlighted the nature of the proxies due to an exemption (found in the FRB's rules) from the notice requirement under the Change in Bank Control Act (CBCA) for the "acquisition of the power to vote securities of a . . . bank holding company through the receipt of a revocable proxy in connection with a proxy solicitation . . . if the proxy terminates within a reasonable period after" the shareholders meeting. However, the Coalition's proxy statement described concerns over SEP becoming a BHC rather than having to file a notice under the CBCA. This may be because the CBCA provisions are generally triggered by an acquisition of voting securities rather than acquiring other forms of control.

2 SEP agreed not to: (1) exercise or attempt to exercise a controlling influence over the management or policies of the Company or any of its subsidiaries; (2) have or seek a representative on the Cardinal board; (3) have or seek any employee or representative of SEP to serve as an officer, agent or employee of Cardinal; (4) take any action that would cause Cardinal to become a subsidiary of SEP; (5) allow SEP to own or control 25% of Cardinal stock; (6) following the Cardinal annual meeting in 2012, propose a director or slate of director in opposition to Cardinal's management or otherwise solicit or participate in a solicitation of proxies with respect to any matter presented to Cardinal shareholders; (7) enter into any agreement with Cardinal that substantially limits the discretion of its management over major policies and decisions; (8) dispose or threaten to dispose of shares of Cardinal in any manner as a condition or inducement of specific action or non-action; and (9) enter into certain business relationships with Cardinal.

3 In a current proxy contest relating to First Financial Northwest, a savings and loan holding company, concerns raised by the FRB staff caused Stilwell Group, an activist shareholder, to reduce the number of its nominees from two out of nine directors to one. However, the Cardinal matter is distinguishable from First Financial Northwest because Stilwell's nominees were Stilwell Group employees rather than individuals who are independent of the activist shareholder, as the Coalition's nominees are. FRB guidance provides that a minority shareholder's board representation should be proportional to the shareholder's ownership stake. Having one out of nine representatives on First Financial Northwest's board is more proportional to Stilwell Group's 7.9% stake than two representatives.

4 An activist could pursue the election of new directors if it is an individual rather than a "company" and presumably not trigger Section 2(a)(2)(B) or Section 2(a)(2(C) of the BHCA, but shareholder activism is often an investing strategy pursued by funds that acquire stakes in a target companies and then try to effect changes or a sale to increase the value of the investments.

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Federal Reserve Opens Door for Chinese Banks to Make U.S. Bank Acquisitions

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The Federal Reserve Board last week approved for the first time a controlling investment by a Chinese bank in a U.S. bank, opening the door for future Chinese acquisitions and investments in the U.S. banking sector. In approving an 80% equity investment by the Industrial and Commercial Bank of China Limited in The Bank of East Asia (U.S.A.) N.A., as well as branch openings by the Bank of China Limited and the Agricultural Bank of China Limited, the Federal Reserve determined that each of the three Chinese banks is subject to comprehensive consolidated supervision or "CCS" – the first time such determinations have been made with respect to a Chinese bank. Although the CCS determinations are institution-specific, historically, once the Federal Reserve has made a CCS determination with respect to one bank in a country, the approval process for other banks based in that country has been significantly streamlined. As a result, we expect that other Chinese banks may begin exploring options to invest in or acquire U.S. banks and that similarly situated Chinese banks are likely to be able to obtain the required CCS determination.

The Federal Reserve's orders were issued in the wake of meetings of the U.S. Secretary of State and Treasury Secretary in Beijing, at which China's "substantial progress" in the area of comprehensive consolidated supervision of Chinese banks was noted, and the U.S. committed to "endeavor to act expeditiously" on pending applications by Chinese banks. At these same meetings, the Chinese government agreed to permit foreign investors to acquire up to 49% of securities and futures broker joint ventures in China and to expand opportunities for auto financing companies, including those with foreign investors. Thus, the China CCS determinations should be viewed as part of a broad political and economic agenda.

The Federal Reserve has made CCS determinations with respect to banks from most of the world's major economies, including Brazil, but last week's orders mark the first CCS determinations for a new jurisdiction in nearly 9 years. The orders may increase the pressure on the Federal Reserve to grant the same status to other jurisdictions, such as India. Several Indian banks have been permitted to open branches in the United States based on a Federal Reserve determination that India is "actively working toward" CCS.

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