

IT'S A HOSTILE WORLD:
Responding to Unsolicited Take-Over
Proposals
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Overview

- Overview of Unsolicited Acquisitions
- Assessment of Takeover Defenses
- Duties of Directors in Adopting and Maintaining Takeover Defenses
- Case Study on Responding to a Hostile Bid

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Overview of
Unsolicited Acquisitions

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Unsolicited Acquisitions

- Defensive Review / Profile
- Legal and business due diligence
- Rights Plan (percentage flip-in)
- Classified Board (Is it leaky?)
- Stockholder action by written consent without a meeting
- Stockholder ability to call special meetings
- Stockholder ability to increase number of directors and fill vacancies
- Removal of directors without cause
- Advance notice provisions for stockholder nominations and introducing business
- Fair price provisions
- Indemnification provisions
- Change of control agreements and provisions
- State law "anti-takeover" statutes
- Stockholder profile (e.g., capitalization, impact on debt arrangements, management, employee plans, large stockholders)

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Overview of Unsolicited Acquisitions (*continued*)

- The Target's Perspective
 - Contact advisors
 - counsel
 - financial advisor
 - others (PR/IR)
 - Ascertain level of interest in transaction
 - interest level to dictate response and strategy
 - formulate response
 - Alternative value-enhancing strategies
 - Board involvement
 - Review of disclosure guidelines in the case of inquiries

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Overview of Unsolicited Acquisitions (*continued*)

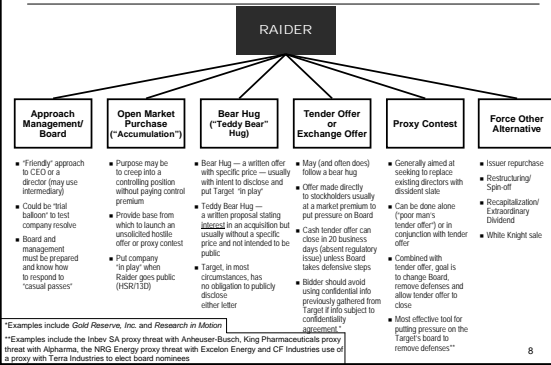
- The Bidder's Approach
 - High level executive vs. bankers
 - Phone call vs. meeting
 - Importance of scripting conversation
 - Message
 - Goals
 - Immediate debriefing
 - Importance of confidentiality

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Overview of Unsolicited Acquisitions (continued)

- The Bidder's Approach (continued)
 - Heightened concern for deal certainty in current economic environment; consider various ways parties may terminate deal and tools to protect against uncertainty
 - **Fiduciary Out:** Target board may terminate if required to do so by fiduciary duties
 - **Financing Out:** Bidder may terminate if it cannot secure necessary funds
 - **Break-Up Fee:** paid by Target to Bidder if Target terminates
 - **Reverse Break-Up Fee:** paid by Bidder to Target if Bidder terminates
 - **Specific Performance:** allows party to compel completion of transaction
 - **Material Adverse Change / Material Adverse Effect:** allow party to refuse to complete transaction if there is a major change during pre-closing period that affects value of or ability of the other party to complete the transaction (highly negotiated with a number of exceptions)
 - e.g.: IMS Health LBO transaction (Nov. 2009)

Overview of Unsolicited Acquisitions (continued)



Overview of Unsolicited Acquisitions (continued)

Hedge Funds – The New Corporate Raiders

- Present estimates indicate that hedge funds worldwide manage as much as \$1.33 trillion. This is down from the peak of approximately \$1.93 trillion managed in the second quarter of 2008.
- Increased growth in hedge fund numbers and increased competition for superior returns have led to some hedge funds becoming activist investors.
- A combination of increased redemptions and de-leveraging required by prime brokers as a result of the current market condition may increase activist activity by survivors as hedge funds scramble to maintain superior returns.

Overview of Unsolicited Acquisitions (*continued*)

Hedge Funds – The New Corporate Raiders

- Hedge funds typically target companies who have:
 - Lower market capitalizations relative to their peers
 - Substantial cash balances
 - Low financial leverage
 - Stock price or earnings underperformance
 - Depressed valuation multiples
 - Low market value relative to apparent "asset value"

- Hedge funds often fight their takeover battles in the arena of public/investor relations rather than with legal and financial maneuvering.

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Overview of Unsolicited Acquisitions (*continued*)

Hedge Funds – The New Corporate Raiders

- Hedge funds often use pressure (i.e., 13D filings) and proxy contests to compel strategic changes such as:
 - Higher dividends
 - Stock buybacks
 - Asset dispositions
 - Removal of executives
 - Sale of company

- In addition, hedge funds are also exerting their influence in opposition to proposed transactions in order to extract "bumps" and sweetened bids.

- Hedge funds are also taking advantage of appraisal rights in M&A transactions to increase their returns.

- In the current credit environment, it will be more difficult for hedge funds to push for a sale of the company.

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Overview of Unsolicited Acquisitions (*continued*)

Range of Tactics Employed (Often in Combination)

Moderate	Aggressive	Hostile
Accumulate Stake	Stockholder proposals	Present detailed proposal (breakup or sale of company, change in strategic direction and/or cash distribution)
Use trading, derivative and hedging strategies to increase position and leverage	Withhold vote campaign	Demand seat on board
Encourage other hedge funds to enter stock	Agitate for removal of takeover defenses	Public relations battle to replace board and/or management
Observe and comment	Form committee/alliance with other stockholders	Solicit buyers for all or part of business
Agitate privately	Interview customers, stockholders and line management	Enlist ISS and Glass Lewis to publicly support dissident action
Aggressive questioning on conference calls	Leak ideas to research analyst community	Litigation against company
	File Schedule 13D	Tender offer
	Hire former employees and/or experts in sector	Proxy fight/consent solicitation

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Overview of Unsolicited Acquisitions *(continued)*

- Unsolicited tender offer
 - conditions
 - cash vs. stock
 - fast-track exchange offer in stock deal
 - timing issues

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Assessment of Takeover Defenses

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Assessment of Takeover Defenses: Charter and Bylaws*

Provision	What Provision Does	Where to Find Provision
Prohibition on Stockholders' Ability to Act by Written Consensus**	Denies hostile raider the ability to remove and replace directors fairly quickly and without a meeting of stockholders.	Must be in Charter.
Prohibition on Ability of Stockholders to Call Special Meeting**	Confirms all business to the annual meeting, leaving a Board's "window of vulnerability" to a proxy contest to one meeting per year.	Can be in either Charter or Bylaws.
Classified Board**	Makes it more difficult to get control of Board by limiting the number of directors elected in any given year (generally elect 1/3 of Board each year).	Should be in Charter.
Removal of Directors Only for Cause**	Prevents dissident stockholders from causing the removal of a director for any reason other than fraud, criminal acts, etc.	Should be in Charter; is automatically part of a Classified Board provision in Charters.
Number of Directors Fixed Only by Share**	Prevents dissident stockholders from "packing" the Board by increasing its size.	Should be in Charter, but often in Bylaws, where it is vulnerable to amendment.
Remaining Directors Have Sole Right to Fill Vacancies	Prevents dissident stockholders from "packing" the Board by filling vacant seats.	Should be in Charter, but often in Bylaws, where it is vulnerable to amendment.
Board has Explicit Authority to Amend Bylaws	Allows Board flexibility in adopting or amending Bylaw provisions.	Charter and/or Bylaws.
Supermajority Vote to Amend Certain Bylaw Provisions	Limits rights of stockholders to change a corporation's governing documents so as to facilitate a takeover.	Should be in Charter.
Prohibition on Ability to Put Forward Stockholder Proposals or to Nominate Directors at Stockholders Meeting Without Advance Notice to Company	Limits the use of "last minute" proposals and gives the Board advance notice of any dissent. Usually requires not less than 90 days' advance notice.	Usually in Bylaws.
Flexibility in Setting Annual Meeting	When coupled with other restrictions on special meetings and action by consent, grants Board flexibility to determine best time to schedule annual meeting (subject to certain Delaware law requirements).	Usually in Bylaws.
Blank Check Preferred Stock	Grants the Board authority to issue the preferred stock necessary to implement certain defenses, including a poison pill shareholder rights plan.	Must be in Charter.
Contingent Cumulative Voting	When coupled with a classified board, permits minority stockholders to further delay a hostile raider from gaining control of board of directors.	Must be in Charter.
Advance Notice	Prevents last minute matters from being proposed at meetings of stockholders and gives the Board time to prepare defensive measures. These provisions should be reviewed in light of recent DE case law.	Usually in Bylaws.

* Chart describes Delaware law. The law of the state of incorporation of the target company governs these provisions, and may vary from state to state.
 ** Consists "High Vulnerability" of listing.
 *** Consists "Lower Vulnerability", especially if combined with a Shareholder Rights Plan.

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Assessment of Takeover Defenses

- The Critical Distinction Between a Charter Provision and a Bylaw Provision
 - Stockholders cannot unilaterally amend Charter; the Board must first approve.

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Assessment of Takeover Defenses *(continued)*

- Limits on Stockholders' Ability to Act by Written Consent or to Call a Special Meeting
 - Provisions that restrict stockholders from (i) taking action by written consent and (ii) calling a special meeting.
 - These provisions restrict the "window of Board vulnerability" only to a proxy contest conducted in connection with the annual meeting.
 - Provision denying stockholders the ability to act by written consent (or requiring unanimous written consent) must be in Charter.
 - Critical defensive provisions that give the Board control of the voting mechanism.
 - Usually accompanied by Bylaw provisions giving the Board maximum flexibility in setting stockholder meeting dates.
 - To the extent stockholders can act by written consent, provision for establishing record date/notice (10/10).

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Assessment of Takeover Defenses *(continued)*

- Classified or "Staggered" Board
 - A Classified Board is one in which directors are divided into separate classes.
 - Usually three classes, with the directors in each class serving three-year terms and only one class elected annually.
 - Staggering directors' terms makes it more difficult for dissidents to use a proxy contest to seize control of a target company immediately.
 - Even if dissidents control a majority of the company's stock, they can elect only one-third of the directors in any one year.
 - As of September 30, 2009, approximately 32% of S&P 500 companies had staggered boards, down from approximately 53% at the end of 2005.

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Assessment of Takeover Defenses (*continued*)

- **Board Vacancies & Size; Removal of Directors**
 - Provisions allowing Board the sole authority to fix the size of the Board and fill vacancies; gives Board control over its own size and constitution.
 - Having the Board determine its own size (within limits) prevents dissidents from "packing" the Board by increasing its size and filling the newly created vacancies.
 - Provisions fixing size of Board should be in Charter; if in Bylaws, it is vulnerable to amendment by stockholders.

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Assessment of Takeover Defenses (*continued*)

- **Board Vacancies & Size; Removal of Directors (*continued*)**
 - Removal of the directors *only for cause* prevents dissident stockholders from causing the removal of a director for any reason other than fraud, criminal acts, etc.
 - These provisions serve as a necessary complement to the Classified Board provision.
 - In Delaware, a Classified Board provision automatically provides for removal only for cause even if Charter is silent.

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Assessment of Takeover Defenses (*continued*)

- **Limited Ability to Amend Charter or Bylaws**
 - These provisions provide limitations on the rights of stockholders to amend the corporation's governing documents.
 - Typical restrictions include requiring a supermajority vote to amend the Charter and/or Bylaws and, where such powers are not granted under state law, empowering directors to amend the Bylaw without stockholders' consent.
 - In Delaware, stockholder vote is required to amend the Charter and stockholders cannot be denied absolutely the right to amend Bylaws. Proxy contests seeking to amend the Bylaws can be restricted more effectively by using supermajority stockholder vote requirements for such action.

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Assessment of Takeover Defenses (*continued*)

▪ **Fair Price Provisions**

- Fair price provisions require a bidder to pay all stockholders a "fair price," usually defined as the highest price the bidder paid for any of the shares it acquires of a target company during a specified period of time before the commencement of a tender offer.
- Most fair price provisions do not apply if a merger is approved by the target's Board or if the bidder obtains a specified supermajority level of approval for the merger from the target's stockholders.
- Generally designed to deal with coercive two-tier offers. The advent of the stockholder rights plan has greatly reduced the need for these provisions.

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Assessment of Takeover Defenses (*continued*)

▪ **Blank Check Preferred Stock**

- "Blank check preferred stock" describes preferred stock authorization provisions that give the Board of Directors broad discretion to establish voting, dividend, conversion and other rights for preferred stock.
 - Such broad authorization provides a Board with flexibility to meet changing financial conditions, but it also grants the Board authority to issue the preferred stock necessary to implement certain defenses, including a poison pill stockholder rights plan.
 - Blank check preferred also can be placed with an employee stock ownership plan or a friendly investor. These parties may control enough voting power to block a takeover attempt.

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Assessment of Takeover Defenses (*continued*)

▪ **Advance Notice**

- All public companies should have a Charter or Bylaw provision that requires stockholders to provide advance notice of business that they intend to present at a stockholders' meeting. Such requirements may apply to Board nominations, resolutions to be offered from the floor, or both.
 - In most cases, the advance notice requirements take the form of a "window" that specifies the earliest and latest dates for such submissions (typically 90-120 days in advance of the annual meeting).

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Assessment of Takeover Defenses (continued)

- Advance Notice (continued)
 - If stockholders fail to comply with the notice requirements, the company has the right to disregard any efforts to discuss or vote on the business at the meeting.
 - Advance notice provisions prevent "last minute" matters from being proposed at meetings of stockholders, generally dissuading disruptive practices.
 - These provisions are usually used with other provisions that give the Board power to determine meeting procedures.

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Assessment of Takeover Defenses (continued)

- Advance Notice (continued)
 - Recently, practitioners and their clients have been giving greater consideration to expanding advance notice bylaws. Such expansions include:
 - Disclosure of derivative positions that allow an investor to vote the security or to create the economic equivalent of ownership without acquiring ownership of the security itself.*
 - Continuous disclosure for beneficial owners of greater than 5% of voting equity securities so that investors must disclose any change of position after the initial advance notice is made.
 - Recent Delaware case law (JANA v. CNET and Levitt v. Office Depot) suggests that the court will construe the language of a company's bylaws narrowly and resolve ambiguity in favor of shareholder rights. In light of these decisions, corporations should review their advance notice bylaw provisions in order to avoid any ambiguity that an activist shareholder could exploit.

*In the recent U.S. N.Y. District Court case of CSX v. TCI Management, the court held that the holders of derivative instruments were beneficial owners for Exchange Act disclosure purposes because they had entered into the derivative agreements with the intention of avoiding disclosure requirements. Practitioners have extrapolated this securities law finding to the corporate governance arena through the expansion of advance notice bylaw provisions.

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Assessment of Takeover Defenses (continued)

- Shareholder Rights Plans
 - A Shareholder Rights Plan can help a board maximize stockholder value.
 - A Shareholder Rights Plan is not intended to and will not prevent a hostile takeover of a company, nor does it eliminate obligation of the directors to exercise their fiduciary duty.
 - Additional Advantages:
 - Provides time to evaluate alternatives in order to maximize value for all stockholders.
 - Board can implement this common takeover defense relatively quickly without a stockholder vote knowing that it has been endorsed by the courts.
 - Board retains power to redeem rights.

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Assessment of Takeover Defenses (*continued*)

▪ State Takeover Laws

- Generally: The inherent threat of plant closings, lost jobs, headquarters relocations and other such community-damaging results provides motivation for state legislatures to take an active interest in takeovers. State legislatures are limited, however, in the degree to which they can regulate takeovers because such state anti-takeover legislation must not be so excessive as to be unconstitutional.

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Assessment of Takeover Defenses (*continued*)

▪ State Takeover Laws (*continued*)

- Control Share Acquisition Statutes bar creeping acquisitions over the 20% threshold.
 - Once an "acquiring person" purchases over 20%, 33% or 50% of target's shares, the "control shares" (the shares to be purchased by the acquiring person that are over the applicable threshold percentage) may not exercise voting rights unless other stockholders approve at a special meeting.

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Assessment of Takeover Defenses (*continued*)

▪ State Takeover Laws (*continued*)

- Business Combination Statutes prevent front-end loaded, two-step coercive takeovers.
 - Target may not engage in any business combination with an "interested stockholder" (a 15% or greater percent stockholder) for three years following such 15% (or greater percentage) acquisition unless:
 - 85% or more of outstanding shares are acquired;
 - the acquisition or business combination was approved by the target's Board before the date of the acquisition; or
 - the business combination is approved by the target's Board and the holders of at least 62 2/3% of target's outstanding shares, excluding shares owned by the interested stockholder.

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Assessment of Takeover Defenses (*continued*)

- **State Takeover Laws (*continued*)**
 - Fair Price Statutes accomplish the same objectives as fair price provisions found in a company's organizational documents.
 - Some states have fair price provisions as the default rule by statute.

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Assessment of Takeover Defenses (*continued*)

- **Constituency Provisions**
 - Constituency Provisions of state law permit target's board to use broad discretion in the face of a hostile bid or, when faced with a choice of competing bids, to accept a takeover proposal that retains employees and a strong local presence but that may be slightly less advantageous to stockholders than a competing nominally higher proposal that involves plant closings or the disposition of critical assets.
 - Delaware does not have a constituency provision.

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Assessment of Takeover Defenses (*continued*)

- **Constituency Provisions (*continued*)**
 - Directors of target may, in discharging the director's duties relating to any proposed corporate action, including any response to a takeover proposal, consider the interests of the corporation's employees, customers, suppliers and creditors, the economy of the state and nation, community and societal considerations, and the long-term as well as short-term interests of the corporation including the possibility that these interests may be best served by the continued independence of the target. (New York, Indiana, Pennsylvania have such provisions.)

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Duties of Directors in Adopting
and Maintaining Takeover Defenses

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Duties of Directors

- The Business Judgment Rule
- Duties in responding to an unsolicited offer
 - Unocal "Enhanced Scrutiny" Standard
 - "Just-Say-No" Defense
 - Revlon Duties

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Duties of Directors

The Business Judgment Rule

- Under Delaware law, a director's duties in managing the business and affairs of a corporation involve three key elements:
 - First, the duty of loyalty;
 - Second, the duty of care; and
 - Third, the duty to act in a manner the director reasonably believes to be in the best interests of the corporation and its stockholders.

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Duties of Directors
The Business Judgment Rule *(continued)*

- The duty of loyalty requires that the director not have any special and material interest in the transaction inconsistent with that of stockholders generally.
 - The fact that a director may be a director of the combined entity does not itself create self-interest under Delaware law.

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Duties of Directors
The Business Judgment Rule *(continued)*

- The duty of care requires a director to act in an informed and considered manner and to take the care that a prudent business person would take when considering a business decision.
 - A director will be considered well-informed if he/she carefully considers the various financial, legal and other aspects of the proposed transaction.
 - A director is entitled, and expected, to rely upon information provided by management and outside advisors, but his/her duty of care is not satisfied merely by the receipt and review of information, recommendations and opinions of others.

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Duties of Directors
The Business Judgment Rule *(continued)*

- As long as a board of directors properly discharges its fiduciary duties of loyalty and care and acts in the best interest of the corporation and its stockholders, the "business judgment rule" should apply to the decisions of a company's board of directors.
 - Under the business judgment rule, Directors' decisions are presumed to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company and its stockholders.
 - A rationale for this doctrine of judicial deference is that business decisions ought to be made in the boardroom not the courtroom.
 - When the traditional business judgment rule applies, directors' decisions (even if they turn out to be incorrect) are protected unless a plaintiff is able to carry its burden of proof in showing that a company's board has not met its duty of care or loyalty or acted in the best interests of the corporation and its stockholders.

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Duties of Directors
Duties in Responding to an Unsolicited Offer

- There is no legal duty to negotiate or propose alternate terms in response to an offer.
 - The duty is to respond to the offer *as presented*.
- There is a duty to carefully investigate the offer and to respond to it in good faith on a reasonable basis.
 - When a board is confronted with an unsolicited offer, it has the obligation to determine whether the offer is in the best interests of the company and its stockholders.
- Unless a company is in "Revlon mode," its board is not under any duty to sell the company or negotiate with the offeror, even if the offer represents a substantial premium to current market prices.

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Duties of Directors
Unocal "Enhanced Scrutiny" Standard

- **Enhanced Scrutiny for Defensive Measures**
 - A decision by target's board not to accept an unsolicited offer generally would be reviewed under the business judgment rule
 - When a board adopts a defensive mechanism in response to an alleged threat to corporate control or policy, however, Delaware courts review the board's action under an "enhanced scrutiny" standard rather than the traditional Business Judgment Rule. The directors have the burden of proof to show that the "enhanced scrutiny" standard has been satisfied. (*Unocal v. Mesa Petroleum*, 493 A.2d 946 (Del. 1985).

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Duties of Directors
Unocal "Enhanced Scrutiny" Standard (*continued*)

- Unocal's enhanced scrutiny standard requires, in the context of a defensive device or transaction, that the board show:
 - that it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed"
 - that the defensive measure chosen was "reasonable in relation to the threat posed"

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Duties of Directors
Unocal "Enhanced Scrutiny" Standard (continued)

- **First Unocal Prong:** "reasonable grounds for believing that a danger to corporate policy and effectiveness"
 - To satisfy the first Unocal prong, a board has a duty to investigate an offer carefully and to respond to the offer in good faith and on a reasonable basis.

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Duties of Directors
Unocal "Enhanced Scrutiny" Standard (continued)

- When assessing whether an unsolicited offer poses a danger to corporate policy, a board's analysis should consider:
 - the adequacy and terms of the offer
 - the offer's fairness and feasibility
 - the proposed or actual financing for the offer, and the consequences of that financing
 - questions of illegality
 - the risk of nonconsummation
 - the bidder's identity, prior background and other business venture experience

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Duties of Directors
Unocal "Enhanced Scrutiny" Standard (continued)

- **Second Unocal Prong:** "defensive measures are reasonable in relation to the threat posed"
 - To satisfy second Unocal prong, board must show (based on *Unitrin v. American General*):
 - defensive measure was not draconian (i.e., not "coercive" or "preclusive")
 - defensive measure, if not draconian, was within a "range of reasonableness"

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Duties of Directors

Unocal "Enhanced Scrutiny" Standard (continued)

▪ Miscellaneous Unocal Considerations

- Poison pills have survived Unocal's/Unitrin's enhanced scrutiny.
- An unfair price is a legally cognizable danger to corporate policy and effectiveness under Unocal.
- The proof presented by the board in support of its burden is "materially enhanced" where a majority of the board consists of "outside independent directors".
- The target board's actions must be "defensive" to be subject to enhanced scrutiny.
 - A previously announced merger is not "defensive" in response to an unsolicited bid unless and until the form of the previously announced transaction changes in response to the unsolicited bid.

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Duties of Directors

The "Just Say No" Defense

- Under Delaware law, if the target's board maintains a "good faith belief, made after reasonable investigation," that the unsolicited offer poses a legally cognizable threat, the target's board may "just say no" by refusing to redeem a poison pill.
- In *Moore Corp. v. Wallace*, the Wallace Board was able to show that the favorable results from a recently adopted capital expenditure plan were "beginning to be translated into financial results which even surpass management and financial analyst projections." Wallace successfully argued that the risk that its stockholders might tender into the Moore offer without fully appreciating the potential impact of the capex plan on Wallace's intrinsic value constituted a "legally cognizable threat."

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Duties of Directors

Revlon Duties

▪ Revlon Duties

- The Unocal standard applies to a board's adoption of defensive measures in response to an unsolicited acquisition proposal.
- However, the standard changes if the target is already trying to sell itself (e.g., by merging with a third party) or the board deems that a break-up of the company is inevitable.
- The directors' role changes from "defenders of corporate policies" to "auctioneers charged with getting the best reasonably attainable value".

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Duties of Directors
Revlon Duties (continued)

- When do “Revlon duties” apply?
 - Target initiates an active bidding process or seeks an alternative transaction involving a break-up of the company
 - Change of control situation
 - all cash mergers
 - not stock-for-stock mergers (in the absence of a controlling stockholder)
 - certain mixed cash/stock mergers
 - Revlon duties not triggered by stock-for-stock merger so long as no controlling stockholder controls the combined entity because the combined entity is considered to remain in the hands of the market (i.e. there is no “change in control”).

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Duties of Directors
Revlon Duties (continued)

- If Revlon duties apply, directors are required to examine competing acquisition proposals and choose a course of action “reasonably calculated to secure the best value available” to the target’s stockholders.
 - Auctions, market checks and “fiduciary outs”
 - Lock-up devices – break-up fees, no-talks and crown jewel options

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Duties of Directors
Revlon Duties (continued)

- Deal Protection Devices
 - Deal protection devices (as distinguished from defensive measures) in a friendly stock-for-stock merger context will also trigger enhanced scrutiny under Unocal.

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