Please feel free to contact us if we can provide further information on these matters.

John W. White
212-474-1732
jwhite@cravath.com

Susan Webster
212-474-1660
swebster@cravath.com

Richard Hall
212-474-1293
rhall@cravath.com

William V. Fogg
212-474-1131
wfogg@cravath.com

Eric W. Hilfers
212-474-1352
ehilfers@cravath.com

Jennifer S. Conway
212-474-1316
jconway@cravath.com

Kimberley S. Drexler
212-474-1434
kdrexler@cravath.com

SEC Adopts Changes to Proxy and Form 10-K Disclosure Requirements

December 17, 2009

At an Open Meeting on Wednesday, December 16, 2009, the Securities and Exchange Commission (the "SEC" or the "Commission") voted 4-1 to adopt several new requirements relating to the disclosures public companies must make in their proxy statements and their Annual Reports on Form 10-K. The SEC's amendments relate to three general categories: corporate governance (directors and boards of directors); compensation matters; and compensation consultants. The SEC also adopted a new rule requiring that the results of shareholder votes be reported on a Current Report on Form 8-K within four business days of the meeting, rather than being disclosed in the periodic Report (on Form 10-Q or Form 10-K) that covers the period in which the vote was held. The rules and amendments adopted yesterday apply by their terms only to reports filed by domestic U.S. companies and therefore will not impose any new requirements on foreign private issuers. The final rulemaking release, SEC Release No. 33-9089 is available at http://www.sec.gov/rules/final/2009/33-9089.pdf (the "Adopting Release"). Page references in this memorandum are to the Adopting Release.

The rules are largely consistent with the proposals issued last summer, but there were several key changes which we discuss below. The rules are intended to apply to this upcoming proxy season. In light of this timing, companies should study the amended rules closely now to ensure compliance with the new requirements in annual reports and proxy statements filed this spring.

CORPORATE GOVERNANCE MATTERS

The Commission adopted two amendments to its corporate governance disclosure requirements which call for new and expanded disclosures about corporate boards and directors.

1. **An amendment to Items 401 and 407 of Regulation S-K to require several new and expanded disclosures about directors and director nominees.**

   This amendment will require that companies include in their proxy statements and Annual Reports on Form 10-K disclosures about:

   - **Qualifications.** The particular experience, qualifications, attributes or skills that led the company's board to conclude that a director or nominee should serve as a director of the company, in light of the registrant's business and structure. The staff at yesterday's Open Meeting confirmed this disclosure will be required for each director on an annual basis, even if that director is not up for election that year.

     Notably the SEC did not adopt those aspects of its proposals which would have required disclosure about directors' qualifications to serve on specific committees. However, the Adopting Release does note that "if an individual is chosen to be a director or a nominee to the board because of a particular qualification, attribute or experience related to service on a specific committee, such as the audit committee, then this should be disclosed under the new requirements as part of the individual's qualifications to serve on the board." (Page 35.)

     Similarly, although the Commission did not adopt the reference in the proposed rule to "risk assessment skills" because the Commission believes companies and other proponents should be afforded flexibility in determining what specific skills benefit the company, the SEC nevertheless has highlighted that if specific skill sets, "such as risk

"... accountability is impossible without transparency. By adopting these rules, we will improve the disclosure around risk, compensation, and corporate governance, thereby increasing accountability and directly benefiting investors."
—Chairman Mary L. Schapiro, Securities and Exchange Commission

assessment or financial reporting expertise, were part of the specific experience, qualifications, attributes or skills that led the board or proponent to conclude that the person should serve as a director, this should be disclosed." (Page 35.)

- **Directorships**. Any public company directorships held by a director or nominee at any time during the past five years (the rules previously limited required disclosure only to concurrent directorships).

- **Legal Proceedings**. Any legal proceedings involving the director or nominee over the past ten years (the rules previously limited their scope to the past five years), including an expanded list of judicial or administrative proceedings that require disclosure. The rule now requires disclosure about judgments or orders finding a violation of: federal or state securities or commodities law or regulations; any law or regulation respecting financial institutions or insurance companies; or any law or regulation prohibiting mail or wire fraud or fraud in connection with any business entity; as well as sanctions or orders imposed by self-regulatory organizations, registered entities or equivalent exchanges and associations that have disciplinary authority over members and associated persons. An instruction to this new disclosure requirement makes clear that disclosure is not required of any settlement of a civil proceeding among private litigants.[1]

- **Diversity**. Information concerning diversity of the board and its directors. The new rules will require disclosure about:

  - Whether the board or nominating committee has a policy of considering diversity when evaluating director candidacies.

  - An assessment of how that policy has been implemented.

  - How the board or nominating committee assesses the effectiveness of its policy.

  The SEC noted that companies may define diversity "in various ways, reflecting different perspectives." (Page 39.) In light of this, the SEC has not defined diversity but has advised that for purposes of this disclosure, "companies should be allowed to define diversity in ways that they consider appropriate." (Page 39.) The SEC also expressly noted that diversity may signal not only racial or gender diversity but "some companies may conceptualize diversity expansively to include differences of viewpoint, professional experience, education, skill and other individual qualities and attributes that contribute to board heterogeneity." (Page 39.)

In light of these new requirements, companies should focus on ensuring that they have all the information necessary to provide these disclosures, including appropriately updating their D&O questionnaires, or circulating supplemental D&O questionnaires. Presumably this highly personalized disclosure, including the newly required information about background and diversity, will be of particular interest to most directors. Accordingly, we encourage companies and their disclosure advisers to draft this disclosure early and provide their directors with an "advance" look at this disclosure with regard to any particular director.

2. Amendment to Item 407 of Regulation S-K and Schedule 14A to provide new disclosures about the board of directors.

The amendments adopted Wednesday will also require that companies provide enhanced disclosure about the leadership structure and risk oversight practices of their board of directors. More specifically, a company will need to disclose:

- Whether it combines or separates the positions of chief executive officer and chairman of the board, and why it believes that structure is the most appropriate structure for the company at the time of the filing. If the company has not separated the chief executive and chairman roles, the company will also need to disclose whether and why it has a lead independent director and the specific role played by that lead director in the leadership of the company.

- Information about the role of the board in the company's risk oversight and the effect, if any, this role has on the organization of the board leadership structure. This disclosure might also address whether and how the board, or board committee, monitors risk. Along these lines, the Commission explained in the Adopting Release that "where relevant, companies may want to address whether the individuals who supervise the day-to-day risk management responsibilities report directly to the board as a whole or to a board committee or how the board or committee otherwise receives information from such individuals." (Page 44.)

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[1] *See* Instruction 5 to paragraph (f) of Item 401 of Regulation S-K.

The SEC modified the final rule from the proposal in that the rule now speaks of "risk oversight" rather than "risk management", clarifying some prior confusion. The Commission also noted, however, that it expects this disclosure "to provide important information to investors about how a company perceives the role of its board and the relationship between the board and senior management in managing the material risks facing the company." (Page 44.)

COMPENSATION MATTERS

The Commission also voted Wednesday to adopt two amendments to its rules governing compensation disclosure.

1. **Amendment to Item 402 of Regulation S-K to require new disclosures about general compensation policies and practices and the relationship of those policies and practices to the company's risk profile, if material.**

   The rules adopted by the Commission Wednesday will require a company to assess whether its compensation policies and practices for employees, including non-executive officers, present risks that are "reasonably likely to have a material adverse effect" on the company. If a company determines that a compensation policy or practice, beyond those that relate only to executive officers, meets this threshold, then the company will need to provide disclosure pursuant to new Item 402(s) regarding that policy or practice and its effect on the company and its risk profile.

   The staff and the Commission have also emphasized that the standard of "reasonably likely to have a material adverse effect" was drawn from the well-known world of Management's Discussion and Analysis ("MD&A") and this disclosure approach should "parallel" the MD&A requirement which mandates "risk-oriented disclosure" of known trends and uncertainties that are material to the business. In this manner, the disclosure requirement has been significantly narrowed from the SEC's proposal where compensation policies and practices would have triggered disclosure whenever risks arising from those compensation policies or practices "may have a material effect on the company".

   Meredith Cross, the Director of the Division of Corporation Finance, also noted at yesterday's Open Meeting that companies may consider offsetting or mitigating factors before concluding that a compensation practice or policy is reasonably likely to have a material adverse effect on the company. As the Adopting Release states, "if a company has compensation policies and practices for different groups that mitigate or balance incentives, these could be considered in deciding whether risks arising from the company's compensation policies and practices for employees are reasonably likely to have a material adverse effect on the company as a whole." (Page 13.)

   Given the narrowed standard and this consideration of offsetting effects, we think many companies will not be required to make disclosure pursuant to this item. In this regard, it is also noteworthy that a company will not be required to include an affirmative statement that it has determined that the risks arising from its compensation policies and practices are not reasonably likely to have a material adverse effect on the company. (Page 17.)

   Unlike the proposal's original plan, this new disclosure will not be placed within a company's Compensation Discussion & Analysis section ("CD&A"). Neither the staff nor the Adopting Release, however, have identified precisely where this new disclosure section should appear. Presumably it should be situated near the other required compensation disclosures, since this requirement is housed in Item 402 of Regulation S-K. It is also important to note that these amendments do not alter existing disclosure requirements regarding the relationship between the compensation of named executive officers and the company's risk management policies when risk is a material aspect of the compensation of those executive officers. Although the latter is not an explicit component of the SEC's executive compensation disclosure requirements, the Commission and its staff have recently highlighted that this disclosure is already mandated by the principles-based requirements of CD&A, when material.

   Consistent with CD&A, and also MD&A, the Commission has identified this new disclosure item as also being principles-based and has provided several illustrative examples to help in this area. For example, the Commission has suggested that, when assessing whether disclosure is required, companies should consider their compensation policies and practices:

   - At a business unit of the company that carries a significant portion of the company's risk profile.
   - At a business unit with compensation structured significantly differently than other units within the company.
   - At a business unit that is significantly more profitable than others within the company.

- At a business unit where compensation expense is a significant percentage of the unit's revenues.

- That vary significantly from the overall risk and reward structure of the company, such as when bonuses are awarded upon accomplishment of a task, while the income and risk to the company from the task extend over a significantly longer period of time.

Once a company has determined it needs to make disclosure in this area, new Item 402(s) of Regulation S-K also provides a principles-based list of matters a company may then want to consider including in its disclosure.

2. Revised disclosure of stock and option awards in the Summary Compensation Table and the Director Compensation Table to require inclusion of aggregate grant-date fair value, as computed under Statement of Financial Accounting Standards No. 123R ("FAS 123R")[2], of such awards.

The SEC has adopted an amendment that will require companies to reflect the aggregate grant-date fair value of stock and option awards in the Summary Compensation Table. This amendment effectively reverses the controversial action taken by the Commission in December 2006, which revised the rule at that time to require that companies disclose only the dollar amount recognized for financial reporting purposes under FAS 123R (generally, the amount determined by amortizing the grant-date fair value of awards over their vesting periods).

This change may affect the composition of the group of officers who are identified as the company's named executive officers (which will also affect the individuals subject to Section 162(m) of the Internal Revenue Code), so companies should pay close attention to this change and any impact it may have on the determination of its named executive officers for reporting purposes. For each executive officer included in this year's proxy, companies will be required to recompute the value of equity awards for any past fiscal years that are required to be included in the table. However, companies are not required to include different named executive officers for any past fiscal year based on recomputing total compensation for those years pursuant to the amendments.

The amendments adopted Wednesday include an instruction that, with regard to performance-based awards, the amount to be included in the Summary Compensation Table is to be calculated based on the probable outcome of the performance conditions at the time of grant. This instruction responds to concerns that this change might discourage the use of performance-based equity awards, or result in misleading and inflated disclosures in cases where such awards are made. The maximum possible award will, however, need to be disclosed in a footnote to the table.[3] Companies may also want to keep in mind the Commission's advice that in circumstances where a large "new hire" or "retention" grant "results in the omission from the Summary Compensation Table of another executive officer whose compensation otherwise would have been subject to reporting, the company can consider including compensation disclosure for that executive officer to supplement the required disclosures." (Page 22.)

There is discussion in the Adopting Release about the difference between awards granted during a year and awards granted after the end of the year for performance during such year. The SEC determined not to change the current rule that equity awards must be included in the Summary Compensation Table for the year of grant, even if the awards were for performance during the preceding year. Against this backdrop, however, the Commission reminds companies that they should "continue to analyze in CD&A their decision to grant post-fiscal year end equity awards where those decisions could affect a fair understanding of named executive officers' compensation for the last fiscal year, and consider including supplemental tabular disclosure where it facilitates understanding the CD&A." (Pages 24-25.)

In another departure from the proposal, the Commission decided not to rescind the requirement to report the full grant-date fair value of each individual equity award in the Grants of Plan-Based Awards Table and corresponding footnote disclosure to the Director Compensation Table, concluding, based on comments received, that those disclosures reveal meaningful information about the value associated with each type of equity award granted and the mix of values among various awards with different incentive effects.

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[2] The final rule refers to Financial Accounting Standards Board Accounting Standards Codification Topic 718, Compensation— Stock Compensation ("FASB ASC Topic 718"), which is the successor provision to FAS 123R.

[3] Instruction 3 to Item 402(c) of Regulation S-K.

COMPENSATION CONSULTANTS

The Commission also voted to amend Item 407 of Regulation S-K to require disclosure in the annual proxy statement of the fees paid to compensation consultants and their affiliates if those consultants (or affiliates) provide consulting services to the board of directors or the compensation committee related to executive or director compensation and also provide additional services to the company (such as those related to benefits administration, human resources consulting and actuarial services). Disclosure will also be required if the board or compensation committee does not have its own consultant, but a compensation consultant to the company also provides such additional services. In either case, the disclosure requirement is only triggered if the consultant receives fees in excess of $120,000 during the company’s fiscal year for those other services. If the compensation committee (or the board) has its own consultant, and the company has another consultant which provides additional services, no disclosure will be required about those additional services or the fees paid for them.

Under those circumstances requiring disclosure, companies must provide the following information:

- The aggregate fees paid for all such additional services and the aggregate fees paid for work related to executive and director compensation consulting.

- Whether the decision to engage the consultant for services not related to executive compensation was made or recommended by management.

- Whether the board, or the company’s compensation committee, approved the other services.

Disclosure will not be required if the consultant’s only role in advising on executive compensation is with regard to broad-based plans that do not discriminate in favor of executive officers or when the consultant’s services are limited to providing advice that is not customized to the company or is only customized based on parameters not developed by the consultant.

This amendment is intended to provide investors with meaningful disclosure that will assist them in understanding and assessing any conflicts of interest that are posed by compensation consultants providing services to a company in addition to advice and recommendations regarding executive or director compensation. The so-called “independence” of the compensation committee’s consultants has received extensive attention from Congress in the past year and may well be the subject of upcoming legislation.

CURRENT REPORTING OF PROXY VOTING RESULTS

Finally, the Commission also voted Wednesday to adopt a rule that will require that companies disclose the results of shareholder votes within four business days after the end of the meeting at which the vote was held. This disclosure must be made pursuant to new Item 5.07 of Current Report on Form 8-K. Many commentators noted after this rule was proposed in July that it was not clear how a company should handle the situation where its shareholder votes are not certified within four business days of the meeting. In response to this concern, the SEC has provided Instruction 1 to Item 5.07 which explains that companies must file a Form 8-K announcing preliminary voting results within four business days of the shareholders meeting ending, and then file an amended Form 8-K within four days of the final voting results being known.

EFFECTIVE DATE

The new proxy disclosure rules will be effective as of February 28, 2010 (and with regard to the change in reporting of equity awards, will apply for years ended on or after December 20, 2009). The Commission and staff have not yet spoken as to whether early compliance will be permitted but we believe that most companies filing their annual reports on Form 10-K or their proxy statements (Schedule 14A) before that date will nevertheless want to comply fully with the new rules. Some type of guidance or exemption will be needed from the SEC, however, to allow companies to follow the revised rule for equity awards reporting (and therefore not provide the previously required data) in filings before the February 28, 2010 effective date.

NEXT STEPS FOR THE SEC

These new rules are an important step forward in advancing the SEC's agenda to increase corporate accountability through additional disclosure requirements. Chairman Mary Schapiro, however, has noted that "disclosure only takes us so far" and that there is a need to further empower shareholders through other tools and substantive changes to the corporate governance landscape. So-called "proxy access", or the ability of shareholders to put their own director nominees on the company proxy card, at company expense, is key among those tools for Chairman Schapiro (and others on the Commission). The Commission continues to consider an outstanding rule proposal on this topic, for which it recently extended the comment period until January 19, 2010 (the deadline originally expired on August 17, 2009). In the notice of its extension, the SEC highlighted four documents in its comment file that had originated after the original comment deadline and upon which the Commission is seeking additional public input. Despite the comment letter extension, Chairman Schapiro indicated Wednesday that she remains committed to having the Commission consider some form of proxy access early in 2010. Presumably such rules will not be effective until the 2011 proxy season at the earliest.

Proxy access and disclosures are not the only matters in this area receiving attention from Chairman Schapiro. She indicated in a speech on November 4, 2009, that she has directed the SEC staff to review "the entire process through which proxies are distributed and votes are tabulated" and that she anticipates that the Commission will be issuing a Concept Release in the near term to solicit public comments on matters in this area (including empty voting, over-voting, shareholder communications, NOBO/OBO, and proxy advisory firms, among others). She reiterated Wednesday her commitment to this comprehensive review of the "infrastructure that supports the proxy process — from ensuring the integrity of voting results to reviewing the role of proxy advisors."

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New York
Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
212.474.1000

London
CityPoint
One Ropemaker Street
London EC2Y 9HR
+44.20.7453.1000

www.cravath.com

Please feel free to contact us if we can provide further information on these matters.

James C. Woolery
212-474-1912
JWoolery@cravath.com

Minh Van Ngo
212-474-1465
MNgo@cravath.com

Lessons from the Selectica Case: A Shift in the Role of Rights Plans

May 18, 2009

In the current downturn, companies have begun to use rights plans to preserve the value of their net operating losses. Selectica, Inc.'s adoption of an "NOL poison pill" and Versata Enterprises, Inc.'s subsequent triggering of that pill reflect a potential shift in the role of rights plans from pure deterrence to deterrence and countermeasure. Companies should reevaluate their approach to rights plans in light of this change.

BACKGROUND

Section 382 of the Internal Revenue Code limits a company's ability to use its net operating losses ("NOLs") if the company undergoes a "change of ownership" (a change of 50% or more of the holdings of one or more of the company's 5% stockholders within any three-year period). For many companies that have NOLs, the recent plunge in equity values has made it much easier to cross this 5% threshold, thereby increasing the risk the NOLs will be limited. One potentially effective way to mitigate this risk is to adopt a so-called "NOL poison pill", which functions similarly to traditional poison pills, except that the trigger is set at 4.9% instead of the more customary range of 10% and above.

In November 2008, Selectica lowered the trigger in its rights plan from 14.9% to 4.9% to protect the value of its NOLs. Versata increased its ownership of Selectica, intentionally triggering the poison pill and setting up a challenge to its enforceability. Selectica implemented the exchange feature of its rights plan, causing the exchange of each outstanding right under the plan (except for rights held by Versata) for one share of Selectica common stock. Selectica filed litigation in the Delaware Court of Chancery seeking a declaratory judgment on the validity of its poison pill and the use of the exchange right under the poison pill. This litigation is currently pending.

LESSONS

Irrespective of the outcome, the Selectica case offers several valuable insights regarding the changing role of rights plans and how companies should adapt to this shift.

Companies Must be Ready for Triggering Events. Rights plans were conceived as deterrents that, in practice, would never be triggered. Most rights plans lack the "back-office" mechanics necessary to implement the flip-in (which permits each right holder to purchase additional shares of company stock at a discount) or exchange feature (which automatically converts each right into additional shares of company stock) and register the shares issued under the flip-in and exchange features. For example, many companies adopting rights plans lack a sufficient number of authorized shares of common stock to permit use of the flip-in or exchange feature.

In the current environment, acquirors may be more willing to trigger poison pills and test the validity of pills and the mechanics used to implement dilution. Trading in Selectica shares was suspended for nearly a month as Selectica developed a method to implement the exchange feature. Rights plans should now contain specific instructions on how a flip-in or exchange feature would be executed and how newly issued shares would be registered. Alternatively, companies should coordinate with their advisors to fully develop an execution plan for flip-ins or exchanges and associated registrations of stock. Companies should also review their existing capital structure to ensure that it is consistent with their rights plans.

Companies Should Consider Adopting Pre-Trigger Waiver Procedures. Companies should consider adopting and publishing a pre-trigger waiver process. We believe that encouraging discussions on a pre-trigger basis creates a better record for the board, regardless if the rights plan is an NOL poison pill or a traditional one. Discussing a waiver on a pre-trigger basis permits a board to decline a waiver without certain dilution to the acquiror. Acquirors that decide to trigger poison pills after a waiver had been declined would do so with full knowledge of the consequences.

Remedies under Rights Plans Should be Tailored to the Purposes of the Plans. Companies may enhance the effectiveness and enforceability of rights plans by customizing remedies to the threats addressed by the plans. Selectica's use of a one-to-one exchange instead of a flip-in is instructive:

- The exchange feature provided certain dilution; whereas the flip-in required action by the holders. This made the exchange feature ideal for protecting the value of the NOL, as unexercised options may not constitute beneficial ownership for tax purposes.

- The one-to-one exchange was less dilutive than the flip-in, but was sufficient to protect Selectica's NOL by reducing Versata's holdings below 4.9%. Under the Unocal standard for evaluating takeover defenses, Delaware courts determine if a board's actions were "reasonable in relation to the threat posed". Selectica may have enhanced its position that it acted reasonably by opting for the less dilutive remedy.

Companies should review the remedies in their rights plans to ensure that they specifically address the purposes of the plans. Boards must carefully consider the pros and cons of each remedy in light of prevailing circumstances.

CONCLUSION

The Selectica case suggests that the role of rights plans may be shifting from pure deterrence to deterrence and countermeasure. Companies should consider the following actions in light of this change:

- Developing appropriate procedures to implement the defensive features of their poison pills to eliminate any disruptions in operations or trading;

- Adopting and publishing pre-trigger waiver procedures; and

- Ensuring that their rights plans provide the appropriate set of remedies.

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NEW YORK
Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
212.474.1000

LONDON
CityPoint
One Ropemaker Street
London EC2Y 9HR
+44.20.7453.1000

www.cravath.com

Director Fiduciary Duties in the Vicinity of Insolvency under Delaware Law

April 6, 2009

Under Delaware law directors of a Delaware corporation are not permitted to use their position of trust and confidence to further their private interests and, while technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. An influential 1991 decision by the Delaware Chancery Court generated considerable confusion over whether this fiduciary relationship extends to creditors when a corporation is operating in the "vicinity" of insolvency.[1] In a series of cases beginning in 2004, the Delaware courts have largely eliminated this confusion, holding that directors of an insolvent corporation or a corporation in the vicinity (or zone) of insolvency have the same fiduciary duties as directors of a solvent corporation.

FIDUCIARY DUTIES OF DIRECTORS GENERALLY

The General Corporation Law of the State of Delaware (DGCL) states that, unless otherwise provided in the corporate charter, the business and affairs of a corporation are to be managed by or under the direction of the board of directors. In carrying out such managerial role, a director stands in a fiduciary relation to the corporation. If a director's acts are challenged, they are tested by rules that demand "the most scrupulous observance of his [or her] duty, not only affirmatively to protect the interests of the corporation committed to his [or her] charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his [or her] skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers".[2] A director's fiduciary duties include the "duty of care" and the "duty of loyalty", as well as the obligation to "act in good faith".

Duty of Care

The duty of care requires that directors use that amount of care that an ordinarily careful and prudent person would use in similar circumstances and consider all material information reasonably available in making business decisions. The standard does not require that a director by necessity behave conservatively in management of the business and affairs of the corporation. Rather, a director must behave with at least the same degree of care that he or she would use in managing his or her own property.

Duty of Loyalty

The duty of loyalty requires that the directors act in good faith and in the reasonable belief that the action taken is in, or not opposed to, the best interest of the corporation. It is best characterized as a duty of disinterestedness, that is, that the directors put the corporation's interests ahead of any self-interest. Consequently, the directors are prohibited from engaging in self-dealing or similar conduct, including misappropriation of a corporate opportunity, taking excessive compensation and using corporate assets or information for personal gain. The duty of loyalty directors owe to the corporation and thus indirectly to the stockholders does not require that the directors cede their independent judgment to the stockholders.

Duty to Act in Good Faith

While the obligation to act in "good faith" is less clearly defined than the fiduciary duties of care and loyalty, it may be appropriately described as a requirement that the actions of directors be consistent with an awareness of their duties of care and loyalty. As described by the Delaware Supreme Court, although the obligation to act in good faith "may be described colloquially as part of a 'triad' of fiduciary duties that includes the duties of care and loyalty, the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty".[3]

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[1] *Credit Lyonnais Bank Nederland, N.V. v. MGM-Pathe Communications Co.*, 1991 Del. Ch. LEXIS 215, 1991 WL 277613 (Del. Ch. 1991).

[2] *Guth v Loft, Inc.*, 5 A.2d 503, 510 (Del. Ch. 1939), *aff'd*, 19 A.2d 721 (Del. Ch. 1941).

[3] *Stone v. Ritter*, 911 A.2d 362, 370 (Del. Sup. Ct. 2006).

Nevertheless, failure to act in good faith may result in the violation of a fiduciary duty because the requirement to act in good faith is a subsidiary element of the fiduciary duty of loyalty. Consequently, a violation of the duty of loyalty may be found not only where a conflict of interest is discovered, but also where a director has failed to act in good faith. The Delaware courts have made clear that "bad faith" (while not necessarily the same as a "failure to act in good faith") will be found if a director "intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his [or her] duties".[4]

Claim for Breach of Fiduciary Duty

Generally, a breach of fiduciary duty claim that alleges mismanagement of the corporation may be brought by a stockholder only as a derivative claim. A derivative claim is brought against the corporation to require the corporation to bring a claim against breaching directors. The corporation, not the suing stockholder, is entitled to any recovery, because the actionable conduct and injury is the harm to the corporation. The stockholder's injury is purely derivative, in that the corporation has lost value, and the loss indirectly affects the value of the ownership interests of all the stockholders collectively.

THE BUSINESS JUDGMENT RULE

To promote the full and free exercise of the directors' managerial power and to protect directors from courts' second-guessing their decisions with the benefit of hindsight, the Delaware courts have established a procedural rule known as "the business judgment rule". The business judgment rule "is a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the corporation".[5]

A plaintiff challenging a director's business decision may bring a derivative action against the director only if the plaintiff can rebut the presumption by establishing, for example, that the director had a conflict of interest or lacked independence relative to the contested transaction, acted in a manner that cannot be attributed to any rational business purpose or reached the decision by a grossly negligent process (including not considering all material facts reasonably available) or the decision is so irrational as to show that the decision was not made in good faith.[6] A court will not substitute its judgment for that of the directors unless the plaintiff rebuts the presumption.

FIDUCIARY DUTIES OF DIRECTORS IN THE "VICINITY" (OR ZONE) OF INSOLVENCY

Although the DGCL does not define insolvency, Delaware case law has indicated that insolvency may be demonstrated by either showing (1) "a deficiency of assets below liabilities with no reasonable prospect that the business can be successfully continued in the face thereof", or (2) "an inability to meet maturing obligations as they fall due in the ordinary course of business".[7] Significantly more imprecise and hard-to-define is the concept of the vicinity (or zone) of insolvency, first introduced by the Delaware Chancery Court in *Credit Lyonnais*, the presence of which will likely be indeterminate until after a corporation has become insolvent.

Credit Lyonnais

In *Credit Lyonnais*, stockholders sued the directors, arguing that the directors owed their fiduciary duty to the stockholders and should have made decisions that were directly in the stockholders' interest, despite the corporation's distressed financial condition. In ruling for the directors, the Delaware Chancery Court noted in passing that "at least where a corporation is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty

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[4] *In re The Walt Disney Company Derivative Litigation*, 906 A.2d 27, 67 (Del. Sup. Ct. 2006).

[5] *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. Sup. Ct. 1984).

[6] *See Walt Disney*, 906 A.2d 27.

[7] *Prod. Res. Group L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 782 (Del. Ch. 2004) (quoting *Siple v. S & K Plumbing & Heating, Inc.*, 1982 Del. Ch. LEXIS 553, 1982 WL 8789, at *2 (Del. Ch. Apr. 13, 1982)).

to the corporate enterprise".[8] Although the statement was unremarkable as a description of Delaware corporate law, it fostered the widely accepted theory that when a corporation was in the vicinity of insolvency, directors' fiduciary duties shifted from the stockholders to the creditors, and the directors were required to balance the interests of stockholders and those of creditors. It also became the source of much confusion, including:

- how to determine when a corporation enters the so-called vicinity of insolvency,
- whether any shift in duties is gradual or abrupt,
- what, if any, balance directors must achieve in fulfilling their fiduciary duties to creditors and to stockholders when a corporation is insolvent or nearly insolvent,
- which creditors directors must serve if there are several groups of creditors, or how directors must behave if creditors are in disagreement,
- whether the business judgment rule would protect a director charged by a creditor with breach of fiduciary duty when a corporation was insolvent or nearly insolvent, and
- whether an exculpatory charter provision eliminating or limiting the personal liability of a director to a Delaware corporation for a breach of the duty of care would apply equally to a claim brought by a creditor.

These issues and others forced directors of a Delaware corporation to engage in considerable guesswork when attempting to characterize the state of financial distress of a corporation or the relative weight to be afforded to creditors' interests when making business decisions.

Delaware Case Law Following *Credit Lyonnais*

Recognizing the significant confusion caused by *Credit Lyonnais*, Delaware courts have since clarified directors' duties when a corporation is insolvent or nearly so.[9] Beginning in 2004, a series of Delaware cases repudiated the idea of any shifting duty and limited greatly creditors' ability to bring a claim for a director's breach of fiduciary duties.

- **A creditor breach of duty claim is only derivative**.[10] First, the Delaware Chancery Court held that a claim by a creditor against an insolvent corporation's director for breach of fiduciary duty due to mismanagement of the corporation is a derivative claim, in the sense that it involves an injury to the corporation as an entity, and any harm to the stockholders and creditors is purely derivative of the direct financial harm to the corporation itself. When a corporation has reached the point of insolvency, the directors continue to owe a duty to exercise their business judgment in the interests of the corporation but the creditors, as the residual risk bearers, replace the stockholders as the constituency for whose benefit the directors are pursuing such goal. The "fact that the corporation has become insolvent does not turn such claims into direct creditor claims, it simply provides creditors with standing to assert those claims".[11] At all times, claims of this kind belong to the corporation itself, because even if the improper acts occur when the corporation is insolvent, the acts operate to injure the corporation in the first instance by reducing its value, injuring creditors only indirectly by diminishing the value of the corporation and therefore the assets from which the creditors may satisfy their claims.

- **Creditors may assert a derivative breach of duty claim only when the corporation is actually insolvent**.[12] The Delaware Supreme Court went further and held that creditors may not assert a derivative breach of duty claim when the corporation is only in the so-called vicinity of insolvency. The Court noted that if creditors had standing to bring a derivative

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[8] *Credit Lyonnais*, 1991 Del. Ch. LEXIS 215, 1991 WL 277613 at * 108 & 108 n. 55.

[9] *See N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 (Del. Sup. Ct. 2007) ("*NACEPF*"); *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168 (Del. Ch. 2006); *Prod. Res. Group L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004).

[10] *See Production Resources*, 863 A.2d 772.

[11] *Id*. at 776.

[12] *See NACEPF*, 930 A.2d 92.

claim when the corporation was only in the vicinity of insolvency, they would share that standing with stockholders, leading to the possibility of derivative suits by two sets of constituents with divergent conceptions of what is best for the corporation.

- **Creditors, whether a corporation is solvent, nearly insolvent or insolvent, have no right, as a matter of law, to assert direct claims for breach of fiduciary duty against the corporation's directors**.[13] Creditors do not obtain the right to assert a direct breach of fiduciary duty claim against directors, irrespective of whether the corporation is in the vicinity of insolvency or insolvent. Delaware courts have found that it is unnecessary, and would create uncertainty for directors who seek to exercise their business judgment in the best interest of the corporation, to recognize a right for creditors to bring a direct claim against directors. Unlike stockholders, creditors may protect their interests by direct nonfiduciary claims, including such claims as may arise by contract or by fraud and fraudulent conveyance law. "To recognize a new right for creditors to bring direct fiduciary claims against … directors would create a conflict between those directors' duty to maximize the value of the insolvent corporation for the benefit of all those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors. Directors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation".[14]

- **Directors are entitled to the protection of the business judgment rule in defending against a creditor's derivative claim of breach of fiduciary duty**.[15] Consequently, a plaintiff creditor must show that the directors had a conflict of interest or lacked independence relative to the contested transaction, acted in a manner that cannot be attributed to any rational business purpose or reached their decision by a grossly negligent process (including not considering all material facts reasonably available), to get past the business judgment rule and hold a director liable.

- **An exculpatory charter provision applies equally to a creditor's derivative claim against a director of an insolvent corporation for breach of fiduciary duty**.[16] Under DGCL §102(b)(7), a Delaware corporation may adopt a charter provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breaches of the fiduciary duty of care. Such a charter provision protects directors from liability to the corporation, even in a derivative action. The plain terms of DGCL §102(b)(7) apply to all claims belonging to the corporation itself, regardless of whether those claims are asserted derivatively by stockholders or by creditors.

- **A corporation's claim for breach of fiduciary duty vests in the corporation's bankruptcy estate once the corporation files bankruptcy.**[17] At that point, neither stockholders nor creditors may bring such a claim against directors without the bankruptcy court's express approval. As a result, such claims are typically either settled under the Chapter 11 plan or vested in a liquidating trust, but are not pursued by creditors.

- **Delaware law does not recognize a claim for "deepening insolvency" and provides directors nearly complete freedom in operating even while the corporation is insolvent**.[18] Delaware law imposes no absolute obligation on the directors of a corporation that is insolvent to cease operations and to liquidate. Even when the corporation is insolvent, the directors may pursue, in good faith and in the appropriate exercise of their business judgment, strategies to maximize the corporation's value (including good faith risk-taking). This position expresses a societal recognition that an insolvent corporation's creditors, and society as a whole, may benefit if the corporation continues to conduct operations in the hope of turning things around.

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[13] *Id*.

[14] *Id*. at 103.

[15] *See Liquidation Trust v. Fleet Retail Fin. Group* (*In re Hechinger Inv. Co.*), 327 B.R. 537 (D. Del. 2005).

[16] *See Pereira v. Farace*, 413 F.3d 330 (2d Cir. 2005); *see also, Prod. Res. Group L.L.C. v. NCT Group, Inc.*, 863 A.2d 772 (Del. Ch. 2004).

[17] *See Torch Liquidating Trust v. Stockstill*, 2009 WL 456418 (C.A.5 (La.)), 51 Bankr.Ct.Dec. 68.

[18] *See Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 204 (Del. Ch. 2006), *aff'd* "for the reasons assigned by the Court of Chancery", 2007 Del. LEXIS 357 (Del. Sup. Ct. 2007).

CONCLUSION

It is a canon of Delaware law that the directors of a Delaware corporation carry an obligation to act in good faith, with the honest belief that their actions are in the best interest of the corporation, on an informed basis and with due care. Directors of an insolvent corporation or a corporation in the vicinity of insolvency have the same fiduciary duties as the directors of a solvent corporation: the duty of care, the duty of loyalty and the obligation to act in good faith. Directors are not obligated to exercise their duties on behalf of or in favor of any particular constituency or to rebalance the risk profile of their decisions, but rather must exercise their duties in the prudent management of the corporation, which may include risk-taking, just as when the corporation is solvent.

For more information, please feel free to contact:

Richard Levin (212-474-1978, rlevin@cravath.com)
Paul H. Zumbro (212-474-1036, pzumbro@cravath.com)

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New York
Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
212.474.1000

London
CityPoint
One Ropemaker Street
London EC2Y 9HR
+44.20.7453.1000

www.cravath.com

Delaware Supreme Court Reverses Opinion Questioning Conduct of Lyondell Directors

March 26, 2009

In *Lyondell Chemical Company v. Ryan*,[1] the Delaware Supreme Court determined that the directors of Lyondell did not breach their duty of loyalty by failing to act in good faith in conducting the sale of their company and, accordingly, were entitled to the entry of summary judgment in their favor. This decision reversed an earlier decision by Vice Chancellor Noble that denied summary judgment. Without much discussion, the Vice Chancellor found that "the Board's failure to engage in a more proactive sale process may constitute a breach of the good faith component of the duty of loyalty".[2]

The lower court decision raised some concerns that directors might face personal liability for breaches of the duty of loyalty that were not exculpated pursuant to Section 102(b)(7) of the Delaware General Corporation Law, even though they were exculpated from any breach of the duty of care that might be proven by the same underlying fact pattern. The Supreme Court's reversal of that decision is welcome news for directors.

It should be noted at the outset that both decisions arose in the context of a motion for summary judgment by the directors of Lyondell and, accordingly, the courts did not give the benefit of any inferences to the directors. In very simple terms, Lyondell was put into play by a Schedule 13D filing in May 2007; and the Lyondell directors met and decided to take a wait and see approach. In July 2007, Basell AF made an offer to the CEO of Lyondell for an all-cash deal at $40 per share, which was raised to $44-45 and then to $48 over the course of discussions on a single day. Under this revised offer, Lyondell was given one week to negotiate and sign a merger agreement. The Lyondell directors met several times over the course of that week, but for a total of only seven hours. The directors did not seriously press for a higher price or conduct any market check. They approved a merger agreement with relatively customary deal protection. Subsequently, the merger was overwhelmingly approved by the Lyondell stockholders.

The Supreme Court determined that "[a]t most, this record creates a triable issue of fact on the question of whether the directors exercised due care". However, Lyondell's charter includes an exculpatory provision protecting the directors from personal liability for breaches of the duty of care. Therefore, the case focused on whether the directors breached their duty of loyalty, as such a breach may not be exculpated.

The Supreme Court decision discussed three ways in which the trial court's view of the applicable law was mistaken. First, the trial court imposed *Revlon* duties on the directors of Lyondell too early in the process -- before the directors had decided to sell Lyondell, or before the sale had become inevitable. As a result, the trial court inappropriately "focused on the directors' two months of inaction, when it should have focused on the one week during which they considered Basel's offer".

Second, the trial court erroneously concluded that directors must follow one of several courses of action to satisfy their *Revlon* duties -- which according to the trial court should include conducting an auction, conducting a market check or demonstrating an impeccable knowledge of the market. The Supreme Court noted that "[n]o court can tell the directors exactly how to accomplish [their *Revlon* duties], because they will be facing a unique combination of circumstances, many of which will be outside their control".

Finally, the trial court erred by equating "an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith". The Supreme Court, referencing its earlier decisions in *Caremark* and *Stone v. Ritter*, found that a breach of the duty of loyalty requires a showing that the directors "knowingly and completely failed to undertake their responsibilities". The Supreme Court stressed the difference between actions that might constitute a breach of the duty of care and the knowing disregard of duties necessary to establish bad faith and a breach of the duty of loyalty.

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[1] *Lyondell Chemical Company, et al v. Walter E. Ryan, Jr., No. 401, 2008 (Del. March 25, 2009).*

[2] *Walter E. Ryan, Jr. v. Lyondell Chemical Company, et al, C.A. No. 3176-VCN (Del. Ch. July 29, 2008).*

In that regard, it is important to note that neither court determined that the process followed by the Lyondell directors satisfied their duty of care; although the Supreme Court's decision did contain an offhand suggestion that the court would be inclined to find that the record supported *Revlon* compliance. As a result, the Supreme Court's decision should be read more from a perspective of what constitutes bad faith, and not for determining how to satisfy *Revlon* duties.

For more information, please feel free to contact:

Peter S. Wilson (212-474-1767, pwilson@cravath.com)

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New York
Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
212.474.1000

London
CityPoint
One Ropemaker Street
London EC2Y 9HR
+44.20.7453.1000

www.cravath.com

"Can we be forced to unwind our merger?"

March 20, 2009

The recent Whole Foods/Wild Oats antitrust litigation and settlement with the FTC have raised numerous questions for companies considering transactions that raise serious antitrust issues: When is it legal to close? Can we be forced to unwind our merger and "unscramble the eggs"? What does this mean for future deals?

While the risk of being forced to "unscramble the eggs" remains very low, parties to a merger expected to raise antitrust issues nevertheless should keep the possibility in mind when negotiating and closing the transaction.

Background

In February 2007, Whole Foods, the largest premium natural and organic supermarket chain in the United States, and Wild Oats, a competitor, decided to merge. As part of the Hart-Scott-Rodino Antitrust Improvements Act (HSR) review process, the Federal Trade Commission (FTC) initiated an investigation and later filed suit seeking a preliminary injunction to block the merger, arguing that it would be anticompetitive.[1] After discovery and a hearing, the federal district court denied the FTC's motion for a preliminary injunction. Although the FTC appealed the very next day, Whole Foods and Wild Oats closed the transaction ten days later and began to "scramble the eggs".

Nevertheless, the FTC continued its appeal and, almost a year after closing, an appellate court reversed the district court's denial of the preliminary injunction. The appellate court rejected Whole Foods' arguments that the merger was "irreversible" and the FTC's appeal was "moot", and instead ruled that the district court has the power to order remedies despite the merger having already closed. The FTC subsequently sought an order from the district court requiring Whole Foods to suspend further integration and hold and manage the Wild Oats stores separately pending a trial to determine final remedies, which could include divestitures. Recently, the FTC and Whole Foods announced a settlement of the case, under which Whole Foods agreed to divest 32 out of 74 acquired Wild Oats supermarkets and other Wild Oats assets and intellectual property.[2]

When is it legal to close?

Under HSR, which applies to most M&A transactions with a value above $65 million, from a U.S. antitrust perspective the parties are permitted to close a deal upon the expiration of the "waiting period".[3] The waiting period is 30 calendar days from filing (15 for a cash tender offer) unless extended to give the FTC or Department of Justice (DOJ) – whichever is the reviewing agency – time to request additional information from the parties and analyze the merger (a "second request"). If there is a second request, the waiting period expires 30 days (10 days for a cash tender offer) after the parties have substantially complied with it. In other words, it is legal to close a transaction subject to HSR at the conclusion of the waiting period even if the FTC or DOJ have unresolved objections. Of course, if the parties move to close over unresolved objections, the FTC or DOJ likely will file suit to seek a preliminary injunction or temporary restraining order (TRO). And if the FTC or DOJ cannot obtain an injunction or TRO, the parties may then legally close even if there is an appeal. This is what happened in Whole Foods – the FTC sued, its motion for a preliminary injunction was denied and, although the FTC immediately appealed, the parties legally closed the merger.

Can we be forced to unwind our merger and "unscramble the eggs"?

Transactions generally are not exposed to meaningful post-closing unwind risk unless one of the following situations exists (none of which are very common):

- a challenged transaction prevails at the preliminary injunction stage and the parties close before the decisions on the permanent injunction or appeals have run their course – *i.e.*, Whole Foods;

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[1] *FTC v. Whole Foods Market, Inc.*, 502 F. Supp. 2d 1 (D.D.C. 2007); *see also FTC v. Whole Foods Market, Inc.*, 548 F.3d 1028 (D.C. Cir. 2008) and *FTC v. Whole Foods Market, Inc.*, 592 F. Supp. 2d 107 (D.D.C. 2009).

[2] *See* FTC Press Release, *FTC Consent Order Settles Charges That Whole Foods' Acquisition of Rival Wild Oats Was Anticompetitive* (March 6, 2009).

[3] Smaller deals not subject to HSR do not have a waiting period.

- the parties close a transaction with a serious antitrust risk but that was not subject to HSR, typically because its size did not meet the filing threshold; or

- the government or private litigants seek unwind of a transaction as a remedy in a monopolization or other antitrust suit at some point after the transaction has closed.

The government is free to bring an antitrust claim at any time that it determines that a transaction has or may result in a substantial decrease of competition, a monopoly or other violation of antitrust laws. While relatively uncommon, the FTC and DOJ have from time to time mounted successful post-closing challenges to transactions, in some cases requiring divestitures even years after closing. However, after the enactment of the HSR Act, these post-closing challenges became even more uncommon.

Nevertheless, in recent years the government has demonstrated an increased willingness to challenge completed mergers, including under circumstances in which the HSR waiting period had expired and the FTC or DOJ had not attempted to prevent the transactions prior to closing. For example, in 2001 the FTC successfully challenged the acquisition by Chicago Bridge & Iron of its closest and primary competitor seven months after the transaction had closed despite the fact that the FTC had not sought to stop the acquisition during the HSR process.[4] As a result, the acquiror was required to divest all acquired assets over two years after the merger had closed. Similarly, the FTC has also recently mounted successful post-closing challenges to mergers that were not subject to HSR requirements because their small size did not meet the filing threshold. In some cases, the parties have claimed that it is “too late” to unwind the transactions, but courts have not always been receptive to this argument.

While historically the FTC has been more likely to challenge completed mergers than has the DOJ, recent developments suggest that the DOJ may step up its efforts in this area. For example, President Obama’s nominee to head the DOJ’s antitrust unit recently testified at her nomination hearing that she was “absolutely” open to retrospectively studying the effects of approved mergers.[5] There are other signs that antitrust enforcement in mergers may become more rigorous. A federal district court recently granted the FTC a preliminary injunction blocking the proposed merger between CCC Information Services Inc. and Mitchell International Inc. and in doing so implied that the standard applicable to the FTC for obtaining preliminary injunctions is less burdensome than that for the DOJ or private litigants (a position consistent with prior rulings by certain other courts).[6]

What does this mean for future deals?

Because the FTC and DOJ can, and sometimes do, revisit and challenge completed mergers, parties to transactions likely to face significant antitrust scrutiny should be sure to seek advice and proceed with caution when drafting agreements and closing transactions.

The first question often will be whether the merger agreement will contain a closing condition requiring the absence of any pending government litigation (including appeals) seeking to block the transaction. While many agreements have this condition, others do not for entirely valid reasons, and instead simply require the parties to close as long as the waiting period has expired and there is no injunction blocking the deal. For transactions which are likely to receive a second request and be subject to serious scrutiny, parties should carefully consider that without the government litigation condition, closing would be required in the face of litigation and substantial uncertainty. Whether this is a risk worth taking depends on the particular transaction. Similarly, if the parties decide to include this condition, they should consider whether the conditions will require closing in the face of threatened but not yet pending litigation.

It should also be noted that although Whole Foods closed in the face of the FTC’s appeal, under the merger agreement it had the right to refuse to close until the appeal was decided. While this approach is not uncommon in merger agreements which have the government litigation condition, parties should understand that this gives one side the ability to substantially delay closing and create nonconsummation risk even though it is entirely legal to close. This risk is particularly noteworthy during a period of substantial uncertainty in business and financing conditions. Parties may ask themselves whether defeating a preliminary injunction motion alone should be enough to require closing irrespective of whether the government continues its challenge – an approach which has not typically been followed if the government litigation condition is in fact included.

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[4] *In the Matter of Chicago Bridge & Iron Co.*, N.V., FTC Docket No. 9300, Initial Decision at 1 (June 18, 2003).

[5] Rob Cox and Robert Cyran, *Banks Can Live as Walking Dead/Deals Under Review?*, N.Y. Times, at B2 (March 16, 2009), available at http://www.nytimes.com/2009/03/16/business/16views.html?_r=1&scp=1&sq=christine%20varney&st.cse.

[6] *FTC v. CCC Holdings Inc. and Aurora Equity Partners, III L.P.*, Civil Action No. 1:08-cv-02043-RMC (March 9, 2009).

On the other hand, parties may be tempted to go in the other direction and include a condition that even if the preliminary injunction or TRO is denied, the parties are not required to close until the opportunity to file an appeal has expired. On balance, such a provision may introduce a degree of uncertainty which one or both parties would for good reason find unacceptable as a business matter, but nevertheless could be worth considering if the risk is very significant. Similarly, parties should at least think about and seek advice regarding the possibility of private antitrust litigation, even if they ultimately decide, as is often the case, not to address it in the merger agreement. Parties should also keep in mind that negotiations never occur in a vacuum and introducing more consummation risk in the closing conditions could affect the negotiation of the covenants requiring divestitures necessary to obtain HSR clearance or even provisions unrelated to antitrust.

Finally, moving beyond the merger agreement itself, acquirors and merged companies should certainly be mindful of the Whole Foods risk and the possibility of having to "unscramble the eggs" after closing. While delaying integration for a long time will usually be unnecessary and in any event unacceptable, the parties should at least keep the risks in mind as they plan and implement integration. While "scrambling the eggs" cannot be avoided, unscrambling them will be much easier if the possibility was at least considered during integration. Furthermore, some advance planning may prevent a party from being forced to accept some worst case alternative.

Please feel free to contact us if we can provide further information on these matters.

Katherine B. Forrest (212-474-1155, kforrest@cravath.com)
Sarkis Jebejian (212-474-1188, sjebejian@cravath.com)

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New York
Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
212.474.1000

London
CityPoint
One Ropemaker Street
London EC2Y 9HR
+44.20.7453.1000

www.cravath.com

New York Court Dismisses Shareholder Challenges to Bear Stearns' Merger Agreement

December 8, 2008

On December 4, 2008, Justice Herman Cahn of the Supreme Court of the State of New York dismissed shareholder class actions challenging the merger agreement that Bear Stearns Companies Inc. entered into with JPMorgan Chase & Co. (*In re Bear Stearns Litigation*). The plaintiffs claimed that the Bear Stearns' directors violated their fiduciary duties by, among other things, approving certain deal protection provisions of the merger agreement. The Court granted a motion for summary judgment on these claims, finding that the directors' decisions are protected by the business judgment rule. The Court went on to find that "[t]he board's efforts to preserve some shareholder value while averting the uncertainty of a bankruptcy . . . would survive scrutiny even if some enhanced standard of review under Delaware law did apply".

The Bear Stearns' merger agreement with JPMorgan was negotiated and entered into over a weekend at a $2 per share implied price and then subsequently renegotiated over the following week to a $10 per share implied price, in both cases with the participation of the NY Federal Reserve and various other Federal authorities. In the initial transaction, JPMorgan was granted an option to purchase 19.9% of Bear Stearns' stock at $2 per share and an option to purchase Bear Stearns' headquarters building. The merger agreement had a no-shop with a fiduciary out for a "superior proposal". In the revised transaction, JPMorgan purchased 39.5% of Bear Stearns' stock at $10 per share.

Applying Delaware law, the Court briefly reviewed the business judgment rule and the heightened standards of review under *Unocal*, *Blasius* and *Revlon*. The plaintiffs argued that one or more of the heightened standards should apply because of the combined effect of the deal protection provisions granted by the Bear Stearns' directors. The Court determined that there were no facts supporting the application of any of these heightened standards. Nevertheless, the Court went on to determine that the shareholder challenges should be dismissed even if one of these standards applied.

The Court's determination took ample note of the circumstances facing the Bear Stearns' directors, finding that "[i]n response to a sudden and rapidly escalating liquidity crisis, Bear Stearns' directors acted expeditiously to consider the company's limited options. They attempted to salvage some $1.5 billion in shareholder value and averted a bankruptcy that may have returned nothing to the Bear Stearns' shareholders, while wreaking havoc on the financial markets. The Court should not, and will not, second guess their decision".

The Court's decision should give comfort to directors acting in good faith to respond to the current economic environment.

For more information, please feel free to contact:

Peter S. Wilson (212-474-1767, pwilson@cravath.com)

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Beneficial Ownership—
By-law Disclosure Proposal

September 8, 2008

Background

Activist investors often accumulate large, and sometimes dominant, positions in target companies secretly by using total return swaps and other derivatives. Despite legal claims that these derivative holdings are not the same as beneficial ownership—claims being tested in litigation arising from the recent CSX proxy fight—in reality activists demand that targets, and their board of directors, defer to the activists as though they were full owners of the stock represented by the derivatives.

The risks of failing to disclose the accumulation of positions in a timely manner are viewed by many activists as modest when compared to the benefits of the quiet consolidation of leverage over the target. In light of the clear potential for abuse from this tactic, corporate lawyers and their clients have been discussing various proposals to require third parties to disclose in a timely and informative manner (1) beneficial ownership interests that may be held through derivatives and (2) the intentions of the person(s) holding large economic positions (regardless of investment form), together with those acting in concert with them, with respect to any proposed changes in a corporation's management, control or business strategy.

Some corporations have sought protection with a shareholder rights plan incorporating a broader concept of "beneficial ownership" that captures interests held though derivatives. However, this solution is likely to be problematic in many respects, including the difficulty a corporation will face monitoring its rights plan and dealing with inadvertent triggers that may come to light weeks or months after the fact. In addition, we understand ISS/Risk Metrics' policy is to recommend that shareholders withhold their votes with respect to any board of directors that renews or adopts a rights plan without shareholder approval.

Other corporations have adopted by-laws requiring extensive disclosure of derivative positions at the time an activist nominates directors or sponsors a shareholder proposal, but that disclosure can occur months after an activist has built a significant position, depriving the corporation and its shareholders of vital, potentially market-moving information.

By-law Proposal Summary

For corporations that are in a position to consider innovative responses to the threat posed by the stealthy accumulation of a significant or potentially dominant position, we suggest considering an alternative approach of amending advance notice by-laws governing shareholder proposals to include new continuous disclosure obligations that incorporate and expand the existing Exchange Act and related SEC rules relating to disclosure of beneficial ownership interests, including those contained in Rule 13d and Schedule 13D.

A corporation's by-laws would be amended to include the following concepts:

- An expanded definition of "beneficial ownership" expressly capturing derivatives.

- A continuous beneficial ownership interest disclosure obligation with a beneficial ownership disclosure trigger set at 7.5% or 10%. This obligation would be in addition to existing SEC/Exchange Act beneficial ownership disclosure obligations.

- Enhanced documentary disclosure requirements in order for shareholders to validly submit nominations for directors or to put forward any other proposal for consideration at the next annual shareholder meeting (or any special meeting). This would include disclosure of derivative interests of both the shareholder and all others acting in concert with that shareholder or on whose behalf that shareholder is making a nomination or proposal.

- If a shareholder or beneficial owner (together with those acting in concert with or on behalf of them) does not comply with either the continuous or enhanced documentary disclosure obligations in the time period between annual shareholder meetings, then they are ineligible to nominate directors or put any other proposal forward at the next annual shareholder meeting (or any special meeting occurring prior to the next annual meeting).

This kind of by-law would provide a self-help remedy for companies and their shareholders to prevent an activist from secretly accumulating a significant or dominant interest in a corporation without disclosure and then nominating directors or putting a proposal forward to shareholders.

To our knowledge, a by-law incorporating these concepts has not yet been adopted by any corporation.

An upcoming decision of the Second Circuit in the CSX matter may affect the need for a disclosure-based by-law amendment such as that discussed above. In any event, Boards of Directors should carefully weigh the benefits of adopting protections from secret ownership accumulation that may negatively impact shareholder value against the potential that an innovative solution to this problem may attract attention or criticism.

Please feel free to contact us if we can provide further information, or if you would like to receive a draft of the proposed by-law provisions.

Philip A. Gelston (212-474-1548, pgelston@cravath.com)
James C. Woolery (212-474-1912, jwoolery@cravath.com)

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New York
Worldwide Plaza
825 Eighth Avenue
New York, NY 10019-7475
212.474.1000

London
CityPoint
One Ropemaker Street
London EC2Y 9HR
+44.20.7453.1000

www.cravath.com

Marc Firestone
Executive Vice President, Corp. & Legal Affairs & General Counsel

Marc Firestone is Executive Vice President, Corporate & Legal Affairs and General Counsel for Kraft Foods Inc. Marc is responsible for the company's corporate and government affairs, legal and compliance functions worldwide.

Marc previously served as Kraft Foods' Executive Vice President, General Counsel and Corporate Secretary. In that role, he was responsible for the company's legal function worldwide and also served as Corporate Secretary of Kraft Foods Inc.

Prior to joining Altria Group, Inc. (formerly Philip Morris Companies Inc.) in 1988, where he held a number of senior management positions within Legal and Regulatory affairs, Marc was an attorney at Arnold & Porter. In 1993, Marc was named Regional Counsel for Philip Morris Europe, covering Central and Eastern Europe, the Middle East and Africa, based in Switzerland. From 1995 to 1997, Marc was Senior Vice President, Worldwide Regulatory Affairs and Associate General Counsel for Philip Morris Companies in New York.

Marc returned to Switzerland in 1998 as Chief Counsel for Philip Morris Europe. In 2001, he became Senior Vice President and General Counsel for Philip Morris International. Marc joined Kraft Foods in 2003 as Senior Vice President and Associate General Counsel, and later that year was named Senior Vice President and General Counsel.

Marc earned his Bachelor of Arts in Romance Languages and Philosophy from Washington & Lee University and received his Juris Doctor from Tulane University School of Law.

PHILIP A. GELSTON

Philip A. Gelston is a partner in the Cravath, Swaine & Moore LLP Corporate Department and the Chairman of the Firm's Mergers and Acquisitions Practice. Philip has extensive experience in mergers and acquisitions, joint ventures and general corporate counseling. His practice encompasses hostile transactions (both offense and defense), complicated negotiated transactions, cross-border transactions and advising boards and senior executives. Philip's clients have included Ciba Specialty Chemicals; Novartis AG; Kraft Foods, Inc.; White Mountains Insurance Group, Ltd.; OneBeacon Insurance Group, Ltd.; BAE Systems; FPL Group; Kerzner International; the independent directors of General Motors; the independent directors of Fannie Mae; British American Tobacco; The Tengelmann Group and London Stock Exchange Group, plc.

Philip's recent assignments include representing Kraft in its successful bid for Cadbury and the sale of its frozen pizza business to Nestlé, the independent directors of General Motors in connection with the financial and operational restructuring of GM as well as in connection with the conversion of GMAC into a bank holding company; White Mountains Insurance in its disposition of two run-off business to Berkshire Hathaway through a tax free "cash rich" split off; Kraft in the tax free disposition of its Post cereal business to Ralcorp and its negotiations with Trian; Applebee's International, Inc. in its proxy fight with Breeden Partners and its sale to IHOP; Novartis AG in the sale of Gerber to Nestlé; BAE Systems in its acquisition of Armor Holdings and Tengelmann in A&P's purchase of Pathmark Stores. He also represented the LSE concerning the United States aspects of the Nasdaq takeover bid; GTECH Corp.'s independent directors in the merger with Lottomatica and the Special Committee of Kerzner International in the buyout of Kerzner. Other representative assignments include advising B.A.T plc and Brown & Williamson in the combination of Brown & Williamson with RJR; White Mountains Insurance Group, Ltd. in its acquisition of CGU Corp., its restructuring of certain insurance operations with Liberty Mutual and its acquisitions of Sirius Reinsurance and Safeco Life; IGEN International Inc. in its acquisition by Hoffman La Roche, BAE Systems in its acquisitions of United Defense and the AES Business of Lockheed Martin as well as in the examination of a number of other strategic transactions; Financial Security Assurance Holdings

Ltd. in its sale to Dexia S.A. and White Mountains Insurance in its redomestication to Bermuda.

Philip has also advised boards and senior management of clients, such as White Mountains, General Motors, Kraft, OneBeacon, FPL Group, Fannie Mae and Kerzner on governance and takeover defense issues.

Philip was cited as being one of the country's leading practitioners in the mergers and acquisitions area in *Chambers USA: America's Leading Lawyers for Business* in 2008 and 2009. He was also named *The Best Lawyers in America* in 2009 and 2010 as a leader in mergers and acquisitions law. In addition, Cravath's mergers and acquisitions practice received a high ranking in the publication for being "knowledgeable and responsive, with excellent levels of service".

Philip was born in New York, New York. He received an A.B. *cum laude* from Harvard College in 1974, where he was elected to Phi Beta Kappa, and a J.D. *magna cum laude* from Harvard Law School in 1977, where he was the Supreme Court Note Editor of the Law Review and awarded the Sears Prize. After a one-year clerkship with Hon. John M. Wisdom (U.S. Court of Appeals for the Fifth Circuit), he joined Cravath, Swaine & Moore in 1978. Philip became a partner in 1984.

Philip may be reached by phone at 212-474-1548 or by email at pgelston@cravath.com.

GARY JAY KUSHNER

Partner, Washington, D.C.

PHONE +1.202.637.5856

FAX +1.202.637.5910 gjkushner@hhlaw.com

HOGAN & HARTSON

Gary Jay Kushner has been a food industry lawyer for more than 30 years.

He represents trade associations and corporations before government agencies, Congressional committees, and the courts in a variety of matters. Gary has particular experience with the development, interpretation, and enforcement of laws and regulations governing food production, processing, and distribution throughout the United States and internationally. He also serves as general counsel to a number of national associations.

As counsel to trade associations and companies involved in the public policy arena, Gary analyzes legislation introduced in Congress and state legislatures, as well as regulations proposed by the U.S. Department of Agriculture, the Food and Drug Administration, and other federal and state government agencies. He routinely evaluates their impact on the food industry from farm to table, and prepares amendments, testimony, and comments on such initiatives. He anticipates how laws and regulations might be changed to facilitate the marketing of food products.

Gary also represents food companies including manufacturers, distributors, and retailers in matters involving regulatory compliance. He advises them on labeling and advertising regulation; counsels them in product recalls, seizures, detention, government inspections, and related actions; and represents them in enforcement actions before government agencies and law enforcement bodies.

Before joining Hogan & Hartson, Gary served as Vice President and General Counsel for the American Meat Institute where he directed the organization's legal, regulatory, and legislative activities. Before first entering the private practice of law, he served as Staff Counsel for Scientific Affairs at the Grocery Manufacturers of America. He began his legal career as a law clerk to The Honorable John R. Hess in the Superior Court for the District of Columbia.

Gary is a frequent lecturer and regularly contributes to numerous trade publications. He is co-author of A *Guide to Federal Food Labeling Requirements*, prepared for the U.S. Department of Agriculture and the U.S. Department of Health and Human Services, Government Printing Office, Washington, D.C., 1990; *HACCP Management Manual: A Guide to Food Regulatory Compliance*, published by Food Chemical News, Washington, D.C., 1996; and *Summary of Law on Warranties and Disclaimers in the Sale of Seed*, published by the American Seed Trade Association, Washington, D.C., 1996.

HOGAN & HARTSON PUBLICATIONS

"China Issues Draft Regulations for Licensing of Imported Food and Food-Related Products and Materials." *Food and Agriculture Alert,* Hogan & Hartson LLP (06.24.2009)

PRACTICES/INDUSTRIES

Food and Agriculture
Food, Drug, Medical Device, and Agriculture
Legislative
Life Sciences
Intellectual Property
International Trade
Customs and U.S. Homeland Security
Trade Legislation and Policy

EDUCATION

J.D., Georgetown University Law Center, 1975
A.B., *with distinction*, University of Michigan, 1972

BAR ADMISSIONS

District of Columbia
Maryland

COURT ADMISSIONS

District of Columbia Court of Appeals
Maryland Court of Appeals
U.S. Court of Appeals, District of Columbia Circuit
U.S. Court of Appeals, Federal Circuit
U.S. Court of Appeals, Second Circuit
U.S. Court of Appeals, Fifth Circuit
U.S. Court of Appeals, Eighth Circuit
U.S. Court of Appeals, Ninth Circuit
U.S. Court of Appeals, Eleventh Circuit
U.S. Court of International Trade
U.S. District Court, District of Columbia
U.S. Supreme Court

Dean N. Panos is a partner in the Firm's Litigation Department. He is Co-Chair of Products Liability and Mass Tort Defense Practice and a member of the Complex Commercial Litigation, Class Action, and Real Estate and Construction Litigation Practices. He is also a member of the Firm's Management Committee. Mr. Panos is AV Peer Review Rated, Martindale-Hubbell's highest peer recognition for ethical standards and legal ability.

Mr. Panos represents Fortune 500 companies and other public and private companies in complex commercial litigation across the country in both state and federal courts. He currently is representing a public REIT in security and ERISA class actions involving hundreds of millions of dollars in claims. He is also currently representing the City of Chicago in litigation brought by the City to recover damages from its architects, design engineers, and building contractors concerning the rehabilitation of the terminals at O'Hare Airport (FACE Project). Mr. Panos had lead trial responsibility on behalf of the City of Chicago in successfully defeating the attempt by DuPage County and communities surrounding O'Hare Airport to enjoin the City from proceeding with its multi-billion dollar expansion of O'Hare, known as World Gateway. On behalf of the City, Mr. Panos also defeated DuPage County's and surrounding communities' attempts to enjoin the City from acquiring land around O'Hare Airport for the construction of additional runways.

Recently, Mr. Panos represented American Airlines in litigation in New York, against Airbus Industries, involving $1 billion in cross-claims arising from the November 2001 aviation disaster known as *In Re Belle Harbor - AA Flight # 587*, which was successfully settled in June 2008.

Mr. Panos is lead litigation counsel to food and consumer product manufacturers on a number of complex commercial litigation matters, class action claims of consumer fraud and deceptive practices and product liability, including high profile national class action claims for deceptive advertising and child obesity. Mr. Panos has also served as lead counsel on several consumer and food product recalls and has substantial experience in counseling clients on recall implementation and coordination with the Food and Drug Administration, the U.S. Consumer Product Safety Commission and the U.S. Department of Agriculture.

MAYER • BROWN

Thomas M. Durkin
Partner
tdurkin@mayerbrown.com

Chicago
Ph: +1 312 701 7997
Fax: +1 312 706 8621

Experience
An experienced litigator, Tom Durkin has tried over 55 federal and state jury trials to verdict. Much of his trial work focuses on patent litigation along with product liability and medical device defense. He has tried patent infringement cases before juries, courts and arbitration panels, and argued before the Federal Circuit. Representative clients in patent cases include Abbott, Baxter and Brunswick. Reflecting the full range of his trial practice, *Chambers USA* 2007 calls Tom a "'seasoned trial lawyer' with 'the ability to master really complex science.'"

In addition to commercial and business litigation, Tom also handles a wide variety of white collar criminal matters, especially in the fraud, tax, and public corruption areas. *Chambers* 2006 has said of Tom that "...[his] trial strength is well documented...Clients commented on his 'strong practical abilities and easygoing manner,'" and earlier complimented him on his "thriving federal criminal litigation practice" *Chambers USA* 2004-2005.

In related compliance counseling, Tom conducts internal investigations of corporate clients involving various fraud allegations and compliance with the Foreign Corrupt Practices Act. He uses this experience to provide review and counseling related to corporate compliance programs.

Clients benefit from the significant prosecutorial experience that Tom had before joining Mayer Brown in 1993. He served as Assistant US Attorney in the Northern District of Illinois from 1980 to 1993, during which time he held positions as First Assistant US Attorney, Chief of the Special Prosecutions Division, Chief of the Criminal Receiving & Appellate Division, and Deputy Chief of the Special Prosecutions Division. During his time with the US Attorney's office Tom received the Excellence in Law Enforcement Award by the Chicagoland Chamber of Commerce (1993) and the Attorney General's John Marshall Award from Attorney General Thornburgh (1991).

Education
DePaul University College of Law, JD, with honors, 1978; Illinois Law Issue Editor, Law Review • University of Illinois, BS, with honors, 1975 • Certified Public Accountant, Illinois, 1975