



# Mergers & Acquisitions and Corporate Governance

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Cleary Gottlieb is representing **Goldman Sachs** and **J.P. Morgan Securities**, as financial advisors to **News Corporation**, in the exchange by News of its stake in **The DIRECTV Group**, three Regional Sports Networks, and \$550 million of cash for **Liberty Media's** entire economic position in News for a transaction value of approximately \$11 billion.

## The Need for Careful Choreography in LBOs

by *Ethan Klingsberg*

Page 2

Recent caselaw, including the Delaware Chancery Court's recent decision in *In re SS&C Technologies, Inc. Shareholders Litigation*, provides valuable guidance on how to choreograph the dual role of target management and the settlement of shareholder litigation in high profile LBOs.

## Exon-Florio Review of Foreign Investment in the U.S. is Tightening

by *Paul Marquardt and Nathaniel Stankard*

Page 5

Review by the Committee on Foreign Investment in the United States has become both more likely and more burdensome as a result of a post-9/11 focus on homeland security and a series of high-profile, controversial transactions. Transactions that, five years ago, would not have been thought to raise national security concerns are now the subject of increasingly aggressive reviews. Foreign acquirors must now seriously weigh the political and competitive risks of a CFIUS review – whether resulting from genuine national security concerns, political considerations, or competitive maneuvering – in their business strategy. There are complex questions of judgment about whether to voluntarily notify a transaction to CFIUS and, if a review is initiated, how vigorously to resist government demands for an extended process or agreement to burdensome security agreement provisions.

## Solvent Company Cannot Use Bankruptcy Code to Skirt Shareholder Vote Requirements

by *Lisa Schweitzer and Joaquin Terceño*

Page 10

The Delaware Chancery Court's recent decision in *Esopus Creek Value LP v. Hauf* expresses strong disapproval of the efforts of a financially healthy company delinquent in its federal periodic reporting requirements to sell substantially all of its assets through a bankruptcy proceeding without a common stockholder vote or otherwise to undermine its common stockholders' voting rights.

## Shareholder Approval of Executive Pay: The UK Experience

by *Tibir Sarkar, Arthur Kohn and Chris Macbeth*

Page 14

The current environment of intense focus on executive compensation has led to a recent announcement by Aflac Incorporated that it will, beginning in 2009, give its shareholders a nonbinding vote on its executive compensation practices. Notwithstanding the view by some that such votes are ill-advised, it seems unlikely that the issue will disappear quickly in light of the Aflac announcement, the significant interest among certain institutional investors in the idea, continued public controversy and attention over levels of executive pay and proposed federal legislation in the area. Moreover, commentators in the United States frequently note that such shareholder votes are required or encouraged in jurisdictions such as the UK, Australia, Sweden and the Netherlands, as evidence that the practice is not impractical. This article provides a brief overview by members of both our New York and London offices of how the practice has been implemented in the UK, as background information for those who may be forced to deal with the issue in the United States in the future.

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## The Need for Careful Choreography in LBOs

by Ethan Klingsberg

Two processes are common in leveraged buy-outs of public companies.

The first involves finding just the right balance for the dual roles of the target's senior management in:

- Execution of the sale process, where the objective is to assure the best outcome for stockholders generally, and
- Negotiation of management's own post-closing arrangements, where the objective is to retain and incentivize management for the period after the target has been taken private.

The second involves settling the seemingly inevitable shareholders' litigation that challenges the LBO based on claims that the sale is the product of a process marred by management conflicts and a failure to take reasonable steps to obtain the highest price.

Important guidance on how to choreograph these two processes to a successful finale emerges from a recent decision by the Delaware Court of Chancery.<sup>1</sup> The guidance comes in the context of the Court's review of a proposed settlement of a shareholder suit challenging an LBO and ultimate determination to reject the settlement due to the following missteps:

- the acceptance by plaintiffs' counsel of a non-monetary remedy (i.e., "the publication of some supplemental disclosure") when the sequencing of the negotiations and role of the target's CEO in those negotiations may have indicated potentially serious violations of fiduciary duties; and

- the timing of the request for court approval of the settlement relative to the consummation of the transaction.

### Is a Good Special Committee Process a Cure-All When Target Management Teams Up with a Financial Sponsor?

In the LBO in question, the target's CEO, together with outside advisors to the company, sought out a half dozen financial sponsors and selected one with which they negotiated terms for an all-cash sale of the company. The negotiated transaction included a provision for the CEO (who held about 25% of the target's equity) to rollover about two-thirds of his equity into a 31% equity position in the surviving corporation. The CEO then brought this deal back to his board of directors, which responsibly turned the matter over to a special committee of disinterested directors. The special committee retained independent advisors, solicited competing bids, improved a few contract terms with the CEO's chosen bidder, and ultimately agreed to a sale to this bidder at a less than one percent increase in the purchase price over what the CEO had initially negotiated.

Nobody has ever doubted that the CEO is an unreliable negotiator for the target where he is simultaneously negotiating the sale of the company and his own, significant post-closing arrangements. But the interesting question that Vice Chancellor Lamb addresses in his decision is whether the submission of a CEO-negotiated deal to a special committee process is capable of cleansing the taint that may attach from the

earlier process run by the CEO. The Vice Chancellor does not even bother considering whether the indicia of a good special committee process were present, such as the independence of the directors and the degree to which they engaged in a well-informed, deliberative and aggressive process to protect the best interests of the stockholders. Instead, the Court addresses the more fundamental question of whether the initial, unilateral negotiation of a buy-out by a conflicted insider has the ability to flaw the sale process to such an extent that even the best special committee that Delaware has ever witnessed would not be adequate to cure the situation.

The answer, suggested by the Court, is that the special committee process may not be able to cure potential problems that may arise from a CEO's going out on his own to pre-commit to a particular buy-out transaction, including:

- Misuse of the company's confidential information and resources when, acting in an official capacity and without board authorization, the CEO hires an "investment banker to help him find a private equity partner to suit his needs"
- Prevention of the board of directors from being able "to objectively consider whether or not a sale of the enterprise should take place"
- Impeding the ability of the special committee to attract competing bids and
- Impeding the ability of the special committee to secure the best terms reasonably available from the CEO's chosen bidder

Vice Chancellor Lamb does not attribute any of these potential problems to interference by the CEO with the special committee process after it had commenced or a misstep by the special

committee. He views these problems as potentially arising entirely from the simple fact that the conflicted CEO negotiated the deal for the company and himself *in advance* of the board's having any involvement.

In view of these sentiments, executives contemplating the entertainment of buy-out offers should consider the advisability under the circumstances of making their full board aware and keeping their board posted. Indeed, these executives may be able to play a greater role in negotiating the buy-out transaction if they work with their board up-front, rather than bringing a conflicted deal back to their board to be filtered through a special committee process. For example, a board may reasonably decide to put management in the front-line negotiations and avoid a separate special committee process if the board:

- has a majority of independent directors,
- gives management strict instructions to avoid negotiating or discussing their personal post-closing arrangements until the board gives express permission following the completion of the negotiation of the best deal for the stockholders and otherwise sets rules for interaction between management and the bidders, and
- the independent directors have regular opportunities to deliberate in sessions outside the presence of management and, if the directors so desire, an opportunity to consult with separate advisors.<sup>2</sup>

This approach permits the board to make use of management's expertise and avoid the scrutiny that a formal special committee process attracts, while enabling management to remain in the center of the action.

### The Non-Monetary Settlement Dance

The Vice Chancellor in the *SS&C* decision also castigates the parties for waiting until after the closing of the merger to request court approval of the settlement of the litigation challenging the transaction. Exacerbating circumstances included the postponement of confirmatory discovery until after closing and the failure to obtain leave of court before the closing.

The principle that settlements should be approved before closing has logical appeal and has been endorsed from the bench previously. However, both contractual obligations and pressure from investors mandate a prompt closing in the public M&A context and therefore it is usually impractical to go from the “memorandum of understanding”-phase of settlement (where plaintiffs counsel and the parties to the transaction agree, subject to confirmatory discovery and court approval, on the terms of settlement) all the way to completion of confirmatory discovery and other settlement approval mechanics in time to present the settlement to the court for formal approval before the closing of the transaction. Accordingly, the concept of obtaining some type of leave of the court to close before the formal approval of the settlement is critical. Before any acquiror closes a transaction with a settlement that has been memorialized in a memorandum of understanding but not yet been formally approved by the court, the acquiror needs to assure that litigation counsel is comfortable that the court has received sufficient notice that the settlement approval process is going to extend beyond closing.

While plaintiffs’ counsel bears the brunt of the criticism in a post-closing court decision that throws out a settlement (as was certainly the

case in this recent opinion by Vice Chancellor Lamb), the real loser in such a decision is the acquiror, who is left with a surviving company that has to defend against a continuing suit. Even worse, in the matter in question, the surviving company has to face a court-authored roadmap to what the Court describes, at least facially, as potentially serious claims for breaches of fiduciary duties..

1 *In re SS&C Technologies, Inc. Shareholders Litigation* (Del. Ch. Nov. 29, 2006).

2 *See, e.g., In re Toys “R” Us, Inc. Shareholder Litigation*, 877 A.2d 975 (Del. Ch. 2005).

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## Exon-Florio Review of Foreign Investment in the U.S. Is Tightening

by Paul Marquardt and Nathaniel Stankard

The Committee on Foreign Investment in the United States (“CFIUS”), comprising representatives from 12 government agencies, reviews acquisitions of controlling interests in U.S. businesses (including U.S. operations of foreign companies) by foreign-controlled entities and determines their effect on U.S. national security. CFIUS implements the 1988 Exon-Florio amendments to the Defense Production Act of 1950 (50 U.S.C. App. § 2170), which provided for national security reviews. On a recommendation from CFIUS, the President can block a transaction or even force a divestiture if the transaction is already consummated. Historically, CFIUS has used its authority sparingly, focusing its attention on transactions involving companies with Department of Defense (“DoD”) contracts or access to classified information or sensitive technologies.

However, CFIUS scrutiny has recently become an increasingly important factor in cross-border transactions touching the United States. Over recent years, driven by an increased focus on homeland security following 9/11 and a number of high-profile cases, CFIUS has broadened the industries it scrutinizes, engaged in lengthier and more intensive reviews, and sought more burdensome remedies. The concept of “national security” now encompasses energy, telecommunications, transportation, and other elements of “critical national infrastructure.” CFIUS uses informal means to encourage and in some cases coerce extensions of the statutory 30-day review period. Finally, CFIUS increasingly requires “national security agreements” or divestitures as a condition of approval, seeking ever more

draconian enforcement mechanisms. Together with pending legislation to expand CFIUS’s authority and a series of controversial transactions—such as CNOOC-Unocal, DP World-P&O, and Alcatel-Lucent<sup>1</sup>—these developments have created substantial regulatory uncertainty for foreign companies acquiring a U.S. target.

### Overview of Notification and Review Process.

CFIUS was created by presidential order to implement the President’s authority under Exon-Florio to suspend, prohibit, or force divestiture of foreign acquisitions, mergers, or takeovers of U.S. businesses that threaten to impair the national security of the United States. CFIUS is authorized to review acquisitions of control over U.S. businesses (including U.S. operations of a foreign business) by a foreign-controlled entity, as well as certain acquisitions of research and development facilities. “Control” is a de facto test, and it is possible for a dominant minority interest to exercise control.

The review process ordinarily begins with the filing of a voluntary notification by the parties, which triggers a 30-day initial review period.<sup>2</sup> The notice includes information such as a detailed description of the transaction and the parties, related government contracts, future plans for the U.S. entity, and foreign government involvement. CFIUS also routinely requires detailed personal information about the individual officers, directors, and significant shareholders of the acquiror and its parents. If, after the initial review, CFIUS decides there may

be national security issues, it can open a 45-day second-stage investigation. A report is then sent to the President, who then has 15 days to decide whether the transaction “threatens to impair the national security” and accordingly block the deal or force divestiture.

Although CFIUS notification is formally optional, there are two reasons why a foreign acquiror may choose nonetheless to do so. First, CFIUS is authorized to initiate its own investigations, and the risk of self-initiation has increased as a result of recent pressures (CFIUS agencies monitor the press for transactions of interest). If the government appears likely to review the transaction in any event, the acquiror may choose to take the initiative. Second, if the transaction is not notified and cleared, the government retains the power to order divestiture indefinitely after closing (although it is procedurally difficult after three years). If a transaction later becomes controversial, that power can give the government considerable leverage.<sup>3</sup> On the other hand, these risks must be weighed against the burdens and delay of notification and the risk that requesting clearance will effectively expose the acquiror to new conditions imposed by the government to avoid blocking a transaction altogether.

### **CFIUS Reviews Are Becoming More Stringent.**

#### **The Definition of “National Security” Is Expanding.**

The CFIUS regulations do not define “national security” (a deliberate choice), nor is there a list of industries or products deemed to affect the national security. In practice, CFIUS has wide discretion to decide what “national security” means. Historically, foreign control was considered a potential threat to national

security most often when a target U.S. company provided goods or services to the DoD or other security agencies, especially if a contract involved access to classified information or sensitive technologies (*e.g.*, satellite optics or high-powered computing). However, the definition of “national security” in CFIUS reviews has since expanded, most notably to include transactions involving “critical national infrastructure” such as telecommunications, energy, and transportation. Transactions in economically critical sectors are now more likely to attract scrutiny.

#### **More Transactions Require “National Security” Agreements for Approval.**

CFIUS also increasingly requires a “national security agreement” or “mitigation agreement” in transactions in sensitive sectors. These agreements impose obligations on the parties to restructure the acquired U.S. business to insulate sensitive functions from control by the foreign parent as an alternative to having an acquisition blocked entirely. In 2006, just one agency, the Department of Homeland Security, required 15 such agreements, more than the previous three years combined.

These agreements are especially prevalent in “critical national infrastructure” deals; for example, they are now routine in telecommunications transactions. Typical agreements might require a security plan, restrictions on foreign personnel, restrictions on locating assets outside the U.S., and reporting or cooperation obligations. Agreements in other sectors tend to follow a similar pattern of attempting to wall off the operations of concern, requiring sensitive U.S. operations be managed separately by U.S. citizens.<sup>4</sup> There is also an increasing trend to include onerous

enforcement mechanisms in the agreement. In the Alcatel-Lucent security agreement, an unprecedented “evergreen” clause allows the government to order Alcatel to divest Lucent if, at any time in the future, its security commitments are breached; in other transactions, the government seeks penalty clauses providing for massive fines in the case of a breach.

#### **Certain Countries Attract Closer Scrutiny.**

Both for political and for security reasons, acquirors from certain countries are more likely to attract attention. Most notable is China; a series of transactions (including CNOOC-Unocal and Global Crossing, in which companies linked with China were forced to abandon proposed acquisitions) has demonstrated that CFIUS closely scrutinizes acquisitions by Chinese-controlled entities. There are also indications that acquisitions by Russian-controlled entities are facing increasing skepticism. Finally, political tensions are increasingly spilling over into the CFIUS process; congressional pressure in the DP World transaction was clearly related to its Middle Eastern ownership, and the recent post-closing investigation of the acquisition of a voting machine company by interests linked to Venezuela had a clear political dimension.

#### **Effective Review Times Are Lengthening.**

While the statutory timetable has not changed, the practical time to completion of CFIUS reviews has lengthened. CFIUS has difficulty meeting the 30-day deadline as its caseload increases, and it strongly encourages parties to potentially controversial transactions to make “pre-filings” or submit draft notifications to lengthen the period CFIUS has to review the transaction. CFIUS also may request at the end of the process that the parties “voluntarily” withdraw and re-file their notification to restart

the 30-day period. In both cases, the threat of an extended investigation provides leverage to the CFIUS agencies and forces the parties into the difficult choice of confronting the government or delaying their transaction.

#### **The Process Is Increasingly Politicized.**

The clearest example of political intervention in the CFIUS process is DP World, a transaction that was actually cleared by CFIUS before congressional pressure (initiated largely by a Florida labor union and the “Hardball” television show) forced DP World to agree to re-open the procedure. Congressional pressure also played an important role in the CNOOC-Unocal transaction, and opponents to transactions (whether targets of hostile bids, disappointed competitors, or local constituents fearing downsizing of the U.S. business) are becoming increasingly sophisticated and active in attempting to generate “national security” concerns regarding transactions.

#### **CFIUS Review Is Not Limited to U.S. Companies.**

CFIUS has always had jurisdiction to review acquisitions of foreign companies to the extent of their business in the United States; for example, the DP World transaction involved the purchase of P&O, a UK company. However, there are indications that CFIUS is becoming increasingly assertive in reviewing transactions whose center of gravity is outside the United States, even between well-known international companies. For example, the formation of a joint venture between Nokia and Siemens in telecom network equipment was reported to be subject to a CFIUS review and a mitigation agreement required, despite the fact that the bulk of the contributed businesses was outside the United States.

### **Pending Legislation Is Likely to Further Increase Pressure on Transactions.**

Congress is divided on the CFIUS process. Some criticize CFIUS for being too lenient and want to increase political oversight; others are more concerned about the impact of any changes to CFIUS on foreign investment and on foreign governments' treatment of U.S. investors. However, the balance appears to favor at least some tightening of CFIUS review. After the DP World transaction in 2006, bills to reform CFIUS passed both the House and Senate, but no final compromise was reached. Legislation has been re-introduced in the new Congress, and while it is too early to be certain what its precise terms will be, there is a good chance a bill will be adopted.

On February 28, the House passed the National Security Foreign Investment Reform and Strengthened Transparency Act of 2007 (H.R. 556), which is endorsed by several large business groups as an alternative to last year's more restrictive Senate bill discussed below. H.R. 556 establishes CFIUS in statute (to replace the existing presidential order) while retaining its essential features, such as the timetable and voluntary notification. However, the bill departs from previous CFIUS practice in several significant ways. Among other provisions, H.R. 556:

- Explicitly includes "homeland security, including its application to critical infrastructure," in the definition of "national security";
- Presumptively requires transactions involving foreign government-controlled entities to undergo a second-stage investigation, unless the Departments of Treasury, Homeland Security and Commerce certify that there are no national security issues;

- Explicitly endorses the practice of negotiating agreements with a party in order to mitigate a threat to national security and adds authority to unilaterally impose conditions;
- Provides that a willful material breach of an agreement or condition may be grounds to re-open the investigation;
- Formalizes the right of any single CFIUS agency to require an in-depth investigation; and
- Provides CFIUS with the ability to extend a second-stage investigation by up to an additional 45 days.

The Senate has not yet introduced new legislation, but its bill last year was significantly less favorable to acquirors than H.R. 556. As of this writing, it appears likely that the Senate will consider a new bill rather than last year's version. However, there are early indications that the Senate is likely to retain a considerably more politicized CFIUS process, requiring notices to Congress regarding CFIUS filings while reviews are still pending.

### **Conclusion.**

CFIUS review has become both more likely and more burdensome as a result of a post-9/11 focus on homeland security and a series of high-profile, controversial transactions. Transactions that, five years ago, would not have been thought to raise national security concerns are now the subject of increasingly aggressive reviews. Foreign acquirors must now seriously weigh the political and competitive risks of a CFIUS review – whether resulting from genuine national security concerns, political considerations, or competitive maneuvering – in their business strategy. There are complex questions of judgment about whether to voluntarily notify a transaction to CFIUS and, if a review is initiated, how vigorously to

resist government demands for an extended process or agreement to burdensome security agreement provisions.

- 1 The state-owned China National Offshore Oil Corporation (“CNOOC”) was forced to withdraw its bid for Unocal Corp. in 2005 after considerable Congressional outcry. In 2006, when Dubai Ports World (“DP World”), a company controlled by the United Arab Emirates, sought to acquire Peninsular & Oriental Steam Navigation (“P&O”), a British company, Congress objected because the acquisition included operating rights to six U.S. port facilities. DP World was forced to transfer the U.S. port operations to an American entity. Also in 2006, the merger between Alcatel SA, a French company, and U.S.-based Lucent Technologies was heavily scrutinized because of Lucent’s Bell Labs, which conducts classified research for the U.S. government.
- 2 All information submitted to CFIUS by the transaction parties is confidential and may not be disclosed to the public.
- 3 For example, a Venezuelan company that bought a U.S. voting machine firm in 2005 “voluntarily” divested its acquisition after CFIUS opened an investigation in 2006 amidst political pressure.
- 4 For example, when IBM sold its PC unit to Lenovo in 2005, CFIUS required certain restrictions on the access of foreign personnel to IBM’s research facilities.

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## Solvent Company Cannot Use Bankruptcy Code to Skirt Shareholder Vote Requirements

by Lisa Schweitzer and Joaquin Terceño

The Delaware Chancery Court's recent decision in *Esopus Creek Value LP v. Hauf*, No. 2487-N (Del. Ch. Nov. 29, 2006), expresses strong disapproval of the efforts of a financially healthy company delinquent in its federal periodic reporting requirements to sell its assets through a bankruptcy proceeding or otherwise to undermine its common stockholders' voting rights.

Metromedia International Group, Inc. ("Metromedia"), the subject of the *Esopus* decision, is a Delaware corporation that previously faced financial distress but has enjoyed steady financial growth since a management change in 2003, including a fifty-fold increase in its common stock value and a near complete deleveraging of its long-term debt. Having sold off other Russian telecommunications assets, the company's current principal asset is a 50.1% stake in Magticom, the Republic of Georgia's leading mobile telephony provider. Magticom's performance has been mostly responsible for Metromedia's financial success, and in 2006, a group of investors offered to purchase Metromedia's stake in Magticom at a price that was both objectively fair and higher than any other unsolicited offer. The Metromedia board of directors instructed management to pursue the sale.

They faced a major obstacle, however. Despite its financial health, Metromedia had not filed its 2004 Form 10-K or any subsequent Form 10-Q due to its auditor's failure to sign off on its audited financial statement.<sup>1</sup> Counsel to Metromedia's board concluded that under section 14(c) of the Securities Exchange Act of

1934, this delinquency precluded the company from seeking the common shareholder approval required for the sale of substantially all its assets under section 271(c) of the Delaware General Corporation Law.

Viewing the shareholder approval requirement as insurmountable, the Metromedia board turned to federal bankruptcy law as a promising alternative. The board proposed effectuating a pre-negotiated sale under section 363 of the Bankruptcy Code (11 U.S.C. § 363) following a voluntary bankruptcy filing. To ensure the sale would occur and a reorganization plan could then be confirmed under section 1129 of the Bankruptcy Code, the company executed a lockup agreement securing the requisite consent of two-thirds of an impaired class of creditors (here, the preferred stockholders).

Metromedia was not able to follow its charted course to completion. After Metromedia publicly announced the existence of the lockup and a letter of intent with the proposed buyers, plaintiffs—hedge funds owning just over eight percent of Metromedia's common stock—sought a preliminary injunction to stop Metromedia from executing a sales agreement with the buying group absent an affirmative stockholder vote and challenged the lockup agreement as *ultra vires*. Rather than litigate its right to pursue the bankruptcy plan, Metromedia ultimately negotiated an agreement with plaintiffs for obtaining a stockholder approval for the asset sale, including a commitment by Metromedia to seek an exemption for solicitation from the SEC. The parties proposed to stipulate to, and have the Court enter, an order implementing their

agreement, which order also would provide for the Chancery Court to retain jurisdiction over the dispute pending effectuation of the parties' agreement. The Court's opinion "discusse[d] the foundations of the order [then being] entered by the court embodying the agreement reached by the parties."

The Chancery Court's thoughtful opinion provides both a rationale for its approval of a consensual settlement and guidance for other companies faced with similar quandaries. While the Court declined to apply a heightened scrutiny to the board's decision to consummate the sale through a bankruptcy,<sup>2</sup> it still found the proposed strategy to be inequitable and held the board to the task of seeking an SEC exemption from the filing requirements in order to hold a stockholder vote for the sale.

Reviewing Metromedia's plan to sell the assets through a bankruptcy under a business judgment standard, the court concluded that while the transaction was possibly legal, it "offend[ed] fundamental notions of equitable conduct" as understood under *Schnell v. Cris-Craft Industries, Inc.*, 285 A.2d 437 (1971). In particular, the court reasoned that Metromedia's resort to bankruptcy relief would be profoundly inequitable as the company was "clearly solvent" on both a balance sheet and cash flow basis. In so concluding, the Chancery Court looked to the grounds upon which a bankruptcy court may dismiss a bankruptcy petition under section 1112(b) of the Bankruptcy Code, which requires such a petition to be filed in "good faith."

While the court declined to make a bad faith finding under section 1112(b) and acknowledged it could not enjoin Metromedia from filing for bankruptcy, it nevertheless relied on the section 1112(b) "good faith" standards

for commencing a case and the "'good business reason'" requirement for selling assets pursuant to section 363 of the Bankruptcy Code as a basis for binding Metromedia to its agreement to not sell Magticom absent shareholder approval. The court specifically focused on the company's solvency, the rising value of Magticom and particularly on Metromedia's stated intention to use the bankruptcy process as a vehicle for avoiding compliance with section 271 shareholder voting requirements, selling Magticom and ceasing its business operations.

The court also found Metromedia's proposed strategy inequitable in its effective shift of voting power to approve the transaction from the company's common stockholders to its preferred stockholders. While under Metromedia's organizational documents only the common stockholders could vote on a fundamental change in the company's form, as the sale of its share in Magticom unquestionably represented, a bankruptcy filing would have eliminated the common stockholders' power to approve such a transaction while at the same time granting such power to the preferred stockholders, who would not otherwise have contractual or statutory voting rights. Most telling may be the court's final statement on this point: "In sum, the actions of Metromedia's directors in structuring the proposed transaction as they did resulted in a theoretically legal, yet undeniably inequitable, reallocation of control over the corporate enterprise. That reallocation does not withstand close judicial scrutiny."

The court then considered whether Metromedia's federal reporting delinquency actually precluded it from obtaining shareholder approval of the proposed sale. Contrary to the advice Metromedia had

apparently received from its counsel, the court opined that the Securities and Exchange Commission might entertain a request for an exemption to allow the solicitation to proceed. The court pointed out, as it had in its earlier decision *Newcastle Partners, L.P. v. Veta Insurance Group, Inc.*, 887 A.2d 975 (Del. Ch. 2005) in the context of a solicitation pursuant to section 14(c) of the 1934 Act, that the purpose of federal regulation of proxy solicitations is to protect stockholder voting rights. While section 14 of the 1934 Act bars a registrant company from soliciting proxies if it is delinquent in its filings, the court seemed convinced that the SEC would seriously consider exempting Metromedia from the filing requirement in this case as the federal statute doesn't facially suggest an intention to interfere with a state court's power to require compliance with state corporation law (including in the solicitation of votes) notwithstanding noncompliance with federal reporting obligations. Here the court reasoned that the transaction raised serious concerns regarding stockholder protection, and to the extent Metromedia's failure to complete its reporting resulted solely from technical disagreements with its auditors, it "would seem to be a prime candidate for the SEC's discretionary use of its exemptive power to allow the stockholders an informed opportunity to vote on a potentially beneficial transaction that would result in the dissolution of the corporation and the deregistration of its securities." In the court's opinion, federal securities law did not create the insurpassable obstacle to a stockholder vote that Metromedia suggested, but rather merely created a need to request an SEC exemption, an exemption the Delaware Chancery Court, at least, felt the SEC was likely to grant.

Of note, notwithstanding its optimism that an exemption could be obtained, the court also suggested that in the event such exemption were not granted, other remedies could be available, such as the appointment of a receiver. The Court of Chancery, pursuant to 8 Del. C. § 322, can appoint a receiver to oversee the operations of a corporation if that corporation fails or neglects to obey a court order. While the statute discusses the powers of such a receiver only in instances of an insolvent corporation, 8 Del. C. § 291, the *Esopus* court suggested a receiver appointed to effectuate a court order for a solvent company would exercise the same powers. The court did not rule that a receiver could or would be appointed to effectuate a sale of Magticom, but it did leave that possibility open if shareholder approval could not otherwise be obtained.

The *Esopus* decision is interesting on several levels. At its most basic level, the opinion makes clear the Chancery Court's disapproval of a solvent corporation's resort to bankruptcy relief solely to avoid compliance with statutory corporate shareholder voting requirements. It remains to be seen how closely the Chancery Court would be willing to scrutinize other instances in which solvent corporations contemplate seeking bankruptcy relief to overcome other requirements of Delaware law or to obtain similar advantages. The court also leaves for another day the question of whether solvent corporations or their shareholders can or would pursue the appointment of a receiver to effectuate transactions that may be in a corporation's best interest but are otherwise prohibited by applicable law.

- 1 Metromedia characterized this failure as attributable to KPMG's mismanagement and stubbornness on discrete points that did not substantially affect shareholder value.
- 2 The Court declined to require a "compelling jurisdiction" showing for the original proposed transaction (as set forth in *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988)), as it concluded that the board's strategy was not an entrenchment attempt and was not designed to circumvent the clear will of a majority of stockholders (44% of which had expressed approval of the Magticom sale).

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## Shareholder Approval of Executive Pay: The UK Experience

by Tahir Sarkar, Arthur Kohn and Chris Macbeth

The current environment of intense focus on executive compensation has led to a recent announcement by Aflac Incorporated that it will, beginning in 2009, give its shareholders a nonbinding vote on its executive compensation practices. Notwithstanding the view by some that such votes are ill-advised, it seems unlikely that the issue will disappear quickly in light of the Aflac announcement, the significant interest among certain institutional investors in the idea and continued public controversy and attention over levels of executive pay. In addition, a number of blue-chip companies, including Pfizer, Intel, Bristol-Myers Squibb, Schering-Plough, American International Group, JPMorgan Chase and Colgate-Palmolive, recently formed a working group with institutional shareholders, including the American Federation of State, County and Municipal Employees, Walden Asset Management and TIAA-CREF, to discuss introducing nonbinding approval votes. On top of these private-sector pressures, on March 1, 2007, Congressman Barney Frank, Chairman of the House Financial Services Committee, reintroduced legislation (H.R. 1257) mandating such nonbinding approval votes. The legislation, which had 21 co-sponsors, also provides for a separate advisory vote if a company gives a new, not yet disclosed, "golden parachute" while simultaneously negotiating to buy or sell a company.

Interestingly, non-U.S. institutional investors have been among those at the forefront of proposals advocating such votes. A coalition of non-U.S. investors, led by the UK Universities Superannuation Scheme and including nine

British, two Dutch and one Australian investor, reportedly urged the Securities and Exchange Commission to take action in a January 25 letter to Chairman Christopher Cox. Moreover, commentators in the United States frequently note that such shareholder votes are required or encouraged in jurisdictions such as the UK, Australia, Sweden and the Netherlands, as evidence that the practice is not impractical. This article provides a brief overview of how the practice has been implemented in the UK, as background information for those who may be forced to deal with the issue in the US in the future.

### Historical Overview

UK rules on executive compensation have developed over the last 15 years since the Cadbury Committee in 1992 (established in response to several UK financial scandals in the 1980s) recommended that listed companies' executive pay decisions be made by a remuneration committee composed entirely or mainly of non-executive directors. This requirement (since strengthened to require an entirely non-executive remuneration committee) is still found in the Combined Code on Corporate Governance (the "Combined Code")<sup>1</sup> but has been supplemented over time by the introduction of other measures, including for example:

- the principle that a significant proportion of executive compensation should be structured to link rewards to corporate and individual performance, in order to align executives' interests with those of shareholders and incentivize good performance, together

with guidance on specific elements of pay packages designed to put this principle into practice;

- a requirement that options should not generally be offered to executives at a discount and should not be offered at all to non-executive directors;
- the principle that compensation for early termination of employment should not reward poor performance, and a recommendation that compensation committees reduce compensation to reflect departing executives' obligation to mitigate loss;
- the principle that executive compensation policy should be developed using a formal and transparent procedure under which no executive is involved in deciding his or her own pay; and
- a requirement that shareholder approval should be sought for all new long-term incentive schemes and significant changes to existing schemes.<sup>2</sup>

In addition, a requirement to report to shareholders on executive compensation was introduced into the UK's Financial Services Authority's Listing Rules in 1998. The report had to contain a statement of policy and the amount of each element in the remuneration package of each director.

### The Remuneration Report

Despite the measures described above, vocal public and political criticism of the burgeoning pay packages of senior executives increased, especially in respect of those at the top of the recently privatized industries (nicknamed "fat cats" by the populist voices in the media bandwagon). As a result, a government consultation in 1999 aimed both to improve disclosure and to introduce a shareholder vote

on the remuneration paid to executive and non-executive directors and ultimately led to the Directors' Remuneration Report Regulations 2002 (the "Regulations"). The Regulations were incorporated into the Companies Act 1985 (the "Act") and replaced the requirement for a report contained in the Listing Rules when they came into force in 2003.

The focus on the pay of directors – both executive directors and non-executive directors but not non-director members of senior management – primarily reflects historical circumstance. In particular, public criticism had been focused on executive directors, reflecting the UK market tendency to pay executive directors substantially more than non-director executives. This led to a focus in the Regulations on directors' pay. The Combined Code provides that the remuneration committee "should also recommend and monitor the level and structure of remuneration for senior management," but there is no shareholder approval requirement for non-director pay nor is individual disclosure required for non-director executives.

The Act now requires all quoted companies<sup>3</sup> to:

- produce a report (the "Report") for each fiscal year on directors' compensation; and
- hold a shareholders' vote on approval of the Report at a general meeting of the company.

The Report must include:

- information about the remuneration committee and a statement of the company's policy on directors' compensation for the following and subsequent fiscal years, including a description of the company's:
  - policy on performance linked pay and explanations of performance conditions applying to stock option programs;
  - policy on length of employment

contracts, notice periods and termination payments; and

- a performance graph showing the company's total shareholder return compared with the total shareholder return of a broad equity index over the previous five financial years;
- an indication of the company's likely liability in the event of early termination of executives' employment contracts;
- a break-down of each director's compensation, including performance-related elements such as bonuses, and expense allowances and the value of any other non-cash benefits for both the previous and subsequent fiscal years to enable comparisons; and
- detailed information on each director's stock options, interests in long-term incentive arrangements and interests in company pension plans, together with details of any contributions paid by the company to any pension plan for directors.

### Board and Auditor Certifications

The Report must be approved by the board of directors and signed by a director or the company secretary<sup>4</sup> and the elements of the Report which relate to individual directors must be reported on by the company's auditors. The auditors must state whether, in their opinion, the details of directors' compensation, including stock options, long-term incentive arrangements and other benefits, have been properly prepared in accordance with the Act. In order to form their opinion, the auditors must carry out investigations to determine whether the relevant parts of the Report agree with the company's accounting records and returns. The Report and the auditors' report must be delivered to all shareholders and to the Registrar of Companies.<sup>5</sup>

### Penalties

Failure to comply with certain of the above requirements in respect of the Report will render each relevant director guilty of a criminal offense and liable to a fine. Directors commit a separate offense if they fail to notify the company of the information needed to compile the parts of the remuneration report relevant to them as individual directors.

The shareholder vote required to approve the Report is an ordinary resolution, which needs 50% plus one share voting in favor. Although the vote is compulsory, it is entirely advisory and no element of executive pay, or implementation of the company's remuneration policy, is conditional on a positive outcome. Only one vote is required in respect of the Report as a whole, so shareholders cannot approve some aspects of the remuneration policy and vote against others (or approve the policy but veto the compensation packages of individual executives).

### A Perspective on the UK Model

The UK government's goal when introducing the requirement for shareholder approval was to enable shareholders to "send an appropriate message to directors." Arguably, the UK framework is not well-suited to achieve that goal, insofar as the vote on the Report "as-a-whole" may not be susceptible to easy and clear interpretation. And one could argue that there are other, more effective, ways for shareholders to send messages about dissatisfaction with decisions of their board: for example, by selling the stock or voting against (or, if a majority vote is required, withholding votes from) board members – votes that, by contrast to a nonbinding vote on an executive compensation report, actually do have a substantive voting impact.

On the other hand, the UK framework arguably has had the notable effect of increasing dialogue between companies and their institutional investors concerning executive compensation. Companies seem reluctant to present shareholders with Reports that are likely to be voted down, because of the embarrassment and adverse publicity such a vote would entail. This reluctance has been accentuated by the fact that shareholders have exercised their new rights conservatively, making “no” votes extremely rare. When they do occur, companies seem likely to react.

This proxy season’s changes to U.S. executive compensation disclosure requirements were intended to provide increased information and clarity concerning executive compensation, and to improve the ability of investors to compare compensation levels across companies. Whether or not intended, we have seen some limited preliminary evidence, and expect to see further evidence, that the new disclosure rules are leading to some changes in compensation practices in the United States. Here is the principal immediate question with regard to the shareholder approval proposal: will last year’s changes in the disclosure rules, and other recent developments in U.S. corporate governance such as the increasing trend towards majority voting policies for director elections, be allowed to run their course before the widespread adoption of an additional significant new requirement, or is the executive compensation issue so hot that we have not yet found a potential equilibrium point?

- 1 The Combined Code operates on a “comply or explain” basis. UK listed companies must include in their annual report an explanation of any departures from the principles and guidance in the Combined Code.
- 2 The UK’s Financial Services Authority’s Listing Rules also require certain long-term incentive schemes to be approved by shareholders before they are adopted.
- 3 Quoted companies are those incorporated in the UK and listed on the Official List of the United Kingdom Listing Authority (i.e. in practice also admitted to trading on the main market of the London Stock Exchange), the official list in another European Economic Area state, the New York Stock Exchange or Nasdaq.
- 4 The Act does not specify whether the Report must be signed by an executive or a non-executive director but usual practice is for either the chairman of the remuneration committee (a non-executive director) or the company secretary to sign.
- 5 The Registrar of Companies (or “Companies House”) is the official depository of company-related filings in the UK. The Report and the auditors’ report are publicly available once filed.

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