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Rights Plans and Proxy Contests: Chancery Court Denies Activist's Motion to Enjoin Sotheby's Shareholder Meeting

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UK Court of Appeal Invalidates Provision in Acquisition Agreement Which Forfeited Deferred Consideration If Seller Breached Non-Competition Covenants

The UK courts have adopted a relatively permissive approach to penalty clauses in recent years and have generally not sought to interfere with commercially reasonable clauses agreed to by sophisticated parties who have had the benefit of legal advice. A very recent decision of the UK Court of Appeal in *Makdessi v. Cavendish Square Holdings*, which has come as a surprise to the UK market, seems to represent a departure from this more permissive approach.

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Rights Plans and Proxy Contests: Chancery Court Denies Activist's Motion to Enjoin Sotheby's Shareholder Meeting

BY BENET O'REILLY AND AARON MEYERS

Mr. O'Reilly is a partner and Mr. Meyers is an associate at Cleary Gottlieb Steen & Hamilton LLP.

On May 2, 2014, the Delaware Chancery Court denied a motion to preliminarily enjoin Sotheby's annual stockholder meeting based on allegations by an activist stockholder, Third Point LLC, that the Sotheby's board of directors violated its fiduciary duties by adopting a rights plan (or "poison pill") and refusing to provide a waiver from its terms in order to obtain an advantage in an ongoing proxy contest.

Applying the two-prong *Unocal* test, Vice Chancellor Parsons held that the plaintiffs failed to demonstrate a reasonable probability of success on the merits of their claims. Notably, the Chancery Court accepted that the threat of "negative control" (i.e., disproportionate influence over major corporate decisions) by a stockholder with less than 20% ownership and without any express veto rights may constitute a threat to corporate policy justifying responsive action by a board, including the adoption and retention of a rights plan.

Background

Beginning in early 2013, Third Point and two other activist hedge funds established a position in Sotheby's stock, with Third Point ownership eventually reaching approximately 9.6% and the collective ownership of the three funds reaching approximately 19%. In August 2013, Sotheby's management met separately with Third Point and one of the other funds, Marcato, with the funds suggesting potential changes to Sotheby's strategy and leadership.

In October 2013, Third Point filed an amended Schedule 13D attaching a letter from Daniel Loeb, Third Point's CEO, to William Ruprecht, Sotheby's Chairman, President and CEO, raising concerns about Sotheby's and suggesting, among other things, that several new directors recruited by Mr. Loeb be added to Sotheby's board. Inferring the letter to be part of an "all-out assault" intended to destabilize Sotheby's, the board adopted a two-tiered rights plan, triggered at a 10% ownership level, but allowing any "passive" stockholder to acquire up to 20%. By its terms, the rights plan would expire in one year unless approved by a vote of Sotheby's stockholders and would not apply to a tender offer for all outstanding Sotheby's shares that remained open for at least 100 days.

In February 2014, Third Point and Sotheby's engaged in negotiations in an attempt to avoid a proxy contest in the lead up to Sotheby's annual meeting scheduled for May 6. Third Point sought, among other things, two seats on Sotheby's board and for the rights plan's trigger to be raised to 15%. Sotheby's offered Third Point a single board seat, subject to certain conditions including a standstill agreement capping Third Point's ownership at approximately 10%. The parties failed to reach agreement and, in March 2014, Third Point requested a waiver from the rights plan to allow it to purchase up to a 20% stake in Sotheby's. Sotheby's board was aware that the proxy contest was a "dead heat" and that an increase in Third Point's stake may have improved its likelihood of success. The board denied the request and Third Point filed suit, alleging that the board adopted and enforced the rights plan against Third Point for the primary purpose of inhibiting its ability to wage a successful proxy contest, without any compelling justification for doing so.

Applicable Legal Framework: *Unocal* and/or *Blasius*?

In evaluating the probability that Third Point's claims would succeed on their merits, the Chancery Court held that the board's compliance with its fiduciary duties as they relate to the rights plan must be assessed under the *Unocal* standard. The *Blasius* stringent "compelling justification" standard, though not mutually exclusive of the *Unocal* standard, could be applied only where "the primary purpose of the board's action is to interfere with or impede exercise of the shareholder franchise and the shareholders are not given a full and fair opportunity to vote effectively." Vice Chancellor Parsons noted that the plaintiffs had not cited any case in which *Blasius* was invoked to examine a rights plan, and suggested that the "reasonableness" prong of *Unocal* may adequately deal with any rights plan that adversely affects the shareholder franchise, making the application of *Blasius* unnecessary.

In any event, the Chancery Court concluded that the plaintiffs did not have a reasonable probability of demonstrating that the board adopted the rights plan for the *primary purpose* of interfering with any stockholder's franchise. In so concluding, the Chancery Court focused on the absence of any inference of entrenchment on the part of the board and the fact that the rights plan is neither coercive (since it does not impose any consequences on stockholders for voting their shares as they wish) nor preclusive (as the parties conceded that the proxy contest could be won by either side).

With respect to the board's refusal to grant Third Point's request to waive the 10% trigger, however, the Chancery Court described the question of the applicability of *Blasius* as "uncomfortably close," noting that the board's refusal came soon after it learned that Third Point's acquisition of an additional 10% stake likely would ensure Third Point's victory in the proxy contest. Vice Chancellor Parsons was "not unsympathetic" to the plaintiffs' position but noted that in *Moran* the Delaware Supreme Court held that some incidental reduction of the stockholder franchise as a result of the adoption of a rights plan was acceptable so long as a proxy contest remained a viable option, and that subsequent case law had expanded the scope of threats justifying an incidental reduction of the franchise beyond the hostile takeover context. Nevertheless, the Vice Chancellor indicated that the plaintiffs' claims in this respect raised important policy concerns that deserved careful consideration under *Unocal*.

Application of the *Unocal* Standard

The Chancery Court applied the two-prong *Unocal* standard separately to its review of Sotheby's adoption of the rights plan and the board's subsequent denial of Third Point's request for a waiver from its 10% trigger, in each case concluding that Third Point had failed to demonstrate a reasonable probability that the board would not be able to demonstrate that it had satisfied the relevant test.

The "reasonableness" prong of the *Unocal* test requires the board to have had reasonable grounds for believing that a legally cognizable threat to Sotheby's corporate policy and effectiveness existed, both when Sotheby's adopted the rights plan and when it refused Third Point's waiver request. With respect to the initial adoption of the rights plan, the Chancery Court focused on the threat of "creeping control" by the activist hedge funds, who may form a "wolfpack" to jointly acquire large blocks of a target company's stock. As to the board's refusal to waive the rights plan's 10% trigger and allow Third Point to buy up to 20% of Sotheby's, the Chancery Court relied on the threat of "negative control": the possibility that Third Point, as a 20% stockholder, could exercise disproportionate influence over major corporate decisions, even without any explicit veto power. Earlier Delaware case law relating to negative control had involved *explicit* veto power obtained via contractual rights or by ownership of a stake sufficient to block actions requiring a supermajority vote. Nevertheless, on the basis of the aggressive and domineering manner in which Mr. Loeb conducted himself in relation to Sotheby's and that, at 20% ownership, Third Point would be Sotheby's largest single stockholder by far, the Chancery Court found that the board could have an objectively reasonable basis to believe Third Point could control important corporate actions, presenting a threat legally cognizable under *Unocal*.

The "proportionality" prong of the *Unocal* test requires the board to demonstrate that its defensive response was reasonable and proportional in relation to the threat posed. The Chancery Court considered that a 10% threshold would allow any activist stockholder to hold a substantial ownership position relative to that of Sotheby's board (which collectively held less than 1%), that Third Point at just under 10% ownership was Sotheby's largest single stockholder, and that a trigger level much higher than 10% would make it easier for a small group of activist investors to achieve control without paying a premium.

Lessons Learned

The Chancery Court's opinion provides various important reminders for Delaware corporations, including:

- When considering whether to adopt, redeem, amend or waive any stockholder rights plan, directors should focus at all stages on the types of legally cognizable threats that will pass muster under the "reasonableness" prong of the *Unocal* test—the focus remains on threats to control of the company, including "creeping control" and "negative control."
- An independent board, advised by competent outside financial and legal advisors, will be granted additional deference in its determination of the threats posed by an activist investor. The Vice Chancellor highlighted that the Sotheby's board included only one member of management and ten of the eleven other directors were independent under NYSE standards, and that the average board tenure of 7.1 years was three years less than the average for the S&P 500.
- Another reminder that all written and electronic communications may be subject to discovery and subsequently revealed in litigation. The parties introduced

numerous and candid emails among members of the board; among members of Sotheby's financial advisors; and among the Third Point investment team—and the Chancery Court's opinion even refers to personal emails exchanged between Sotheby's CEO and his sister. The candid sharing of ideas among independent directors is critical to a healthy board debate, but is best reserved for a meeting or conversation. The likelihood of potentially embarrassing communications can be reduced by providing sufficient and regular opportunities for directors to engage in in-person discussions.

More generally, a rights plan is of limited utility in connection with shareholder activism and therefore boards ought to continue to take into account the considerations and advice conveyed in our recent memorandum, Selected Issues for Boards in 2014.

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For more information, please contact Benet O'Reilly at +1 212 225 2746 (boreilly@cgsh.com) or Aaron Meyers at +1 212 225 2844 (ameyers@cgsh.com), both resident in our New York office.

Schedule 13D's Ten-Day Window, Insider Trading Law and Other Issues Involving a Prospective Bidder's Stock Accumulation: Will the Pershing Square/Valeant Accumulation of Allergan Stock Lead to Regulatory Reform?

BY VICTOR LEWKOW, CHRISTOPHER AUSTIN AND DAVID BRODSKY

Mr. Lewkow, Mr. Austin and Mr. Brodsky are partners at Cleary Gottlieb Steen & Hamilton LLP.

As widely reported, a vehicle formed by Pershing Square and Valeant Pharmaceuticals acquired just under 5% of Allergan's shares. The Pershing Square/Valeant vehicle then crossed the 5% threshold and nearly doubled its stake (to 9.7%) over the next ten days, at which point it made the required Schedule 13D disclosures regarding the accumulation and Valeant's plans to publicly propose an acquisition of Allergan. The acquisition program has raised a number of questions.

Insider Trading Considerations

Based on public information, there is nothing to suggest insider trading. First, it appears that neither Valeant nor Pershing Square had obtained any material non-public information from Allergan. Second, it has been long established that a prospective bidder can accumulate a stake in a target without disclosure of its own plans (i.e., a bidder's own intention to pursue an acquisition is not "inside information").

There is, however, a special SEC insider trading rule that deals with tender offers. Rule 14e-3 provides that once a prospective bidder has "taken a substantial step or steps to commence a tender offer," then any person other than the bidder who is in possession of material non-public information relating to such tender offer is prohibited from acquiring shares in the prospective target. There may be some uncertainty as to whether or not the Pershing Square/Valeant vehicle would be subject to this rule given that one (but only one) of its parents is the prospective bidder. But that likely is irrelevant. While the concept of "substantial steps to commence a tender offer" has been construed liberally, it is highly likely that Valeant has been careful to avoid any actions that could be characterized as steps towards commencement of a tender offer. Instead, Valeant is likely to pursue the acquisition by making public merger proposals ("bear hugs") together with a threatened or actual proxy contest or consent solicitation to change the Board of Directors.

One might ask why Rule 14e-3 is focused only on tender offers and not on other acquisition structures. The answer is simply that the Williams Act gave the SEC authority to adopt rules regulating tender offers and this rule was adopted in 1980, at a time when tender offers were the principal means of acquisitions and there were concerns about people trading based on advanced knowledge of tender offers. This was during the era of "raiders," who often made tender offers, and well before the current era of "activists."

There also has been considerable discussion recently as to the appropriateness of trading by persons with knowledge of an activist investor's plans. For example, it has been reported that during the ten-day period prior to the filing of the Pershing Square/Valeant 13Ds there was unusually heavy volume in Allergan trading over and above the Pershing Square/Valeant trades. We have no reason to believe any such trading resulted from a tip by Pershing Square or Valeant and there is, of course, nothing wrong with an investor acquiring shares based on a recognition that increased volume may indicate an accumulation by a potential bidder. But even if third-party trading did result from a tip by an accumulator, that trading would not constitute insider trading under Rule 14e-3 if (as discussed above) no substantial steps had been taken to commence a tender offer.

It also would not constitute insider trading under Rule 10b-5 unless the tip violated a legal duty of trust or confidence (for example, if one participant in an accumulation tipped in violation of a duty of confidence to the other). Of course, if there were a tip and there were also an agreement or understanding (which need not be in writing) to act together between any such trader and one or both of the participants in the accumulation, the failure of the trader to file as part of the group filing the Schedule 13D would be a violation of Section 13(d) by both the filing parties and the trader, which could lead to SEC enforcement action and, in egregious circumstances, criminal prosecution.

The 13D Ten-Day "Window"

The Schedule 13D ten-day "window" (which does not require a filing until ten days after the 5% threshold is crossed and permits acquisitions in excess of 5% during the ten days) dates back to Congress's adoption of the Williams Act in 1968. For many years numerous market participants have urged Congress to shorten the window, noting that almost every other developed market has a much shorter period to make filings disclosing large positions (and some have filing thresholds at levels under 5%). Eventually, the Dodd-Frank legislation (adopted in 2010) authorized the SEC to shorten the ten-day window. While many commentators assumed that the SEC would move quickly to substantially shorten it, activist hedge funds and their supporters argued that encouraging activism was good public policy (since it was a counterweight to "entrenched" boards of directors) and that the ten-day window encouraged activism by permitting acquisitions of larger stakes without disclosure (and the resulting run-up in share price). The SEC has not yet taken a position and has not exercised its authority to shorten the 13D window.

HSR Filing Requirements

Substantially the entire investment was in the form of American-style call options and forward purchase contracts. Thus, since the vehicle did not have the ability to vote any of the underlying shares, it appears that no filing had been required under the antitrust pre-notification filing requirement of the Hart-Scott-Rodino Act ("HSR"). An HSR filing would be required only when the underlying shares are acquired.

Will Congress or the SEC Take Action?

The recent high-profile events regarding Allergan may put pressure on the SEC (and potentially Congress) to address a number of important policy questions. These include (1) whether the 13D window should be substantially shortened, (2) whether all derivative positions, even purely economic positions, should be treated as "beneficial ownership" for 13D purposes (as is common under similar disclosure systems in many other countries and as the SEC now has the authority to require under Dodd-Frank) and (3) whether the Rule 14e-3 limitation on third-party trading in anticipation of a tender offer should be expanded to include other acquisition structures (which would likely require Congressional action). Importantly, these issues can be viewed as part of a growing debate as to whether there are cases of "illegitimate" imbalances of information beyond classic "insider trading" that regulators should address. These include, in addition to the 13D and 14e-3 issues raised above, high speed traders' use of informational advantage due to timing or visibility of order flow and possible informational advantages available in dark pools.

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For more information, please contact Victor Lewkow at +1 212 225 2370 (vlewkow@cgsh.com), Christopher Austin at +1 212 225 2434 (caustin@cgsh.com) or David Brodsky at +1 212 225 2910 (dbrodsky@cgsh.com), all resident in our New York office.

Going Private Transactions – MFW's Bumpy Road to Business Judgment Review

BY VICTOR LEWKOW, ETHAN KLINGSBERG, MITCHELL LOWENTHAL AND NEIL WHORISKEY

Mr. Lewkow, Mr. Klingsberg, Mr. Lowenthal and Mr. Whoriskey are partners at Cleary Gottlieb Steen & Hamilton LLP.

On March 14, 2014, the Delaware Supreme Court affirmed then-Chancellor Strine's grant of summary judgment in the *MFW* case, which set forth a roadmap for a less rigorous standard of review for going private transactions by controlling stockholders. The Supreme Court agreed that if specified steps were taken in such a transaction, the courts would not review the transaction under the stringent "entire fairness" test but instead would apply the more deferential business judgment rule. However, the Supreme Court's conditions for business judgment review, taken together with the process for establishing these conditions, make it unlikely that many controlling stockholders will elect to go down this path, even more unlikely than we expected after the Chancellor's opinion last year, as discussed in our June 25, 2013 memorandum (*Controlling Stockholder "Going Private" Transactions after In Re MFW: Reasons to Be Wary of the Path to the Business Judgment Rule*).

In its March 14 opinion, the Supreme Court concluded that business judgment review will be available in a going private transaction with a controlling stockholder only if *all* of the following conditions are satisfied:

- The controlling stockholder conditions the transaction, from the time it makes its initial proposal, on approval of both a special committee and a majority vote of the outstanding shares owned by unaffiliated stockholders (generally referred to as a majority-of-the-minority vote, even if the unaffiliated shares are actually a majority of the outstanding shares);
- The special committee is independent and empowered to select its own advisors and to say no "definitively" and thus veto a proposed transaction;
- The special committee meets its duty of care in negotiating a fair price (a condition that the Court appears to view as involving a combination of both traditional "due care" process considerations and substantive results akin to those necessary to satisfy the "fair price" prong of the entire fairness test); and
- The majority-of-the-minority vote is fully informed and there is no coercion of the minority.

Most significantly, the Supreme Court then noted that the *MFW* complaint itself would have survived a motion to dismiss under these standards because it adequately pleaded that the price of the merger was too low (citing allegations that certain ratios were well below those in similar transactions; that the merger price was lower than the trading price two months earlier; that the share price was depressed at the relevant time due to short-term factors; and that commentators viewed the initial offer and ultimate merger price as surprisingly low). According to the Supreme Court, "These allegations about the sufficiency of the price call into question the adequacy of the special committee's negotiations, thereby necessitating discovery on *all* of the new prerequisites to the application of the business judgment rule" (emphasis added). Furthermore, if a plaintiff "can plead a reasonably conceivable set of facts showing that any or all of those enumerated conditions did not exist," the case would not be dismissed and the plaintiff can conduct discovery. If after discovery, triable issues of fact remain about whether any of the requirements for business judgment review are satisfied, "the case will proceed to a trial in which the court will conduct an entire fairness review."

Thus, while the Supreme Court's analysis was animated by the apparent view that a controlling stockholder's take-private transaction with the features described above should be treated as an arm's length third party acquisition, the practical result will likely be far different. Assuming the plaintiff can satisfy the seemingly easy pleading burdens of raising some question about the fairness of the price or, for example, raising issues about the independence or engagement of the committee, the case will survive dismissal at the pleading stage. This means the buyer will incur what will likely be substantial discovery costs. Only thereafter will the defendants be able to move for summary judgment (as did the *MFW* defendants). If the Chancery Court concludes at the summary judgment stage that there are no genuine issues of material fact and that the *MFW* standard has been met, then it will apply the business judgment rule, and will almost inevitably dismiss the case (given the finding necessary to conclude that the

MFW standard has been satisfied). But succeeding on summary judgment will not be easy in this context, where the defendants will have the burden of establishing the absence of issues of fact as to whether the criteria for the applicability of the business judgment rule have been satisfied. Indeed, the Court highlights that the plaintiffs in *MFW* failed to submit any factual or expert affidavits to create issues of fact as to the achievement of a fair price and how ordinarily there are issues of fact for resolution at trial relating to a fair price determination.

Moreover, if defendants can establish satisfaction of all the *MFW* conditions and therefore benefit from the presumption of the business judgment rule at the summary judgment stage or at trial, they would almost certainly have prevailed under entire fairness review even before *MFW*. Furthermore, if the defendants can establish the presence of a well-constituted and functioning special committee that meets its duty of care in negotiating a fair price, and satisfy the *MFW* disclosure and non-coercion conditions, then they would also be likely to prevail under entire fairness even though the controlling stockholder had neither committed at the outset to proceed only with a majority-of-the-minority vote condition nor agreed later in the process to such condition.

Will this approach meaningfully change the incentives of controlling shareholders in structuring these transactions and assessing related litigation risks? Despite the good intentions of the Delaware courts to encourage controlling stockholders to utilize an approach that is most favorable to the unaffiliated stockholders, we do not believe that many controlling stockholders considering a going private transaction will be inclined to follow this blueprint due to the following considerations:

- In most cases, plaintiffs will likely be able to avoid motions to dismiss based on allegations challenging the fairness of the price. In addition, as we noted last year with respect to the Chancery Court decision, in many cases the plaintiff will be able to adequately allege a basis to challenge the independence of members of the special committee, the quality of the committee's process, and the quality of the proxy statement disclosure. Thus, the controlling stockholder would likely still be subject to the distractions and costs of extensive discovery—a result the Supreme Court found to be appropriate in *MFW* itself. In addition, plaintiffs may similarly be able to defeat motions for summary judgment by producing factual and expert affidavits (which the *MFW* plaintiffs failed to do) on the subject of fair price and thereby drive the case to a costly trial.
- High execution risks are often created by an unwaivable majority-of-the-minority condition, as evidenced by a number of recent transactions and proposed transactions.
- Following the Court's approach is unlikely to reduce the costs of settling most typical stockholder class actions challenging going private transactions, as discussed in our prior memorandum and analyzed based on a data set of five years of going private transactions in an article we published in the *Delaware Journal of Corporate Law*.
- A transaction with a good special committee process and with a proxy statement that meets the applicable Delaware duty of disclosure but that is subject to entire fairness scrutiny because there is no majority-of-the-minority condition, should withstand plaintiffs' motion to enjoin stockholder approval of the transaction, because there will be an adequate opportunity for a post-closing trial on a damages remedy. Moreover, there are a number of precedents for defendants winning entire fairness trials after the closing of the transaction if an effective special committee had negotiated the merger, even in the absence of a majority-of-the-minority vote condition.
- The controlling stockholder will sharply limit its flexibility for an unspecified period by making the *MFW*-required upfront commitment to proceed only if the special committee approves the transaction and there is a majority-of-the-minority vote condition.

Accordingly, we expect that controlling stockholders in most contexts will negotiate with a special committee but not commit to (or, often, even subsequently agree to) a majority-of-the-minority condition, and that they will instead retain flexibility. This flexibility will include the possibility, if negotiations are unsuccessful, to switch to a unilateral tender offer conditioned on a majority-of-the-minority tender under the *Pure Resources* line of cases, where a special committee would be empowered to make its informed recommendation to stockholders despite holding no veto power.

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For more information, please contact Victor Lewkow at +1 212 225 2370 (vlewkow@cgsh.com), Ethan Klingsberg at +1 212 225 2588 (eklingsberg@cgsh.com), Mitchell Lowenthal at +1 212 225 2760 (mlowenthal@cgsh.com) or Neil Whoriskey at +1 212 225 2990 (nwhoriskey@cgsh.com), all resident in our New York office.

Terminating the CEO: Some Practice Tips from the Delaware Supreme Court

BY ARTHUR KOHN, LEWIS LIMAN, SUNEELA JAIN, SRI KUEHNLENZ AND JONATHAN REINSTEIN

Mr. Kohn and Mr. Liman are partners, Ms. Jain and Ms. Kuehnlenz are associates, and Mr. Reinstein is a Knowledge Management Attorney at Cleary Gottlieb Steen & Hamilton LLP.

When the directors of a public company lose confidence in their chief executive officer and choose to remove him or her, the communication of that message is typically a highly choreographed affair. A recent decision of the Delaware Supreme Court, sitting *en banc* in *Klaassen v. Allegro Development Corp.*,[1] provides the opportunity to review some basics of Delaware board process and highlights the need to be careful about both a Delaware law technicality involving the difference between regular and special board meetings, and what should be a more common-sense aversion to the use of deception in the choreography. The Supreme Court in *Klaassen* affirmed a Chancery Court decision by Vice Chancellor Laster[2] that the Vice Chancellor stayed pending appeal.

Eldon Klaassen founded Allegro in 1984 and was its CEO until November 1, 2012. Klaassen also owned nearly all of Allegro's stock until late 2007 and early 2008, at which time Allegro raised capital through the sale of a preferred class of stock to two private equity firms. Following the investment, Allegro's board consisted of two members appointed by the new investors, two members appointed by Klaassen in his capacity as CEO and approved by the new investors, and Klaassen.

The Allegro board eventually became dissatisfied with Klaassen's leadership and, at a regularly scheduled board meeting on November 1, 2012, terminated his employment and appointed one of the board members appointed by Klaassen as interim CEO. Klaassen remained as a director. Although Klaassen acted initially in a manner suggesting acceptance of the change—e.g., he agreed to serve on the audit and compensation committees of the board at a subsequent board meeting—by mid-2013, Klaassen sent a letter to Allegro's general counsel and two of its board members arguing that his removal as CEO was invalid.

The Chancery Court ruled against Klaassen but, in a post-trial memorandum opinion addressing Klaassen's motion for a stay pending appeal, reviewed at length a line of cases dealing with notice requirements for board of director meetings, beginning with a 1992 Chancery Court opinion in the case of *Koch v. Stearn.*[3] Klaassen argued that these cases "recognize a special equitable notice requirement that benefits any individual who is (i) both an officer and a director and (ii) can exercise a right that could alter the composition of the board."[4] Basically, the alleged rationale for such a special notice requirement was that the absence of notice improperly deprived the "super-director" of the ability to exercise his right to change the composition of the board so as to preempt the board's plans. The Chancery Court concluded that the *Koch* line of cases "reveals tensions…with Delaware's director-centric system of corporate governance…[but does] present serious legal questions" relevant to the claim in *Klaassen*.[5] While the Chancery Court's review of the *Koch* line of cases was interesting and entertaining from a historical and theoretical perspective, the Chancery Court ultimately avoided deciding *Klaassen* on the basis of those cases, instead holding against Klaassen on the basis of the equitable principle that Klaassen had acquiesced in the termination of his employment.

In affirming the Chancery Court's decision, the Supreme Court sidestepped the Chancery Court's questioning of the holdings of the *Koch* line of cases ("we need not respond to that question, as an answer is not required to resolve this case"[6]) and instead resolved Klaassen's appeal in favor of Allegro and the defendant directors on the basis of a straightforward application of Delaware's notice requirements and of equitable principles.

The notice requirement distinction with respect to regular and special meetings is an important practice point that can be easily overlooked in the context of terminating the employment of a chief executive officer, when typically very few, if any, people who might be facile with the minutiae of the Delaware General Corporation Law are brought into the loop:

> "It is, of course, fundamental that a special meeting held without due notice to all the directors is not lawful, and all acts done at such meeting are void. 10 Cyc. 784, 785. As to regular, or stated, meetings

> the rule is different. Presence at the meeting waives the notice, and so may a waiver be properly executed before the meeting, for there is still an opportunity to attend it. But a waiver subsequent to the meeting is ineffective."[7]

The terms "regular meeting" and "special meeting" are, also of course, not defined in the Delaware General Corporation Law but refer, often but not always as specified in a corporation's bylaws, to meetings that are respectively scheduled in advance and on a regularized basis, or those that are not. The Supreme Court's decision in *Klaassen* strongly implies, although the issue is *dicta*, that directors must be given "advance notice of the specific agenda items to be addressed" at special board meetings in order for the actions at those meetings not to be void.[8] That requirement, to be clear, does not depend on whether any employee director would have the ability to influence the composition of the board if given notice.

As to the issue of deception, while Klaassen had reason to know that his tenure as CEO of Allegro was in jeopardy, the Supreme Court found that the other Allegro directors "decided not to forewarn Klaassen that they planned to terminate him, because they were concerned about how Klaassen would react while still having access to Allegro's intellectual property, bank accounts, and employees."[9] Klaassen argued that the directors' real concern was that they would be replaced by him. The Supreme Court also concluded that one of the defendant directors sent Klaassen a misleading email, asking if the company's general counsel could attend the climactic board meeting in order to address preferred stock redemption issues, when in fact he was needed to implement the termination immediately after Klaassen was notified. Against that backdrop, and the fact that the Supreme Court decided the case in favor of the defendants, the Supreme Court quite understandably began its analysis of the equitable issues in the case by noting that "our courts do not approve the use of deception as a means by which to conduct a Delaware corporation's affairs, and nothing in this Opinion should be read to suggest otherwise."[10] Still, the Supreme Court held that under equitable principles the Allegro board's action was voidable and not *per se* void, and that Klaassen's claim would therefore fail because of his acquiescence in the decision. In the course of so concluding, the Supreme Court overruled any portions of the *Koch* line of cases that suggest that a board action carried out by means of deception is *per se* void, not voidable.

The disposition of the equitable claim in *Klaassen* presents an important practice point. As it did with questions concerning the interpretation of the *Koch* line of cases, on the question whether the deception alleged by Klaassen was enough to potentially void the board's decision to terminate him, the Supreme Court sidestepped the issue ("we need not address the merits of Klaassen's deception claim, because we find…that Klaassen acquiesced").[11] In the context of terminating a chief executive officer, as in any good drama, the urge to use minor deceptions is often strong. Acceding to that urge can, depending on the facts and circumstances, have real consequences.

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For more information, please contact Arthur Kohn at +1 212 225 2920 (akohn@cgsh.com), Lewis Liman at +1 212 225 2550 (lliman@cgsh.com), Suneela Jain at +1 212 225 2445 (sjain@cgsh.com), Sri Kuehnlenz at +1 212 225 2551 (skuehnlenz@cgsh.com) or Jonathan Reinstein at +1 212 225 3448 (jreinstein@cgsh.com), all resident in our New York office.

1 *Klaassen v. Allegro Development Corp.*, No. 583, 2013 (Del. Mar. 14, 2014).

2 *Klaassen v. Allegro Development Corp.*, C.A. No. 8628-VCL (Del. Ch. Oct. 11, 2013).

3 *Koch v. Stearn*, 1992 WL 181717 (Del. Ch. July 28, 1992).

4 *Klaassen v. Allegro Development Corp.*, C.A. No. 8626-VCL, slip op. at 7 (Del. Ch. Nov. 7, 2013).

5 *Id.* at 7-8.

6 *Klaassen v. Allegro Development Corp.*, No. 583, 2013, slip op. at 21 n.65 (Del. Mar. 14, 2014).

7 *Lippman v. Kehoe Stenograph Co.*, 95 A. 895, 898 (Del. Ch. 1915).

8 *Klaassen v. Allegro Development Corp.*, No. 583, 2013, slip op. at 19 (Del. Mar. 14, 2014).

9 *Id.* at 11.

10 *Id.* at 23.

11 *Id.*

UK Court of Appeal Invalidates Provision in Acquisition Agreement Which Forfeited Deferred Consideration If Seller Breached Non-Competition Covenants

BY SAM BAGOT

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

The UK courts have adopted a relatively permissive approach to penalty clauses in recent years and have generally not sought to interfere with commercially reasonable clauses agreed to by sophisticated parties who have had the benefit of legal advice. A very recent decision of the UK Court of Appeal in *Makdessi v. Cavendish Square Holdings*, which has come as a surprise to the UK market, seems to represent a departure from this more permissive approach.

Background and Facts

The facts were that a member of the WPP Group, the global advertising group, bought shares in a company from Makdessi. Makdessi retained a shareholding in the target company. Both parties were represented by highly experienced lawyers, and the purchase agreement was the subject of extensive negotiations between the parties over a six-month period.

It appears to have been accepted that the purchase price included a substantial element of goodwill associated with the target company. In fact, Makdessi expressly acknowledged and agreed to this in the purchase agreement.

The purchase agreement provided that the consideration payable to Makdessi included an upfront payment and two deferred elements. The deferred elements of the consideration were dependent on the operating profit of the target company in certain periods after completion of the transaction.

The purchase agreement also contained various restrictive covenants. These covenants, which were enforceable both by the buyer and the target company, included covenants by Makdessi not to solicit employees or clients from, or compete with, the target company. The purchase agreement went on to provide (the "Defaulting Shareholder Covenant") that if Makdessi breached these restrictive covenants: (i) he would not receive any of the deferred consideration; and (ii) the buyer had the option to acquire his remaining shares in the target at net asset value (a value which was apparently materially below the then market value of his remaining shares).

The Court of Appeal held that the Defaulting Shareholder Covenant was a penalty and unenforceable.

Was the Defaulting Shareholder Covenant a genuine pre-estimate of loss?

The court began the analysis by concluding that the Defaulting Shareholder Covenant was not a genuine pre-estimate of loss. It came to this conclusion principally for the following reasons:

1. The Defaulting Shareholder Covenant did not distinguish between: (i) material and immaterial breaches and (ii) isolated and continued breaches. In the case of an isolated and immaterial breach, Makdessi faced the loss of the entirety of his deferred consideration and having his remaining shares compulsorily acquired from him at below market value.
2. The amount of the deferred consideration was not ascertainable at the time the purchase agreement was signed (i.e., it was dependent on future profitability). This suggested that the amount to be withheld from Makdessi could not have been a genuine pre-estimate of loss at the time the purchase agreement was signed.
3. The purchase agreement as a whole subjected Makdessi to a duplication of prejudicial provisions. In the event that the restrictive covenants were breached, Makdessi potentially faced: (i) losing his deferred consideration and having his remaining shares bought out at an undervalue; and (ii) then also being sued by the target company (which was also entitled to enforce the restrictive covenants in the event of breach).

Notwithstanding that the Defaulting Shareholder Covenant was not a genuine pre-estimate of loss, was it commercially justifiable?

Having concluded the Defaulting Shareholder Covenant was not a genuine pre-estimate of loss (which was not of itself fatal), the court then considered whether the Defaulting Shareholder Covenant could be commercially justified.

The buyer argued that the Defaulting Shareholder Covenant was wholly justifiable. The buyer argued in particular that:

- with respect to the forfeiture of the deferred consideration, the buyer had agreed to pay a price substantially based on goodwill, and if Makdessi did not comply with the restrictive covenants which were designed to protect the goodwill of the business, there was nothing objectionable in having the consideration reduced in that event; and

- with respect to the right to acquire Makdessi's remaining shares, this provision enabled a repaid decoupling of Makdessi from the target company in circumstances where Makdessi had breached the restrictive covenants.

The court did not accept the buyer's arguments on commercial justification. It is not entirely clear why it did not accept those arguments. The reasoning seems to suggest that the court was particularly troubled by the fact that the <u>terms</u> on which the deferred consideration was adjusted, and Makdessi's remaining shares were acquired from him, were in its view disproportionate (this position was seemingly based in part on points 1 to 3 above). The court determined that those terms "went way beyond compensation and into the territory of deterrence." As one example, the court specifically noted that the proposed acquisition of Makdessi's remaining shareholding did not have to be on terms that were materially below market value.

Implications

This decision has surprised the UK market and suggests that the UK courts may adopt a more formalist and less permissive approach to penalty clauses than has been adopted in other recent cases. It may be, however, that the Court of Appeal was specifically swayed in this case by the fact that the Defaulting Shareholder Covenant did not distinguish between material and immaterial matters and the fact that, in the event of breach (potentially even an immaterial breach), Makdessi not only lost his deferred consideration but also could be forced to sell his remaining shares at below market value (which, in aggregate, could cause Makdessi to lose sums in the tens of millions of dollars, according to the court). However, given that the purchase agreement was heavily negotiated between parties advised by highly experienced lawyers and that the goodwill associated with the target business quite clearly represented a substantial proportion of the purchase price, it seems surprising that the court did not display more reluctance to intervene.

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For more information please contact Sam Bagot at +44 20 7614 2232 (sbagot@cgsh.com), resident in our London office.

CLEARY GOTTLIEB

Offices

MAY 2014

www.clearygottlieb.com

New York
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

Washington
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

Paris
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

Brussels
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

London
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

Moscow
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

Frankfurt
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

Cologne
Theodor-Heuss-Ring 9
50668 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

Rome
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

Milan
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

Hong Kong
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Hysan Place, 37th Floor
500 Hennessy Road, Causeway Bay
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

Beijing
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

Buenos Aires
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires,
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

São Paulo
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

Abu Dhabi
Al Sila Tower, 27th Floor
Sowwah Square, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

Seoul
Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T: +82 2 6353 8000
F: +82 2 6353 8099