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Perspectives

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PRESERVING THE STOCKHOLDER FRANCHISE: ISSUANCE OF SERIES B PREFERRED STOCK WITH SEPARATE SERIES VOTE ON ALL MATTERS SUBJECT TO STOCKHOLDER APPROVAL BREACHED DIRECTORS' DUTY OF LOYALTY AND HELD INVALID UNDER "ENHANCED SCRUTINY" STANDARD

In *Johnston v. Pedersen* (Del. Ch. Sept 23, 2011), Vice Chancellor Laster of the Delaware Court of Chancery held that the issuance of Series B Preferred Stock conferring on the holders of Series B Preferred Stock a separate series vote on any matter submitted to the stockholders for approval, including the election of directors, was invalid. Vice Chancellor Laster found that while defendant directors had acted in good faith, they also breached the duty of loyalty in granting such right to minority stockholders. Despite its somewhat perplexing conclusion, *Johnston* provides clear guidance on (1) the elevated standard directors face when making decisions involving stockholder voting rights, particularly in regards to corporate governance matters and election of directors, and (2) the conflicts that can emerge when what directors believe is best for the company is not a legitimate objective in and of itself.

Factual Background

Xurex is an early-stage company that endeavored to develop protective coatings derived from nano-technology invented by Bo Gimvang. Unfortunately, the coatings deteriorated in real-world environments and resisted several commercialization attempts. After expensive research and testing, Xurex found a limited application in the oil and gas industry, where Xurex secured one major customer, DuraSeal, which was responsible for 99% of the company's sales.

Gimvang and Bob Bishop, an early CEO, raised an additional $10 million from outside investors in a combination of common stock and Series A Preferred Stock offerings while also retaining a majority of the company's outstanding voting power. Bishop's tenure as CEO quickly drew criticism. In response to dwindling company assets and growing investor discontent, Gimvang and Bishop hired defendant Rex Powers, a recruiter who identified Bill Loven for the role of CEO.

Among other actions following his hiring as CEO, Loven investigated allegations that Gimvang and Bishop had defrauded investors, raising the ire of Gimvang and Bishop, who still controlled Xurex. As Loven pursued the matter, he soon found himself ousted by his original sponsor, Powers, who had been given proxies by Gimvang and Bishop. Powers then elected himself to the board along with defendant directors Clifford and Pedersen. Within a short time, two successive contests for control ensued. Although Powers, Clifford and Pedersen were retained on the board, they were well aware, with the addition of two other directors, that their board seats could only be maintained with the continued support of directors Gimvang and Bishop.

Powers and the other members of the board stabilized Xurex's finances with a long-term licensing deal with DuraSeal, but the company continued to face a dire need for additional capital. Although certain members of the board wanted to continue the investigation of the investor fraud allegations that Loven initiated prior to his ouster, they knew doing so could result in their own removal from the board. At this point, the board felt that Xurex could not withstand yet another proxy battle; Xurex needed "stability" (*i.e.*, entrenched incumbency) to ensure additional investment.

In an effort to address both objectives of capital and stability, the company pursued a convertible bridge loan followed by a Series B Preferred Stock financing round – with the Series B Preferred Stock having a "super voting right." As a result of the convertible bridge loan that was pushed through on an accelerated pace and the Series B Preferred Stock financing that limited investor participation and included limited disclosures and side communications, a majority of the Series B Preferred Stock ended up in the hands of board members and investors friendly towards the incumbent management. Through the "super voting right," which conferred on the holders of Series B Preferred Stock a separate series vote on any matter submitted to stockholder vote, negative control of Xurex had been sold for 12.2% of the company's post-money valuation.

DuraSeal, seeking to buy Xurex, then triggered a third proxy contest. Along with the delivery of written consents from the majority of the voting power constituted by the common and Series A Preferred Stock that replaced the board of directors, the plaintiffs also initiated an action seeking a determination that such consents (absent the consent of a majority of the Series B Preferred) were valid and effective, on the basis that the "super voting right" was invalid and conferred on the holders of Series B Preferred Stock in breach of the defendant directors' fiduciary duty of loyalty.

Court's Rulings

Vice Chancellor Laster found that the defendant directors breached their duty of loyalty by issuing Series B Preferred Stock that conferred on its holders a "super voting right," notwithstanding the accepted fact that the defendant directors had acted in good faith and subjectively believed that it was in the company's best interests that the board be entrenched before they could be replaced. However, despite their presumed good intentions, directors cannot entrench themselves on the basis that stockholders are unable to reasonably decide themselves. In reaching his conclusion, Vice Chancellor Laster applied the *enhanced scrutiny* test applicable when director actions affect the stockholder franchise and in situations "where the law provides stockholders with a right to vote and the directors take action that intrudes on the space allotted for stockholder decision-making" (quoting *Reis v. Hazelett Strip-Cashing Corp.* (Del. Ch. Jan. 21, 2011)). Under such enhanced scrutiny, the burden is on the directors to persuade the court that their actions were predicated on proper and not selfish motivations, did not preclude stockholders from exercising their right to vote or coerce them into voting in a particular way, and reasonably related to a legitimate objective. Furthermore, because the vote to issue the Series B Preferred Stock and its "super voting right" also involved the election of directors or matters that touch upon corporate control, the standard upon which the directors must support their decisions shifted from "reasonable" to "compelling," and required "a closer fit of means and end."

In applying these standards, the court found the defendant directors' justification for granting negative control to the minority holders of Series B Preferred Stock lacking and not narrowly fitted to supplying additional funding for Xurex. Defendant director Pedersen admitted at trial that the vote provision at issue was "broader than necessary to address investor concerns." Furthermore, neither the accelerated schedule of the convertible bridge loan nor the limitations placed upon investor participation squared neatly with the defendant directors' claimed legitimate purposes. Because the court did not find the board's justifications related to a legitimate purpose in a compelling manner, the court ruled that the defendant directors had breached their duty of loyalty and that the holders of the Series B Preferred Stock are not entitled to a separate series vote in connection with the election of directors. The written consent submitted by the plaintiffs and other Xurex stockholders to remove the defendant directors and replace them with directors elected by stockholders representing the majority voting power of Xurex's outstanding capital stock was upheld.

Takeaways

Johnston serves as a useful application of the following elements of the "enhanced scrutiny" standard that applies to board actions relating to stockholder rights:

- Directors must understand that good faith actions for the benefit of their company may conflict with their other fiduciary duties, such as their duty of loyalty to stockholders.

- In actions affecting a stockholder vote, the burden will be on directors to show their actions are reasonably related to a legitimate objective.

- In cases involving director elections or matters of corporate governance, a compelling justification for the action related to a legitimate objective must be shown.

Also, this case is a reminder that important fiduciary duty principles – especially the duty to respect the voting rights and the integrity of the franchise – must be considered no matter how difficult the company's financial situation.

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RECENT COMPENSATION TRENDS IN MERGERS AND ACQUISITIONS AND SECTION 409A

This article discusses the traps for the unwary created by Section 409A of the Internal Revenue Code ("Section 409A") with respect to current trends in change-in-control compensation for public company executives and the structure of private company acquisitions. Although Section 409A is a deferred compensation statute, it potentially applies to many types of compensatory arrangements implicated in a change in control, including severance arrangements, stock options, incentive arrangements and certain other forms of compensation. The consequences to the executive of violating Section 409A are severe—accelerated income inclusion, interest and a 20% federal penalty tax (California imposes an additional 20% penalty).

Double-Trigger Severance Payments

In the last several years, we have observed a trend away from "single-trigger" change-in-control benefits for executive officers of publicly-traded companies. Single-trigger arrangements generally provide for the payment of benefits upon a change in control without a requirement that the executive be terminated at the time of the acquisition. As a result of heavy attack by various shareholder constituencies, these arrangements are quickly fading as an acceptable market-standard practice and are being replaced with "double-trigger" change-in-control protections. Unlike single-trigger arrangements, double-trigger arrangements require the executive to suffer an adverse employment action within a specified period of time following a change in control, such as an involuntary termination or a resignation for "good reason," in order for the executive to receive the benefits under the arrangement.

Double-trigger severance arrangements often provide severance protection both before and after a change-in-control. Typically, the pre-change-in-control severance is paid in installments (to help enforce post-employment restrictive covenants) and the post-change-in-control severance is paid in a lump sum (because post-employment restrictive covenants are less of a concern to the acquired company after a change-in-control and to protect the executive against the whims of the acquirer). Alternative payment methods for double-trigger severance arrangements have the potential to cause a Section 409A violation. This Section 409A concern is sometimes overlooked because pre-change-in-control and post-change-in-control severance are often set forth in different documents (such as in a company severance plan and an individual executive change-in-control severance agreement).

A double-trigger change-in-control arrangement will typically be subject to Section 409A if it either contains a good reason payment trigger that is too broad (e.g., it allows the executive to quit and receive severance following a minor reduction in authority or compensation) or it provides payments in installments that exceed $490,000 (this limit is indexed every year) or extend more than 2 years after the year of separation of service. Any such installment/lump sum double-trigger will violate Section 409A unless the change-in-control definition meets certain requirements under Section 409A, which it often does not. The obvious way to avoid this issue is for the pre-and post-change-in-control payments to be payable in the same manner. Otherwise, companies and executive officers that enter into this type of arrangement should consult with their counsel to ensure compliance with Section 409A.

Earn-Out Arrangements

In the context of private company acquisitions, the uncertain future economic environment has corresponded with an increase in "earn-outs." An earn-out generally provides for future payments to the sellers of an acquired company if certain business-related milestones are achieved by the acquired business after the acquisition. Typical earn-out periods range from 2 to 5 years, however, in certain cases they can extend as long as 10 years or more. Earn-outs are not new but present complications under Section 409A.

Stock option cash-outs and management incentive plan payments that would otherwise be paid at the time of the acquisition can be made subject to the earn-out without violating Section 409A, as long as the payments are made at the same time and generally on the same terms and conditions as apply to payments to shareholders generally. Although this is a straightforward rule, certain arrangements may not comply. In addition, this rule only applies to the extent that the earn-out payments are made within 5 years of the date of the closing of the transaction. For earn-outs that exceed 5 years, there are limited alternatives under Section 409A that would need to be specifically crafted for each situation. Companies and executives should consult their counsel in this situation.

Of greater concern is the assumption of stock options in transactions with earn-outs. Stock options may be assumed in a corporate transaction without violating Section 409A if the assumption satisfies the rules that apply to the assumption of "incentive stock options" ("ISOs"). The ISO rules generally require that the economics of the assumed option be preserved, which requires valuing the consideration paid in the acquisition for the target company stock, potentially including the earn-out. By nature, earn-outs are speculative and difficult to value, but getting it wrong can have meaningful consequences—over-valuing the earn-out will potentially result in a Section 409A violation and under-valuing it will result in an economic detriment to the option holders. Companies have taken different approaches with respect to this problem. Some prefer to value the earn-out at the time of the assumption, while others prefer an "open transaction" approach that adjusts the option to reflect the earn-out only as the earn-out is paid. Yet another approach is to force option holders to exercise their options immediately prior to the transaction to avoid this Section 409A issue altogether. Each approach has its concerns, so acquisition parties faced with this situation should consult their counsel.

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FRENCH TAKEOVER BID - RECENT REFORMS

The Amendment to the French Financial Market Authority General Regulation (AMF General Regulation), by an order dated January 31, 2011, completes last year's legislative changes on the banking and financial regulation law n° 2010-1249 (BFRL), dated October 22, 2010. This Amendment reforms takeover bids in several ways, including the following changes.

Mandatory bid threshold lowered to 30%

The stock exchange market transparency and safety law formerly imposed the filing of a mandatory offer in two situations: (i) where a person becomes the holder of more than one third of the capital or voting rights of a listed company; and (ii) where a person holding between one third and one half of the capital or voting rights of a listed company increases such holding by at least 2% of the outstanding capital or voting rights of such listed company in less than 12 months, also referred to as a "speed-limit acquisition." The January 2011 amendment decreased the threshold for mandatory offers to 30% of the capital or voting rights of a listed company in each of these situations.

Calculation method of the mandatory offer thresholds

In determining whether this 30% threshold of capital or voting rights is triggered, a person should be careful to include all holdings of securities, including derivatives (e.g., swaps and credit default swaps), required by the applicable rules. For simplification, the AMF General Regulation provides that the same rules apply when determining market transparency thresholds (5%, 10%, 15%, 20%, 25%, 30%, 33.33%, 50%, 66.6% 90% and 95% of the capital or voting rights) as apply to mandatory offer thresholds (30% of capital or voting rights and speed-limit acquisition). These rules require, among other things, that debt instruments providing rights to outstanding equity, forward contracts, and options partially or totally deliverable in the form of equity (whether exercisable immediately or at maturity irrespective of the exercise price) be taken into account in determining whether the 30% threshold has been reached. Agreements with cash-only settlements are not currently taken into account in calculating the 30% threshold, but in reaction to recent transactions (Saint Gobain and Hermès), an amendment to the law for more transparency of the market has been presented to the senate to require the inclusion of such cash-only settlements in calculating the market transparency thresholds. The legislature might also reconsider the question of whether economic exposure should be taken into account in calculating the mandatory offer thresholds.

Grandfather clause

The January 2011 amendment includes a grandfather clause applicable to persons who held between 30% and one-third of the capital or voting rights of a listed company as of January 1, 2010. Such persons are subject to the old mandatory offer rules and, thus, are only required to file a mandatory offer if their holdings exceed the old one-third thresholds.

Reorganization of derogations to the mandatory offer

Prior to the January 2011 amendment, the AMF General Regulation had different articles, one relating to a direct crossing of the threshold and another relating to the indirect crossing of the threshold (*i.e.,* in connection with the acquisition of control of a parent company holding a 30% stake in a listed subsidiary on a French or European regulated market, where the subsidiary represents an essential part of the assets of the parent company). These provisions have been reorganized and modified, giving rise to new derogations cases, but without significant modification of the substance of the regulations.

FRENCH TAKEOVER BID - RECENT TRENDS

The development of tender offer and merger agreements

When a listed company is controlled by a shareholder or a group of shareholders, a shareholder who wants to acquire control first enters into a share purchase agreement with respect to the controlling interests then files an offer for 100% of the shares of the target company. These purchase agreements comply with international standards, with boilerplate conditions precedent and seller representations and warranties. Sometimes, significant shareholders desire to maintain maneuvering flexibility in the event of a third party competing offer. In such cases, the significant shareholders may only agree to sign an undertaking to tender their shares in the offer.

When a company is not fully controlled and the purchaser does not want to effect a transaction without warranties, in addition to the purchase agreement or the tender and support agreement, it may preliminarily obtain approval of the transaction by the target company's management and board of directors before filing the offer. In this situation, the French practice used to be that the chairmen of both boards would reach a mutual understanding, and then the offeror would file the offer. This gentleman's practice is now less common, with an increasing number of offerors requiring contractually binding commitments from the target prior to filing the offer. This trend has led to the development of "tender offer agreements" or "merger agreements," which protect the offeror from having to launch a transaction unless the necessary target approvals are obtained. A recent example of such a transaction was the offer filed by Solvay for the non-controlled company Rhodia, which was subject to a binding agreement signed between the two companies. This approach was also utilized in the "competing" offer of Honeywell for Sperian Protection following the announcement of Cinven's buy-out attempt.

Compared to a U.S.-styled merger agreement, the provisions in these tender offer or merger agreements are flexible and not yet standardized. The target company verifies the intentions of the offeror and ensures that it has a positive opinion from its board of directors regarding the offer, and may accept a soft "no shop clause" in order to provide offeror protection against the target's potential implementing of deal-defeating defenses. Some typical U.S.-styled merger agreement provisions are still nonexistent in their French equivalents, as in the case of "top-up options," which provide that if the offer does not reach, but is close to, the statutory ownership thresholds required for a back-end squeeze-out of the remaining minority interests (typically 90% to 95% ownership is required) the target can effect a capital increase to enable the offeror to reach the required squeeze-out ownership threshold. Although such capital increases require both the approval of the target company's board of directors and shareholders at an extraordinary general meeting, we believe such provisions will eventually be adopted in France, perhaps via a different method.

The uncommon break-up fees

Where an offeror cannot purchase the shares of significant shareholders before filing an offer, the offeror may want significant shareholders to agree to pay a significant "break-up" fee if those shareholders back out of the deal.

Such break-up fees in tender offer and merger agreements are practically nonexistent in France. The few examples of French transactions that were subject to negotiated break-up fees include the transaction contemplated among Alcan, Pechiney and Alusuisse, SAP's offer for Business Objects in 2007, and Honeywell's offer for Sperian Protection in 2010.

In France, the duties and responsibilities of the board of directors require that the interests of all stakeholders, including, most importantly, employees, be taken into account in considering any offer. As a result, most directors refuse substantial restrictions in their freedom to analyze an offer and appropriately defend the target against a change in control. Thus, there has not been a judicial or legislative need to strictly prohibit deal protection measures and break-up fees in a tender offer, unlike what has occurred recently with our English neighbors.

The increasingly important use of the "debt push down"

The resurgence of the debt markets has allowed offerors to once again utilize leverage in most buyouts. Thus, a target company's debt capacity has increasingly become an important consideration for financing transactions.

More and more target companies now pay dividends or distribute reserves after receiving an offer. We believe these practices will continue in the future, particularly in light of the anticipated amendment of the European directive implemented in the late 1990's that prohibited financial assistance. Nevertheless, potential changes in the development capacity of a target in the future and protection of its corporate interests will remain a major issue in the French market. Currently, the return of high debt ratios similar to the boom years of 2006-2007 does not seem to inhibit deal-making.

In transactions with "debt push down," there has also been a trend of capital decreases through buy-back offers, which are often used to offer cash to shareholders who seek liquidity on part of their holdings at a price generally well above the market price. Here, we actually see the use of debt to restore the value of equity. These transactions allow investors to achieve their desired internal rate of return in difficult economic periods. It should be noted that the French Financial Market Authority (AMF), in order to allow these transactions to proceed, will sometimes grant derogations when, as a result of not participating in the capital decrease, significant shareholders cross a mandatory bid threshold (in particular the 30% capital or voting rights threshold).

A mandatory threshold success of 50.01% for offers under the normal proceeding

It should be noted that in light of recent cases, particularly the tender offer by AS online for Seloger.com in 2010, there is currently some discussion of amending the stock exchange regulations. Some bids at a weak price have resulted in the offeror holding less than 50% of the capital of the target company after the offer. In order not to deprive shareholders of such offers, the AMF is considering imposing a mandatory success threshold of 50.01% for certain tender offers (*i.e.*, where AMF control of the offer price is limited).

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DELAWARE SUPREME COURT RULES ON WHETHER A "SERIES OF TRANSACTIONS" SHOULD BE AGGREGATED IN ANALYZING THE SALE OF "SUBSTANTIALLY ALL" ASSETS QUESTION

The Delaware Supreme Court recently ruled that a company's proposed splitoff of assets should not be aggregated with three prior spinoff and splitoff transactions, where the proposed splitoff was not "sufficiently connected" to the prior transactions, for purposes of determining whether the company has disposed of "substantially all" of its assets. In an en Banc decision, *The Bank of New York Mellon Trust Co. v. Liberty Media Corp.*, C.A. No. 5702 (Del. Supreme Ct.), the Court distinguished a series of related transactions consummated as part of an integrated plan from multiple transactions that are each a part of an overall business strategy, to determine whether a "series of transactions" warrant aggregation in the context of a "substantially all" analysis.

Factual and Procedural Background

Beginning in 2001, Liberty Media Corporation and Liberty Media LLC ("Liberty") consummated several sales and purchases of cable television businesses and assets. Among these sales and purchases were three spinoff and splitoff transactions: the first spinoff occurred in 2004, the second spinoff in 2005, and the third transaction, a splitoff, in 2009.

In 2010, Liberty announced a proposal to split off businesses allocated to its Capital and Starz Groups. Following the announcement, Liberty received a letter from counsel for an anonymous bondholder stating that the splitoff might violate the successor obligor provision in a bond indenture governed by New York law. This provision prohibited Liberty from transferring "all or substantially all of its assets" in a "transaction or series of transactions" unless the successor entity assumed Liberty's obligations under the indenture. Although the parties agreed that the Capital and Starz Groups splitoff alone would not constitute a transfer of substantially all of Liberty's assets, the indenture trustee claimed that when aggregated with the previous three spinoff and splitoff transactions, the proposed splitoff would violate the successor obligor provision because Liberty would have disposed of substantially all of its assets.

In response, Liberty sought injunctive relief and a declaratory judgment that the splitoff would not constitute a disposition of substantially all of its assets. The Delaware Court of Chancery agreed with Liberty, finding that the proposed splitoff was not sufficiently connected to the previous three transactions to warrant aggregation for purposes of the "substantially all" language in the successor obligor provision. The Supreme Court affirmed the decision, relying on the Second Circuit's holding in *Sharon Steel Corp. v. Chase Manhattan Bank, N.A.*, which the Court referred to as "the leading decision on aggregating transactions for purposes of a 'substantially all' analysis in the context of a successor obligor provision."

Determination that the Series of Transactions Need Not be Aggregated

In *Sharon Steel*, the Second Circuit considered a transaction in which a corporation had transferred its assets in a series of sales to multiple buyers pursuant to a plan of liquidation. The final purchaser sought to assume the seller's indenture obligations under a boilerplate successor obligor provision, claiming it could do so without bondholder consent because the final sale constituted all or substantially all of the seller's assets as measured immediately prior to the sale. The Second Circuit disagreed, holding that the assets transferred to the final purchaser had to be measured against the totality of assets owned by the seller at the inception of the plan of liquidation, not immediately before the final sale. The Court called the

series of sales a "piecemeal liquidation," distinguishing it from sales of assets in the regular course of business: "To the extent that a decision to sell off some properties is not part of an overall scheme to liquidate and is made in the regular course of business it is considerably different from a plan of piecemeal liquidation, whether or not followed by independent and subsequent decisions to sell off the rest."

The Supreme Court in *Liberty Media* focused on this distinction, explaining that where asset transactions are not components of an integrated plan to dispose of almost all of a corporation's assets, and where each such transaction stands on its own merits, courts have declined to aggregate for purposes of the "substantially all" analysis. The Court noted that Liberty's spinoff and splitoff transactions were part of a "context-driven application of the overarching business strategy that Liberty has followed since [2001] . . . not part of a master plan to strip Liberty's assets out of the corporate vehicle . . . [or] a strategy of disposing of substantially all of its assets." The Court held that this analysis was sufficient to find that Liberty had not disposed of substantially all of its assets.

The Court of Chancery had also analyzed the transactions under the step-transaction doctrine, which treats formally separate but related property transfers as a single transaction if the component transactions meet certain tests, but the Supreme Court found this analysis unnecessary in light of the application of *Sharon Steel* and declined to decide whether the step-transaction doctrine would be adopted as New York law with respect to the "substantially all" analysis.

Finally, the Supreme Court noted that the successor obligor provision in the indenture consisted of boilerplate language, which courts endeavor to apply uniformly to promote market stability. Because boilerplate provisions are not tailored to the specific relationship of the parties—and indeed the successor obligor language had not been a subject of negotiations between the *Liberty Media* parties—the Court looked to the accepted common purpose of the provision. After considering the history of the boilerplate language, the Court concluded that the phrase "series of transactions" was intended to clarify that a disposition of substantially all assets may occur as a single transaction or as an integrated series of transactions, as in *Sharon Steel*. Because the parties in *Liberty Media* did not negotiate the successor obligor language or include a separate covenant apart from the boilerplate, the Court declined to read additional protections into the boilerplate provision.

Take-Away

Liberty Media is important because it clarifies that a series of transactions that may, in the aggregate, result in the sale or transfer of a significant percentage of a company's assets will not necessarily be considered a disposition of substantially all of the company's assets. This decision could have wide-ranging applications, as the phrase "substantially all" appears not only in bond indentures but in successor obligor, assignment and consent provisions in a variety of contracts. While each determination will depend on specific facts and circumstances, if the transactions are done in the ordinary course of business or are an application of a general business strategy rather than part of an integrated plan to dispose of all or substantially all of a company's assets, *Liberty Media* indicates that such transactions most likely will not be aggregated. Both buyers and sellers should carefully consider the context of a transaction involving the transfer of significant portions of the seller's business, whether that transaction stands alone or is part of a series of transactions in what could be viewed as an integrated plan.

Finally, the Court's discussion of boilerplate language is a useful reminder to parties to negotiate separate covenants or use particularized language if they wish to incorporate protections that deviate from the commonly-accepted interpretations of boilerplate provisions.

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