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Activism and Election Contests: Some Facts, Practice Tips, Defense Strategies, Tactics and Legal Considerations[1]

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In Case You're Wondering, Activism is Not Going Away Any Time Soon.

Stockholder activism is no longer a sideline venture. It's a legitimate asset class, a source of outsized returns for institutional investors, a core profit maker for many hedge funds, and an increasingly significant driver of M&A deals. Unlike "corporate raiding" in the 1980s, there is little to no stigma today associated with launching an activist campaign against an underperforming company. It's estimated that, in the aggregate, the 50 largest activist funds (constituting the "SharkWatch 50") currently have approximately $220 billion in total assets under management, compared to approximately $9 billion at the end of 2010. Capital investment in activist funds is also more long-term today than it was 10 years ago. Accordingly, the leading funds have assembled sizeable in-house professional teams to spend more time conducting valuation research and developing an investment thesis, accumulation strategy and overall plan of attack before a decision is made to target a specific issuer. Because activist hedge funds typically do not have strict asset diversification requirements or single investment limits, substantial sums can be deployed to wage an opposition campaign against a single target or just a couple of targets at one time.

Company size is no longer a factor and no issuer or industry is immune to attack. Approximately 30 percent of the issuers targeted by activists in 2014 had a market capitalization in excess of $1 billion and,

reportedly, there were approximately 94 proxy fights (including election contests) announced in 2014 and approximately 495 from 2009 through 2013. In 2014, approximately 65 percent to 70 percent of proxy fights launched by activists resulted in settlements or the election of insurgent directors.

Due, in large part to pressure from institutional investors and the influence of ISS' and Glass-Lewis' voting recommendations, takeover defenses over the past 10-plus years have been dismantled by the overwhelming majority of S&P 500 issuers and by a significant number of Russell 3000 issuers. In fact, reportedly only 6 percent of S&P 500 issuers have a live poison pill in place today (compared to 57 percent in 2003), and only 10 percent of such issuers maintain a classified board of directors today (compared, also, to 57 percent in 2003). Rights plan adoptions as a purely prophylactic device and pills with five or 10-year terms are a thing of the past. Poison pills today are "on the shelf" and adopted typically for 12-month (or shorter) terms only in response to an overt takeover or creeping accumulation threat or, to a lesser extent, to facilitate an issuer-initiated sale of control process or protect an announced MOE or unique business combination.

Indeed, other structural defenses and organic "shark repellents" have been dismantled or scaled back over the past 10 years. For example, there has been a decline in: (i) the elimination of the right of stockholders to call special meetings, (ii) the elimination of stockholder action by written consent, (iii) supermajority voting requirements for stockholders to amend bylaws and charter instruments, and (iv) the right of stockholders to remove directors only "for cause." Notably, however, advance notice bylaw provisions (governing stockholder nominations of directors and the ability to present "other business" at annual meetings) have become increasingly potent and detailed over the past five years.

In the wake of the "Great Recession", many issuers still have record amounts of cash on their balance sheets that has not been returned to stockholders (via dividends or other distributions), used to fund acquisitions of synergistic and accretive businesses, or otherwise deployed to generate significant returns in today's historically low interest rate environment. Despite the long-standing bull market of the past six years and record (or near-record) breaking levels for the DJIA, S&P 500, Nasdaq Composite, NYSE Composite, Russell 3000 and other leading indices, the stock prices of a fair number of issuers across various industries are still trading at a discount to their implied disaggregated (or "break-up") value.

Stealth accumulation techniques (e.g., trading in complex derivative securities) have become more sophisticated and the SEC has not yet shortened the 10-day Schedule 13D initial filing window. Corporate governance activists (e.g., state and local retirement funds) are increasingly teaming up with economic activists. Last year a major pharmaceutical company and one of the most prominent activist hedge funds formed a co-bidder alliance in a high profile hostile takeover attempt of a strategic competitor, one of the world's leading private equity firms just announced a significant minority investment in a well-known hedge fund, and investors are more focused today than ever before on an issuer's trailing 12-month and five-year cumulative return performance, enhanced forward-looking disclosure, board accountability , and corporate governance best practices.

For all of these reasons, and due to the more widespread acceptance by index funds and other institutional stockholders of activist investment strategies and opposition initiatives, the surge in activism exhibited over the past 10-plus years is unlikely to subside any time soon.

The Proxy Access Movement

The SEC rescinded Rule 14a-11 approximately four years ago after it was vacated by the U.S. Court of Appeals for the D.C. Circuit. However, Rule 14a-8 was amended approximately at that time to facilitate

private ordering and enable an "opt-in" model for direct proxy access. Subject to the procedural and eligibility requirements of Rule 14a-8, issuers no longer may seek to exclude from their proxy statements (pursuant to Rule 14a-8(i)(8)) stockholder proposals to amend the issuer's organizational instruments to facilitate director nominations. Such proposals may not, however, (i) seek to disqualify a director-nominee up for reelection, (ii) remove an incumbent director from office prior to the expiration of his or her term, (iii) question the competence, business judgment or character of a nominee or director, (iv) nominate a specific individual for election as a director, or (v) affect the outcome of an upcoming election of directors. Stockholder access proposals can be precatory (i.e., couched as a non-binding advisory vote or referendum) or, depending on applicable state corporate law (e.g., Section 112 of Delaware's General Corporation Law), drafted as proposed binding amendments to an issuer's bylaws.

Rule 14a-8 effectively establishes a two-year implementation cycle. For example, a stockholder seeking to amend an issuer's bylaws to enable direct access in connection with the issuer's 2017 annual meeting would have to submit its proposal to amend the bylaws prior to the Rule 14a-8(e) deadline for the issuer's 2016 annual meeting. If the proposed amendment is included in the issuer's 2016 proxy statement and approved by stockholders at the 2016 annual meeting, stockholders would then be able to submit the names and credentials of their nominees for inclusion in the issuer's 2017 proxy statement (to the extent the nominating stockholder satisfied the eligibility requirements and other conditions of the bylaw adopted the previous year).

After the amendments to Rule 14a-8 became effective, many anticipated that the foregoing path to direct access would become a cheaper and more expeditious alternative for activists to launch opposition slates. Indeed, there has been an increasing number of direct access proposals submitted in the last two years predominantly by corporate governance activists, including the proposals submitted in October 2014 by NYC Pension Funds to 75 target companies. Moreover, a number of issuers have either proposed direct access bylaw amendments for adoption at an annual meeting, or unilaterally adopted such bylaws. Either way, by "picking up the pen" in the first instance, issuers can prescribe their own definitions of ownership and aggregation limits, percentage ownership thresholds (e.g., 3 percent), length of ownership requirements (e.g., three years), board seat limitations (e.g., 20 percent or 25 percent of the board), notice deadlines (e.g., a 30-day window period ending coincident with the Rule 14a-8(e) deadline) and other eligibility requirements.

Earlier this year the SEC announced that it was suspending its consideration of no-action letter exclusion requests submitted pursuant to Rule 14a-8(i)(9) (i.e., the so-called "conflict exclusion"). A number of issuers sought to submit to stockholders their own direct access proposal (typically with more onerous eligibility requirements and conditions than the bylaw amendments proposed by a stockholder) and then exclude the stockholder's Rule 14a-8 proposal from the proxy statement on the grounds that it conflicted with the Board's proposal concerning the same subject matter. The SEC currently is reviewing the scope and application of Rule 14a-8(i)(9).

Although the direct access movement is gaining traction, it has not had a material impact, to date, on the way serial activists wage their election contests. The leading activist funds continue to fight the old fashioned way to retain 100 percent control over the process and the messaging campaign. Seasoned activists running a competing slate want to communicate with investors from day one using their own opposition proxy materials, fight letters, blogs, chat rooms, whitepapers, 13D filings, press articles, interview transcripts, town hall meetings, one-on-one presentations and roadshow materials. They have the experience, credibility and resources to conduct a widespread messaging campaign at their own cost.

Also, there has been an increase over the past few proxy seasons in majority or full board control contests which cannot be prosecuted under the short slate limitations contained in direct access bylaws.

Issuer Preparation and Planning

Sometimes, a good defense is a good offense. Issuers need to be proactive and well-prepared. At the first hint of trouble, it's very important to assemble the appropriate internal and external "special ops squad" (consisting, for example, of the CEO, lead independent director and/or corporate governance committee chair, IR head, general counsel, outside counsel, proxy solicitation firm, media consulting firm, financial advisor, and other "war time consiglieres"). Doing this will save valuable time once an activist surfaces and begins to agitate. The Board and management need to be educated by counsel on how to monitor, address and react to hypothetical activist threats and the techniques used by activists to target companies and put them "in play." These techniques are becoming more sophisticated and the activist playbook is continually being updated. Directors and management need to understand their fiduciary duties in all of these contexts and have a ready-to-go "Plan A" and "Plan B" (both offensively and defensively).

13D, F and G positions should be monitored closely, and an issuer's IR team needs to know the investment philosophy, exit horizon and historical cost basis of the top institutional holders. Outreach to the portfolio managers and proxy departments at top institutions is vitally important. Sudden shifts in ownership concentration – from index funds and non-activist private investment partnerships to hedge funds – are a yellow flag (and may ultimately be a red flag). It's important for management and the Board to keep abreast of M&A activity in the industry.

A frequent and open communication policy with stockholders is the best means of obtaining meaningful feedback. It's essential to identify investor concerns when they're still relatively nascent and not yet in the public domain. The Shareholder-Director Exchange (SDX) protocols (recently introduced by representatives from leading institutional investors and a consortium of independent directors) is an extremely helpful guide for developing and enhancing an issuer's disclosure practices and formalizing its stockholder engagement program. Likewise, the NACD"s Blue Ribbon Commission has published comprehensive recommendations for effective board-stockholder communications. Of course, not only is an open communication policy a matter of best practice and tactically important but, presciently, the SEC adopted Item 407(f) of Regulation S-K in 2003. Item 407(f) requires the issuer to disclose in its proxy statement (or publish on its website) whether it has established a process for stockholder communications with the board and, if so, how the process works. If the issuer has not established a process it must disclose such fact and the reasons therefor.

When communicating with stockholders, management and the board should speak in a consistent voice and not allow an activist to engage in ad hoc, or one-off, dialogues with directors and management in an attempt to elicit inconsistent responses. Inconsistent substantive messaging, or even nuanced differences in tone, can come back to haunt the issuer in a big way and enable an activist to drive a wedge between directors and between management and the board.

If underperformance (vis a vis stock indices, and in relation to ISS-constructed or issuer-selected peer groups) is a problem or, for example, if corporate governance practices and executive compensation policies need to be improved and updated, the company should address these issues right away. If an activist surfaces and a contest is threatened or ultimately ensues, reactive measures to improve corporate governance weaknesses and address performance problems by announcing new governance

policies or a new business strategy will receive far less investor credit and ISS and Glass-Lewis recognition than if the issuer adopts and announces positive changes on a clear day. By getting out in front, the issuer can remediate the problem and control the messaging instead of being in reaction mode. It's much more difficult to respond convincingly and effectively after a detailed criticism is published in an open letter to the board, a 13D filing or in investor chat rooms. Moreover, an activist target does not want to get into a public "ping pong" match with an activist investor from both a disclosure and tactical perspective.

The board and management need to conduct regular risk assessments and review management's business plan and consider implementing modifications if the issuer's performance falls materially below internal forecasts or street estimates for more than a short-term period. At a minimum, the issuer should make known through public disclosure and investor outreach that it's aware of the problem and focused on prompt solutions. Issuers should not wait to read negative reports from sell side analysts, investors or the business media.

With respect to board composition and tenure, boards and nominating committees need to take a hard and realistic look at the composition of the board. Director tenure is a "hot button" for institutional investors and for ISS and Glass-Lewis. Rightfully or wrongfully, many institutions (as well as the leading proxy advisory firms) equate lengthy tenure (e.g., more than 12 years) with a decline in director objectivity and independence. The board and nominating committee also need to carefully review whether the company and stockholders would benefit from more diversity among the incumbent directors and whether there are notable gaps in terms of industry experience and gender, as well as corporate governance, financial and transactional expertise. Director term limits, overboarding, anti-hedge and pledge policies, the appointment of a lead independent director, elimination of affiliate transactions, and director stock ownership requirements, are check list issues for many institutional investors.

With respect to structural and organic defenses, issuers need to carefully review their anti-takeover arsenal to ensure that it's state of the art and properly protective of the company. If needed, updating older generation advance notice bylaws should be at the top of the "to do list." This is a first line of defense against a surprise opposition director campaign. The ability of stockholders to call special meetings and to take action by written consent should be reviewed so that the board understands the options available to activists who may seek compositional change. Of course, reversing course on the ability of stockholders to act by written consent requires a charter amendment in Delaware (and in most states) and is all but certain to receive a "vote no" recommendation from the leading proxy advisory firms and be voted down by stockholders. Altering the percentage necessary for stockholders to call special meetings may be viewed as unilateral board action that diminishes the substantive rights of stockholders which, depending on the issuer's overall governance rating, could result in "withhold authority" recommendations from ISS and Glass-Lewis. That said, there are certain amendments that can be implemented unilaterally, some of which (e.g., the adoption of special meeting and written consent record date procedures, enhanced information requirements, and other technical and clarifying amendments) are somewhat more subtle and innocuous than others.

It is far better to implement any organic changes on a clear day and prior to an overt activist threat (e.g., receipt of a nomination letter or a books and stockholder list inspection request, a 14a-12 filing or some other published statement by an activist of its campaign intentions). This is advisable both as an investor relations matter and to better survive potential legal challenges to the validity of such changes. Any organic shark repellent implemented unilaterally by the board – especially one that touches on stockholder voting rights – will be construed strictly against the issuer in the case of any facial ambiguity,

and may strengthen the activist's (and other stockholder-plaintiff) arguments that "moving the goal posts" after a campaign commences is coercive, preclusive, and inequitable.

Rights plans on the shelf should be updated and reviewed with the board, and if the issuer does not have a shelf pill it should consider having one prepared by counsel. It's important to underscore that rights plans cannot be used to frustrate the proxy machinery and disenfranchise voting rights. The case law in Delaware for more than 30 years has made clear that pills cannot be used to impede the ability of stockholders to exercise their voting rights in a public proxy solicitation. Notably, for decades every rights agreement has excepted from the definition of "beneficial ownership" a voting arrangement evidenced exclusively by a revocable proxy or consent obtained in a public (non-exempt) solicitation conducted in accordance with the solicitation, filing and proxy dissemination requirements of Regulation 14A under the federal proxy rules (to the extent the arrangement is not then-reportable on Schedule 13D under Item 4 thereof or otherwise). That said, the courts have long-recognized that rights plans do have an incidental effect on stockholder voting and proxy contests. Depending on the flip-in percentage (e.g., 10 percent, 15 percent or 20 percent), a pill is designed to and will deter: accumulations of stock in the open market above the relevant threshold, certain group formation and "in concert" activity, formal voting agreements (involving a cumulative position higher than the relevant flip-in or "acquiring person" threshold), certain synthetic securities and derivatives trading activities, and other methods of acquiring beneficial ownership above the relevant threshold. Derivatives clauses in rights agreements are de rigueur today and, to a more limited extent, "wolf pack" clauses have crept into rights plan technology.

In the Delaware Court of Chancery's recent *Third Point LLC v. Ruprecht decision*, Vice Chancellor Parsons declined to enjoin a non-NOL "dual-trigger" rights plan in the context of an impending short slate proxy fight. After Third Point (a 13D filer and approximately 9.5 percent stockholder) publicly announced its intention to recruit new director candidates, seek the ouster of the company's CEO, and influence changes to the target company's operating strategy and corporate governance practices, the company adopted a dual-trigger pill. Specifically, the rights agreement contained two flip-in triggers – 10 percent for 13D filers (who did not expressly disclaim a control or other Item 4 intention) and 20 percent for passive investors eligible to file a Schedule 13G. The Vice Chancellor ruled that potential "wolf pack" activity by Third Point and two other activist hedge funds constituted an objectively reasonable and cognizable threat to the company because the hedge funds, were they to act in concert, could acquire "creeping control" of the company without paying a control premium. Accordingly, he concluded that the board's decision to adopt the pill was neither preclusive nor coercive and fell within a range of reasonable and proportionate responses to the threat. He also found that the board did not act for the primary purpose of disenfranchising stockholder voting rights, which would have required the board to demonstrate a "compelling justification" for such action.

In the wake of the *Third Point* decision, the jury is still out on the use of dual flip-in thresholds in non-NOL pills (at least in the context of a short slate proxy fight) and whether such features would be impermissibly discriminatory and inequitable under a given set of circumstances. Vice Chancellor Parsons observed that the dual-trigger provisions raised "some valid concerns" because they allowed passive investors who were likely to vote with management to acquire a 20 percent stake while activists were capped at 10 percent. However, he noted that any discriminatory impact was hypothetical because there were no passive 13G investors who owned more than 10 percent of the company at the time and the company's directors collectively owned less than one percent of the outstanding common stock.

Perhaps the most interesting portion of the *Third Point* decision is the discussion of whether and when a target board may be required to waive certain features of a poison pill because the threat that existed on

the date the pill was adopted no longer is the same. After Third Point formally nominated three opposition directors, it requested a waiver from the 10 percent flip-in trigger to enable it to purchase up to a 20 percent block. Third Point reiterated that it had no intention of pursuing a tender offer or hostile acquisition of the company and intended only to wage a short slate election contest. When the company declined to grant a waiver, Third Point sought to preliminarily enjoin the company's annual meeting. The Delaware Court of Chancery noted that the threat of "creeping control" at the time the poison pill was first adopted (months earlier), no longer existed, but that if Third Point were allowed to acquire a 20 percent stake it could exert "negative control" of the company. The threat of "negative control" under all of the circumstances constituted a legitimate threat to the company and the company's refusal to grant Third Point's waiver request was deemed to be a reasonable response. That said, Vice Chancellor Parsons cautioned that the failure to grant the waiver presented a "much closer question" than the decision to adopt the rights plan on day one.

To date, a number of companies facing activist threats have adopted rights plans containing dual flip-in triggers that distinguish between passive and activist investors. In light of the fact-intensive *Third Point* decision, such features should be used carefully and examined very closely. A rights plan is a living and breathing instrument and, as a fiduciary matter, a board needs to be cognizant of materially changed circumstances (since the adoption date) that may warrant the grant of a waiver from the application of certain of the pill's features or an amendment to the pill's terms (prior to a trigger event), in each case to better ensure that the terms and use of the pill address the new or different threat in a reasonable and proportionate matter. This may be especially true in the absence of a hostile takeover threat where an activist announces its intention to wage a short-slate contest and is willing to sign a customary standstill agreement against other hostile activity. Suffice it to say, the Delaware courts have consistently announced that a poison pill must allow a proxy contestant a "real world shot" (in the mathematical sense) to wage and win a proxy contest.

Whether, When and How to Settle a Threat or Fight

There is no one-size-fits-all blueprint. Directors have an overarching fiduciary duty of care and loyalty and they must determine what's in the best interest of the issuer and all of its stockholders. Proxy fights are very costly, disruptive and distracting. Avoiding a fight is the better alternative almost all of the time. If an activist has gone to the trouble of publishing a whitepaper or presenting a detailed operating strategy or business plan, directors and management should not reject the presentation out of hand. Large funds today employ significant in-house teams of research analysts, valuation experts, investment bankers, tax and accounting experts, and legal staffs. Often, they have very constructive ideas and just because their critique or recommendations were not solicited by management or the board, that doesn't mean fresh ideas should be ignored as if they're merely rhetoric "from the enemy." There may be a way to incorporate some of the proponent's ideas into management's and the board's overall strategy, and engaging the activist at an early stage to work behind the scenes together in a constructive forum may yield the best outcome for the issuer and its stockholders.

Settling sooner than later is usually better (but not always). There always are offensive and defense tactics and the parties' relative bargaining power to consider. Settling early does not mean that an issuer should just concede and roll over at the very first salvo and under any set of circumstances. Many settlements are reached shortly before the annual meeting date, whereas others are reached prior thereto, but weeks or months after the activist first surfaces. The history of contacts and dialogue between the parties will dictate much of the strategy, tactics and tone. The strategy selected by the

Board and management must always be what they believe to be in the best interest of the issuer and its stockholders. They must make an independent and disinterested assessment and business decision.

If an activist overtly threatens or launches an election contest that could not be diffused through prior outreach, attempts at compromise and good faith engagement, the board might want to consider negotiating (as part of a proposed settlement) the replacement of one or two long-tenured directors with a new candidate or two. For example, the issuer might consider adding a director candidate selected by the activist (but who is not a principal or employee of the fund) and another candidate who is selected mutually by the fund and the issuer (and perhaps identified in the first instance by an executive search firm). Typically, agreeing to certain corporate governance best practices (if the issuer has been criticized historically by the fund and other stockholders or has a low corporate governance scorecard) is part of the settlement framework. Any candidates, of course, must meet requisite director eligibility criteria, be fully vetted by the nominating committee (and recommended to the board) and have industry, public company and other experience that will enhance the overall qualifications, credentials and capabilities of the board. Adding persons who might facilitate more constructive debate and diversity of viewpoints can be a healthy addition to the boardroom, but polarizing personalities and directors with a special interest agenda should be avoided.

If the issuer is comfortable that the new director candidates will selflessly and dispassionately champion the best interest of all stockholders, improved corporate governance practices are agreed to (as necessary), there is a meeting of the minds on overall corporate strategy and the execution of management's business plan, and the issuer can obtain a reasonably comprehensive standstill agreement from the activist (to enable positive changes to take root), this should create a path for an acceptable settlement agreement.

What are Solicitations, Non-Solicitations, and Exempt Solicitations?

The starting point is Rule 14a-1(l)(1) under Regulation 14A. Rule 14a-1(l)(1) defines "solicitation" to include (i) any request for a proxy, irrespective of whether the request is accompanied by or included in a formal proxy card; (ii) any request to sign or abstain from signing or to revoke a proxy; and (iii) the furnishing of a form of proxy or other communication to stockholders under circumstances reasonably calculated to result in obtaining, withholding or revoking a proxy.

Clause (iii) captures a broad range of communications (which may occur prior to the start of formal solicitation activities) that are designed to influence voting decisions. That said, Rule 14a-1(l)(2)(iv) provides that a communication by a stockholder (who does not otherwise engage in a solicitation) that is is limited to a statement of how the stockholder intends to vote and the reasons for its voting decision, is not a solicitation provided that the statement is communicated by certain prescribed means. Disclosure by a significant institutional holder regarding its voting intentions, and the reasons therefor, can be very useful for an activist stockholder or for the issuer depending on the circumstances. However, knowing the boundary between the third clause of Rule 14a-1(l)(1) and the exemption in Rule 14a-1(l)(2)(iv) requires careful analysis.

Rule 14a-2 also exempts certain solicitation activities from the full breadth of the federal proxy rules. For example, Rule 14a-2(b)(1) exempts solicitations by any person who does not, directly or indirectly, seek authority to act on its own behalf or on behalf of another person as a proxy or furnish or request a proxy. This exemption is often used in "vote no" campaigns—where a dissident stockholder is opposing a merger or similar transaction—and in "withhold authority" campaigns for the election of directors.

Importantly, the foregoing exemption does not apply to solicitations by the issuer or any of its officers, directors, affiliates or associates; any director-nominee on whose behalf proxies are being solicited; Schedule 13D filers, unless such persons have disclaimed in Item 4 any intention or reservation of the right to engage in a control transaction; and certain other enumerated persons. Pursuant to Rule 14a-6(g), persons who utilize the exemption for solicitations conducted in reliance on Rule 14a-2(b)(1) and who own securities with a market value in excess of $5 million, must file with the SEC (i.e., under cover of a “Notice of Exempt Solicitation”) all written materials used in the solicitation not later than three days after their date of first use.

“The Rule of 10” is a private solicitation exemption sometimes used by activists. Under Rule 14a-2(b)(2) any solicitation by a person, other than on behalf of the issuer, where the aggregate number of persons solicited is not more than 10, is exempt from the proxy statement filing and informational requirements (but not the anti-fraud requirements) of the federal proxy rules. This can be meaningful exemption where the institutional ownership of an issuer is extremely concentrated. Many advance-notice bylaw provisions today require disclosure of whether an opposition stockholder intends to engage in a widespread proxy solicitation or, instead, rely on any one or more exemptions from solicitation.

If a dissident uses The Rule of 10, it elects to forgo public solicitation activities and cannot conduct a widespread (or full public) messaging campaign. Even in the case of an institutionally concentrated issuer, this can have some practical adverse consequences. For example, a number of large index funds, private investment partnerships and other non-hedge fund institutions may not, as a matter of policy, meet with an opposition contestant who has not filed with the SEC and mailed to stockholders an opposition proxy statement and proxy card. Moreover, ISS similarly may not meet (in person or by telephone conference) with an activist who has not filed definitive materials and will only reference in its report information that’s in the public domain. Glass-Lewis, on the other hand, does not generally meet with the issuer or activist before issuing its report. Lastly, if the dissident is a 13D filer, the Rule of 10 may not be available depending on the dissident’s Item 4 disclosures and, if the activist communicates with ISS, under certain circumstances such communication could be deemed to exceed the Rule’s 10-person limitation.

Rule 14a-12 Solicitations Before Filing a Proxy Statement

Under Rule 14a-12, a contestant— whether the issuer or a dissident stockholder—is permitted to engage in a solicitation (and, therefore, furnish written solicitation materials) before furnishing a definitive proxy statement to stockholders. There are certain requirements to utilize the rule; namely, each communication has to identify the persons who are participants in the solicitation and describe their stock ownership and other interests in the solicitation. Alternatively, the communication can advise stockholders where to obtain such information so long as the disclosure is clear and prominent.

The 14a-12 communication also has to advise stockholders, again in a clear and prominent legend, that they should read the proxy statement once it becomes available because it contains important information, and where to obtain the proxy statement (e.g., on the SEC’s EDGAR website) and other documents free of charge.

The 14a-12 communication cannot contain or furnish a form of proxy card, voting authorization, or written consent. These are furnished to stockholders together with or prior to furnishing the definitive proxy statement.

All 14a-12 communications must be filed with the SEC on the date they are first published, sent or given. This means before 5:30 p.m., Eastern time, on the day the communication is first disseminated. The filing is made on Schedule 14A and there is a "14a-12 box" to check on the cover page.

Registrants typically use 14a-12 for "stop, look, and listen" communications that caution stockholders not to make up their minds or take any action until they receive from the issuer all relevant information. 14a-12 can be used for a variety of messaging purposes and there are certain additional technical requirements where 14a-12 is used in opposition solicitations.

The SEC staff has made clear that Rule 14a-12 cannot be used unless, at the time of use, the user has a good faith intention to file with the SEC and furnish in definitive form to stockholder a proxy statement and proxy card. This is sometimes a point of attack by issuers where an activist in its nomination letter—or other communication—discloses an equivocal intention to file a proxy or merely reserves a right to do so.

SEC Filings and Staff Review Process

In a contest, the issuer's preliminary proxy materials and the insurgent's opposition proxy materials are filed publicly with the SEC. These are live filings with special EDGAR tags that denote "proxy contest" so that the filings are routed to the SEC's Office of Mergers & Acquisitions (OMA) for assignment to the appropriate staff attorneys.

The trigger event requiring the issuer to file preliminarily, in lieu of just mailing definitive proxy materials, is the disclosure in the proxy statement that refers to, or comments on, a commenced or impending opposition solicitation. If the issuer has received a formal nomination letter and/or books and records inspection demand, or the dissident already has filed a preliminary opposition proxy statement, a Rule 14a-12 notification or a 13D indicating its intention to wage an opposition solicitation, the issuer will be blocked from mailing definitively in the first instance. Sometimes there are "gray area threat letters and equivocal communications from an activist that may not constitute an absolute statement of intention to nominate and seek the election of its opposition slate. Whether the issuer can just file and mail its proxy statement definitively in such latter circumstances is a tough judgment call that requires careful analysis and advice from counsel.

The disclosure in the issuer's proxy statement about an impending contest is contained in a "background section" that describes the material past contacts, meetings and communications between the issuer and its opponent, and the events that led to submission of the nomination letter or other opposition notice.

The issuer's proxy statement also will state why the board believes that the reelection of its nominees or, if applicable, a vote for adoption of a transaction agreement, is in the best interests of the issuer and its stockholders. The issuer's proxy statement will notify stockholders that they may be receiving opposition proxy materials and that such materials should be disregarded, as well as other information about returning the issuer's (white) proxy card and not the dissident's (other color) proxy card; how to change a previously submitted vote by submitting a later dated and signed proxy card; the inability to "split votes" on cards; and other technical disclosures of such nature.

Under the federal proxy rules, definitive proxy materials cannot be filed and mailed until at least 10 calendar days after the preliminary filing. Never say never, but receiving no review or no comments from the staff in respect of a preliminary filing for a proxy contest is exceptionally rare (in fact, this author has

never seen that happen). Also, in a contest it's unlikely to have proxy materials cleared within exactly 10 days from the filing date.

However, the OMA attorneys are extremely diligent about issuing comments and trying to get filings cleared quickly for mailing. The staff review process ordinarily is completed in approximately two weeks (plus or minus a day), depending on how careful the parties are with their disclosure. The staff understands how time sensitive a proxy contest is and the importance of enabling both sides to disseminate definitive materials. Hitting the street quickly with definitive materials provides stockholders with as much time as possible to digest the disclosure from each side about the history leading to, the nature of, the reasons for, and the consequences of, the proxy contest.

Often the OMA attorneys will work outside of ordinary business hours to review certain proposed disclosures in advance of formal EDGAR amendments to preliminary filings, depending on the sensitivities and time pressures involved. Therefore, it behooves both sides to expedite the SEC staff's review and comment process, and to get proxy materials disseminated as soon as possible.

Fight Letters

The best way to reduce SEC staff comments and to expedite the review process is to file preliminary materials that are relatively "light" in terms of advocacy and platform statements. The real campaign talking points and theme statements are saved for the "fight letters." Unlike the proxy statement—which is reviewed by the SEC staff in advance of definitive mailing—under the federal proxy rules, fight letters are additional solicitation materials and not pre-cleared by OMA. These materials can be mailed right away to stockholders so long as they are filed with the SEC no later than 5:30 p.m., Eastern time, on the date the materials are first used or disseminated.

Typically, both sides will file their preliminary proxy statements with minimal campaign statements, and on the day the definitive proxy statement is first mailed, it will be accompanied by a fight letter that was not pre-cleared by the SEC staff—although the fight letter will be filed with the SEC on the date it is first mailed. Stockholders receive the proxy statement and the first fight letter in the same initial mailing package.

Fight letters are two or three-page documents that advocate, in a pithy, attention-grabbing format, the contestant's most persuasive campaign talking points and themes. These communications contain what the contestant believes to be the most salient selling points to obtain stockholder votes. They usually contain both qualitative and quantitative historical performance information and, in the case of the issuer, its plans and proposals to improve financial results, increase the stock price and, if applicable, enhance corporate governance best practices. The issuer will set forth four or five examples of recent "success stories" and its plans to drive growth and enhance profitability over the medium and long-term. With respect to board composition, the registrant will explain why there is no need for change or, alternatively, what it has done recently or already is in the process of doing to refresh the independence, experience, qualifications and diversity of the board.

The activist's fight letters will advocate why it believes change is warranted and why its candidates are best-suited to implement such change. The opposition letters will include statistics regarding the registrant's past performance shortfalls relative to its peers, stock market indices and sometimes indices constructed by the activist (especially 12-month and five-year cumulative returns on investment). Sometimes the activist will publish a "whitepaper" detailing its plans and recommendations to redirect management's operating strategy, accelerate earnings growth, deploy stagnant cash reserves, reduce

costs, simplify the issuer's capital structure, divest non-core assets, and pursue M&A opportunities. These whitepapers, which are used in roadshows with the issuer's top institutional investors and submitted to ISS and Glass-Lewis for their review, are additional solicitation materials that are filed with the SEC on their date of first use. Excerpts therefrom are typically included in the activist's fight letters. Conflicts of interest, perceived flaws in board composition, the registrant's affiliate transaction history, missed corporate opportunities, failed transactions, executive compensation in relation to issuer performance, corporate governance weaknesses, and the like, will be highlighted to the extent applicable.

In the typical proxy fight, each side will mail four (sometimes five) fight letters commencing on the definitive proxy statement mailing date and continuing until approximately one week prior to the stockholder meeting date. In an election contest, one or two of the letters usually are in the nature of an "attack ad" emphasizing the key negatives about the opposition candidates' non-independence, employment history, experience and qualifications.

Even though fight letters are not pre-cleared by the SEC staff they are reviewed after filing and mailing in definitive form. Therefore, the parties must make certain that they don't overreach with overstated, understated or other misleading statements or characterizations that are expressed as fact, if such statements are unsubstantiated or merely expressions of opinion or belief. Otherwise, such statements could violate Rule 14a-9, which could result in embarrassing corrective mailings or retractions.

Bed Bug Letters

Having preliminary proxy materials cleared by the SEC's staff as quickly as possible is key to giving a contestant more time to engage in full solicitation activities. Each contestant will try to delay the other side as much as possible in this process, and one of the tactics used is the poison pen (or "bed bug") letter.

From the perspective of counsel to the issuer, as soon as the dissident's opposition proxy materials are filed with the SEC in preliminary form, counsel and the appropriate personnel at the company will comb through every statement of fact, inference, statistic, past performance disclosure, as well as everything couched as a conclusion, statement of belief, innuendo and inflammatory statement, to identify anything that is factually inaccurate, unsubstantiated, mischaracterized or taken out of context, or anything that otherwise omits material information (or tells a half-truth).

The issuer will also look for any line-item disclosure defects and federal proxy rule compliance failures in the opposition's disclosures. In the case of a dissident who is a 13D filer, the issuer will examine whether there were any failures to timely file amendments, make requisite disclosures and file exhibits.

Then, any findings are addressed in correspondence to the SEC's examining attorney at OMA. With respect to every allegation of factual inaccuracy or mischaracterization, it's important to provide the examining attorney with copies of all supporting data, primary source information, published reports, and the like, to substantiate the allegations and to make his or her review easier. Of course, the dissident will go through the exact same process to challenge as much as possible in the issuer's preliminary filings.

Because it's important not to inundate the SEC staff, contestants should pick and choose their battles judiciously. Bed bug letters and all of the supporting materials can sometimes be quite lengthy, so it's important to submit them as quickly as possible after the opponent's preliminary materials are first filed.

The purpose of bed bug letters—which are not live EDGAR correspondences, although they eventually become publicly available—is not to convince the staff to halt the proxy contest or commence an enforcement proceeding against the opponent (although in the most egregious and rare case, that could be a possibility). Instead, it's to bring to the SEC staff's attention any disclosures that, in good faith, a contestant believes is inaccurate so that the disclosures are either corrected or deleted.

In effect, the bed bug letter assists the SEC staff in ensuring that stockholders have fair, complete and accurate disclosure to base their voting decision. Tactically, they're designed to dilute the opponent's message.

The bed bug letter also is used to delay the OMA attorney's issuance of comments (or to increase the number of comments they issue) so that clearing the opposition's proxy statement for definitive mailing takes additional time (sometimes days). If the examiner agrees with a number of comments provided in the letter and, in turn, issues them (in one form or another) in a staff comment letter, the proponent has done its job. At a minimum, the bed letter gives the examiner a head start and may influence the way he or she reads the opposition's materials.

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[1] Portions of this article have been derived from Mr. Neimeth's published discussion contained in the transcript of the DealLawyers.com webcast, "Anatomy of a Proxy Fight: Process, Tactics & Strategies." which first aired Oct. 22, 2014, and portions of this article have been excerpted, in part, from a subsequent article authored by Mr. Neimeth and published by DealLawyers, Vol. 9, No. 1, in February 2015. The webcast was chaired by Mr. Neimeth, with co-panelists from Institutional Shareholder Services; Joele Frank Wilkinson Brimmer & Katcher; and MacKenzie Partners. These excerpts have been published herein with the permission of DealLawyers and Executive Press, Inc. Statistical information in the forepart of this article was derived from SharkRepellent.net, FactSet- SharkWatch and FactSet-Hedge Fund Ownership.

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Appraisal Arbitrage – Delaware's Response

By Kelly A. Terribile and Justin Mann

Introduction

Appraisal litigation involving public companies is "undergoing explosive growth in Delaware."[1] This growth is being driven by sophisticated repeat petitioners who specialize in bringing appraisal claims – so called "appraisal arbitrageurs."[2] The growing incidence of appraisal arbitrage has garnered significant attention and commentary, and led the Council of the Corporation Law Section of the Delaware State Bar Association (the Council) to propose the amendments to Section 262 of the General Corporation Law of the State of Delaware (the DGCL) discussed below.

Delaware's Appraisal Statute

Section 262 of the DGCL provides stockholders[3] with appraisal rights in certain transactions, principally cash-out mergers.[4] The availability of and exercise of appraisal rights in modernity is theorized to serve "as a check against opportunism by a majority shareholder in mergers and other transactions in which the majority forces minority shareholders out of the business and requires them to accept cash for their shares."[5]

"More recently, [however,] a market has arisen between the stockholders subject to a merger – protection of whom was the traditional concern of the appraisal statute – and those who purchase stock from them pending the merger, seeking to maximize value through appraisal litigation."[6] That is, appraisal arbitrageurs are pursuing the investment strategy of acquiring "an equity position in a cash-out merger target with the specific intention of exercising [appraisal rights]; in the subsequent appraisal action the court awards the appraisal petitioners what the court determines to be the fair value of the target, which, if the target was undervalued in the transaction, represents a positive return on the arbitrage investor's initial investment."[7]

Recent Delaware Cases

Two recent decisions by the Court of Chancery of the State of Delaware (the Court of Chancery) – *In re Appraisal of Ancestry.com, Inc. (Ancestry)*[8] and *Merion Capital LP v. BMC Software, Inc. (BMC)*[9] – confirm that appraisal arbitrageurs' practice of seeking appraisal of shares purchased after the record date, but before the vote on the merger, is permissible under Section 262 of the DGCL.

The Court of Chancery in *Ancestry* and *BMC*, following the Court of Chancery's earlier holding in *In re Appraisal of Transkaryotic Therapies, Inc. (Transkaryotic)*,[10] rejected the contention that a petitioner who purchases shares after the record date must prove that each share it seeks to have appraised was not voted by any previous owner in favor of the merger.[11] In both cases, the respondent corporation argued that such a holding created the risk of "over-appraisal" ("the number of shares for which appraisal is sought exceeding the number not voted for the merger")[12] warranting a "share-tracing" requirement (requiring the shares subject to appraisal not to have been voted for the merger).[13] This argument was rejected by the Court of Chancery as a "theoretical" problem not present in the record.[14]

Observers "troubled" by the "explosive" growth of appraisal litigation posit that *Ancestry* and *BMC* imprudently provide renewed support for appraisal arbitrage.[15] The Court of Chancery in *Ancestry* and *BMC* recognized that each case implicated the recent policy debate surrounding the "unwholesomeness"

of appraisal litigation,[16] but affirmatively declined to consider such policy concerns on the grounds that the language of Section 262 of the DGCL was plain and unambiguous, and the Delaware legislature was the proper forum to consider and address such concerns.[17]

Also bearing on the appraisal litigation debate are the Court of Chancery's decisions in *Huff Fund Investment Partnership v. CKx, Inc. ("CKx")*[18] – both of which recently were affirmed by the Delaware Supreme Court – holding that (a) the merger price was the best indicator of the fair value of the appraised shares where the corporation was sold after a full market check, and where discounted cash flow analyses, comparable companies analyses, and comparable transaction analyses were either unavailable or unreliable,[19] and (b) the Court of Chancery lacked discretion to force the petitioner to accept payment of what the respondent corporation "consider[ed] the undisputed portion of the value of its stock" and thereby effectively toll the accrual of statutory interest under Section 262(h) of the DGCL.[20]

The Delaware Supreme Court's affirmance of the Court of Chancery's fair value decision in *CKx* may have important precedential value for the future of appraisal litigation, as it may mark the beginning of a judicial trend placing increasingly greater reliance on the merger price as the most reliable indicator of fair value, at least where there has been a robust market check.[21] Such a trend – should it occur – will undoubtedly increase the risk associated with the investment strategy of appraisal arbitrageurs.

On the other hand, the Delaware Supreme Court's affirmance of the Court of Chancery's tolling decision in *CKx* leaves the door open for "interest rate arbitrage," given the alleged "near risk-free return five percent above the Federal Discount rate," at least "where market rates of return are low…."[22] As discussed below, however, the Delaware legislature appears poised to amend Section 262(h) of the DGCL to permit respondent corporations to close the door on interest rate arbitrage.

Proposed Amendments to the Appraisal Statute

On March 6, 2015, the Council released its proposed amendments to Section 262 of the DGCL. Most significantly, the proposed amendments do not limit the exercise of appraisal rights to shares held prior to the public announcement of a proposed transaction, nor do they impose a "share-tracing" requirement, and therefore the proposed amendments do not eliminate or limit appraisal arbitrage.[23] The Council determined not to limit or eliminate appraisal arbitrage on the grounds that appraisal arbitrage does not upset the "proper balance between the ability of corporations to engage in desirable value enhancing transactions and the ability of dissenting stockholders to receive fair value for their holdings."[24]

In determining not to modify Section 262 of the DGCL to eliminate or limit appraisal arbitrage, the Council cited the following considerations, among others: (i) "Studies of appraisal arbitrage do not suggest that it encourages frivolous litigation…only 17% of the appraisal eligible transactions during 2013 resulted in appraisal litigation in Delaware"; (ii) "[A]ppraisal-out conditions [in merger agreements] remain fairly rare," suggesting "that the availability of appraisal arbitrage is not a significant factor in the market"; (iii) "Where transactions cannot be subject to a market check for structuring reasons (such as buy outs by controlling stockholders who are unwilling to sell), fiduciary duties and litigation may not be sufficient to ensure that the merger price reflects the fair value of the acquired shares"; (iv) "Recent case law[25] has suggested that a market test of a transaction will serve as a proxy for fair value in appraisal suits, so that arm's-length deals with adequate market checks do no create appraisal risks for buyers"; and (v) Delaware law has long "recognized the right of a stockholder…to pursue appraisal of shares purchased after the terms of the merger were announced."[26]

Rather than eliminate or limit appraisal arbitrage, the modifications to Section 262 proposed by the Council are intended to "improve [the] operation" of Section 262.[27] The first modification forecloses the appraisal of shares traded on a national securities exchange prior to the merger "unless the dispute with regard to valuation is substantial and involves little risk that the petition for appraisal will be used to achieve a settlement because of the nuisance of discovery and other burdens of litigation."[28] To achieve this goal, the proposed amendment to Section 262(g) of the DGCL requires (i) the appraisal proceeding with respect to shares traded on a national securities exchange prior to the merger to involve shares in excess of 1 percent of the outstanding shares entitled to appraisal, (ii) the value of such shares (based on the consideration paid in the merger) to exceed $1,000,000, or (iii) the merger to have been approved pursuant to Sections 253 and 267 of the DGCL (governing "short-form" mergers).

The second modification provides respondent corporations with the option of cutting-off the accrual of interest by paying to all petitioners, at any time before the entry of judgment in an appraisal proceeding, an amount in cash, such that from and after such payment interest would only accrue upon the difference, if any, between the amount so paid and the fair value of the shares as determined by the Court of Chancery. The Council reasons that this modification will "dampen" "the incentive for interest rate arbitrage without compromising the interests of pre-existing equity holders" and ensure that "appraisal actions will be motivated by a genuine dispute in proving that the transaction price was unfair."[29]

The Council's proposed amendments have done little to put the appraisal litigation debate to rest. To the contrary, the proposed amendments have fueled further debate.[30]

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[1] Minor Myers & Charles R. Korsmo, *Appraisal Arbitrage and the Future of Public Company M&A* (April 14, 2014), 92 Wash. U. L. Rev. ___, at 1 (forthcoming 2015), available here (hereinafter, "*Myers & Korsmo*") ("Appraisal activity involving public companies is undergoing explosive growth in Delaware, driven by sophisticated parties who specialize in bringing appraisal claims. The value of claims in appraisal in 2013 was nearly $1.5 billion, a tenfold increase from 2004 and nearly 1 percent of the equity value of all merger activity in 2013.")

[2] Id. An appraisal arbitrageur "buys stock following merger announcements for the purpose of seeking an appraisal as one of its investment strategies, a practice sometimes known as appraisal arbitrage." *In re Appraisal of Ancestry.com, Inc.*, 2015 WL 66825, at *1 (Del. Ch. Jan. 5, 2015).

[3] Section 262(a) of the DGCL sets forth the standing requirements for the exercise of appraisal rights and provides in relevant part that:

> Any stockholder of a corporation of this State who holds shares of stock on the date of the making of a demand pursuant to subsection (d) of this section with respect to such shares, who continuously holds such shares through the effective date of the merger or consolidation, who has otherwise complied with subsection (d) of this section and who has neither voted in favor of the merger or consolidation nor consented thereto in writing pursuant to § 228 of this title shall be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder's shares of stock under the circumstances described in subsections (b) and (c) of this section. As used in this section, the word "stockholder" means a holder of record of stock in a stock corporation….

8 Del. C. § 262(a).

[4] *8 Del. C. § 262.*

[5] In re *Appraisal of Ancestry.com, Inc.*, at *4 (quoting Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 Geo. L.J. 1, 4 (1995)). *See also In re: Appraisal of Transkaryotic Therapies, Inc.*, 2007 WL 1378345, at *3 (Del. Ch. May 2, 2007) ("Thus, the primary purpose of § 262 is to protect the contractual rights of shareholders who object to a merger and to fully compensate shareholders for any loss they may suffer as a result of a merger.") (citations omitted).

[6] *In re Appraisal of Ancestry.com, Inc.*, at *4.
[7] *Merlin Capital LP v. BMC Software, Inc.,* 2015 WL 67586, at *1 (Del. Ch. Jan. 5, 2015).
[8] 2015 WL 66825 (Del. Ch. Jan. 5, 2015).
[9] 2015 WL 66825 (Del. Ch. Jan. 5, 2015).
[10] 2007 WL 1378345, at *3 (Del. Ch. May 2, 2007) ("Must a beneficial shareholder, who purchased shares after the record date but before the merger vote, prove, by documentation, that each newly acquired share (i.e., after the record date) is a share not voted in favor of the merger by the *previous* beneficial shareholder? The answer seems simple. No.") (emphasis original).
[11] *Ancestry*, at *9 ("Nothing in [Section 262(e) of the DGCL] suggests that the [Delaware] General Assembly intended to require beneficial owners who made post-record date purchases to show that their specific shares were not voted in favor of the merger…."); *BMC*, at *4 ("Notably absent from t[he] language [of Section 262(a) of the DGCL], or any language in the statute, is an explicit requirement that the stockholder seeking appraisal prove that the *specific shares* it seeks to have appraised were not voted in favor of the merger.") (emphasis original).
[12] *Ancestry*, at *7; *BMC*, at *7.
[13] *Ancestry*, at *8; *BMC*, at *7.
[14] *Ancestry*, at *8; *BMC*, at *7.
[15] *See e.g.*, Theodore N. Mirvis, Trevor S. Norwitz, Andrew J. Nussbaum, William Savitt and Ryan A. McLeod, *Delaware Court Decisions on Appraisal Rights Highlight Need for Reform*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Jan. 21, 2015). ("Two recent decisions of the Delaware Court of Chancery highlight the troubling expansion of stockholder appraisal rights…the Court of Chancery permitted claims to be pursued by a petitioner who purchased its shares after public announcement of the merger for the purpose of bringing an appraisal lawsuit…."); William E. Curbow, *Recent Delaware Rulings Support Practice of "Appraisal Arbitrage,"* Harvard Law School Forum on Corporate Governance and Financial Regulation (Jan. 29, 2015), available at ("The decisions [in *Ancestry* and *BMC*] support the practice known as 'appraisal arbitrage' – a practice which has contributed to the more than tripling of incidents of appraisal petition filings in eligible deals over the past 10 years….").
[16] *Ancestry*, at *4 ("A rigorous debate exists as to whether [appraisal] litigation is wholesome…."); *BMC*, at *7 ("It is possible that appraisal arbitrage itself leads to unwholesome litigation.").
[17] *See Ancestry* at *8; *BMC*, at *7.
[18] 2013 WL 5878807 (Del. Ch. Nov. 1, 2013) and 2014 WL 454958 (Del. Ch. Feb. 12, 2014), *aff'd*, 2015 WL 631586, ____ A.3d ___ (Del. Feb. 12, 2015).
[19] 2013 WL 5878807, at *13 ("Having concluded that our law recognizes merger price as an acceptable factor that I may consider in conducting my appraisal of CKx, I also find that the evidence demonstrates in this case, where no comparable companies, comparable transactions, or reliable cash flow projections exist, that the merger price is the most reliable indicator of value. The record and the trial testimony support a conclusion that the process by which CKx was marketed to potential buyers was thorough, effective, and free from any spectre of self-interest or disloyalty…. Nor is this a case where the only evidence that a merger price was the result of 'market' forces was a post-signing go-shop period (which failed to produce competing bids) relied on to demonstrate that the transaction represented market price, and thus fair value.") (citations omitted).
[20] 2014 WL 545958, at *1 (Del. Ch. Feb. 12, 2014). Section 262(h) of the DGCL provides for an award of interest on a fair value judgment in an appraisal action of the Federal Discount rate plus 5 percent. 8 Del. C. § 262(h). Commentators have suggested that this statutory rate is overly "generous" and therefore creates "perverse incentives" encouraging "interest rate arbitrage." Trevor S. Norwitz, *Delaware Legislation Should Act to Curb Appraisal Arbitrage Abuses* (Feb. 10, 2015).
[21] *See CKx*, 2013 WL 5878807, at *11 ("This Court has previously recognized that 'an arms-length merger price resulting from an effective market check is entitled to great weight in an appraisal.'") (citing *Global GT LP v. Golden Telecom, Inc.*, 993 A.2d 497, 507 (Del. Ch. 2010), *aff'd*, 11 A.3d 214 (Del. 2010)). See also *Merlin Partners LP v. AutoInfo, Inc.*, 2015 WL 2069417 (Del. Ch. Apr. 30, 2015)

(putting "full weight" on the merger price resulting from a robust auction process). Such a judicial trend may appease commentators who have suggested that appraisal should be "reformed" "to allow acquirers a safe harbor from appraisal claims where they can demonstrate that the merger price was subject to a genuine market test." *Myers & Korsmo*, at 51. Of course, as such commentators recognize, "[t]he difficulty is in defining [the appropriate] safe harbor." *Id.* at 52. *See CKx*, 2013 WL 5878807, at *14 ("I disagree with the conclusions reached by [petitioners' expert witness, an economist]. Nothing in our jurisprudence suggests that an auction process need conform to any theoretical standard, whether a pure English auction, a second-price sealed bid, or a Vickrey auction, or any other auction format.") (emphasis original).

[22] *CKx*, 2014 WL 545958, at *2 (citing to the respondent corporation's argument in support of the tolling of interest). It appears that there is no consensus regarding whether the statutory interest rate has a negligible or significant effect on a sophisticated petitioners' decision to bring and maintain an appraisal action. Compare *Myers & Korsmo* ("[The] statutory interest rate available to appraisal petitioners (the federal funds rate plus 5 percent) is unlikely to have been the catalyst for the appraisal boom. Given the risks an appraisal petitioner must assume – an extended period of illiquidity with an unsecured claim against a surviving company that may be highly leveraged, plus the risk of the legal claim itself – the idea that interest rates are driving sophisticated parties to target appraisal is implausible."); Steven Davidoff Solomon, *Delaware Courts Pause on the Deal Price Do-Over*, The New York Times (Feb. 19, 2015),.("at the end of the day, a 5.75 percent return is not going to cut it for a hedge fund, even in a zero-interest rate environment") with Alison Frankel, *Delaware Supreme Court Upholds Market Price as Proxy for Value in Appraisals*, Reuters (Feb. 12, 2015), t ("If shareholders know judges will default to using market price as an indicator of fair value, their only risk in bringing an appraisal case is time and litigation costs. The upside, meanwhile, is that 5.75 percent interest – and the possibility that they will reap a bonanza if the judge agrees with their higher valuation. That's a bet that a lot of appraisal arbitrageurs will take."); Wilson Sonsini Goodrich & Rosati, *The Growth of Appraisal Litigation in Delaware* (Nov. 2013) ("The statutory interest rate under Delaware law creates substantial risk to the target corporation (while also incentivizing a stockholder to bring an appraisal claim by potentially limiting the investor's 'downside' risk) since even if the stockholder's recovery is limited to a value similar to the price paid in the merger, the investor currently receives compounded interest at a rate significantly above the market rates on whatever award is ultimately obtained.").

[23] It remains to be seen whether the Delaware legislature will – in considering the amendments proposed by the Council – be sensitive to the opinions of commentators, and even some companies, who have expressed the opinion that the Council's proposed amendments to Section 262 of the DGCL do not go far enough to limit appraisal arbitrage. See e.g., Trevor S. Norwitz, *Delaware Poised to Embrace Appraisal Arbitrage*, Harvard Law School Forum on Corporate Governance and Financial Regulation (Mar. 9, 2015), ("If the lawmakers follow the recommendations of the Council (which they usually do) the changes will likely disappoint Delaware corporations, make mergers and acquisitions in that important state more difficult, reduce deal flow, and lead to lower prices being paid to selling shareholders."); Steven Davidoff Solomon, *A Three-Pronged Front to Limit Shareholder Litigation*, The New York Times (April 2, 2015), ("Instead of rushing to correct perceived flaws, it might benefit everyone to take a step back, let this unfold a bit more in the courts and then take a broader look at the entirety of Delaware law and how these provisions interact with it."); Jonathan Starkey, *Dole Pressures Delaware on Corporate Law Changes*, The News Journal (March 12, 2015) ("Dole Food Co., the fruit producer and the Port of Wilmington's largest tenant, has urged lawmakers to limit shareholder lawsuits…'Dole, like other companies incorporated in Delaware, has been spending millions of dollars in defense costs due to appraisal litigation initiated by hedge funds'"); Brandon Lowrey, *Corporate Firms Take Aim At Delaware's Appraisal Laws*, (April 7, 2015), ("Seven major corporate law firms are jointly calling for tighter controls on appraisal arbitrage…in an April 1 letter to the Council.... The letter urges legislative action to deny appraisal rights to those who purchase shares after the public announcement of a transaction, or at least restricting those who purchased their shares after the record date for the vote to seek appraisal as dissenters."). To the extent that the amendments to Section 262 of the DGCL are enacted as proposed by the Council, we may witness an increased utilization of "self-help" mechanisms such as appraisal-out conditions.

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[24] Explanatory Paper titled "Section 262 Appraisal Amendments" prepared by Council, at 1-2 (Mar. 6, 2015) (hereinafter, the "Council Paper").

[25] *See e.g., CKx*, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013), *aff'd*, 2015 WL 631586, ____ A.3d ___ (Del. Feb. 12, 2015).

[26] Council Paper at 2-3.

[27] *Id.* at 3.

[28] Synopsis § 2, Proposed Amendment to Section 262(g) of the DGCL.

[29] Council Paper at 6.

[30] *See supra* note 23.

Deadlocked – Resolving Impasses over Material Decisions and Exiting a Joint Venture

By Kenneth A. Gerasimovich and Jennifer Brady

Joint venture partners often begin their relationship full of optimism for a successful future. The pressures of growing and managing a business can drive a wedge between the closest of partners, however. This becomes particularly acute in 50/50 joint ventures where deadlocks over material decisions can cripple a company and destroy business relationships and friendships, as demonstrated by two recent cases involving Delaware and New York corporations, *Charron v. Sallyport Global Holdings, Inc.*[1] *(Charron)* and *In the Matter of Bermor, Inc.*[2] *(Bermor).*

The shareholders in *Charron* and *Bermor* pursued different solutions to their management deadlocks. The parties in *Charron* negotiated a buyout of one partner's interest, but the terms of the buyout itself lead to further disputes. The shareholders in *Bermor* turned to the courts to resolve their impasse resulting in judicial dissolution of their companies. In both cases, some of the stress and expense the parties endured may have been avoided with careful planning on how to address deadlocks and thoughtful implementation of exit strategies.

Charron - Buyout with Windfall Protection

A "windfall protection" mechanism can facilitate a buyout transaction by helping to ensure that the exiting owner receives a fair price for his interest, alleviating concerns about seller's remorse. If the remaining owner sells the business for a higher valuation within a short period, the former partner shares in the proceeds. The duration of the "windfall protection" period and the percentage of the proceeds payable to the former owner are usually highly negotiated. The remaining owner will want a short period and a lower percentage to ensure that the former owner is not rewarded with proceeds related to the growth of the business under the remaining owner's sole stewardship. The exiting owner will want to ensure he is not cheated out of a deal with a buyer that the remaining owner may have waiting in the wings.

When the 50/50 shareholders of Sallyport Global Holdings, Inc. (SGH) found it impossible to continue as business partners, they resolved their impasse through a buyout agreement that provided "windfall protection" for the departing shareholder. The interpretation and application of the "windfall protection" provision unfortunately lead to further disputes and litigation for the parties.

SGH provided logistical support to government operations in Iraq, Afghanistan, and South Sudan.[3] Its 50/50 shareholders, Thomas Charron and John DeBlasio, were West Point graduates who met in Iraq in 2004.[4] Through Charron and DeBlasio's leadership and military connections, within a few years SGH grew from a small start-up enterprise financed by a home equity loan on Charron's house, to a prosperous company valued at tens of millions of dollars.[5] But as the conflicts in Iraq and Afghanistan escalated, so did tensions between Charron and DeBlasio.

By 2009, Charron and DeBlasio started looking for an exit from their joint venture. After failed efforts to sell the company to a third party, in December 2010 Charron agreed to have his shares redeemed by the company for approximately $40.7 million, leaving DeBlasio as the sole shareholder.[6] The purchase agreement for the transaction contained a "windfall protection" clause that provided for additional

payments to Charron if DeBlasio sold the business to a third party within one year for a purchase price exceeding an enterprise value of $65 million.[7]

Two weeks after the buyout of DeBlasio's interest, Charron began discussions with DC Capital Partners to sell the company.[8] On June 29, 2011, DeBlasio sold SGH to DC Capital Partners for $60.7 million in cash and a 38 percent equity interest in Sallyport Holdings LLC, a new company set up by DC Capital to acquire SGH and an unaffiliated entity.[9]

Charron claimed that the sale to DC Capital triggered the windfall protection provision in the buyout agreement. Disputes arose between DeBlasio and Charron with respect to whether the sale price, taking into account the equity interest in Sallyport Holdings LLC, reached the $65 million threshold amount established in the windfall protection provision. The court eventually calculated the sale price at $81.7 million, finding that the windfall protection provision applied.[10]

Charron and DeBlasio also disagreed on whether the provision entitled Charron to 20 percent of the total proceeds of the sale or 20 percent of the amount that exceeded the $65 million threshold. Based on earlier drafts of the "windfall protection" provision and e-mail communications, it seemed likely that the parties intended for the 20 percent payment only to apply to the portion of the purchase price that exceeded the threshold amount, but the final agreement did not include any concept of the payment of incremental proceeds above the threshold amount.[11] Noting the "clear language" of the windfall protection provision, the court found that Charron was entitled to 20 percent of the total proceeds of the sale, resulting in a larger payment in the aggregate than if he had remained a shareholder and sold his 50 percent stake directly in the DC Capital transaction.[12]

In the end, Charron's "windfall protection" provided him with a windfall. The rush to conclude the buyout of Charron's interest may have contributed to a costly error in the contract, as the court pointed out. "The sense of urgency was palpable on all sides, but in retrospect, no one can explain why the parties and their highly-paid professionals rushed to conclude the transaction on an arbitrary and 'self-imposed' deadline. Perhaps this litigation could have been averted by several days' reflection."[13]

***Bermor* - Judicial Dissolution**

Although Charron and DeBlasio's business relationship had broken down, they were able to negotiate a buyout that at least allowed them to terminate their contentious partnership. What happens when the parties cannot even agree on their separation? Section 273 of the Delaware General Corporation Law (the DGCL) allows a shareholder in a 50/50 joint venture to petition for judicial dissolution, if the joint venture partners are unable to agree upon the desirability of discontinuing the joint venture and disposing of its assets. In *Bermor*, the Delaware Chancery Court granted a petition to dissolve two Delaware corporations after the shareholders reached an impasse over liquidity issues.

Although the corporations subject to the dissolution petition in *Bermor* were owned by two 50 percent shareholders, Louis Grossman and Claire Cohen, the disputes at issue embroiled several members of two extended families. Morton Grossman, Louis' father, and Bernie Cohen, Claire's deceased husband, had a long standing partnership and the families had known each other for nearly 50 years.[14] The two Delaware corporations subject to the petition for dissolution were formed to serve as general partners of two limited partnerships that owned commercial properties originally acquired by Morton and Bernie. At the time of the filing of the petition for dissolution, 25 members of the Grossman family and six members of the Cohen family were limited partners in the companies.[15] The two Delaware general partners were

each managed by a board of four directors, two from the Cohen family and two from the Grossman family.[16]

In 2011, members of the Grossman family asked their board representatives at the Delaware corporations to seek ways to generate liquidity from the limited partnerships. The Grossman directors proposed a refinancing, but this was rejected by the directors representing the Cohen family. When the issue could not be resolved, the Grossman directors proposed a buyout by one family or the other, but negotiations over a purchase eventually stalled. Proposals to add a buy-sell mechanism to the corporate documents, to hold an internal auction among the partners, and to sell the properties also failed.[17]

Louis eventually filed a petition pursuant to DGCL Section 273 to dissolve the two Delaware corporations serving as the general partners. In its decision on Louis' petition, the Chancery Court reviewed the applicability of Section 273 and the court's powers to grant dissolution, noting that under Section 273 the court may deny a petition that satisfies the minimum standards required by the section, but that such power should be used sparingly.[18] The court found that there was a genuine inability between the shareholders to agree upon the desirability of continuing the joint venture and ordered dissolution of the corporations.[19]

Exit Stage Right

Judicial dissolution, as granted in *Bermor*, is often an imperfect solution of last resort. Negotiated solutions, such as the buyout in *Charron*, hammered out while disputes and personal animosities may be clouding the parties' judgment, also may fail to provide satisfactory relief.

The best time to step back and reflect on potential issues and solutions may be at the very beginning of a partnership. No one wants to plan the divorce on the way to the wedding, but in joint ventures the parties need to be prepared if the time comes to part ways.

The shareholder agreement, partnership agreement, or limited liability company agreement for any 50/50 joint venture should anticipate deadlocks and provide some mechanism for dealing with them. This may include a process and a timeline for escalating deadlocks so disputes do not linger, mediation provisions to guide the parties' efforts to resolve deadlocks, and arbitration to finally settle disputes. Bringing in an independent board member or manager with the power to vote on deadlocks can also provide a solution.

In many situations, parties will not want to leave important business decisions in the hands of a third party arbitrator or board member. A buy-sell mechanism agreed at the outset can provide a fall back when attempts to resolve deadlocks fail. There are several variations on buy-sell agreements with colorful monikers like "Russian roulette" and "Texas shoot-out." In one version, the first partner to trigger the buy-sell agreement names a price and the other partner must decide to sell his interest at that price or buy-out the first partner at the same price. In another rendition, the parties submit sealed bids and the one with the higher bid buys out the other at the higher price. In a slight variation on the theme, the parties submit sealed bids with their lowest sale price and the party with the highest bid buys out the other party at the lower price. Less dramatic provisions allow for a sale or redemption at a predetermined price or at fair market value as determined by an independent appraiser.

Ultimately, the relative liquidity of the partners, their future plans, and their willingness to bring in neutral parties to help break deadlocks will play a role in determining which, if any, of these mechanisms

is right for their joint venture. The most important thing is to address the possibility of impasse and deadlocks at the beginning of the venture so that disputes can be minimized and dealt with efficiently.

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[1] *Charron v. Sallyport Global Holdings, Inc.*, No. 12CV6837, 2014 WL 7336463 (S.D.N.Y. Dec. 24, 2014).
[2] *Matter of Bermor, Inc.*, No. CV 8401-VCL, 2015 WL 554861 (Del. Ch. Feb. 9, 2015).
[3] *Charron v. Sallyport Global Holdings, Inc.*, No. 12CV6837, 2014 WL 7336463, at 1.
[4] *Id.*
[5] *Id.*
[6] *Id.*, at 3.
[7] *Id.*
[8] *Id.*
[9] *Id.*, at 3-4.
[10] *Id.*, at 12.
[11] *Id.*, at 12.
[12] *Id.*, at 14.
[13] *Id.*, at 3.
[14] *Matter of Bermor, Inc.*, No. CV 8401-VCL, 2015 WL 554861, at 1.
[15] *Id.*
[16] *Id.*
[17] *Id.*, at 2.
[18] *Id.*, at 3.
[19] *Id.*, at, 4.

View from Amsterdam: New Dutch Arbitration Act

By Hans E. Urlus and Ilana Haramati‡

On Jan. 1, 2015, the revised Dutch Arbitration Act (Act) entered into force, replacing the 1986 version of the Act.[1] The new Act is intended to make the Netherlands' commercial arbitration procedures more attractive to international parties, as well as improve the national arbitration system by modernizing provisions. Like its predecessor, the new Act's provisions apply equally to domestic and international commercial arbitration proceedings.

It is too soon to tell whether and to what extent the revised Act will be successful, but at first blush the revised Act appears to be a substantial improvement over the old Act. While there remains room for improvement, the revised Act modernizes some of the outdated portions of its predecessor, which should make Dutch arbitration more efficient, flexible, and user-friendly.

First, the new Act creates a framework for e-arbitration, allowing procedural documents and awards to be rendered in electronic formats with electronic signatures. This will permit quick and efficient communication during arbitration proceedings and will also reduce costs.

Second, the new Act makes various procedural improvements that are a direct result of the codification of international best practices. For example, it is no longer a requirement to file an arbitral award before Dutch court in order to end arbitration proceedings. The new Act furthermore allows an arbitral tribunal to hear objections against arbitrators, instead of requiring a separate Dutch court procedure to adjudicate these objections. Additionally, regular Dutch courts are no longer involved in challenging proceedings, meaning the Court of Appeal is the only institution capable of ruling on the annulment of awards. Overall, the procedural improvements of the new Act aim to make arbitration less reliant on Dutch national courts.

Moreover, the new Act is in line with European Unfair Terms in Consumer Contracts Directive 93/13/EE. It aims to be more consumer-friendly with various amendments to the provisions regarding arbitration agreements. For example, an arbitration clause contained in a company's general terms and conditions is not binding on the consumer if it does not provide the consumer with an option to choose to have the dispute decided by the courts (although this does not apply if the consumer and company have explicitly agreed to settle their dispute through arbitration).

The new Act is also much more flexible than its predecessor. Parties are provided with increased autonomy to determine the procedure that is followed by the arbitral tribunal conducting the proceedings. Parties are provided with more freedom to determine procedures regarding availability of appeal, evidence taking, written procedures, oral rounds, and preliminary measures, among others.

As a whole, the new Act maximizes party autonomy and allows parties to shape arbitration procedures to meet their mutual needs and interests.

Despite various improvements, some may argue that the new Act may not have gone far enough , as it remains silent on a number of issues. These include, for example, the confidentiality of arbitration and the qualification requirements for arbitrators. However, practically speaking, parties may fill any gaps left by the new Act directly in their arbitration clauses or by referring to international arbitration frameworks (e.g., UNICITRAL Model Law on International Arbitration).

Although the jury is still out on the success of the new Dutch Arbitration Act, it appears that it will enhance the efficiency and flexibility of the arbitration process in the Netherlands by reducing administrative burdens and maximizing party autonomy. This will likely boost the position of the Netherlands as a leading arbitration venue for both domestic and international disputes.

**Special thanks to Maxime van den Dijssel and Eline Vancraybex for their valuable contribution to this article.*

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[1] Note that all arbitration proceedings commenced prior to Jan. 1, 2015, remain governed by the old version of the Act.

View from China: Four Agencies Jointly Release the Notice Concerning Parallel Administrative Approval Work on Mergers, Acquisitions and Restructurings of Public Companies

By George Qi and Dawn Zhang

On Oct. 24, 2014, the Ministry of Industry and Information Technology, China Securities Regulatory Commission (CSRC), National Development and Reform Commission (NDRC) and Ministry of Commerce (MOFCOM) jointly issued the Notice Concerning Parallel Administrative Approval Work on Mergers and Restructurings of Public Companies (the Notice). The Notice is aimed at streamlining the administrative approval procedures for the mergers, acquisitions and restructurings of public companies.

Parallel Approvals

The Notice states that the following governmental approvals will no longer be required to be obtained prior to CSRC's approval for any merger, acquisition or restructuring of public companies: (a) NDRC's approval or registration of overseas investment carried out by the public company, (b) MOFCOM's approval for strategic investment by foreign investors, and (c) MOFCOM's merger control approval. That is, each of these approvals will be independent from one another and the approval process can proceed in parallel with CSRC's approval. This change will shorten the timeline for the completion of a merger, acquisition or restructuring of public companies and improve the efficiency of the approval process.

The Notice explicitly states that a public company may not close any merger, acquisition or restructuring project until it obtains approvals from all relevant authorities. Further, the public company is required to indicate in its publicly available proposed restructuring report all of the required governmental approvals for the transaction and describe the risks for the failure to obtain such approvals.

Disclosure Requirements

During CSRC's review of the proposed transaction, if another authority grants its approval with respect to the transaction, the public company is required to make a public disclosure that such approval has been obtained.

If the public company obtains CSRC's approval but the other required governmental approvals are still pending, the public company must publicly disclose the CSRC's approval and status of the other approvals, including a disclosure of the risks associated with the failure to obtain necessary approvals.

Conclusion

This Notice will shorten the timeline for the completion of the mergers, acquisitions and restructurings of public companies and benefit the development of the Chinese capital market.

- *Notice Concerning Parallel Administrative Approval Work on Merger, Acquisition and Restructuring of Public Company*
- *Issuing authority: Ministry of Industry and Information Technology, China Securities Regulatory Commission, National Development and Reform Commission and Ministry of Commerce*
- *Date of issuance: Oct. 24, 2014 / Effective date: Oct. 24, 2014*

View from London: Antitrust Reviews of Minority Shareholding Acquisitions in Europe…Two Steps Forward, One Step Back?

By Simon Harms

First created in 1989, the supranational European Union (EU) merger control regime has been operational for a quarter of a century and is now an accepted fact of life for businesses involved in major M&A transactions. Since then, the European Commission (the Commission) has firmly secured for itself a place at the "top table" of leading merger control authorities around the world.

The Commission periodically reviews the EU Merger Regulation[1] (EUMR) to ensure that it continues to enable effective intervention in relation to transactions that pose threats to competition in the EU. In this context, the Commission has, in recent years, been assessing the case for expanding its jurisdiction to include acquisitions of non-controlling, minority shareholdings. While the final decision in this respect ultimately rests with the EU Member States, some of which are increasingly strident in their opposition to ceding additional powers to "Brussels," the Commission's push to expand the scope of the EUMR to non-controlling shareholdings had – until very recently – acquired an air of inevitability about it (i.e. not whether but when).

The Commission's perceived predicament is that – in contrast to a small, but influential, minority of merger control regimes (including those of Germany, the United Kingdom and the United States) – the Commission's jurisdiction to review concentrations is currently limited to transactions resulting in the acquisition of control, or "decisive influence," by one or more companies over another company. With very few exceptions, the EUMR leaves the Commission powerless when it comes to acquisitions of non-controlling, minority shareholdings.

To U.S. antitrust counsel experienced in applying the Hart-Scott-Rodino (HSR) rules, which have always provided for reviews of certain minority acquisitions by the U.S. agencies, the proposed expansion of the Commission's jurisdiction might appear to be somewhat uncontroversial or, indeed, a long overdue plugging of an obvious enforcement gap.

In this context, it must, however, be borne in mind that "U.S.-style" merger control notifications differ significantly from their European counterparts. While the substantive analysis is very similar on both sides of the Atlantic, an HSR notification consists of filing a relatively simple, standard notification form to the Federal Trade Commission or the Department of Justice. Only if the reviewing agency has questions, are the parties required to provide detailed, data-heavy "narrative" submissions. In contrast, the EUMR filing form requires the merging parties to provide a fully articulated case up front – supported by a large amount of market data – "proving" why the proposed transaction does not adversely affect competition.

As a result, preparing an EUMR filing is considerably more time-consuming and costly than preparing an HSR notification – even for a non-problematic transactions. In light of the anticipated volume of paper-pushing involved, it is fair to say that the business community did not greet the Commission's proposals to pull minority acquisitions into the existing system with a great deal of enthusiasm. In an effort to minimize the regulatory burden placed on businesses, the Commission has already proposed a "targeted transparency system" pursuant to which only acquisitions of non-controlling shareholdings that create a "competitively significant link" would require a short, relatively data-light information notice with the

Commission prior to completion. Based on the information notice, the Commission would assess whether to "call in" the transaction for a full review.

To date, the Commission has carried out two rounds of public consultation and it had been expected that, following the conclusion of the latest round, the Commission would move to finalize its proposals and commence the process of seeking sign-off from the EU Member States. It appears, however, that the Commission significantly underestimated the strength of opposition to the mooted reforms. Many "stakeholders," particularly those in the business community, have vociferously protested against the extension of the EUMR on the basis that very few minority transactions raise competition issues and that, ultimately, the burden and legal uncertainty associated with notifications would have a negative impact on the "investment climate" in the EU. Further, many commentators have asserted that the concept of a ‘"competitively significant link" as a jurisdictional threshold test is potentially problematic in that it deviates from the "bright line" jurisdictional test used for outright acquisitions of control and, thereby, introduces considerable legal uncertainty at a key juncture of M&A transactions: the determination of whether a transaction must be reviewed by merger control authorities. Many also questioned the Commission's view that only a small number of transactions would need to be notified.

In response to the veritable barrage of criticism (by Brussels standards), the new Competition Commissioner Margrethe Vestager – who inherited the reform package having assumed office in November 2014 – has gone on record acknowledging that "*there is widespread concern regarding the proportionality*" of the Commission's proposals and concluding that "*the balance between the [competition] concerns that this issue raises and the procedural burden of the proposal […] may not be the right one and that the issues need to be considered further.*"

In other words: the Commission is returning to its drawing board. While the proposals are unlikely to be shelved in their entirety, a fast-track expansion of the EUMR to minority shareholdings now looks dead in the water and a further round of refinement of the proposals by the Commission, followed by another round of public consultation, appears inevitable.

This news will provide at least a period of respite to those concerned by the impact on the proposed reforms on the still fragile EU "investment climate" and, in equal measure, cause consternation to those who worry about the continued unchecked harm to competition being caused by certain acquisitions of minority shareholdings.

Both camps must, however, admit that that EU's often maligned public consultation system ("why bother commenting if they do not listen?") has, in this instance at least, proved to be much more than a hollow exercise. In addition, the new Commissioner has taken an early opportunity to demonstrate her "pro-business" and "listening" credentials.

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[1] Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings.

View from Mexico City: SAPI – The Walking Dead?

By Hugo López-Coll

Introduction

The Mexican equivalent of a corporation is the *sociedad anónima* (SA). The SA is regulated by the General Law of Business Organizations (*Ley General de Sociedades Mercantiles*) (LGSM) of 1934, as amended. In the early 2000s, the Mexican Congress tried unsuccessfully – due to political reasons – to modify the LGSM to loosen the restrictions on the content of an SA's bylaws to allow its shareholders to include a number of rights and obligations that the Mexican courts were ruling as null or void.

The solution by the Mexican Congress to such impasse was to introduce a new type of entity, the Investment Promoting Company (*Sociedad Anónima Promotora de Inversión*) (SAPI), as part of the 2005 amendments to the Mexican Exchange Law (*Ley del Mercado de Valores*) (LMV). Due to its flexibility as described below, the SAPI has been one of the most used forms of entity in Mexico since 2006.

However, in June 2014 the LGSM was amended to, among other changes, modify the restrictions on the bylaws of SA's, as attempted by the Mexican Congress years ago. Now the distinctions between the SAPI and the SA have been minimized and the question is whether there is any need to incorporate a SAPI or modify an SA into a SAPI.

The SAPI

The SAPI is regulated by the LMV, which was amended in December 2005 and enacted in June 2006. The SAPI was created to provide more adequate protection for shareholders' rights and, in particular, more effective minority rights than those available for shareholders of an SA. Although the SAPI is regulated by the LMV, the SAPI is not supervised or inspected by the Mexican National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*). Therefore, the SAPI operates as a company incorporated under the LGSM.

The provisions of the LMV that regulate the SAPI exempt the SAPI from certain obligations provided by the LGSM, specifically those limiting the transfer of certain corporate and economic rights. Consequently, the LMV expressly recognizes that shareholders of a SAPI may execute shareholders' agreements to: (a) prevent the assignment or transfer of stock or any interest in the SAPI, in addition to those formerly applicable to the SA; (b) provide certain events in which shareholders may be excluded or exercise rights of withdrawal or separation or even have their shares redeemed, in addition to those events formerly provided in the LGSM; (c) issue stock different from stock regulated by the LGSM; (d) restrict or even prohibit voting rights in certain matters to be submitted to shareholders; (e) limit or broaden profit distributions or other economic rights, regardless of limits formerly set forth in the LGSM; (f) confer a veto right or even require the affirmative vote of certain shareholders in general shareholders meetings; (g) establish any type of mechanisms for specific matters with the purpose of avoiding dead-locks; (h) broaden, limit or even nullify the right of first refusal regardless of the terms provided in the LGSM; and (i) limit civil responsibility for damages and prejudices caused by the directors and relevant managers of the SAPI.

A SAPI is managed by a board of directors, whilst the surveillance of the company is performed either by a statutory examiner or by an external auditor. The LMV also provides for special provisions that regulate

shareholders' agreements executed among its shareholders and for additional minority rights that are more favorable than those formerly available to the shareholders of an SA.

Finally, shareholders of a SAPI may agree and implement tag-along and drag-along rights; call and put options; rights of first refusal; mechanisms for the sale of shares; pooling voting and preemptive rights; and agreements for the transfer of stock in public offerings.

Due to the provisions described above, the SAPI has been a very popular form of entity used in Mexico and many SAs have changed their legal regime to a SAPI.

The SA

In June 2014, the LGSM was amended, among other changes, to allow the inclusion of provisions in the bylaws of an SA similar to those available for a SAPI, as well as to modify shareholders' minority rights. Due to such amendments, the present main differences between the SA and the SAPI are the following:

Main Differences		
	SA	**SAPI**
1. Management	May be managed by a sole administrator or board of directors	May only be managed by a board of directors
2. Types of Shares	May not issue shares that limit or broaden profit distributions or other economic rights	May issue shares that limit or broaden profit distributions or other economic rights
3. Minority Rights	A shareholder or group of shareholders representing at least *25 percent* of the capital stock may: - appoint a statutory examiner - appoint a member of the board of directors - postpone a shareholders' vote for three days if they consider the provided information insufficient - claim civil liability from the members of the board of directors and the statutory examiner - challenge or oppose resolutions of shareholders meetings A shareholder or group of shareholders representing at least *33 percent* of the capital stock may call shareholders meetings	A shareholder or group of shareholders representing at least *10 percent* of the capital stock may: - call shareholders meetings - appoint a statutory examiner - appoint a member of the board of directors - postpone a shareholders' vote for three days if they consider the provided information insufficient A shareholder or group of shareholders representing at least *15 percent* of the capital stock may claim civil liability from the members of the board of directors and the statutory examiner A shareholder or group of shareholders representing at least *20 percent* of the capital stock may challenge or oppose resolutions of shareholders meetings

4. Bylaws	May agree and implement tag-along and drag-along rights, call and put options, rights of first refusal, mechanisms for the sale of shares, pooling voting and preemptive rights, as well as agreements of transfer of stock in public offerings	May agree and implement tag-along and drag-along rights, call and put options, rights of first refusal, mechanisms for the sale of shares, pooling voting and preemptive rights, as well as agreements of transfer of stock in public offerings May agree to non-compete agreements among its shareholders with limited scope and for a period of no longer than three years
5. Repurchase of Shares	The SA may not repurchase its own shares, except upon a distribution thereof ordered by a court of law	The SAPI may repurchase its own shares

Conclusion

There are several proponents who believe the use of the SAPI will be reduced dramatically. Unless there is a reason to opt for a SAPI based on the differences described above, the SA may now be used as a proper vehicle to structure a transaction between shareholders with different interests and may include relevant protections and voting mechanisms through the by-laws.

Likewise, in the past many companies decided not to transform their entity from a SA to a SAPI due to the consequent burdens, many of which were more practical than legal, such as having to give notice to authorities, banks, customers and suppliers, the need to obtain a new tax ID number or to adapt invoices. Now an existing SA may be able to modify its bylaws and adapt them to reflect the different positions of its shareholders without suffering such nuisances.

Finally, the changes to the SA also may affect views regarding the SAPI from abroad. For example, due to the former differences between the SA and the SAPI, in certain jurisdictions the SAPI was considered a pass-through entity for tax purposes. As a cautionary matter, parties may want to review such decisions in light of the similarities between SA's and SAPI's since last year.

Will the SAPI survive? It is still too early to know.

View from Tokyo: 'Abenomics' Abolishes Residency Requirement with Respect to Establishment of Japanese Presence

By Koji Ishikawa and Ryo Takizawa

On March 16, 2015, Japan's Ministry of Justice abolished the requirement that at least one representative of a Japanese company must be a resident in Japan. While no statute, including the Companies Act of Japan, imposed a residency requirement, the Ministry of Justice, the authority with which incorporation documentation is filed, would not accept any incorporation application if the applicant corporation did not have a representative in Japan, under the Ministry's rules. This abolishment means that going forward a Japanese company no longer needs to have a representative individual who lives in Japan. It is generally understood that this change is a part of the "*Abenomics*" economic policy, named after Japanese Prime Minister *Shinzo Abe*, which has sought to stimulate investment in Japan by foreign nationals.

How to take advantage of the change

This change in the residency requirement accompanies a change in the Japanese visa requirements under the Immigration Control and Refugee Recognition Act of Japan. A four-month visa will be newly available under the "Business Manager" (*keiei kanri*) visa category, and an anticipated representative of a Japanese company can carry out incorporation procedures in Japan with the newly created visa. However, procedures for obtaining the four-month visa and the incorporation mechanics can be complicated and somewhat burdensome, especially when an applicant has no previous experience. It may be difficult for an applicant to complete the procedures within four months, unless the applicant has sufficient knowledge of the process. Therefore, using law firms in Japan and other established service providers, rather than carrying out all incorporation procedures without any professional support, still should be considered, regardless of the changes in the residency requirements and the visa rules.

Change does not apply to branch offices

Under Japanese law, there are three main options for corporation formation:

a. Kabushiki Kaisha (KK), which is a joint stock company;

b. Godo Kaisha (GK), which is similar to a U.S. LLC; and

c. a registered branch office of an offshore company.

The rule change that took effect March 16, 2015, is applicable to KKs and GKs only. Therefore, if you wish to establish a branch office of a foreign company, the branch office is still required to have at least one representative who is a resident in Japan. However, there are some discussions that this inconsistency among KKs, GKs and branch offices does not have any specific rationale. These discussions could potentially result in abolishment of the residency requirement for registered branch offices, which would require an amendment to the Companies Act of Japan, although no specific timeline as to when such amendment will be introduced to the Diet has been reported.

No tax impact

The change does not involve a change in the tax imposed on representatives' compensation paid by Japanese companies to non-resident representatives of the company. The way in which it will be addressed depends on individual tax treaties that Japan has executed with other countries; for example, under the Japan-U.S. tax treaty, officers' compensation that Japanese companies grant to U.S. residents is subject to Japanese tax requirements.

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