CLEARY GOTTLIEB

Mergers & Acquisitions and Corporate Governance Report

JANUARY 2011

www.clearygottlieb.com

CLEARY GOTTLIEB IN THE NEWS

CG is representing **J. Crew** in its sale to **TPG** and **Leonard Green & Partners**.

CG is representing **Weather Investments/Orascom Telecom** in its $21.5 billion combination with **VimpelCom**.

CG represented **BHP Billiton** in its attempted $40 billion acquisition of **PotashCorp**.

CG represented **Hewlett-Packard** in its $2.35 billion acquisition of **3PAR**.

CG represented **Google** in its acquisitions of **ITA Software** and **AdMob**.

CG represented **Dollar Thrifty Automotive Group** in connection with attempted acquisitions by **Hertz Global Holdings Inc.** and by **Avis Budget Group Inc.**

CG is representing **Royal DSM** in its $1 billion acquisition of **Martek Biosciences**.

CG is representing **Electricité de France** in its €4.7 billion sale of a participating interest in **EnBW** to **Land of Baden-Württemberg**.

CG represented **Interactive Data Corporation**'s Special Committee in its $3.4 billion acquisition by a private equity consortium of **Silver Lake** and **Warburg Pincus**.

CG represented **J.P. Morgan Ventures Energy Corporation** in its $1.7 billion acquisition of **RBS Sempra**'s energy commodities operations.

CG represented **FEMSA** in its $7.6 billion strategic exchange with **Heineken**.

CG represented **América Móvil** in two concurrent exchange offers to acquire all the outstanding shares of **Telmex Internacional** and of **Carso Global Telecom**.

CG represented **Vale** in its $4.7 billion acquisition of **Bunge Limited**'s fertilizer nutrients assets in Brazil, including Bunge's interest in **Fosfertil**.

Reduced Uncertainty for Top-Up Options

BY CHRISTOPHER AUSTIN 2

"Top-up options", a common feature of two-step mergers, have been the subject of recent shareholder lawsuits including the *In re Cogent, Inc. Shareholder Litigation* decision, litigated by Cleary Gottlieb and discussed by Chris Austin.

Airgas v. Air Products: Delaware's Supreme Court on the Meaning of Meaning

BY DANIEL STERNBERG 4

The Delaware Supreme Court in its recent decision in *Airgas, Inc. v. Air Products & Chemicals, Inc.* ruled that a bylaw amendment advancing the date of an annual shareholders meeting could not reduce the term of directors on a staggered board. Dan Sternberg reviews the analysis of the court.

Tips for PE Firms Participating in Stalking Horse Auctions

BY NEIL WHORISKEY 6

A number of potential benefits enjoyed by private equity firms as stalking horse bidders are discussed by Neil Whoriskey.

A Reasonable Path: Delaware Chancery Court Confirms Board's Right to Select the Path to Value Maximization under *Revlon*

BY MATTHEW SALERNO, JENNIFER KENNEDY PARK AND LINDSAY BARENZ 10

The recent *In re Dollar Thrifty Shareholder Litigation* decision litigated by Cleary Gottlieb and discussed by firm M&A lawyers who represented Dollar Thrifty provides several valuable insights regarding the obligations of a board of directors evaluating a change of control transaction.

Preparing for 'Say on Golden Parachutes'

BY KATHLEEN EMBERGER 13

Although the effects on executive compensation practices in the M&A context in light of the new Dodd-Frank legislation have yet to be determined, potential issues are discussed in the context of the new regulations.

© Cleary Gottlieb Steen & Hamilton LLP, 2011. All rights reserved.
This report was prepared as a service to clients and other friends of Cleary Gottlieb to report on recent developments that may be of interest to them. The information in it is therefore general, and should not be considered or relied on as legal advice. Under the rules of certain jurisdictions, this report may constitute Attorney Advertising.

Reduced Uncertainty for Top-Up Options

BY CHRISTOPHER AUSTIN

Mr. Austin is a partner at Cleary Gottlieb Steen & Hamilton LLP.

An increasing number of negotiated cash acquisitions are structured as a first-step tender offer followed by a second-step merger. Under Delaware law, if the bidder owns at least 90% of the target's outstanding shares after completion of the tender offer, the second-step merger can be completed shortly thereafter under a "short-form" merger process that avoids the need for a shareholder meeting to approve the merger. Given that the first step tender offer normally will not be consummated unless shareholders have tendered sufficient shares to assure approval of the second-step merger, there is no substantive benefit to shareholders associated with this shareholder vote – in fact, the delay caused by the shareholder meeting generally means they will simply get paid for their shares at a later date.

In order to take advantage of the timing benefits of the short-form process, most merger agreements for these types of transactions include a so-called "top-up option" that permits the bidder, if the tender offer results in the bidder owning more than a majority but less than 90% of the target's outstanding shares, to acquire at the agreed acquisition price authorized but unissued shares from the target in order to achieve the 90% ownership level.[1] The bidder normally has the right to pay the option exercise price either in cash or a promissory note.

Shareholder plaintiffs have recently sought to enjoin transactions on a number of bases related to top-up options. These included claims that top-up options were "sham" transactions since any note issued by the bidder to pay the exercise price would be payable to a company that would become a wholly owned subsidiary of the bidder shortly thereafter and that the use of a promissory note to pay the exercise price could dilute the value of the target – and therefore the value of the target shares held by any shareholder exercising appraisal rights – if the promissory note was valued at less than face value. This "appraisal dilution" argument was the subject of increased discussion in the M&A legal community after Vice Chancellor Laster, in granting a motion for expedited discovery in respect to a top-up claim, noted that the appraisal dilution claim is "unsettled in our law" and involved "open questions".[2]

In part because of Vice Chancellor Laster's comments, parties to merger agreements with top-up options increasingly have included a provision designed to address the appraisal dilution claims. These merger agreements provide that in any appraisal proceeding the top-up options and any shares issued on exercise thereof would be disregarded.

The questions related to top-up options were clarified in a helpful manner in litigation related to 3M's recent acquisition of Cogent. (Cleary Gottlieb represented 3M in this matter.) In denying plaintiffs' motion to preliminarily enjoin the acquisition, Vice Chancellor Parsons concluded that (1) the top-up option had been properly authorized by Cogent's board, (2) the use of a promissory note to pay the option exercise price did not render the option a sham transaction and (3) that merger agreement language included to negate the appraisal dilution claim was effective and therefore the plaintiffs were unlikely to prevail on that claim.[3]

Vice Chancellor Parson's decision provides significant comfort with respect to the continued use of top-up options in two-step acquisition transactions and guidance as to the proper structuring of such options. Our recommendations for top-up options would include the following:

- Include in the merger agreement language intended to negate the appraisal dilution claim. The language accepted by Vice Chancellor Parsons in the 3M/Cogent matter was "the fair value of the Appraisal Shares shall be determined in accordance with DGCL § 262 without regard to the Top-Up Option, the Top-Up Option Shares or any promissory note delivered" on exercise thereof.
- Provide that the option may only be exercised after the minimum condition in the tender offer has been satisfied (and not waived) and the shares tendered in the offer have been accepted for payment and paid for.

- Provide that the option may only be exercised if the issuance of shares pursuant to the top-up option would be sufficient to allow the bidder to effect a short-form merger.
- Consider whether to provide that the par value of the shares issued on exercise of the top-up option would be paid for in cash, and not a promissory note. (Some Delaware practioners have recommended this approach although it does not appear to be required after 2004 amendments to applicable Delaware law.)
- Be certain to consider issues under the margin rules, particularly in private equity and similar transactions where the bidder's only assets will consist of shares of the target.
- Be certain that the target Board separately considers the terms of the option and that the Board minutes reflect such consideration.

* * *

For more information please contact Mr. Austin in our New York office at 212 225 2434 (caustin@cgsh.com).

1 The number of shares available under the option, and therefore the level of shares that will need to be acquired by the bidder in the tender offer in order to permit use of the option to achieve 90% ownership, will depend on the number of authorized shares under the target's charter documents.

2 *Olson v. EV3, Inc.*, Transcript of June 25, 2010 hearing.

3 *In re Cogent, Inc. S'holder Litig.,* 2010 WL 4491331, (Del. Ch. Oct. 5, 2010).

Airgas v. Air Products: Delaware's Supreme Court on the Meaning of Meaning

BY DANIEL STERNBERG

Mr. Sternberg is a partner at Cleary Gottlieb Steen & Hamilton LLP.

'When I use a word,' Humpty Dumpty said, in rather a scornful tone, 'it means just what I choose it to mean – neither more nor less.'

'The question is,' said Alice, 'whether you can make words mean so many different things.'

'The question is,' said Humpty Dumpty, 'which is to be master – that's all.'

In September 2010, Air Products, in aid of its then pending unsolicited and strenuously opposed tender offer for Airgas, mounted a proxy fight at Airgas' 2010 annual meeting. In addition to electing three directors to Airgas' staggered nine-member board, Air Products, in an innovative and clever stratagem, also proposed, and succeeded in passing, an amendment to the Airgas bylaws moving the date of its annual meetings to January (from its traditional August date). This amendment would have accelerated by some eight months the natural end of the term of service of the class of Airgas directors scheduled for election at the company's 2011 annual meeting and dramatically foreshortened the gap that would otherwise have existed before Air Products could seek to elect a second slate of directors to the Airgas board and thus place control of the board in the hands of its nominees.

Airgas promptly brought an action in the Delaware Court of Chancery for a declaration that the amended bylaw was invalid for the very reason that it effectively cut short what it contended was the three year "full term" of its directors by moving up the annual meeting to take place earlier in the year. Airgas' charter and bylaws provided that "[a]t each annual meeting of stockholders, the successors of the class of Directors whose term expires at the meeting shall be elected to hold office for a term <u>expiring at the annual meeting of stockholders held in the third year following the year of their election</u>" (emphasis added). Airgas argued in essence that the relevant provisions of the Delaware General Corporation Law, its charter and its bylaws collectively required that annual shareholder meetings be held not merely once each year but also not less than a full year apart and that therefore the terms of office of directors on its staggered board were required to last for at least three full years.

In his October 8, 2010 opinion,[1] Chancellor Chandler rejected the Airgas position. The Chancellor concluded that the language of Airgas' charter and bylaws establishing its staggered board and setting the terms of office of its directors did not mean, as Airgas proposed, *a term expiring on approximately the third anniversary of their election.* Instead, he held the language should be taken at their face value and understood to mean that the term of each class of directors expired at the annual meeting of stockholders held in the third year following the year of their election. He writes "[m]y holding here gives the word annual a single, consistent meaning throughout the statute. My holding does not give 'annual' more than one meaning—whether it is an 'annual election' or an 'annual meeting,' it occurs once a year, every year. But there is no statutory requirement that there be a durational minimum amount of time between annual elections or annual meetings, unless it is so specified in a company's bylaws or charter." To the extent he found it necessary to resolve ambiguities in the language of the Airgas charter and bylaws (the proper meaning of "annual" and "year"), the Chancellor both cited and followed the established doctrine of construction in Delaware that when interpreting ambiguities in corporate charters and bylaws "doubt is resolved in favor of the stockholders' electoral rights." The Chancellor held the amended bylaw valid and declared that the term of the 2008 class of Airgas directors would expire at the Airgas 2011 annual meeting to be held in January.

Airgas appealed to the Delaware Supreme Court and in late November the Court, in an opinion by Justice Ridgely for an apparently unanimous *en banc* panel, reversed. The Court agrees with the Chancellor that the relevant language of the Airgas charter and bylaws is ambiguous and cites approvingly the same principle of construction relied on by the lower court ("*If charter or by law provisions are unclear, we resolve any doubt in favor of the stockholders' electoral rights*"). Justice

Ridgely also acknowledges that the charter and bylaw provisions used to implement staggered boards in fact commonly come in one of two models: the first providing explicitly that each class of directors serves until the annual meeting held in the third year following the year of their election, which he dubs the "Annual Meeting Term Alternative;" and a second that provides that "each class serves for a 'term of three years.'" The Justice dubs this second formulation the "Defined Term Alternative" and with notes, that it "unambiguously provides … that each class of directors serves for three years."

Despite this essentially concordant starting place, Justice Ridgely arrives at a decidedly different conclusion than the Chancellor.

> [T]he Court of Chancery heavily relied on the different wording of the Annual Meeting Term Alternative and the Defined Term Alternative to arrive at its conclusion that different wording equates to different meaning.

He finds instead that "overwhelming and uncontroverted extrinsic evidence," establishes "that the Annual Meeting Term Alternative [*for a term expiring at the annual meeting of stockholders held in the third year following the year of their election*] and the Defined Term Alternative [*directors shall be elected to hold office for the term of three years*] language mean the same thing: that each class of directors serves three year terms." Relying on this reading of the Airgas charter, Justice Ridgely goes forward to find that "because [Air Products' proposed bylaw] prematurely terminates the Airgas directors' terms, conferred by the charter and the statute, by eight months, the [bylaw] is invalid." The Justice brushes aside the annoying fact that many annual meetings do not occur at exact one year intervals. Recognizing that corporations have "some latitude" in setting the date for their annual meetings, he concludes that a director's term may end even though that director has only served "approximately three years rather than exactly three years" but declines to define "with exactitude" what the parameters of an acceptable "approximate" term would be.

There are several unsatisfying aspects of the Supreme Court's opinion.

Having invoked the principle of construction that ambiguities in corporate constituent documents must be resolved in favor of stockholders' electoral rights, the Court's opinion never mentions it again, does not apply or distinguish it in reaching its holding and arrives at a conclusion that seems a long way from that to which application of the stated principle would have led. Instead the Court asserts that its alternative reading of the language of the Annual Meeting Term Alternative is founded on "overwhelming and uncontroverted extrinsic evidence." But the "evidence" cited in the opinion is an informal survey of vernacular descriptions of the general operation of staggered boards. Justice Ridgely undercuts the logic of his own conclusion that the words of the Annual Meeting Term Alternative mean, not what they say, but "a term of three years," by conceding almost immediately that the words, "*three years*," do not themselves actually mean what they say either but rather must be understood as meaning "*approximately three years*." The Court does not examine the policy considerations underpinning the use of classified boards as a general matter nor weigh the shareholder and corporate interests implicated by interpreting the charter/bylaw provision to permit the term of a director to be shortened by shareholder action. The Court does make the point that, in the particular circumstances and timing of the Air Products/Airgas imbroglio, permitting the amended bylaw to stand would have the indirect effect of removing directors from the Airgas board by the vote of a simple majority when the company's bylaws would have required a two-thirds supermajority to effect removal directly. While it does not seem to be an entirely untoward result under the doctrine of independent significance, this point may nonetheless provide a more principled ground for the result in this case beyond the debate about which reading of the bylaws, the Chancellor's or the Justice's, was the correct one.

Despite its flaws, *Airgas* is now the law in Delaware and corporations must take care not to overstep its bounds when setting dates for their annual meetings. More importantly, bidders will have to continue to contend with the *de facto* two-year waiting period before control of a staggered board can be obtained.

* * *

For more information please contact Mr. Sternberg in our New York office at 212 225 2630 (dsternberg@cgsh.com).

1 *Airgas, Inc. v. Air Products & Chemicals, Inc.*, 2010 WL 3960599, (Del. Ch. Oct. 8, 2010) (citing Centaur Partners, Jana Master Fund).

Tips for PE Firms Participating in Stalking Horse Auctions

BY NEIL WHORISKEY

Mr. Whoriskey is a partner at Cleary Gottlieb Steen & Hamilton LLP.

Being the stalking horse bidder in a bankruptcy auction confers a number of important benefits on the bidder, including the ability to shape the deal that will be bid against in the auction. This means that the stalking horse can set the mark for what assets will be included in the deal, what liabilities will be excluded, the contract assumption/rejection regime, the regime on cure costs, what the (sometimes all-important) transition services agreement will cover and for how long, etc. The stalking horse bidder may be able to commence antitrust and other regulatory filings before other bidders, potentially clearing critical closing conditions prior to competition with other bidders at the bankruptcy auction. The stalking horse bidder has the opportunity to get a head-start on meeting with future employees and obtaining their help in better understanding the business. Subject to antitrust concerns, a stalking horse bidder will also have an opportunity to develop relationships with nervous customers and provide them credible assurances about the future of the business being acquired. A stalking horse bidder, unlike other bidders, will be entitled to receive a breakup fee (and often expenses) if it is outbid at the bankruptcy auction. In short, there are plenty of reasons for a serious bidder to seek stalking horse status. The following provides some suggestions on how a private equity bidder can maximize its chances of becoming the stalking horse.

1. Play Up Your Strengths to Seller and the Creditors Committee

Believe it or not, there are some significant advantages that PE firms enjoy over strategic bidders.

- Strategic bidders are very often competitors with the bankrupt entity. This sometimes creates an initial trust deficit, with Sellers and the creditors committee having to consider whether the strategic bidder really wants to buy the target business, or whether it merely wants to be sure no one else buys the business. Is the bidder better off eliminating its rival, or buying it? Strategic bidders are also sometimes suspected of wanting to get a “free peek” at a competing business, or to glean competitively sensitive information. These questions are amplified if the past rivalry has been bitter, or if the strategic bidder is generally slow, overly-aggressive in its diligence (without showing commensurate progress in negotiating a stalking horse agreement), or otherwise fails to act like a motivated buyer. This initial mistrust is often overcome in time, so if PE firms wish to take advantage of their temporary “preferred” status, they need to move quickly to establish their interest, and establish a lead in the diligence and negotiation processes.
- In addition to being able to potentially get a jump on the diligence and negotiation phase of the deal, PE firms can sometimes also sell their ability to close faster and with more certainty. Speed and certainty are critically important to the creditor’s committee, for the obvious reason that the sooner they sell the target business, the more quickly creditors can get paid and stop funding a money losing business. If the strategic bidders in the auction bring with them significant antitrust risk, or fail to provide sufficiently strong assurances regarding the risk – whether in the form of a “hell or high water” covenant or a high reverse break fee – they will be at a disadvantage to a PE firm buyer that has no business overlap and is willing to provide seller with these strong assurances.
- Sellers and the creditors committee will also be keenly interested in the scope of the operations to be purchased. A PE buyer typically will not have operational redundancies that would cause it to want to reject real estate leases, dismiss back office, legal, or sales or supply channel staff. Of course, the business is typically bankrupt for a reason, and the PE firm buyer may also wish to use the bankruptcy process to restructure the business along more efficient lines, including by requiring that the debtor reject leases for certain expensive sites or cut staff in various areas, etc. However, by and large, the PE firm buyer is likely to require less of this than the strategic buyer, and therefore may be able to reduce the costs to the estate (severance, rejection damages, cost of operating until wind down) of winding up the parts of the business that are not purchased.

2. Protect Your Achilles Heel(s)

- Remedies can be a real issue for private equity bidders. PE bidders are unlikely to agree to a specific performance remedy (permitting seller to force buyer to close) or to agree to uncapped damages. While sophisticated creditors committees and sellers will recognize the institutional difficulties that PE firms have with these remedies, the fact is that a bid that offers a specific performance remedy and/or uncapped damages gives the creditors committee significantly more comfort regarding the certainty of closing, and certainty of closing is a paramount objective. These are vulnerabilities that strategic bidders do not typically have and they will take every opportunity to point out the difference to a nervous creditors committee. In response, the PE firm will need to give as much comfort as it can on other closing certainty issues (e.g., a hell-or-high water antitrust covenant), and will have to consider crafting the capped damages/reverse break fee structure so that it is not simply an option on the business, but rather a limitation on damages for breaches that are not willful or intentional. A reverse break fee, large enough to convince the creditors committee that walking away would be very expensive for the PE firm, can only help.[1]

- Financing issues constitute the most important subset of the remedies question, and are always an issue for PE firms participating in auctions. How tight is the commitment? Is closing of the financing a closing condition? What are the remedies for a failure of financing? Unlike a solvent seller, with bankrupt sellers there is much less optimism that the business can eventually be re-sold after a failed closing, and the prospect of increased costs for maintaining the business until it can be re-marketed and sold can be particularly daunting. Accordingly, a financing closing condition is unlikely to be acceptable, and, as noted above, there will be significant pushback from the creditors committee if the remedy for a failed financing is simply a 3 percent reverse break fee.

  If a PE bidder finds itself in a position where a financing contingency is becoming a fatal flaw in its bid, there is one last hope – turning to the creditors committee for financing. It is not unheard of for creditors committees to agree to allow the debtor to take back a note from the business being sold. While the note may be discounted to some extent (and the creditors committee will no doubt tell the PE bidder that the note is being very heavily discounted) and while negotiating the terms of the seller financing is another complexity, a note may be acceptable, especially in cases where the note can be made to be marketable in a short period of time after closing (marketability will depend on the availability of proper financial statements, among other factors). In any event, if the creditors committee is unwilling to accept a financing contingency, offering to take seller financing as a back-up source of financing may help to bridge the gap.

- Due diligence is one critical area where strategic bidders can have a significant advantage over PE firms. The strategic bidders may have an excellent understanding of the operational challenges facing the target, how its supply chains work, how its sales force works, what production facilities are up to date, whether the indemnities in its sales contracts are favorable, whether a long term supply contract is an off-market burden, what the environmental sensitivities are, etc. before they even have their first management meeting. Occasionally, as in any process, this can lead to paralysis, as functionals from each area of the strategic bidder drive their area as if it were the only one that mattered, but in general, the strategics are in a better position to move quickly to understand the business and what it is worth. What is different in the bankruptcy arena is the tremendous upheaval that a bankrupt company is experiencing, often resulting in a situation where key employees with critical knowledge may have left the business (either before or after the filing), where records may not be easily accessed, where the workforce may be distracted, and where any desire to fix systems is gone. Given these difficulties, and the likelihood that there will be no meaningful indemnity, due diligence of a bankrupt company is both more difficult and more important than is typically the case. As a result, PE firms generally will have to resolve to commit the resources necessary to understand the business as well as it can be understood as quickly as possible. There are no magic bullets, though a PE firm that is likely to keep a lot of jobs and that is respectful to employees that are in difficult positions may as a practical matter get more cooperation than a competitor who is likely to cut jobs or is less than diplomatic with respect to any failings it finds in the business practices of the target.

3. Pick Your Battles

As noted, creditors are generally in something of a hurry to get what cash they can from any anticipated sale. This is of course particularly true when the business is operating at a loss, and the creditors see the liquidation value of the business being reduced on a daily basis by the costs of on-going operations. Most creditors committees are staffed by professionals with a good deal of experience in bankruptcy auctions, and they know what they want, even if the bankrupt company is having trouble figuring out what it wants. In order to avoid having a second round of negotiations with creditors when the stalking horse agreement is submitted to the bankruptcy court for approval, bidders should first of all use their best efforts to be sure that the creditors committee(s) are organized and reviewing each draft of the stalking horse agreement in close coordination with seller's counsel. Bidders should also keep in mind the following:

- Indemnities. Unless there are special circumstances, don't spend a lot of time looking for an indemnity, escrow or holdback. Creditors are likely to be somewhat less familiar with any particular business being sold than is a diligent buyer that has done its diligence, and are likely to deduct a very significant portion (if not all) of the amount of any holdback or escrow from the purchase price in reviewing bids. If the stalking horse competition is at all robust, then having even a limited holdback or escrow can be a significant detriment to your bid. That said, if there is a particular problem, or an area where diligence is simply not available given the state of the company, a very focused indemnity for a limited period and limited amount may be acceptable to the seller and the creditors committee(s). Nevertheless, a bidder may be better off pricing in the risk than, in effect, asking the creditors to do so.
- Representations and Warranties. As there will likely not be a general indemnity for a breach of the representations and warrantees, and as the bring down condition will very often be qualified by a MAC standard, the main purpose of the representations will be to supplement and test the bidder's due diligence efforts. This is far from a trivial objective, especially in cases where the diligence process has been unsatisfactory – which, as noted above, is not infrequent. However, if diligence has been more or less satisfactory, spending a lot of time lowering thresholds in the representations and expanding their coverage to areas of concern that are marginal to the business being acquired will not be productive. While the creditors will be less sensitive to this point, an unnecessarily heavy markup of the representations can make the sellers cringe, thinking of the time their diminished staff will have to devote to preparing the requisite disclosure schedules.
- Assumption of Contracts. The ability to assume or reject contracts is at the heart of a 363 sale in bankruptcy. In any scenario, bidders will want to be certain that they are not required to assume customer contracts or supply contracts that provide unfavorable pricing or other key terms. Sellers will want to assure themselves that the bankrupt estate will not have to bear significant rejection costs. In general these two goals are not incompatible.

  Consider a company with only one customer contract, which provides the customer with the right to purchase 100 widgets for $100. If the market price of 100 widgets is $200, the bidder saves $100 in refusing to assume this customer contract, but the seller will incur a pre-petition claim of $100 in rejecting such contract. However, seller's estate will only have to pay out to the objecting customer a fraction of the $100 in damages – the fraction being the same fraction all unsecured creditors receive in respect of their pre-petition claims. Let us assume that the fraction is 50%. If buyer were willing to pay $5,000 for the business with the contract, then he should be willing to pay up to $5,100 for the business without the contract. If seller were willing to sell the business for $5,000 with the contract, then they should also be willing to sell the business for $5,050 without the contract. Buyer and seller should accordingly be able to happily settle on a price anywhere between $5,050 and $5,100. This arbitrage is key to creating value for the bankrupt estate.

  Life, however, is not ever so simple. In addition to the tedious difficulties of ascertaining whether all of a business's material contracts really are unfavorable from a pricing point of view, there are any number of other important contract terms that may color a buyer's views as to the desirability of assuming such contract, including payment, warranty, indemnity, damages waivers and other terms that a buyer may not wish to extend to customers. Additionally, there may be customers that a buyer no longer wishes to service, either because the bidder plans to shut down operations in the region where the customer is, or because there are long

term service or warranty obligation that will be expensive or simply of unknown cost. On the other hand, seller may want to force the assumption of all of the customer contracts in circumstances where leaving a customer without warranty, service and ongoing software upgrades would result in large rejection damages. When these terms come into play, the scope of the arbitrage available to buyers and sellers in a bankruptcy sale may be reduced.

- Cure Costs. Cure costs are closely related to the ability to assume or reject contracts. Deals typically cut on cure costs include the following varieties: (i) buyer pays up to x amount in cure costs, with seller – who may have delivered a schedule of estimated cure costs – taking the risk of cure costs exceeding that amount, (ii) buyer and seller split all cure costs 50/50 – pure risk sharing and (iii) buyer pays all cure costs for supply contracts, while seller pays cure costs associated with customer contracts. The theory behind this last variety is that buyer can build its own supply chain, and cause seller to reject supply contracts that buyer does not need, or with respect to which buyer can get a better deal elsewhere, while on the customer side, assuming that seller has continued to deliver product, cure costs will be minimal while the cost of rejecting a customer contract may be significant, especially in cases where there are extended warranty and service commitments. Which deal a bidder strikes will depend upon how certain the cure costs are when it signs the agreement, and whether there are advantages that will accrue to one or more of the bidders if it has the ability to rebuild the supply chain to its own liking.

- Bid Procedures. The key topics covered in this order include (i) the amount of the breakup fee and expense reimbursement, (ii) the cure cost regime and assumption and assignment procedures, (iii) the sale hearing date, and (iv) the procedural rules governing the auction. All of these are important topics, but it seems that occasionally an inordinate amount of time is spent searching for tactical advantages in crafting the rules governing the auction –including on topics such as the amount of the "overbid" (i.e., the minimum amount that another bidder must bid over the aggregate of the amount bid by the stalking horse plus the amount of the breakup fee and expense reimbursement), how to define "qualified bidders" that may participate in the auction, timing of bids, who gets to review bids and when, procedures for selecting the highest bidder, etc. Note that the bid procedures order needs to be approved by the bankruptcy court, and since these topics come up in every bankruptcy auction, the courts have over time established fairly well defined parameters regarding what they will or will not accept with respect to each of these topics. Time spent by the bidder tailoring its requests in this area to fit within these parameters will avoid wasting time trying to convince first the seller, then the creditors committee and finally the bankruptcy court to accept off-market terms.

- Defining scope of business and assumed liabilities. This is a battle of course in every asset deal, with the difference that in the bankruptcy context there may be a greater ability to leave behind with the estate certain pre-petition liabilities that would in the normal course be assumed with the acquired business outside of the bankruptcy context. As in the contract assumption context, it can be cheaper for the estate's creditors to have their claims diluted by a liability left behind than to suffer a reduction in the purchase price resulting from the business being sold with the liability.

- Transition Services. If the bidder is buying just part of the bankrupt company, and will require transition services, it should not take for granted that those services will be available. There is a cost to the estate of continuing to provide these services when it would otherwise have wound up the estate, so questions regarding the scope, quality and term of these services should be addressed early in the process.

* * *

For more information please contact Mr. Whoriskey in our New York office at 212 225 2990 (nwhoriskey@cgsh.com).

1 The structural issues that are present in every PE acquisition will be present in the bankruptcy setting as well – e.g., using a special purpose vehicle as the acquisition vehicle will lead to the usual tussle over whether there should be a limited but direct guarantee by the PE fund itself of all of the obligation undertaken by the acquisition vehicle, or whether a third-party beneficiary right under the equity commitment letter will suffice.

A Reasonable Path: Delaware Chancery Court Confirms Board's Right to Select the Path to Value Maximization under *Revlon*

BY MATTHEW SALERNO, JENNIFER KENNEDY PARK AND LINDSAY BARENZ

Mr. Salerno is a partner and Ms. Park and Ms. Barenz are associates at Cleary Gottlieb Steen & Hamilton LLP.

In a September 8, 2010 decision, *In re Dollar Thrifty Shareholder Litigation*,[1] Vice Chancellor Strine denied a request to enjoin a special meeting of Dollar Thrifty's stockholders to vote on a proposed merger with Hertz. The decision examined, under the *Revlon* standard, the motivations of the Dollar Thrifty board of directors, as well as their actions and deliberations in connection with the proposed merger with Hertz. The decision provides several valuable insights regarding the obligations of a board of directors evaluating a change of control transaction.

Background

Over a three-year period, Dollar Thrifty Automotive Group, Inc. engaged in on-again, off-again discussions regarding a potential business combination with two other car rental companies, Hertz and Avis. During this period the value of Dollar Thrifty's publicly traded shares tumbled from above $50 per share to below $1 per share and then rose steadily throughout 2009, reaching the mid-$20s per share by December 2009.

In late December 2009, Hertz sought to renew discussions with Dollar Thrifty regarding a potential merger between the two companies and submitted a non-binding indication of interest to Dollar Thrifty's board of directors. The two parties engaged in sporadic negotiations through April 2010. On several occasions during this period, Dollar Thrifty's board of directors considered whether it should contact any other potentially interested parties, including Avis. Each time, however, the Dollar Thrifty board concluded that doing so might put any potential deal with Hertz in jeopardy and that on balance, the risks associated with contacting Avis outweighed the anticipated benefits of doing so, especially because the proposed merger agreement with Hertz would not preclude Avis from making an unsolicited proposal to acquire Dollar Thrifty. There also was some question as to whether Avis would be able to raise sufficient debt financing and to procure the necessary lender consents to engage in such a transaction.

On April 25, 2010, Hertz and Dollar Thrifty entered into a merger agreement that provided that at closing of the merger, Dollar Thrifty stockholders would receive a mixture of Hertz stock and cash valued at $41.00 per share on the day the deal was announced, a 5.5% premium over Dollar Thrifty's then-market price of $38.85 per share (but a premium of more than 63% over the price of Dollar Thrifty's share price at the time deal discussions commenced in 2009). The agreement also provided that under certain conditions Dollar Thrifty could consider unsolicited alternative acquisition proposals; however, Hertz had the right to match any such alternative proposal. If Dollar Thrifty terminated the Hertz merger agreement to accept an unsolicited alternative acquisition proposal, or accepted an unsolicited alternative proposal in certain other circumstances, Dollar Thrifty was required to pay Hertz a termination fee. The agreement also required Hertz to pay Dollar Thrifty a reverse termination fee if the transaction did not close because it failed to receive antitrust clearance by either the United States or Canadian regulatory authorities.

Within days of the announcement of the Dollar Thrifty and Hertz merger agreement, Avis issued a press release stating its intention to make a "substantially higher offer to acquire Dollar Thrifty." At the time Vice Chancellor Strine issued the *Dollar Thrifty* decision, Avis had made two proposals to the Dollar Thrifty board of directors to engage in a merger with Dollar Thrifty, each proposing a higher price per share than the Hertz deal but without providing for the payment of a reverse termination fee or other consequence upon a failure of Avis to obtain regulatory approval for the deal. As a result, Dollar Thrifty's board of directors did not declare either of the Avis proposals to be a superior proposal to the merger agreement with Hertz.

Revlon Obligations of the Board

Under the *Revlon* standard as articulated by the Delaware courts, when a board of directors considers a transaction involving the sale of the company, it must seek the "best value reasonably attainable for its stockholders." A board's decision to enter into such a transaction is subject to a heightened level of scrutiny, under which a court will review:

a. the adequacy of the decisionmaking process employed by the directors, including the information on which the directors based their decision; and

b. the reasonableness of the directors' actions in light of the circumstances then existing.

Emphasis on the Board's Motivation

In *Dollar Thrifty*, the court emphasized that when examining a board's conduct under this heightened level of scrutiny, it is important to consider the board's true motivation for its decisions, noting that "[t]hrough this examination, the court seeks to assure itself that the board acted reasonably, in the sense of taking a logical and reasoned approach for the purpose of advancing a proper objective, and to thereby smoke out mere pretextual justifications for improperly motivated decisions." In concluding that the Dollar Thrifty board was properly motivated, the court pointed to the following facts: five of the six board members were independent; each board member, including the only non-independent director, the CEO, owned material amounts of Dollar Thrifty stock, which aligned their interests with those of stockholders; and there was no evidence that the board, including the CEO, harbored any entrenchment motivation or desire to sell the company to Hertz rather than Avis. Based on these facts, the court concluded that there was an "absence of any colorable basis to question the Board's motivation at any stage of the process."

No Particular Process Required

The court noted that *Revlon* does not require that a board of directors adhere to any particular procedure in seeking the best value reasonably attainable for its stockholders, nor does it require a board to establish and conduct any particular sales process, stating that "directors are generally free to select the path to value maximization, so long as they choose a reasonable route to get there."

In reaching the conclusion that the actions of the Dollar Thrifty board were reasonable, the court emphasized that "*Revlon* does not require that a board, in determining the value maximizing transaction, follow any specific plan or roadmap in meeting its duty to take reasonable steps to secure – i.e., actually attain – the best immediate value." The court must then evaluate whether the steps taken by a board of directors to secure the best immediate value were reasonable steps. The court acknowledged that the Dollar Thrifty board had repeatedly considered whether to reach out to Avis but the board had determined not to because it believed that Hertz would not participate in an auction-like process and the risk of a leak in that scenario outweighed the likelihood of a competitive bid from Avis. In particular, the Dollar Thrifty board expressed concern that a leak would upset its employees resulting in lost productivity and higher employee turnover and could harm the company's market performance, and noted that the terms of the merger agreement under discussion with Hertz would not preclude Avis from making a proposal after signing of the merger agreement if Avis desired to do so. In light of these factors, the court found that the board's decision to proceed with Hertz, without contacting Avis and to negotiate for a passive, but viable post-signing market check was reasonable. The court held that the board's decision to forego a pre-signing market check and proceed to finalize the merger agreement with Hertz, thereby setting a price floor for any eventual transaction, while leaving room to consider alternative proposals following execution of the agreement, was a reasonable course for the Dollar Thrifty board to have chosen considering the circumstances.

Balancing Value and Deal Certainty

In declining to declare any of the Avis proposals (each of which specified a higher purchase price than provided for in the merger agreement with Hertz) to be a superior proposal, the Dollar Thrifty board of directors expressed concern about the lack of a reverse breakup fee or some other adequate closing assurance in the Avis proposals. The plaintiffs argued that such considerations were inappropriate under the *Revlon* standard. The court rejected this notion, observing that "[t]o pretend that contractual provisions designed to ensure that the buyer actually pays have no relation to the value of the deal ignores economic reality and common sense." Thus, the court agreed that a board's consideration of whether a transaction offers the best value reasonably attainable for stockholders includes consideration of both the economic value to be paid and certainty of closing.

Non-Preclusive Deal Protection Terms

A key component of the Dollar Thrifty board's approach was a passive, but viable post-signing market check. While emphasizing that no single set of deal protection terms will be satisfactory in every circumstance, the court called the deal protection terms in the Hertz merger agreement, which included a "window shop" feature, unlimited (but time-restricted) matching rights for Hertz and payment of a termination fee in certain circumstances, "relatively lenient." The court also said that although the $44.6 million termination fee and $5 million of expense reimbursement (3.5% of deal value or 3.9%, if including the full expense reimbursement amount) was robust, it was a relatively insubstantial barrier to any serious topping bid.

In light of Dollar Thrifty's history of failed negotiations with Hertz and Avis and the back-and-forth between Dollar Thrifty and Hertz on the specifics of the deal protection terms, the court found that such terms were not unreasonable or in any way coercive or preclusive. Indeed, the court found that given Dollar Thrifty's history of negotiations with Avis "the inference arises that the Board's decision to conduct a passive, post-signing check was a reasonable, indeed perhaps the most savvy, way to induce Avis to decide whether it wanted to make a real deal for Dollar Thrifty."

Conclusion

The *Dollar Thrifty* decision emphasizes that even under *Revlon*'s enhanced scrutiny, Delaware courts will not substitute their own judgment for that of an independent, well-informed board acting reasonably and in good faith. Such a board of directors is free to consider the unique facts facing the company and the proposed transaction and choose its own path to maximize value for stockholders, so long as the chosen path is a reasonable one.

Postscript

On September 10, 2010, two days after this decision was reached, Dollar Thrifty and Hertz amended the merger agreement to increase the purchase price payable to Dollar Thrifty stockholders to a mixture of cash and stock valued at $50 per share based on the closing prices on that date, which Hertz later confirmed was its "best and final offer" for Dollar Thrifty. On September 23, 2010, Avis announced that it was increasing its proposed merger consideration to a combination of Avis stock and cash valued at $52.71 based on the closing prices on that date, but still was not offering a reverse break-up fee. On September 29, 2010, the day prior to the Dollar Thrifty stockholder meeting to vote on the Hertz merger, Avis publicly announced that it was prepared to pay a reverse termination fee of $20 million on the same terms as the Hertz reverse termination fee. At the Dollar Thrifty stockholder meeting on September 30, 2010, Dollar Thrifty stockholders declined to approve the Hertz merger, and Hertz terminated the merger agreement with Dollar Thrifty the next day. Following termination of the Hertz merger agreement, Dollar Thrifty and Avis agreed to cooperate with respect to Avis's efforts to pursue antitrust clearance for its proposed merger between Avis and Dollar Thrifty.

* * *

For more information please contact Mr. Salerno at 212 225 2742 (msalerno@cgsh.com), Ms. Park at 212 225 2357 (jkpark@cgsh.com) or Ms. Barenz at 212 225 2774 (lbarenz@cgsh.com), all based in our New York office.

1 *In re Dollar Thrifty S'holder Litig.*, 2010 WL 3503471 (Del. Ch. Sept. 8, 2010).

Preparing for 'Say on Golden Parachutes'

BY KATHLEEN EMBERGER

Ms. Emberger is counsel at Cleary Gottlieb Steen & Hamilton LLP.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") was signed into law on July 21, 2010. Among other things, Dodd-Frank added enhanced golden parachute disclosure obligations in specified public filings and a requirement that U.S. public companies provide their shareholders with an advisory "say on golden parachutes" vote in any proxy statement or consent solicitation for a shareholder meeting to approve an acquisition, merger, consolidation or sale of substantially all of a company's assets occurring after January 21, 2011.[1] Although it's too soon to predict what impact, if any, the new requirements will have on executive compensation practices in the M&A context, this article briefly summarizes the new requirements and lays out some issues to start considering now. [2]

What Disclosure Is Required?

Very generally, the proposed regulations would require subject companies to disclose all "golden parachute" arrangements covering named executive officers or "NEOs" of the target and acquiror, including arrangements or proposed arrangements between an acquiring company and the NEOs of a soliciting target company. Under the proposed regulations, no disclosure would be required for previously vested equity awards or compensation to be paid under a bona fide post-transaction employment agreement to be entered into in connection with the transaction. The new rules specify a tabular format for quantitative disclosure of compensatory arrangements affected by the transaction, including cash severance, the value of stock-based awards that are cashed out or accelerated, enhancements to pension and nonqualified deferred compensation, tax reimbursements and other similar types of payments and benefits. [3]

When Is a Vote on Golden Parachutes Required?

In any proxy or consent solicitation for a shareholder meeting to approve an acquisition, merger, consolidation or sale of substantially all of a company's assets, the soliciting company must provide its shareholders with a separate advisory vote on the golden parachutes disclosed unless the arrangements were previously disclosed in a company's annual proxy statement in the format required by the regulations and subject to a "say on pay" vote. [4] When a target company conducts the proxy or consent solicitation, consistent with the drafting of Dodd-Frank the proposed regulations do not require an advisory vote on arrangements between the acquiring company and target company NEOs even though those arrangements may be required to be disclosed. Similarly, although disclosure of golden parachutes is required in connection with all of the corporate transactions and filings noted in footnote 3, a shareholder advisory vote is required only in a proxy or consent solicitation.

Issues for Consideration

Including 'Say on Golden Parachutes' Disclosure in Current Proxy. Under the proposed regulations, if a company's golden parachutes were disclosed in the company's annual meeting proxy statement pursuant to the proposed enhanced disclosure rules and subject to a "say on pay" vote, then a shareholder vote will not be required in an M&A transaction *unless the arrangements have been modified*. Given that many M&A deals involve some changes to compensation, this exception may not have much practical utility. However management may want to review this issue with the compensation committee in preparing this year's proxy statement, and analyze the costs and benefits of providing more extensive annual proxy disclosure.

Timing of Management Negotiations. In an M&A transaction, it is not unusual for compensation negotiations to take place after the operative transaction documents have been signed. Although the timing of these negotiations have always implicated potential disclosure considerations for companies and their counsel, these issues may become more acute under the new say on golden parachutes disclosure and voting regime, subject to the carveout for bona fide post-transaction employment agreements. Targets and acquirers alike may want to set clearer parameters from the outset regarding when these negotiations must be concluded in order to accommodate disclosure and voting requirements. Difficult judgment calls seem inevitable if, for business reasons,

modifications are desirable after shareholder disclosure documents have been distributed and a meeting date set.

Reputational Risks to Directors. Although the say on golden parachutes votes will be only advisory, the failure to achieve a favorable outcome could attract adverse press. While it would be unlikely to impact the consummation of most transactions, it may raise a reputational risk both for continuing directors of the acquiring entity and departing directors of the target who in many cases will continue to serve on other boards. Continuing directors of the acquiring entity in particular could become subject to enhanced scrutiny from shareholder advisory groups if target NEOs become NEOs of the acquiror and arrangements that attracted negative attention are assumed and continued post-closing.

Voting Issues. We have heard some concern that shareholder confusion on the advisory say on golden parachutes vote could impact the outcome of the transaction vote in a closely-contested acquisition. For example, if proxy advisory firms decide to split their recommendation (yes on the merger but no on the parachute arrangements), it is possible that certain institutional shareholders could vote no on the merger – either as a result of simple confusion, or in order to avoid approving a transaction with an objectionable governance element.

* * *

For more information please contact Ms. Emberger in our New York office at 212 225 2074 (kemberger@cgsh.com).

1 The Say on Golden Parachutes vote is not self-executing and will not be required for merger proxy statements until after the effective date of the SEC’s implementing rules. The SEC issued proposed Say on Golden Parachute Rules on October 18, 2010 and the comment period for the proposed regulations closed on November 18.

2 For a more detailed summary of the disclosure and voting requirements set out in the SEC’s proposed regulations, please see the CGSH Alert Memo of October 21, 2010 entitled: “Say on Pay and More: SEC's First Proposed Regulations Implementing Dodd-Frank's Executive Compensation and Governance Requirements.”

3 The required disclosure may include disclosure of some types of compensation not ordinarily disclosed in an annual proxy statement and, under the proposed rules, a tabular format is required (unlike under the current annual proxy disclosure requirements). Disclosure will be required in proxy or consent solicitations as noted above, as well as in information statements, proxy or consent solicitation statements not containing merger proposals but requiring disclosure of information under Item 14 of Schedule 14A pursuant to Note A (for example, seeking approval for the issuance of shares to conduct a merger transaction), registration statements on Forms S-4 and F-4 containing disclosure relating to mergers and similar transactions, going private transactions on Schedule 13E-3 (except where the target or subject company is a foreign private issuer), third-party tender offers on Schedule TO (except where the bidder or target company is a foreign private issuer, and only to the extent the bidder has made a reasonable inquiry regarding the golden parachutes and has knowledge of the arrangements) and Schedule 14D-9 solicitation/recommendation statements.

4 Under the Dodd-Frank Act, say on golden parachutes votes will be “non-routine” so brokers will be unable to vote uninstructed customer shares.

CLEARY GOTTLIEB

Offices

JANUARY 2011

www.clearygottlieb.com

New York
One Liberty Plaza
New York, NY 10006-1470
T: 1 212 225 2000
F: 1 212 225 3999

Washington
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: 1 202 974 1500
F: 1 202 974 1999

Paris
12, rue de Tilsitt
75008 Paris, France
T: 33 1 40 74 68 00
F: 33 1 40 74 68 88

Brussels
Rue de la Loi 57
1040 Brussels, Belgium
T: 32 2 287 2000
F: 32 2 231 1661

London
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: 44 20 7614 2200
F: 44 20 7600 1698

Moscow
Cleary Gottlieb Steen & Hamilton LLP
CGS&H Limited Liability Company
Paveletskaya Square 2/3
Moscow, Russia 115054
T: 7 495 660 8500
F: 7 495 660 8505

Frankfurt
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: 49 69 97103 0
F: 49 69 97103 199

Cologne
Theodor-Heuss-Ring 9
50668 Cologne, Germany
T: 49 221 80040 0
F: 49 221 80040 199

Rome
Piazza di Spagna 15
00187 Rome, Italy
T: 39 06 69 52 21
F: 39 06 69 20 06 65

Milan
Via San Paolo 7
20121 Milan, Italy
T: 39 02 72 60 81
F: 39 02 86 98 44 40

Hong Kong
Bank of China Tower
One Garden Road
Hong Kong
T: 852 2521 4122
F: 852 2845 9026

Beijing
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: 86 10 5920 1000
F: 86 10 5879 3902