HERSHEY

THE HERSHEY COMPANY

Key Issues Facing General Counsel in the New Global Realities

Leslie M. Turner, SVP, General Counsel and Secretary, The Hershey Company

October 20, 2015

- *Founded in 1894, HERSHEY is the largest producer of quality chocolate in North American and a global leader in chocolate and sugar confectionery*
- *Headquartered in Hershey, Pennsylvania, focused on growing our presence in key international markets such as Mexico, Brazil, China and India.*
- *$7.4 billion in annual revenue*
- *Ranks No. 366 on the Fortune 500 rankings; one of 57 original Fortune 500 companies to make the list every year since 1955*
- *Hershey products sold in 70+ countries across the globe*

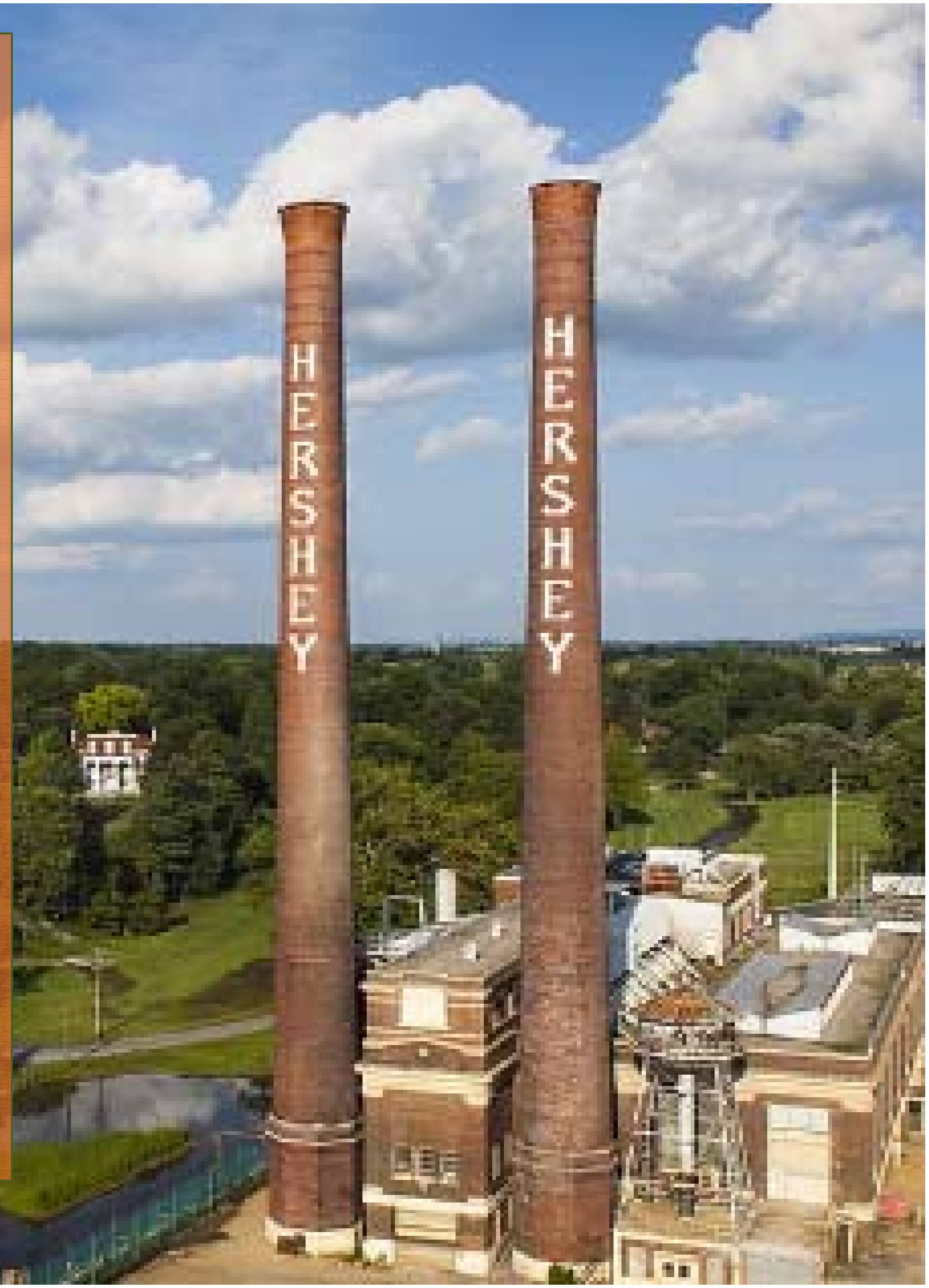
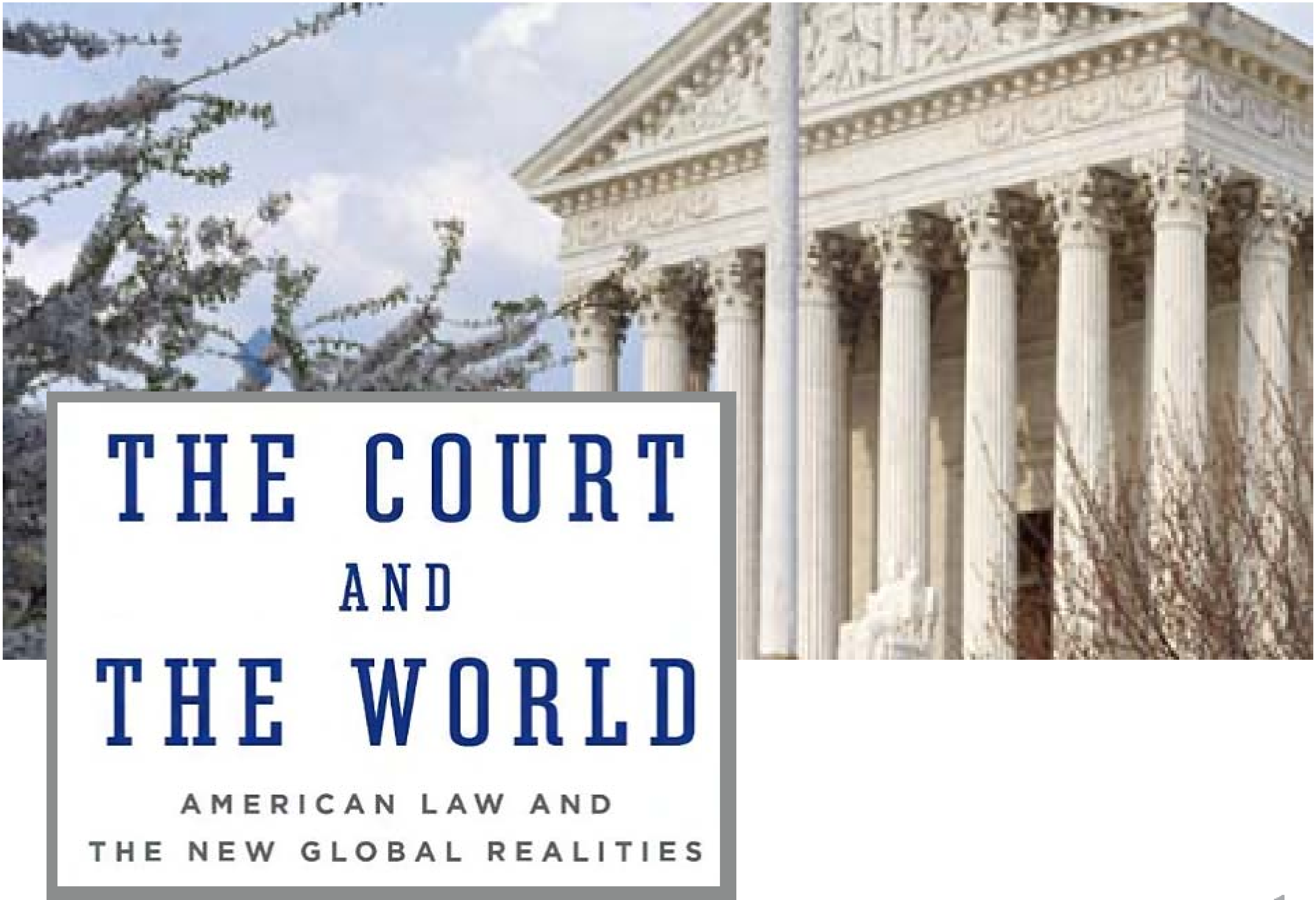


Photo Source: Pennlive.com

Iconic Brands

There are more than 80 brands in the Hershey portfolio, including iconic favorites such as:

Hershey's Global Presence



Supreme Court Photo Source: http://www.supremecourt.gov

‘The Court and World’ is about more than the role of citing foreign law in the Court’s decisions . . . .

“It is the liberal Breyer’s third book trying to explain his view of how Supreme Court justices should decide cases and a gloved rebuke of conservative colleagues who disagree with him.”

Robert Barnes, 9/25/15

The Washington Post

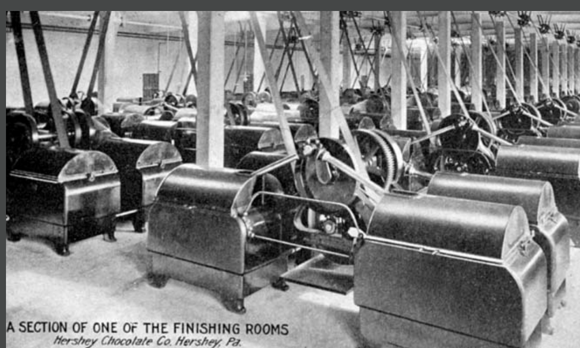
In [his] new book, liberal justice Stephen G. Breyer says conservative criticism of foreign references is “beside the point.”

Photo Source: http://www.cnn.com/2015/06/29/politics/scotus-death-penalty-justice-scalia-breyer/

It demonstrates the need for a proper judicial response to Global Interconnectedness and how the Court has analyzed foreign laws

Source: images from ‘127 Hours’ (opening credits), Fox Searchlights 2010 (Danny Boyle, director)

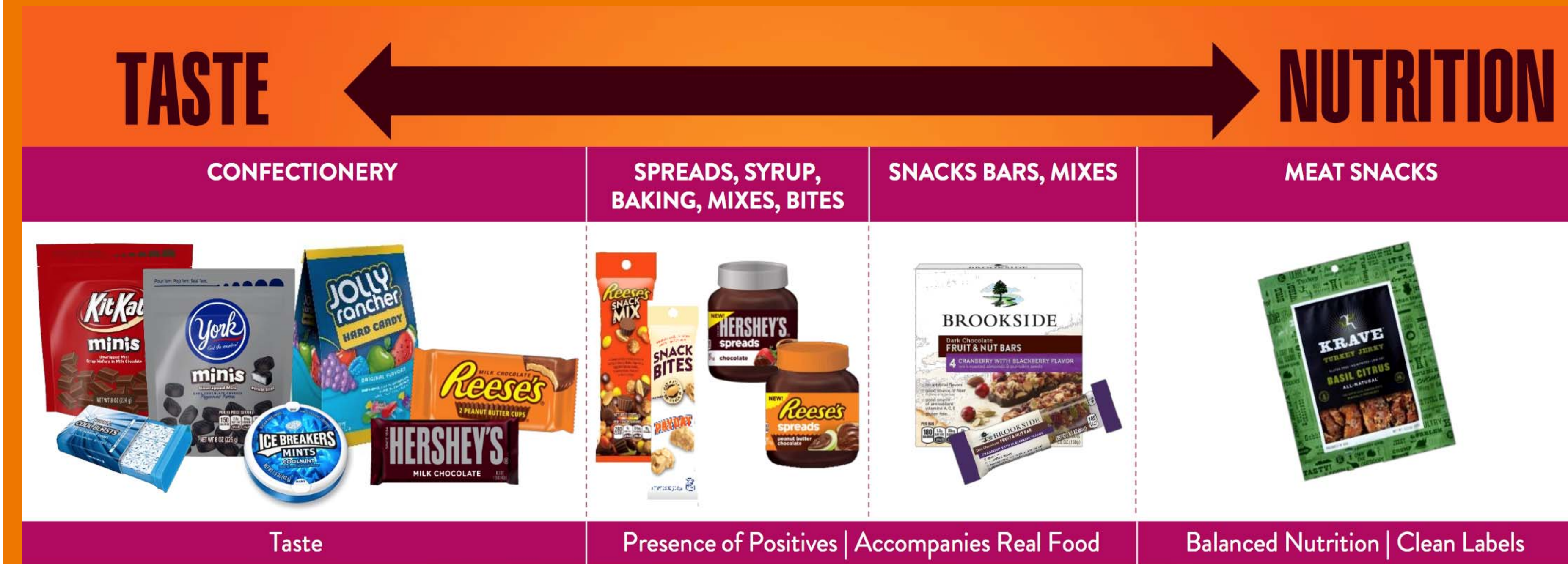
Production commences at Hershey's Plant, June 1905



Ford Model 'T' first produced October, 1908

One Size Does not fit all . . . . .

People are moving away from set meals towards snacking and need more nutrition from their snacks. . . .



Volkswagen is now beset by multiple investigations and shareholder claims all over the world

BBC

October 12, 2015:

"Volkswagen questioned by Parliament"

THE WALL STREET JOURNAL.

October 16, 2015

"U.S. pursues several paths in Volkswagen probe"

Le Monde

October 19, 2015

"French headquarters of Volkswagen raided"

FORTUNE

September 30, 2015

"Investors are suing Volkswagen over its stock drop"

Regulatory – Consumer shifts are accelerating change in our packaging and how we communicate information

2014 | Facts Up Front

2015 | Simple Ingredients

SIMPLE INGREDIENTS. SIMPLY DELICIOUS.

2016 | Smartlabel

smartlabel

2017 | ?

Cyber – the new reality with enterprise level risk

Compliance – In 2015 Hershey makes its first appearance on the World's Most Ethical Companies list

M&A: Can’t Live With It, Can’t Live Without It

Harvard Business Review

“[C]ompanies spend more than $2 trillion on acquisitions every year. Yet study after study puts the failure rate of mergers and acquisitions somewhere between 70% and 90%”

“Almost nobody understands how to identify targets that could transform a company, how much to pay for them, and how to integrate them . . . .”

Source: https://hbr.org/2011/03/the-big-idea-the-new-ma-playbook

Hershey's CSR Framework: *Shared Goodness*

SHARED
GOODNESS

Good business. Better life. Bright future.

Current UBS Campaign:

Can I truly make a difference?

Should I invest in the world I'm in? Or the one I want?

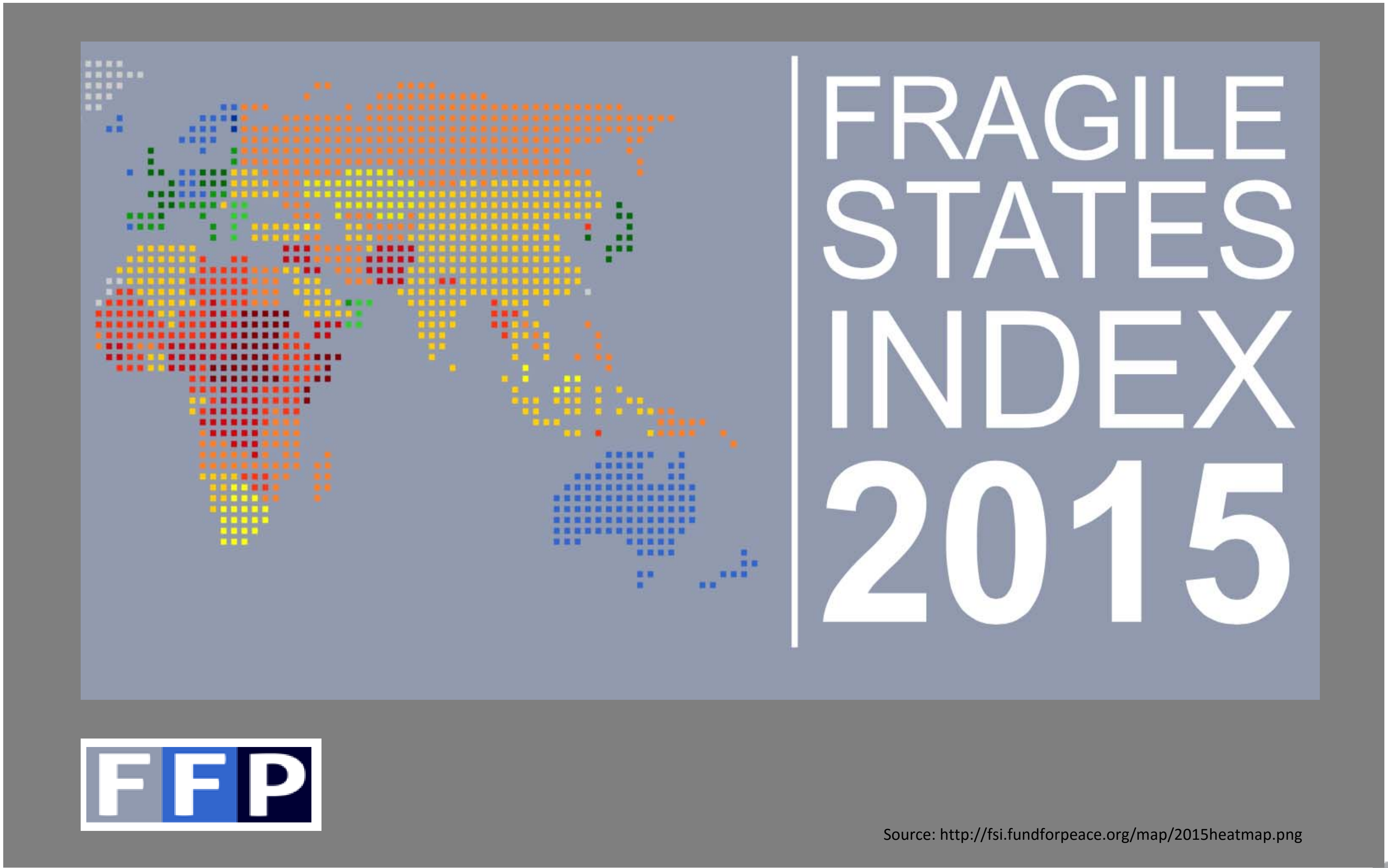
We think it's possible to do good and still do well. Together we can explore new and innovative ways of creating lasting positive change.

This could include sustainably invested portfolios that upload your values while seeking to grow your assets. The right investments can help make a difference on the environment and society.

Source: https://www.ubs.com/microsites/together/en/can-i-truly-make-a-difference.html

Don’t be the next Volkswagen . . . .

With increasingly fragile markets, questions over the reach of the War Powers and the Alien Tort Statute become increasingly important



Source: http://fsi.fundforpeace.org/map/2015heatmap.png

Thank You!

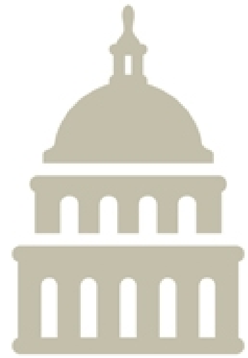
Akin Gump
STRAUSS HAUER & FELD LLP

Client Alert

August 21, 2015

If you read one thing…

- A crowded field of presidential candidates advances many competing tax plans, with many specific details yet to come
- A consensus on the need for comprehensive reform has developed on both sides of the aisle, but disagreements over which tax rates to change and how to allocate revenue remain.



The Developing 2017 Tax Agenda: The Tax Plans of Presidential Candidates

With Gov. John Kasich (R-OH) officially in the race for President, the total number of Republican candidates for President stands at 17, while Democrats, led by former Secretary of State Hillary Clinton (D-NY), total five. This crowded field of presidential candidates has produced a wide variety of tax policy positions and plans for tax reform as evidenced in the Democratic and Republican candidate breakdown. While almost every candidate has acknowledged the need for tax reform, many have been slow to disclose the specifics of their reform proposals. Nonetheless, general themes are taking shape, with Republicans favoring lower rates overall and Democrats seeking to ease the tax burden on middle-class taxpayers. Candidates in both parties seem focused on the need for stimulating economic growth.

Republican Field

A number of Republican candidates favor some version of a “flat” tax rate on personal income, with proposals ranging from 10 to 15 percent based on income levels. Sen. Marco Rubio’s (R-FL) proposal would implement a 15 percent rate on middle-class earners, with a rate of 35 percent for higher-income taxpayers. Similarly, Sen. Rand Paul (R-KY) has proposed a 14.5 percent “Flat and Fair” tax rate that would apply to all earners and businesses, with the first $50,000 of family income untaxed. Sen. Ted Cruz (R-TX) has said that he supports a flat tax, but he has not provided details as to a specific rate level. Neurosurgeon Ben Carson (R-MD) has proposed a flat tax rate of 10 percent.

Another priority for Republican candidates appears to be lowering the corporate tax rate to encourage investment in the United States and the repatriation of foreign earnings. Proposals by Sen. Rubio and Gov. Chris Christie (R-NJ) would reduce the maximum corporate rate to 25 percent, while former Gov. Rick Perry (R-TX) has proposed a 20 percent rate. Other candidates support lowering the corporate rate but have not given a specific tax level. As stated above, Sen. Paul's plan would apply a 14.5 percent rate to businesses, as well as individuals.

The candidates generally agree that taxes on capital gains and dividends should be lowered or eliminated. In addition, many proposals assert that any revenue loss from reducing tax rates should be offset by restricting or eliminating various tax deductions, with the exception of charitable donations and mortgage interest.

While candidates have stated that their proposals would result in either revenue increases or at least no increase in the federal deficit, none of the plans to date has been scored by the Congressional Budget Office or Joint Committee on Taxation, who are the official budget and revenue scorekeepers for Congress. However, Sen. Paul's tax plan was analyzed by the Tax Foundation, which concluded that it would "grow the economy by 9.4 percent in the long run, create 1.4 million jobs, and cost $2.97 trillion over ten years on a static basis and $960 billion when accounting for economic growth".[1] The Tax Policy Center declined to do a full analysis of the Paul plan until more details are disclosed, but did comment that Sen. Paul's plan would likely result in dramatically reduced revenue for entitlement programs, such as Social Security and Medicare.[2] Senator Lindsey Graham (R-SC) has said that he supports the Simpson-Bowles budget plan, which would lower individual and corporate rates and broaden the tax base. Of the 17 Republican Presidential candidates, only Gov. Bush (R-FL), Gov. Pataki (R-NY), Gov. Gilmore (R-VA) and Mr. Trump (R-NY) have not signed the Americans for Tax Reform Taxpayer Protection Pledge, by which candidates pledge not to support any tax increase.

During the Republican presidential debates on August 6, candidates were not asked many questions about tax policy and therefore did not elaborate on their tax policy positions. However, two candidates, former Gov. Mike Huckabee (R-AR) and Dr. Carson, did express support for the Fair and Flat tax plans as a way to simplify the tax code. Dr. Carson described his 10 percent flat tax rate as a form of "tithe" for all earners, regardless of income level. Gov. Bush and current Gov. Scott Walker (R-WI), as well as Gov. Kasich, touted various reductions in state taxes enacted in their respective states. Several of the other candidates pledged to lower corporate tax rates as a means to stimulate economic growth.

Democratic Field

Secretary Clinton remains the front-runner of the Democratic field. While she has not released a specific tax plan, Secretary Clinton has expressed support for lowering the tax burden on middle-class taxpayers. In addition, Secretary Clinton has indicated that, if elected, she would close several business tax "loopholes", including the current tax treatment of carried interest. Secretary Clinton has also stated that she opposes the current tax incentives for oil and gas companies and would seek to end them. That said,

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[1] "The Economic Effects of Rand Paul's Tax Reform Plan," by Andrew Lundeen, Michael Schuyler, Tax Foundation, available at http://taxfoundation.org/blog/economic-effects-rand-paul-s-tax-reform-plan

[2] "Rand Paul's Tax Cut Isn't Quite What It Seems," Forbes, available at http://www.forbes.com/fdc/welcome_mjx.shtml

she has expressed support for implementing tax incentives to encourage profit-sharing between businesses and their employees and has proposed a $1,500 tax credit for businesses that hire apprentices. Recently, Secretary Clinton proposed a comprehensive college affordability plan, financed by a 28 percent cap on itemized deductions similar to the budget proposal advanced by President Obama.

Sen. Bernie Sanders (I-VT) appears to be narrowing the gap with Secretary Clinton in several national and state-specific polls. With respect to Sen. Sanders' tax policy positions, he has proposed to increase and restructure the estate tax, beginning with a 45 percent rate on estates worth up to $7 million, a 50 percent rate on those worth $7 million to $10 million and a 55 percent rate on those worth $10 million to $50 million. In addition, Sen. Sanders has expressed support for an additional 10 percent surtax on estates valued at more than $1 billion. Sen. Sanders has also sponsored legislation that would change the current tax rules for corporate inversions and earnings stripping by foreign companies, and another bill that would prohibit U.S. corporations from deferring federal income taxes on profits of offshore subsidiaries. Like Secretary Clinton, Sen. Sanders opposes current tax incentives for the oil and gas industry.

Other Democratic presidential candidates, such as former Maryland Gov. Martin O'Malley (D-MD) and former Sens. Jim Webb (D-VA) and Lincoln Chafee (D-RI), have all expressed support for lowering individual tax rates generally while not advancing any specific tax plans. The one exception was an open letter written by Gov. O'Malley to the financial sector on July 9, 2015, outlining steps that he would take to prevent another major banking crisis. In that letter, he proposes a tax on financial instruments to discourage high-frequency trading and a separate financial transaction tax to discourage speculation.

Outlook: The Developing 2017 Tax Agendae

At this stage, the field of presidential candidates in both parties is quite diverse and unsettled—as is the eventual tax agenda for 2017 after the election of a new President in November 2016. Obviously, the congressional elections in November 2016 will also have a significant bearing on the specific issues that eventually comprise the tax agenda in the new Congress. Understandably, most candidates have not provided many specifics of their tax reform plans, but a general consensus for comprehensive tax reform appears to be developing on both sides of the aisle. However, the devil is always in the details, and "tax reform" means many different things to many different candidates. At this point, the developing consensus appears to be one of theoretical agreement that the current tax system is broken—measured by its complexity, inefficiency and policy sclerosis. We will be tracking developments among these presidential candidates and will be reporting on any that may have a significant bearing on the 2017 tax agenda and the prospects for comprehensive tax reform.

For more information, please review the charts summarizing Democratic and Republican presidential candidates' public tax positions.

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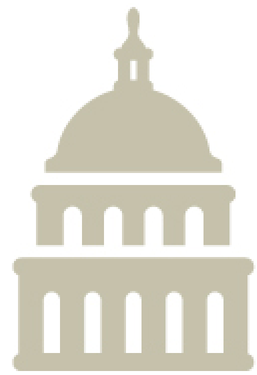
Tax Alert

September 9, 2015

If you read one thing...

- Congress' tax and budget challenges include funding the government for FY 2016 and a required federal debt ceiling increase to avoid catastrophic default on the nation's debt. These legislative challenges echo the 2012-2013 "fiscal cliff" debate—only resolved through much time and difficult negotiations.
- Calendar deadlines to drive the fall tax and budget agenda: (1) September 30—expiration of governmental funding and funding for the Federal Aviation Administration; (2) October 29—expiration of the Federal Highway Program; (3) late fall-debt ceiling limit hit; and (4) December 31—tax extenders require extension.
- Looming over all these issues is the revenue question and whether offsets will be needed for a variety of policy initiatives or legislative compromises. In addition, significant tax issues will also be actively debated, including the possibility of international tax reform.



This fall, Congress faces a challenging agenda of tax and budget issues ranging from the need to fund the government for FY 2016 to a required increase in the federal debt ceiling to avoid an unprecedented and catastrophic default on the nation's debt. In many respects, the legislative challenges now confronting Congress are reminiscent of the 2012-2013 "fiscal cliff" debate, which took an extended period of time and difficult negotiations to resolve. Complicating the fall fiscal agenda will be two significant intervening events: (1) congressional consideration of a resolution disapproving the President's Iranian nuclear agreement; and (2) the visit of Pope Francis, who is scheduled to make an address to a joint session of Congress on September 24, 2015.

Much of the fall tax and budget agenda will be driven by various calendar deadlines, including the following:

A. September 30: Government Funding Resolution

1. Expiration of Governmental Funding

The current funding of the federal government will expire on September 30, 2015, with the end of the current fiscal year. Prior to the August recess, the appropriations process for FY 2016 came to a halt in both the House and Senate. In light of the compressed time available for legislation in September (due to the Iran legislation, the Pope's visit and religious holidays), a continuing resolution (CR) is expected to be passed, keeping the government open for some brief period of time to allow for negotiations on a funding resolution for the balance of FY 2016. It should be noted, however, that passage of a temporary CR may be complicated by an ongoing policy dispute regarding federal funding for Planned Parenthood.

With respect to funding the federal government for the balance of the new fiscal year, congressional Democrats are seeking negotiations on appropriations for FY 2016 in order to provide relief from the statutory sequesters enacted in 2011 as part of the Budget Control Act of 2011. Under that act, discretionary federal spending is statutorily capped, with the limits on both defense and nondefense spending enforced by separate sequesters (across-the-board spending cuts) for each year from 2013-2021. Under the sequestration caps currently in effect, nominal discretionary appropriations would rise only by $3 billion (0.3 percent) in FY 2016. (Note: The statutory spending caps and sequesters apply to only appropriated spending and not to mandatory or entitlement spending, such as Social Security, Medicare or Medicaid.)

The budget resolution for FY 2016 passed earlier this year by congressional Republicans would provide sequester relief for defense spending while maintaining the sequester cap on nondefense spending. President Obama has proposed increasing overall discretionary spending by $74 billion in FY 2016 above the sequester caps for both defense and nondefense spending. In a report issued on August 11, 2015, the Congressional Budget Office (CBO) indicated that eliminating the sequester caps for both defense and nondefense spending for FY 2016 would allow overall federal spending to increase by $90 billion.

In 2013, a compromise (the Bipartisan Budget Act of 2013) struck by Rep. Paul Ryan (R-WI) and Sen. Patty Murray (D-WA)—at the time, both chairmen of their respective House and Senate Budget Committees—provided sequester relief for FY 2014 and FY 2015. Some members of Congress are hopeful that a similar “sequester relief” compromise can be negotiated for FY 2016. It is important to note that the 2014 Ryan-Murray compromise provided sequester relief for both defense and nondefense spending, and it included compensating spending reductions and revenue enhancements (although not “tax increases”) to preserve the overall level of deficit reduction enacted in the 2011 Budget Control Act. Some version of the 2014 Ryan-Murray compromise could become a template for a similar sequester relief package this fall.

2. Funding for the Federal Aviation Administration

Funding for the Federal Aviation Administration (FAA), including the air traffic control system, is scheduled to expire on September 30, 2015. Complicating the funding issue debate is the interest of some members of Congress to privatize various air traffic control functions. In light of the crowded legislative agenda this fall, Congress may pursue a temporary extension of funding for the FAA to avoid furloughs of air traffic controllers and to provide additional time for resolving both the funding and privatization issues.

B. October 29: Expiration of the Federal Highway Program

Prior to the August recess, Congress passed another short-term extension of the highway trust fund, extending the program through October 29, 2015, with general revenue financing provided by a variety of revenue enhancements. The Department of Transportation estimates that these enhancements will help maintain trust fund solvency through the third quarter of FY 2016. However, program authorizations will continue to expire on October 29, 2015, without further legislative action. Senate Republican leaders have proposed a multiyear extension of the highway program beyond the 2016 national elections. To this end, the Senate has passed a six-year reauthorization of the highway program, with revenues sufficient to fund the program for approximately three years with an infusion of additional general revenues, but with no increase in the federal gas tax. The Senate-passed bill also includes an extension of the Export-Import Bank (Ex-Im), which is controversial with some members of Congress.

In the House, Ways and Means Committee Chairman Ryan has expressed support for advancing an international tax reform package to help pay for a long-term extension of the federal highway program. It appears that Chairman Ryan has been joined in this effort by the administration and some committee members—from both sides of the aisle. The administration has expressed particular interest in increasing infrastructure spending by $150 billion over the next six years. In addition, Sens. Rob Portman (R-OH) and Chuck Schumer (D-NY), co-chairs of the Senate Finance Committee working group on international tax reform, have encouraged this developing effort.

The tax policy issues that appear to be under consideration in the context of the international tax reform debate include (1) a change from the current U.S. worldwide taxation system to a form of territorial or dividend exemption system; (2) a mandatory or "deemed" repatriation of offshore earnings currently "trapped" abroad—with possibly different tax rates for liquid and reinvested earnings (revenues raised by this policy change have been proposed to be used in this context to fund infrastructure spending); (3) a "patent" or "innovation" box with favorable tax rates for income derived from intellectual property (Note: Prior to the August recess, Reps. Charles Boustany (R-LA) and Richard Neal (D-MA) advanced an innovation box discussion draft—the Innovation Promotion Act—a draft similar to the innovation box concept in the working group report authored by Sens. Portman and Schumer); and (4) unspecified revenue offsets, including possible changes to the deductibility of interest and research and experimental expenses, as well as policy proposals made by the OECD Base Erosion and Profit Shifting (BEPS) project.

It is important to note that Senate Majority Leader Mitch McConnell (R-KY), and Senate Finance Committee Chairman Orrin Hatch (R-UT) have expressed a preference for keeping international tax reform and long-term funding for the federal highway program on two separate legislative tracks. Therefore, the prospects and prioritization of these two important tax policy issues will have to be resolved this fall by and among congressional leaders and the administration.

C. Late Fall: The Debt Ceiling

The current statutory debt ceiling is $18.1 trillion. The statutory suspension of the ceiling expired on March 16, 2015. Since that time, the Treasury Department has been utilizing "extraordinary debt management measures" to avoid default. However, on July 29, 2015, Treasury Secretary Jack Lew officially notified Congress that the debt ceiling will have to be increased (or suspended again) by the end of October 2015, or soon thereafter (depending on the level of federal receipts). Secretary Lew is expected to provide Congress with another debt ceiling update soon after it returns to session in September. In addition, on August 25, 2015, the CBO issued a report indicating that debt ceiling legislation will be needed by mid-November to early-December 2015 to avoid default.

It should be noted that, when the debt ceiling was last considered by Congress in February 2014, Congress chose to suspend the limit for 13 months to put the debt ceiling issue and any prospect of default beyond the 2014 mid-term elections.

It should also be noted that the informal "Boehner Rule" (requiring federal spending to be reduced, dollar-for-dollar, for any increase in the debt ceiling) was instituted in the Budget Control Act of 2011 when the debt ceiling was increased. In addition, the Budget Control Act gave rise to the "McConnell mechanism" for increasing the debt ceiling by which the President could request an increase in the debt ceiling that would take effect unless a disapproval resolution is passed by Congress (including an override of the anticipated presidential veto). It will be interesting to see whether the Boehner Rule or McConnell mechanism resurfaces in the context of the debt ceiling debate this fall.

D. December 31: Extension of the "Tax Extenders"

Approximately 55 temporary tax provisions (the "tax extenders") expired at the end of 2014. The House has passed several extenders on a permanent basis in separate legislation, including the research and development tax credit, the state sales tax deduction, the small business expensing and a variety of charitable tax incentives. Chairman Ryan has indicated that he intends for the House Ways and Means Committe to consider the balance of the tax extenders at some point this fall. It should be noted that a permanent extension of all the tax extenders (including bonus depreciation and various tax credits) is estimated to cost approximately $940 billion.

In the Senate, the Finance Committee has approved a two-year extension of all the tax extenders through 2016. The Finance Committee-approved extender package has not yet been scheduled for consideration by the full Senate.

Neither tax committee is expected to "pay for" or offset the budgetary cost of the tax extenders. At the time of markup, the Senate Finance Committee extender package was estimated by the Joint Committee on Taxation staff to cost approximately $96 billion over a 10-year period, using traditional scoring conventions. However, post-markup, the Joint Committee on Taxation staff estimated that the Senate Finance Committee extender bill would cost approximately $86 billion using the dynamic scoring conventions instituted in the 114th Congress.

E. Other Possible Tax or Budget Legislation this Fall

1. Funding for the Social Security Disability Insurance Program

On July 22, 2015, the Social Security and Medicare trustees released their annual report on the financial condition of the Social Security and Medicare programs. The trustees' report served notice to the public and Congress that the Social Security Disability Insurance (SSDI) program is expected to be insolvent by late 2016. In the absence of legislation, the trustees project that disability benefits to approximately nine million beneficiaries will be reduced by 19 percent next year.

In light of this insolvency risk, both tax committees have begun the process of considering possible legislative responses, including (1) the possibility of reallocating social security payroll taxes that support the SSDI program and the old-age retirement and survivors' program, (2) interfund borrowing between the retirement program and the disability program, and (3) programmatic changes to the SSDI program itself. It should be noted that a change to the House Rules, adopted at the beginning of the current Congress, requires any reallocation of payroll taxes to be accompanied by provisions that would improve the overall financial health of the combined Social Security program. It is also anticipated that any legislation advanced to address the SSDI issue will not involve any new taxes on employers or employees.

2. Reconciliation

The FY 2016 budget passed by Congress earlier this year establishes a "reconciliation" process, which allows a budget reconciliation bill to be considered and passed in both the House and Senate by majority vote only. As of this writing, a reconciliation bill has not been advanced in either the House or Senate (and may yet be postponed until 2016). However, congressional Republicans have expressed an intention to use the reconciliation process to repeal as much of the Affordable Care Act of 2010 as possible. Under the rules and procedures of reconciliation, the underlying provisions of a reconciliation bill must have a "budget effect," and, thus, not all provisions of the Affordable Care Act could be included in a reconciliation bill. In addition, any reconciliation bill proposing a repeal of all or some parts of the Affordable Care Act is likely to be vetoed by President Obama, requiring a two-thirds vote in both houses of Congress to override the President's anticipated veto—a legislative hurdle that would be difficult, if not impossible, to achieve.

3. Possible Need for Additional Budgetary Offsets

In addition to the issues discussed above, one or both houses of Congress may consider initiatives this fall that require budgetary offsets—either spending cuts or revenue increases—to comply with budget enforcement rules or to avoid budgetary points of order.

Such initiatives could include:

- a successful conclusion and submission to Congress of the Trans-Pacific Partnership trade agreement
- consideration by the full Senate of the multiple miscellaneous tax bills approved earlier this year by the Senate Finance Committee
- repeal or modification of various health-related taxes, such as the medical device tax or the excise tax on so-called "Cadillac" tax plans.

Any of these initiatives, as well as others, could have budget effects requiring consideration of budgetary offsets.

Conclusion

Many major tax and budget issues will be actively in play this fall—with calendar deadlines driving much of the timing and decision making by Congress. Critically important issues will dominate, including avoiding a government shutdown by funding the federal government for the upcoming fiscal year and avoiding an unprecedented and catastrophic default on the national debt. In addition, significant tax issues will also be actively debated, including long-term reauthorization and financing of the nation's highway program and the possibility of international tax reform.

Looming over all these issues is the revenue question and whether offsets will be needed for a variety of policy initiatives or legislative compromises. In this complicated and uncertain legislative environment—a policy environment with great potential and great vulnerability—parties must be well represented by sophisticated and experienced counsel to secure favorable policy outcomes.

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HUNTON & WILLIAMS

Client Alert

December 2014

DE Court Upholds Claims Challenging Unreasonable Termination Fee Structure

In *In re Comverge, Inc. Shareholders Litigation*, the Court of Chancery recently denied a motion to dismiss a complaint which alleged that a board of directors acted in bad faith by approving an unreasonable termination fee structure in a merger agreement.[1] The termination fee purportedly was equal to 5.55% of the deal's equity value if triggered during a "go-shop" period and 7% of the deal's equity value if triggered afterwards. The plaintiff further argued that the potentially preclusive effects of these termination fees had to be assessed in conjunction with a convertible bridge loan provided by the buyer. The plaintiff claimed that, after giving effect to the convertible debt, a buyer would have to pay 11.6% to 13.1% of the transaction's equity value to submit a successful topping bid.

Background

The post-closing litigation involved the 2012 sale of Comverge, Inc. to a private equity fund. At the time, Comverge apparently was struggling financially and facing a potential default under its debt instruments. Of particular note, the buyer purchased some of Comverge's debt that had potential blocking rights over a sale of the company. During the merger negotiations, the buyer claimed that Comverge was in default and threatened to accelerate payment of the debt. The plaintiff argued, however, that the buyer's purchase of the debt violated a standstill covenant in its confidentiality agreement, and that Comverge's board of directors should have sued the buyer.

The definitive merger agreement included a 30-day go-shop period with a 10-day extension for certain qualified bids that were submitted by the end of the original go-shop period. The buyer also agree to provide a $12 million bridge loan, which was accompanied by a convertible note in which the buyer could obtain common stock at a price below the merger consideration. The transaction's total equity value was approximately $48 million. The per share price of $1.75 was below the stock's then-current trading price of $1.88 per share.

Court's Decision

In ruling on the defendants' motion to dismiss, the court found that the stockholder-plaintiff had failed to allege that a majority of the directors acted with an improper purpose. In that regard, the directors held a material amount of the company's stock and all but one were independent. The court also deferred to the board's judgment not to sue to enforce the standstill agreement, and to focus instead on seeking improved terms in the merger agreement. The court noted that the buyer was the only bidder at that time, the litigation had the potential to be costly and time-consuming, and recovery was uncertain.

The court did find that it was reasonably conceivable that "the ultimate merger price was far enough 'off-the-mark' as to implicate the fiduciary duty of care." As is typical among Delaware corporations, however,

[1] *In re Comverge, Inc. S'holders Litig.*, Consol. C.A. NO. 7368-VCP (Del. Ch. Nov. 25, 2014).

the directors were exculpated from due care violations.[2] The court then held that the complaint failed to allege that the board breached its duty of loyalty in conducting the sale process. Among other things, the court noted that "the Board was highly engaged in the process, and this type of engagement precludes a finding of bad faith conduct."

Turning to the deal protections in the merger agreement, the court found that the 30-day go-shop period, along with the 10-day extension in certain circumstances, was reasonable. The court explained that Delaware law "places more emphasis on the length of a post-signing go-shop if there was not an effective market check before signing." It then noted that the company had engaged in a prolonged search for strategic transactions before entering into the merger agreement.

The court then found that the termination fees of 5.55% of equity value (or 5.2% of enterprise value) during the go-shop period and 7% of equity value (or 6.6% enterprise value) after the go-shop period "test the limits of what this Court has found to be within a reasonable range for termination fees." The court also analyzed the termination fee in connection with the convertible note held by the buyer in connection with the bridge financing. The plaintiff alleged that the conversion feature in the note, which allowed the buyer to purchase common stock at a price below the merger consideration, would significantly increase the cost to a topping bidder of acquiring the company. Factoring in that cost to the existing termination fee, the plaintiff argued, would result in a total payment equal to 11.6% of the deal's equity value during the go-shop period and 13.1% of the deal's equity value after the go-shop period.

The court concluded that, for purposes of surviving a motion to dismiss, it was "reasonably conceivable that the Convertible Notes theoretically could have worked in tandem with the termination fees effectively to prevent a topping bid" from a buyer that might otherwise offer greater value to the company's stockholders. Perhaps more importantly, the court found that the plaintiff adequately alleged that the board of directors acted in bad faith in approving these terms. The court said that "it conceivably is true that the Board's apparently passive acceptance of those terms without any pushback was 'so far beyond the bounds of reasonable judgment that it seems essentially inexplicable on any grounds other than bad faith." In so doing, the court noted that this was "a deal with a *negative* premium to market" when it was announced.

Conclusion

Despite the amount of litigation challenging M&A transactions, there are not many Delaware rulings that have upheld challenges to deal protections such as termination fees, matching rights, and no-shop provisions. This is because the Delaware courts have generally created a body of precedent that provides helpful guidance to buyers and sellers and also recognized the value of such terms. In *Comverge*, the parties appear to have deviated from this precedent, but more importantly, the court looked to the bridge loan to view the aggregate effect of the various terms on the ability of a third party to make a topping bid.

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[2] Comverge's certificate of incorporation contained a provision authorized by Section 102(b)(7) of the Delaware General Corporation Law that exculpated its directors for breaches of the duty of care.

Client Alert

December 2014

DE Court Rejects Challenge to Related-Party Transaction Approved by Audit Committee

In *In re Sanchez Energy Deriv. Litig.*, Consol. C.A. No. 9132-VCG, memo. op. (Del. Ch. Nov. 25, 2014), the Delaware Court of Chancery dismissed a derivative complaint challenging a related-party transaction. The court held that the plaintiff failed to sufficiently allege that the three members of the company's audit committee who approved the transaction were not disinterested and independent. The decision reaffirms Delaware law, requiring plaintiffs to plead facts with particularity when challenging the decisions of outside directors in derivative litigation.

Background

Sanchez Energy Corporation had a five-member board consisting of two members of its founding family and three outside directors. The company entered into a transaction with an entity controlled by the founding family to purchase certain "working interests" in a shale project. The transaction was approved by the other three directors in their capacity as members of the board's audit committee.

Court's Decision

Under Delaware law, a derivative plaintiff must make a demand on the board of directors to initiate litigation or show why demand was excused. The plaintiff argued that demand would have been futile because two of the outside directors were not independent due to their relationships with the founders outside of the company. One of the founders was a director at another company which had a subsidiary that employed one of those directors. The court held, however, that the complaint did not sufficiently explain how the founder, as "one of nine directors on the board of a parent corporation... could exert power to remove an executive in a subsidiary corporation." The court also concluded that the fact that the director had contributed $12,500 to one of the founders' political campaigns 11 years earlier did not support a lack of independence.

With respect to the other outside director, the plaintiff alleged that such director was a co-investor with the founding family in certain ventures and thus not independent. The court disagreed, stating that it was "not apparent from the allegations in the Complaint why [the founder's] minority interest in two companies in which [the outside director] owns a large equity interest would cause [that outside director] to abandon his fiduciary duties to favor [the founder]."

The court also found that the plaintiff failed to show that the founders, who had two of five board seats and collectively owned 21.5% of the equity of Sanchez Energy, should be treated as a controlling stockholder and thus warrant heightened scrutiny under the entire fairness standard. In addition, the court held that the plaintiff failed to allege the transaction was not otherwise the product of a valid exercise of business judgment. Among other things, the court found that the complaint lacked detail about how the transaction was negotiated, other than to indicate the transaction was approved by the audit committee and that the audit committee had engaged a financial advisor.

Conclusion

Sanchez Energy reaffirms Delaware's pleading standards in derivative suits – conclusory allegations challenging a director's independence will not suffice. To challenge a director's independence, a plaintiff "must allege particularized facts manifesting 'a direction of corporate conduct in such a way as to comport with the wishes or interests of the [person] doing the controlling.'" In addition, when a plaintiff attempts to do so based on a director's external relationships with the interested party, *Sanchez* held that "the nature of that relationship must be of a kind that would support a reasonable inference that '*the non-interested director would be more willing to risk his or her reputation than risk the relationship with the interested director*" (emphasis added).

Still, boards of directors and in-house counsel should be vigilant in monitoring directors' independence under a variety of standards or definitions, including Securities and Exchange Commission rules, stock exchange listing standards, corporate governance guidelines, committee charters, and common law. The court acknowledged that "[i]t is a fact of human nature that close personal relationships can influence decisionmaking, even, in certain circumstances, at the expense of moral and legal strictures such as fiduciary duties." But under Delaware law, mere personal friendships and business relationships are not sufficient to strip a director of his or her independence. Directors and their advisors should remain attentive to this issue, however, because it is contextual based on the circumstances present.

It should also be noted that the plaintiff in *Sanchez Energy* failed to inspect the company's books and records prior to filing the lawsuit. Delaware courts have repeatedly admonished plaintiffs for not conducting a books and record inspection, which can provide information that might allow a plaintiff to successfully plead demand futility. Thus, companies should continue to take seriously such inspection requests since they are precursors to stockholder litigation.

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Client Alert

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Delaware Supreme Court Addresses Outside Director Liability in Interested Transactions

The Delaware Supreme Court recently issued an important decision in *In re Cornerstone Therapeutics Inc. Stockholder Litigation* that affects outside directors' potential liability in conflict of interest transactions. The court held that, even if a conflict of interest transaction is subject to the stringent entire fairness standard of review, a plaintiff must still plead that an outside director breached the duty of loyalty. Otherwise, the outside director can seek a dismissal from the proceedings before the transaction is reviewed for entire fairness.

The Delaware Supreme Court's Opinion

The Delaware Supreme Court's opinion was in response to appeals filed from two separate rulings of the Court of Chancery.[1] The cases involved freeze-out mergers in which controlling stockholders acquired the outstanding minority interests. Both mergers were subject to the entire fairness standard of review. The outside directors, however, filed motion to dismiss, arguing that the plaintiffs had failed to plead non-exculpated breach of fiduciary duty claims against them. The lower courts concluded that, under existing Delaware precedent, a determination of a director's liability had to be done after the transaction was tested for fairness. As a result, the outside directors could not escape the litigation prior to trial.

The Delaware Supreme Court reversed the lower courts' rulings, holding that a plaintiff must still plead non-exculpated breaches of fiduciary duty against the outside directors.[2] Chief Justice Leo E. Strine, Jr., writing for the court, explained that "the mere fact that a plaintiff is able to plead facts supporting the application of the entire fairness standard to the transaction, and can thus state a duty of loyalty claim against the interested fiduciaries, *does not relieve the plaintiff of the responsibility to plead a nonexculpated claim against each director who moves for dismissal*" (emphasis added). He further stated that "each director has a right to be considered individually when the directors face claims for damages" and that Delaware law presumes directors are "motivated to do their duty with fidelity." The court also indicated that its holding was not limited to entire fairness cases and thus also applies to challenges to a sale of the corporation or the adoption of takeover defenses under *Revlon* and *Unocal*, respectively.

Conclusion

The Delaware Supreme Court's decision is protective of well-motivated, independent directors. Under prior case law, it appeared that all of the directors had to remain defendants through trial as long as the plaintiff successfully invoked the entire fairness standard – even if the well-pled loyalty claims were made only against the interested parties. This increased the cost of litigation by requiring the outside directors to

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[1] *In re Cornerstone Therapeutics Inc., S'holder Litig.*, No. 564, 2014 (Del. May 14, 2015); *Leal v. Meeks*, No. 706, 2014 (Del. May 14, 2015).

[2] Under Section 102(b)(7) of the Delaware General Corporation Law, a corporation's certificate of incorporation can eliminate directors' personal liability for breaches of the duty of care. Thus, a non-exculpable breach of duty means a breach of the duty of loyalty at a corporation with a Section 102(b)(7) provision.

be parties to the litigation. More importantly, it cast a cloud of potential liability over the outside directors as the litigation worked its way through the courts.

Under *Cornerstone*, outside directors can now seek dismissal at early stages of the litigation, even if there will be a trial against the interested parties to determine the fairness of the interested transaction. Those outside directors should be dismissed unless the plaintiff sufficiently alleges that they acted in bad faith or were otherwise disloyal. This ruling should give comfort to independent directors who negotiate and review interested transactions. In that regard, the court noted that Delaware wants independent directors to review such transactions and does not want to discourage them from such service.

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U.S. Antitrust Compliance Programs:

Crafting Robust Cost-Effective Programs that are Protected by the Attorney-Client Privilege

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Why Have a Compliance Program?

Why Are Antitrust Compliance Programs Important?

- Prevention
- Detection
- Mitigation

Why Are Antitrust Compliance Programs Important? Prevention.

Antitrust violations can have serious consequences.

- Criminal penalties
  - Monetary fines.
    - Corporate fines - $100M per offense or twice the gain or loss.
    - Individual fines – from $350,000 - $1M per offense.
  - Possible prison sentence for individuals.
- Civil damages
  - Private antitrust suits may result in treble damages.
  - Implications for future mergers, acquisitions and joint ventures.
- Business disruption
  - The time, cost, distraction, and injury to business reputation associated with an investigation and follow-on litigation cannot be underestimated.
- Reputational injury

Why Are Antitrust Compliance Programs Important? Prevention.

Criminal penalties can be substantial.

- Criminal antitrust fines and penalties in excess of $1.8 billion in 2014 fiscal year.
- Five companies paid penalties that exceeded $100 million:
  - $425 million: Bridgestone, Corp.
  - $195 million: Hitachi Automotive Systems Ltd.
  - $190 million: Mitsubishi Electric Corp.
  - $120 million: Toyo Tire & Rubber Co. Ltd.
  - $103.2 million: JTEKT Corp.
- Jail terms for 21 individual defendants, with an average sentence of 26 months.

Why Are Antitrust Compliance Programs Important? Detection.

- Most jurisdictions, including the United States, have amnesty and leniency programs for companies that are the first (or early) to report antitrust violations and cooperate with government investigations.
- Time is of the essence: amnesty is available only to the first company to report a particular cartel.
  - Other companies to report may negotiate lower penalties, but not amnesty.
- An effective compliance program may propel early internal investigation.

Why Are Antitrust Compliance Programs Important? Detection.

Type A Leniency Requirements:

- A violation of the Sherman Act.
- Must be the first company to qualify.
- Company must take prompt and effective action to terminate conduct.
- Company must demonstrate full, continuing, and complete cooperation.
- Available only if the company is not the organizer or leader of a cartel.

Why Are Antitrust Compliance Programs Important? Detection.

Type B Leniency Requirements:

- Applies to companies that cooperate after an investigation begins.
- Company may still be eligible, if no one else has applied and the Antitrust Division does not have a prosecutable case against the company.

Why Are Antitrust Compliance Programs Important? Mitigation.

- Existence of an antitrust compliance program may lead to a reduced fine at sentencing.
  - U.S. Sentencing Guidelines §8C2.5(f)(1): reduction in penalties "[i]f the offense occurred even though the organization in place at the time of the offense an effective compliance and ethics program."
- The DOJ may seek to impose a monitor on companies that violate antitrust laws and:
  - Show no remorse.
  - Have no effective compliance program.
  - Allow culpable employees to remain in positions where they can commit further violations.

Brett Snyder, Deputy Assistant Attorney General
Speech: Compliance is a Culture, Not Just a Policy (Sept. 9, 2014)

- The existence of a policy will almost never deter the Antitrust Division from bringing criminal antitrust charges because an effective policy would have deterred the conduct. You can't argue that you have an effective policy when there is evidence of criminal violations.
- The DOJ likely will not give a company credit at sentencing for a preexisting compliance program, for much the same reason – culpability is lowered when there is an "effective" compliance program.

Bill Baer, Assistant Attorney General
Speech: Prosecuting Antitrust Crimes (Sept. 10, 2014)

- **Existence of a compliance program will not deter prosecution:**
  - "Some have argued that the mere existence of a compliance program should be sufficient . . . to avoid prosecution, secure a non-prosecution agreement, or otherwise dramatically reduce the penalties for criminal antitrust violations . . . The fact that the company participated in a cartel, and did not detect it until after the investigation began, makes it difficult for the company to establish that its compliance program was effective."
- **Leniency requires cooperation:**
  - "We expect leniency applicants to make those investments, including conducting a thorough internal investigation, providing detailed proffers of the reported conduct, producing foreign-located documents, preparing translations, and making witnesses available for interviews. Companies unwilling or unable to make the investments necessary . . . will lose their opportunity to qualify for leniency."

Elements of Effective Compliance

Elements of Effective Programs

- **Tailor the program.**
  - Establish standards and procedures.
  - No "one size fits all" policy.
  - Account for the nature of your business and markets in which you operate.
- **Make compliance a priority.**
  - Senior executives should support—and oversee—compliance efforts.
  - Create reporting channels:
    - Establish an effective system for confidential, internal reporting of violations.
    - Assigned executives should have the ability to report directly to independent monitoring bodies, such as the Board of Directors or internal auditors.
    - Make clear employees are required to report both:
      - Actions of the company or employee that raise potential antitrust concerns; and
      - Misconduct that potentially violates antitrust laws.

Elements of Effective Programs

- **Communicate clearly.**
  - Distribute written policies.
  - Training and guidance:
    - Explain why compliance is important.
    - Involve senior personnel to show “buy-in.”
    - Hold training sessions for all executives, managers, and employees, especially those with pricing responsibilities.
    - Include case studies and relevant examples.
    - Solicit anonymous feedback, and use it to improve the program itself and training.

Elements of Effective Programs

- **Enforce existing policies.**
  - Investigate and respond to potential violations.
  - Enforcement and discipline:
    - Compliance with the program should be incentivized, and violations should be disciplined.
    - Enforcement should be even-handed; both senior managers and low level employees should be held responsible for improper conduct.
    - No excuses: it is no excuse that illegal activity is rampant throughout an industry.
- **Revise policies over time.**
  - Periodically review and revise policies over time, even if there is no evidence that the current program is not working.
  - Be aware of changes in law, business practices, and technology.

Maintaining Attorney-Client Privilege

In re: Domestic Drywall Antitrust Litigation
Pending before Judge Baylson (MDL No. 2437, E.D. Pa.)

- Court ordered CertainTeed Gypsum, Inc., a defendant in an action alleging a conspiracy to fix prices of drywall, to produce a copy of its antitrust compliance policy.
- CertainTeed argued its compliance program was privileged because it was a communication between privileged persons that was maintained in confidence and was for the purpose of providing legal advice.
- CertainTeed also noted the policy benefits of applying the attorney-client privilege to encourage communications between attorneys and their clients that promote compliance with the law.

In re: Domestic Drywall Antitrust Litigation

- Court determined that the antitrust compliance policy was not privileged.
- Reason #1: the attorney-client privilege is "limited to legal advice leading to a decision by the client."
  - "CertainTeed's policy, by contrast, is general and does not contain any specific advice. Its purpose is to help insure that its employees do not violate the antitrust laws. No court has yet held that a corporate policy of lawfulness is protected from discovery as privileged."
  - "CertainTeed's antitrust compliance policy is more akin to a reference or instructional guide. Although it is based on legal advice, the policy is primarily a business policy."

In re: Domestic Drywall Antitrust Litigation

- Reason #2: CertainTeed did not maintain the policy in confidence.
  - "CertainTeed distributed the policy to more than 120 employees who attended a training session and made it available to numerous employees on an internal Internet site."
  - "[T]here is no evidence CertainTeed labeled the document as confidential or privileged or indicated it had that status to employees when distributing the policy."

Implications for Compliance Programs

- Corporations (and their attorneys) may be less comfortable providing guidance to employees when there is the possibility that compliance policies will be disclosed in future litigation.
- Corporations should be mindful of the elements that may make a compliance program more (or less) likely to be considered privileged.

Strategic Considerations:
How Detailed Should the Policy Be?

- Tailored, practical programs are more effective.
- Specific guidance relevant to the corporation's business may help establish that the policy is a communication to provide concrete legal advice, not a general primer on antitrust law.
- Balance between adding additional detail (more likely to be privileged) and risk of a forced disclosure (discourages detail).

Strategic Considerations:
Who Should Receive the Policy?

- Compliance programs can't be effective unless employees know they exist and are able to easily access them.
- However, company-wide disclosure may increase the likelihood that a court determines the policy is not privileged.

Strategic Considerations:
Labelling

- Placing a “confidential” or “privileged” legend on a document will not protect from disclosure a document that is not otherwise privileged.
- Nonetheless, the absence of such a legend may be one factor that a court considers in evaluating whether the corporation considered the document to be privileged.

Strategic Considerations:
Other Jurisdictions

- Be aware that other jurisdictions may not provide the same level of protection for compliance programs.
- *Akzo Nobel v. Commission* (European Court of Justice, April 2010):
  - "[N]either of the two directives relating to the profession of lawyer militates in favour of extending legal professional privilege to enrolled in-house lawyers."
  - "[N]either the increased importance of enrolled in-house lawyers nor the indisputable usefulness of their legal advice . . . supports the proposition that internal company or group communications should be placed under the protection of legal professional privilege."

Protecting Privilege: Internal Investigations
In re: Kellogg Brown & Root, Inc., 756 F.3d 754 (D.C. Cir. 2014)

- District Court found that the internal investigation was undertaken pursuant to a corporate policy, not for the purpose of obtaining legal advice, and was therefore not privileged.
- D.C. Circuit vacated District Court's order to produce documents.
  - Reaffirms *Upjohn's* ruling that the attorney-client privilege protects confidential employee communications made during a business's internal investigation led by company lawyers.
  - The fact that the internal investigation was undertaken pursuant to a compliance program is irrelevant.
    - "So long as obtaining or providing legal advice was one of the significant purposes of the internal investigation, the attorney-client privilege applies, even if there were also other purposes for the investigation and even if the investigation was mandated by regulation rather than simply an exercise of company discretion."

Selected Areas of Guidance

Overview

- Antitrust compliance programs should explain that the antitrust laws prohibit business practices that improperly limit competition.
- Broadly stated, the following practices may be scrutinized and banned under the antitrust laws:
  - Cartels.
  - Anticompetitive agreements with competitors.
  - Anticompetitive dealings with customers or suppliers.
  - Monopolization.
  - Anticompetitive corporate transactions.

Cartels

- A cartel is an agreement among horizontal competitors (*e.g.*, between manufacturers) to fix prices, restrict output, allocate markets, rig bids, etc.
- Cartels are illegal.
- Participation in a cartel can lead to severe penalties, including imprisonment.

Anticompetitive Agreements With Competitors

- Collaboration among competitors can at times violate the antitrust laws when it has a harmful effect on competition.
- Be particularly aware of:
  - Agreements.
  - Meetings.
  - Communications (*e.g.*, emails, instant messages, documents, or notes discussing present or future prices, terms or conditions of sale, pricing policies, discounts, promotions, identity of customers, bids, etc.).
  - Memberships in industry associations.

Dealings with Competitors: Trade Associations

- Set clear expectations and boundaries for participation in trade associations, including what topics can/cannot be discussed.
- Maintain agendas and minutes for the meetings.
- Consider whether counsel should attend meetings.
- Consider which business participants should attend: courts are sensitive to senior personnel with price-setting authority attending trade meetings.

Dealings with Competitors: Parallel Behavior

***In Re: Text Messaging Antitrust Litigation*, 630 F.3d 622 (7th Cir. 2010):**

- Plaintiffs alleged that wireless network providers and a trade association conspired to increase the "price per use" for each text message.
- "[T]he allegation in the complaint that the defendants belonged to a trade association and exchanged price information directly at association meetings . . . identifies a practice, not illegal in itself, that facilitates price fixing that would be difficult for the authorities to detect."
- Seventh Circuit denied motion to dismiss finding that "[c]ircumstantial evidence can establish an antitrust conspiracy."

Dealings with Competitors: Parallel Behavior

***In Re: Text Messaging Antitrust Litigation*, (7th Cir. April 9, 2015):**

- Court affirms district judge's grant of defendants' motion for summary judgment.
- "Tacit collusion, also known as conscious parallelism, does not violate section 1 of the Sherman Act."
  - "The challenge to the plaintiffs in discovery was thus to find evidence that defendants had colluded expressly—that is, had explicitly agreed to raise prices—rather than tacitly ('follow the leader' or 'consciously parallel' pricing)."
- Circumstantial evidence that is "consistent with tacit as well as express collusion" will not support a Sherman Act violation.
- "Sherman Act imposes no duty on firms to compete vigorously, or for that matter at all, in price."

Anticompetitive Dealings With Customers Or Suppliers

- Restrictions on the resale of a company's products, such as resale price agreements, exclusive territory agreements, and customer restrictions, may be problematic if they impair competition.
- Be particularly aware of:
  - Sales that require the customer to purchase two or more separate products.
  - Price discrimination among customers.
  - Price discrimination among buyers.
    - Robinson-Patman Act prohibits the sale of two products of similar grade and quantity at different prices to two different buyers where the price difference may result in injury to competition
  - Cooperative purchasing agreements.

Monopolization

- Monopolization is measured within a defined market.
  - Consider how to define the market in which your company operates, but be open to the possibility that regulators may have a different view.
  - Generally, monopoly power is not found if the firm (or group of firms acting in concert) has less than 50 percent of sales of a particular product or service.
- Be aware of predatory or exclusionary practices – *e.g.,* pricing at a loss.

Anticompetitive Corporate Transactions

- Some corporate transactions may have antitrust implications, *e.g.*:
  - Mergers and acquisitions.
  - The formation of a joint venture.

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Attempts to Curtail Executive Compensation –

Unintended Consequences

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Code Section 280G – Golden Parachute Excise Tax

- The Problem?
  - In the early ‘80s, merger mania had captured corporate America
  - in order to make executives “neutral” to being acquired and perhaps losing their positions, Boards protected them with stock award acceleration, deal bonuses payable on closing and/or multi-year severance protection.
  - Although only triggered upon a deal, the resulting payments to executives were perceived to be corporate abuse that hurt shareholders
- The Solution?
  - In 1984, Sections 280G and 4999 were added to the tax code to impose a 20% excise tax on “excess parachute payments” and deny corporate tax deductions for those payments, steps believed would curtail such payments and benefit shareholders
  - The excise tax and loss of deduction applied to executives who received parachute payments in excess of 3.0 times five-year average W-2 pay
  - “Parachute payments” were defined as payments contingent on the change in control – the definition captured deal bonuses, severance payments and a portion of accelerated vesting of stock options or restricted stock awards (the longer the vesting period, the greater the parachute payment).
- The Reaction?
  - Severance packages of at least 2.99x average W-2 pay became the “norm”
  - Vesting schedules for equity awards were shortened to minimize 280G risk
  - Golden parachute excise tax gross-ups were put in place to maintain the protections needed to keep executives “neutral” to a transaction
- The Result?
  - Payments to executives were not curtailed
  - Companies incurred greater after-tax compensation-related costs due to the loss of the deduction and excise tax gross-up
  - Those increased costs were ultimately borne by the shareholders whom were supposed to benefit from Sections 280G and 4999

Code Section 162(m) – $1 Million Deduction Cap

- The Problem?
  - In the early 90s, CEO and executive pay were believed to be outsized, unless conditioned on performance
  - Congress believed that imposing a $1 million deduction cap on pay to top public company officers would rein in runaway pay to the benefit of shareholders
- The Solution?
  - In 1993, Section 162(m) was adopted to limit the annual deduction for compensation paid to the CEO and each of the other four “proxy officers” to $1 million
  - The limit does not apply to “performance-based” compensation and compensation paid after the individual ceased to be the CEO or included in the proxy statement
  - To be performance-based, the cash or stock-based incentive awards had to be paid pursuant to a shareholder -approved plan that contained criteria upon which the performance metrics would be based (such as EPS, asset growth, change in stock price); the actual performance hurdles to be achieved could be determined by the compensation committee
  - Stock options granted under the shareholder-approved plan automatically qualify as performance-based compensation
- The Reaction?
  - At the risk of losing talent to private companies, public company compensation committees were forced to determine that attracting and retaining talent was more important than the tax deduction
  - For many companies, stock options went to the top of the list of preferred vehicles for delivering compensation
  - Deferred compensation plans were used to enable base salaries and other non-performance based compensation to be paid post-employment, when the deduction limit would not apply
- The Result?
  - Executives reaped significant compensation from stock options (as shareholders reaped significant returns)
  - Companies without significant growth or in cyclical business lost deductions when paying higher base salaries or using time-vested restricted stock awards to attract and retain talent
  - For those companies, the loss of the tax deduction increased after-tax costs to the detriment of shareholders

TARP and Dodd Frank – Efforts to Limit Risky Behavior

- The Problem?
  - The financial crisis was believed to be due, in part, to risky, compensation-motivated actions by senior executives and others
  - Stock options, bonuses and other cash incentive opportunities created incentives for executives and others to take outsized risks in order to achieve outsized gains
- The Solution?
  - Entities receiving TARP money were required to eliminate annual bonuses for senior executives and limit incentive compensation to time-vested restricted stock amounting to no more than one-third of annual compensation; no limitation was placed on base salary
  - TARP and Dodd-Frank imposed obligations on financial institutions and public companies to conduct "risk reviews" of incentive compensation plans to confirm the incentives do not create material financial risk (see accompanying summary of related Dodd-Frank provisions)
  - Financial regulators implementing Dodd-Frank are assessing the incentive plans maintained by banks and other financial industry participants for risk, requiring risk mitigation provisions such as elimination of the use of stock options, discretionary (instead of formulaic) bonus payouts, bonus deferrals to adjust payout to risk-outcomes, long-term holding periods for equity awards and clawbacks.
  - Recently proposed clawback rules impose "no-fault "clawbacks of compensation based on financial statement metrics, stock price or TSR
- The Reaction?
  - TARP companies increased base salaries and granted the maximum permitted restricted stock awards in order to maintain competitive compensation levels
  - Post-TARP, financial institutions have cut back or eliminated stock options, opting for higher base salaries, discretionary bonuses and time-vested equity
- The Result?
  - Risk aversion through elimination of stock options and introduction of discretionary bonus programs instead of performance-based, formulaic plans, is eroding the alignment of compensation plans with shareholder interests preferred by institutional investors
  - The desire to shift more long-term compensation to time-based vesting from performance-based vesting may increase due to desire to minimize compensation that could become subject to the "no-fault" clawback policy required by Dodd-Frank, furthering the misalignment with shareholder interests

Dodd-Frank Act Regulatory Update – Pending and Recently-Adopted Rules Relating to Executive Compensation
(As of September, 2015)

	Dodd-Frank Act Provision	Implementation Schedule
1.	**<u>Incentive Compensation Clawbacks ("Listing Standards for Recovery of Erroneously Awarded Compensation")</u>**: Mandates that stock exchanges require each listed company to adopt a policy to recover (i.e., clawback) incentive compensation from current or former executive officers following a restatement of financial results. (DFA § 954)	SEC proposed rules were issued July 1, 2015. The listing rules must become effective within one year after the final rules are adopted by the SEC. The recovery policy would apply to incentive compensation based on financial information for a fiscal period ending on or after the Rule 10D-1 Effective Date.

<u>Observations:</u>

a) If the company is required to prepare an accounting restatement due to "material noncompliance" – an "error that is material to previously issued financial statements" – the company must "recover" erroneously awarded incentive-based compensation. "Erroneously-awarded compensation" is compensation that exceeds the amount that otherwise would have been received had the incentive-based compensation been determined based on the accounting restatement.

b) Excess compensation is to be recovered from any individual who served as an executive officer (defined for this purpose as Form 4 filers) within a performance period for which the excess compensation was paid. The rule is "no-fault" – each executive officer is subject to clawback, regardless of whether there was any misconduct. In contrast, Sarbanes-Oxley requires fault to trigger a clawback and it only applies to the CEO and CFO.

c) Recoverable compensation is limited to "incentive-based compensation" – "any compensation that is granted, earned or vested based wholly or in part on the attainment of a financial reporting measure." "Financial reporting measures" are measures that are determined and presented in the company's financial statements, any measures that are derived wholly or in part from such measures, and stock price and TSR."

c) Of significance is what is <u>not</u> recoverable compensation: stock awards that vest solely upon the completion of time, such as service-vesting stock options or RSUs, fully discretionary bonuses, incentives granted, earned or vested based solely on non-financial events (such as opening a specified number of stores, obtaining regulatory approval for a product, or completing a merger or divestiture), because the compensation is not granted, earned or vested based on financial reporting measures.

d) If a clawback is triggered, the board must determine if excess compensation was paid and must recover it unless "impracticable" – the cost of recovery exceeds the amount to be recovered or recovery violates home country law. There is a three-year look back period (the three fiscal years preceding the year the company is required to prepare the restatement) over which a determination is to be made whether there was any excess compensation based on attainment of financial reporting measures during those three years. The regulations admit that determination of excess compensation based on stock price or TSR hurdles will be complex and may require expert analysis.

e) Companies will not be permitted to indemnify executives officers or otherwise permit them retain excess compensation, nor can the company purchase insurance that would provide such indemnification. An executive officer could personally buy third-party insurance.

f) Companies will be required to file a copy of their recovery policy with the 10-K and make disclosures concerning any recoveries in the proxy statement.

<u>Implications: With the issuance of the proposed rules, and the parameters of what the required clawback policy may look like, consideration may be given by some companies to changing the mix of incentive compensation toward more fixed, time-based vesting options or RSUs, performance-hurdles that are not financial measures, stock price or TSR, or fully-discretionary awards. Of course, those approaches could raise 162(m) deduction and shareholder/ISS "performance-based" compensation issues. Additional areas for consideration may be to include longer deferrals or holding period requirements to facilitate enforcement of a recovery. Finally, incentive plans and award agreements should include language that clearly states the right to enforce the recovery policy that will ultimately be adopted, and then clear language tying to the policy once in place.</u>

<table>
<tr><td>2.</td><td><u>Disclosure of Relationship of Pay to Performance (“PvsP”)</u>: Requires annual proxy statement disclosure concerning the relationship between executive compensation actually paid and the total stockholder return of the company. (DFA § 953(a))</td><td>Proposed rules (proposed Item 402(v) of S-K) published in Federal Register on May 7, 2015. Comment period ended July 6, 2015.</td></tr>
<tr><td colspan="3"><u>Observations:</u>

a) This rule will require disclosures comparing the change in executive compensation actually paid/earned (as opposed to grant date values) over a five-year period to the change in the company’s stock price over the same period.

b) The disclosure is similar to the “relative degree of alignment” factor that ISS uses as one of the quantitative tests in its “say-on-pay” analysis. The primary difference being ISS uses pay as reported in the summary compensation table (grant date value for stock awards) and not the pay that was actually received from those awards.

c) The actual rules will require very detailed and complex calculations with respect to the executive compensation actually paid (for example, the total pay during the periods to anyone who served as CEO (so if two CEOs in one year, add up the amounts) and the average paid to the NEOs.

d) The comment period for the proposed regulations has closed. Further action on this proposal is not expected until well in to 2016.

<u>Implications: None at the present time, other than to wait and see when and what further action is taken on these rules.</u></td></tr>
<tr><td>3.</td><td><u>Disclosure of CEO Compensation Pay Ratio (“CEO Pay Ratio”)</u>: Requires annual proxy statement disclosure of (1) the median annual “total compensation” of all employees of the company (other than the CEO), (2) the total annual compensation of the CEO, and (3) the ratio of the two numbers. (DFA § 953(b))</td><td>Final rules were adopted by the SEC on August 5, 2015.

The first disclosures will relate to 2017 compensation and appear in 2018 proxy statements.</td></tr>
<tr><td colspan="3">Observations:

a) SEC officials have acknowledged that this disclosure – the ratio of the CEO’s pay to the median employee’s pay –has nothing to do with protecting investors. The proposing release stated “neither the statute nor the related legislative history directly states the objectives or intended benefits of the provision.” Rather, it’s a “name and shame” provision.

b) The required disclosures are the median annual total compensation of all employees of the registrant (except the CEO) [Mr. or Ms. Middle], the annual total compensation of the CEO, and the multiple (ratio) of the CEO’s compensation to the median. Total compensation is “proxy compensation.”

c) Companies have been given some leeway in how Mr. or Ms. Middle is identified. For example, a US-only employer could rank employees by year-end W-2 pay, identify the middle employee and then calculate that employee’s “proxy compensation.” The rules also permit the company to use the employee identified in year one for years two and three, unless there is a change in the workforce population or compensation arrangements that would significantly impact the pay ratio.

d) The rules include specifics for picking the date for determining the employee population (any date in the fourth quarter of the fiscal year); all employees are to be counted, including seasonal, part-time, non-US and temporary employees.

<u>Implications: First, there is nothing to do immediately. That said, many companies may treat 2016 for a dress rehearsal in order to make decisions about the date to use for establishing the employee population, the reasonable method for identifying the middle employee and getting a handle on what the disclosures may look like. It remains to be seen how ISS and institutional shareholders will use this information, if at all.</u></td></tr>
</table>

4.	**<u>Disclosure of Hedging Policy</u>**: Requires annual proxy statement disclosure concerning whether employees or directors are permitted to purchase derivative financial instruments (e.g., swaps and collars) that are designed to hedge or offset any decrease in the market value of the company's equity securities granted to, or otherwise owned by, the employee or director. (DFA § 955)	Proposed rules (proposed Item 407(i) of S-K) published in Federal Register on February 17, 2015. Comment period ended April 20, 2015. Per recent RFA, April 2016 is given as timeframe for issuing final rules

<u>Observations</u>:

a) As noted, when finalized these rules will require disclosure of whether employees or directors are permitted to "hedge" their holdings in company stock.

b) This is a disclosure rule only: companies are not required to have a hedging or anti-hedging policy in place. The requirement is simply to report whether a policy is in place, or not, and whether there are any restrictions on employees or directors hedging.

c) ISS and Glass Lewis both report on whether companies have/disclose anti-pledging and/or anti-hedging policies. The presence of pledges or hedged positions will be noted by ISS and Glass Lewis as contributing to risk and may adversely affect the governance score and voting recommendations with regard to directors or say-on-pay.

<u>Implications: Many companies have policies expressly prohibiting hedging transactions in the company's stock and either prohibit or limit pledging transactions by officers and directors. Companies may want to revisit these policies in anticipation of the disclosure rule on hedging.</u>

5.	**<u>Incentive-Based Compensation Arrangements</u>:** Requires the various agencies (Fed, OCC, SEC, FDIC, etc.) to jointly prescribe regulations or guidelines relating to incentive-based compensation at financial institutions. Specifically, the rules are to require reporting of incentive-based compensation arrangements at covered financial institutions and prohibit incentive-based compensation arrangements that provide excessive compensation or that could expose the institution to inappropriate risks that could lead to material financial loss. (DFA § 956)	Proposed rules were published in the Federal Register on April 14, 2011. The comment period has run and no further action has been taken with respect to proposed rules. Recent statements by OCC officials have suggested that the agencies are close t re-proposing the rules.

<u>Observations</u>:

a) These rules have been outstanding for more than four years. The rules themselves would require reporting with respect to incentive compensation and the inclusion of features (such as delayed or deferred payments, the possibility of adjustment (reduction) for bad risk outcomes, and caps on payouts) intended to minimize risk and excessive pay.

b) The rules would require annual reporting to the appropriate federal regulator concerning the structure of incentive compensation arrangements (ICAs)– variable compensation that is an incentive for performance. The report is intended to enable the regulator to assess the ICA against the excessive compensation and material risk of loss standards.

c) The proposed regulations set standards for making the excessive compensation determination based on the FDIC standards – is pay unreasonable or disproportionate to the amount, nature, quality and scope of the services performed. Factors to be looked at include total compensation, compensation history, compensation practices at comparable institutions, and the financial condition of the institution.

d) With regard to avoiding a material risk of loss, the proposed regulations provide that the ICA must balance risk and financial reward by using deferral of payments, risk adjustment of awards and reduced sensitivity to short-term versus long-term performance, fit within the financial institutions risk controls and be supported by strong governance.

e) In many ways, these rules track both the risk-review aspects of TARP and the Supervisory Guidance issued by the Fed in mid-2010. The Supervisory Guidance called upon financial institutions to adopt ICAs which balance-risk taking through deferred payouts, adjustment for material risk events and longer performance periods; consideration of risk management in the design, review and assessment of ICAs and active committee and board involvement in the process.

<u>Implications</u>: *To a large extent, many financial institutions have been following processes and taking actions that address the excessive compensation and material risk of loss aspects of the proposed rules. Many financial institutions conductan annual risk review with respect to ICAs and reported the results of that review to the Compensation Committee. Compensation levels are benchmarked against peers. Risk mitigation provisions such as the delayed bonus payouts and vesting schedules have been incorporated into various incentive plans and programs. What remains to be seen, and to be responded to, will be the specifics on the reporting obligations and any substantive requirements, such as minimum percentages of deferral or delayed payout that will be incorporated into the final rules or arise out of standards developed in the regulatory examination process.*

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