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Reversing Course: Delaware's Supreme Court Provides Comfort to Directors Regarding Revlon Process and Bad Faith

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On March 25th, in *Lyondell Chemical Company v. Ryan*[2]—a much anticipated appellate decision—the Delaware Supreme Court reversed the Delaware Chancery Court's decision from last summer[3] and ruled that Lyondell's directors did not breach their fiduciary duty of loyalty with respect to (i) the process by which they sold Lyondell to Basell BF and (ii) the deal protection provisions contained in the merger agreement for that transaction. Basell's $13 billion cash merger with Lyondell was consummated in December 2007.

The Delaware Chancery Court Decision

The plaintiff sued Lyondell's directors in Delaware Chancery Court seeking monetary damages for personal liability, alleging that the defendant-directors breached their fiduciary duties of loyalty, care and candor and that they "put their personal interests ahead of the interests of the Lyondell shareholders." Lyondell's certificate of incorporation contained a Delaware General Corporation Law Section 102(b)(7) provision, exculpating Lyondell's directors from personal liability for breach of their duty of care (as opposed to acts or omissions not in good faith, involving intentional misconduct or involving a knowing violation of law). In the absence of any apparent conflicts of interest with respect to the merger (*i.e.*, the absence of any disqualifying "interestedness" or lack of "independence" on the part of Lyondell's directors), the defendants moved for summary judgment in reliance on Lyondell's exculpatory charter provision.

The Delaware Chancery Court denied the defendants' summary judgment motion with respect to two of plaintiff's claims: (i) whether the directors discharged their *Revlon*[4] obligations in good faith and

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[2] *Lyondell Chemical Co. v. Ryan*, No. 401, 2008, 2009 WL 790477 (Del. Super. Ct. Mar. 25, 2009).

[3] *Ryan v. Lyondell Chemical Co*, No. CIV.A. 3176-VCN, 2008 WL 2923427 (Del. Ch. July 29, 2008).

[4] *Revlon, Inc. v. MacAndrew & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985).

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(ii) whether the directors agreed to unreasonable deal protections in the merger agreement. However, the Delaware Chancery Court granted defendants' summary judgment motion with respect to plaintiff's additional claims—chief among them—plaintiff's claim that the directors were motivated by "self-interest." The Delaware Chancery Court's dismissal of plaintiff's self-interest claim and its related findings regarding the directors' independence and disinterestedness, was central to the appeal, which followed and helped fashion the Delaware Supreme Court's analyses and conclusions.

In denying the defendants' motion as to plaintiff's *Revlon* and deal protection claims, the Delaware Chancery Court concluded that the factual record before it raised sufficient controversy about the manner in which the directors discharged their *Revlon* duties leading to execution of the definitive merger agreement and with respect to the reasonableness of the deal protection package agreed to by Lyondell's directors, such that summary judgment on those issues was premature and inappropriate.

For both context and background, the pre-trial facts proffered by the litigants and the inferences drawn therefrom by the Delaware Chancery Court on defendants' summary judgment motion can be largely summarized, as follows:

- The directors did not engage in self-dealing or act out of self-interest. They were not infected with any lack of independence or an entrenchment motive. This was not a case involving a controlling stockholder or a majority of directors beholden to a controlling stockholder or a dominant CEO, or a case involving any allegations of structural bias, retributive threats made against the directors, management coercion or any intention to harm Lyondell.
- The $48 per share merger price offered by Basell represented a 45% premium to Lyondell's unaffected stock price on May 10, 2007—a "blowout" price.
- Lyondell was financially sound and not for sale at the time discussions between the CEOs of Basell and Lyondell initially ensued, and Lyondell was not prepared for a sale process.
- There was no record of the authority of Lyondell's CEO to engage in unilateral discussions and negotiations with Basell regarding a merger or business combination transaction after he was first contacted by Basell on an unsolicited basis.
- The directors' direct involvement in the negotiating process, once they became engaged and requested a written offer from Basell, occurred over a seven-day period. By that time, however, the price and other material deal terms, as well as the transaction structure, were established, and Lyondell's CEO received no prior substantive, strategic or tactical input from the board, outside counsel or Lyondell's financial advisor in devising or executing his negotiating strategy.
- Lyondell's CEO successfully negotiated an increase in Basell's initial price indication and a nominal reduction (*i.e.*, $400 million reduced to $385 million) in the break-up fee payable to Basell upon a fiduciary termination of the merger agreement in the event of an unsolicited superior offer received by Lyondell during the "window shop" period that Basell failed to match.
- Lyondell's financial advisor, Deutsche Bank, furnished the directors with its opinion that $48 per share in cash was fair to Lyondell's stockholders, from a financial point of view.
- Lyondell's CEO requested a post-sign, 45-day "go-shop" period (preceding the merger agreement "window shop" period), but was rebuffed by Basell. The record indicates no real push back by the CEO or the Lyondell directors on the deal protection provisions of the merger agreement.
- At or about the time the CEOs of Basell and Lyondell engaged in substantive negotiations, Basell announced a $9.6 billion acquisition of one of Lyondell's primary competitors, Huntsman Corporation. An affiliate of Apollo Partners submitted a superior proposal to "jump" the pending Basell-Huntsman deal, leaving Basell with several days to match Apollo Partners' superior bid or lose its agreement to acquire Huntsman and collect only a break-up fee from Huntsman under the Basell-Huntsman merger agreement. Because Basell could not effectively complete both transactions—the acquisition of Huntsman and Lyondell—Basell exerted extreme time pressure on Lyondell's CEO to conclude substantive negotiations and Basell demanded an indication from the CEO that the board firmly supported Basell's acquisition of Lyondell.

- Apollo Partners previously had expressed interest in a sponsored management buyout of Lyondell, but substantive discussions and negotiations never ensued.
- The pre-trial record is sketchy on the valuation materials reviewed by Lyondell's directors when they indicated support for Basell's $48 per share offer and instructed Lyondell's CEO to communicate their support to Basell.
- Basell's affiliate filed a Schedule 13D reporting the acquisition of an 8.3% common stock position in Lyondell some months prior to the time the CEOs of Basell and Lyondell began merger discussions. The record indicated that the board did not consider nor did Lyondell prepare any defensive strategy in response to the Schedule 13D filings. Lyondell's board apparently did not engage an investment banker or outside counsel immediately upon learning of the Schedule 13D filing to review potential strategic and financial courses of action and to assess whether the purchase of the 8.3% stake was a precursor to an unsolicited future bid to acquire Lyondell by Basell or another third party. The board apparently also did not request management and outside expert reports regarding a "stay independent" strategy or a current presentation on the company's enterprise, equity per share and going-concern values, or its long-term prospects.
- Lyondell recently had been in the buyside deal market and, having reviewed potential target-candidates and completed an acquisition, the board acquired certain knowledge as to relevant market multiples, segment values, and integration costs and synergies relative to portions of Lyondell's business. However, a complete valuation of Lyondell as a stand-alone, consolidated entity had not been performed.
- Lyondell's stockholders overwhelmingly voted "for" adoption of the Basell merger agreement.
- The merger was consummated in December 2007.

Vice Chancellor Noble observed that the foregoing factual record did not demonstrate, as a matter of undisputed fact, that Lyondell's directors properly discharged their *Revlon* duties (*i.e.*, to seek to obtain the best price reasonably attainable) which, according to the Vice Chancellor, required "certain [directorial] conduct or impeccable knowledge of the market in the face of Basell's offer to acquire [Lyondell]."

Specifically, he noted that (i) Lyondell's directors knew Lyondell was "in play" by reason of the Schedule 13D filing by Basell's affiliate reporting the acquisition of an 8.3% equity stake in Lyondell; (ii) the directors exhibited two months of "slothful indifference," did nothing (or virtually nothing) to prepare or develop a strategy to maximize stockholder value in the wake of such 13D filing, and took a "wait and see" approach; (iii) the directors did little or nothing (in the way of a pre-sign market check, auction or otherwise) to determine whether a better deal than the Basell offer could be obtained and consummated; (iv) there was scant negotiation of Basell's offer (including the deal protection package in the merger agreement); and (v) Lyondell's directors did nothing to ensure, post-signing, that a better deal could reasonably be obtained (*i.e.*, Vice Chancellor Noble presumably was expressing his "take" on the directors' need to vigorously bargain for a post-sign "go-shop" period; indeed, one of the more curious and questionable recitations by the Delaware Chancery Court).

Accordingly, the Vice Chancellor concluded that although the factual record appeared to support the defendant-directors, he was constrained (in the context of reviewing defendants' summary judgment motion) to draw every reasonable factual inference in favor of the plaintiff. On that basis, he determined (at least at such stage of the litigation), that a controversy remained as to whether the directors' conduct might rise to "something more than [an exculpated] violation of the board's fiduciary duty of care" and, instead, might constitute a conscious, knowing and bad faith disregard of the directors' fiduciary duties. He offered that it was, therefore, premature to permit the defendant-directors to avail themselves of the exculpatory protections of DGCL Section 102(b)(7) to dismiss the litigation.

Following the Delaware Chancery Court's ruling, deal commentators, academics and public M&A practitioners questioned whether the decision heralded the judicial demise of the exculpatory protections of DGCL Section 102(b)(7), which was enacted in the wake of the Delaware Supreme Court's landmark *Smith v. Van Gorkom*[5] policy decision to shield directors from personal liability for breach of the duty of care.

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[5] *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

Many feared that the Delaware Chancery Court found in *Lyondell* that, under certain circumstances, an egregious breach of a director's duty of care could be transformed into a sustainable claim for breach of the duty of loyalty (or flat out constitute bad faith).

The Delaware Chancery Court's decision may have been "overread" in this regard by some; however, the overall concern regarding the Delaware Chancery Court's bad faith analysis was justified. So much so, that in a subsequent (somewhat unusually textual) August 2008 Delaware Chancery Court decision denying the defendants' certification of an interlocutory appeal to the Delaware Supreme Court, Vice Chancellor Noble sought to clarify that his earlier decision should be read narrowly in the specific procedural setting of the litigation. He stressed that on the defendants' motion for summary judgment, he had no choice but to read all reasonable inferences in favor of the plaintiff, unlike a motion for a preliminary injunction where he would have been permitted to determine which litigant had the better argument and was more likely to prevail at trial on the merits.[6] This subsequent decision did little, however, to allay the DGCL Section 102(b)(7) fears (or at least confusion) of M&A professionals and transaction principals.

The Delaware Chancery Court's decision remained quite troubling because the challenged transaction, although not necessarily a textbook example of the most optimal sale process nor, for that matter, an "A+" exhibition of director proactivity, carefully orchestrated negotiating strategy or fluid CEO-board interaction, did not possess the transactional indicia of a classic conflict of interest, breach of loyalty or "entire fairness" case. That is to say, the transaction was not a management buyout or a take-private transaction initiated by a controlling stockholder, and there was no evidence in the summary judgment record to suggest that a majority of the directors (or any director, for that matter) lacked requisite "independence" or "disinterestedness," or that the directors otherwise were beholden to or subject to the domination of management or a control person. In fact, the Delaware Chancery Court expressly concluded to the contrary.

The Delaware Supreme Court Reverses

On September 15, 2008 (some nine months following consummation of the Lyondell-Basell merger), the Delaware Supreme Court accepted the defendants' application for appeal. In her (rather short) 20-page decision, Justice Berger, writing for the Delaware Supreme Court, concluded that the Delaware Chancery Court improperly construed and applied the *Revlon* doctrine to the facts of the case, reversed and remanded the decision, and ordered the Delaware Chancery Court to enter judgment for the defendant-directors.

In that the sole issue framed on defendants' appeal was adjudication of the "bad faith" claim, reversal of the Delaware Chancery Court's decision was not at all surprising, especially in view of the rather egregious examples of conduct constituting directorial bad faith articulated in *In re Caremark Int'l Deriv. Litig.*, 698 A.2d 959 (Del. Ch. 1996); *Stone v. Ritter*, 911 A.2d 362 (Del. 2006); *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27 (Del. 2006) and other recent Delaware decisions where plaintiffs have sought judicial imposition of personal liability on directors.

In Justice Berger's decision, she concluded that the Delaware Chancery Court reviewed the limited factual record with a mistaken understanding of the *Revlon* doctrine. Firstly, the Delaware Supreme Court stated

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[6] On the same day that Vice Chancellor Noble issued his August 2008 clarifying decision in Lyondell, Chancellor Chandler, in McPadden v. Sidhu, 2008 WL 4017052 (Del. Ch. Ct., August 29, 2008), granted the defendants' motion to dismiss the plaintiff's complaint with respect to a sale to management , at an allegedly below-market price, of a wholly owned subsidiary of i2 Technologies. Specifically, the plaintiffs in that case alleged that the defendant-directors entrusted the sale process to the management team of the subsidiary with little or no oversight and that the subsidiary's Vice President previously had expressed interest in purchasing the subsidiary and did not genuinely seek to obtain competing superior offers. Chancellor Chandler, in a procedural context not dissimilar to Vice Chancellor Noble's review of the defendants' summary judgment motion in Lyondell, concluded that although the plaintiff's complaint alleged actions that were either "recklessly indifferent or unreasonable", they did not rise to the level of "intentional dereliction of duty or conscious disregard for one's responsibilities." Accordingly, Chancellor Chandler distinguished pleading with particularity facts that suggest gross negligence or even recklessness vis a vis breach of loyalty and bad faith. Moreover, on the heels of Chancellor Chandler's McPadden decision, in September 2008, Vice Chancellor Strine, in In re Lear Corporation Shareholder Litigation, 2008 WL 4053221 (Del. Ch. Ct., September 2, 2008), dismissed plaintiffs' complaint against the directors of Lear Corporation for failure to state a duty of loyalty claim outside the ambit of Lear's DGCL Section 102(b)(7) exculpatory charter provison. The plaintiffs in Lear alleged that the directors acted in bad faith by agreeing to a $25 million "naked no vote" breakup fee payable in cash and stock to a Carl Icahn-controlled acquiror in exchange for a $1.25 per share purchase price increase in the amended merger agreement to buy Lear. The merger, in fact, was voted down by Lear's stockholders and Lear paid the breakup fee. Vice Chancellor Strine found that the plaintiffs' complaint failed to "create an inference of negligence or gross negligence, no less a more egregious inference of . . . a breach of loyalty." He further cautioned that "courts should . . . be extremely chary about labeling what they perceive as deficiencies in the deliberations of an independent board majority over a discrete transaction as not merely negligence or even gross negligence, but as involving bad faith." Strine observed that, as a practical matter, Delaware directors "may have to choose between acting rapidly to seize a valuable opportunity without the luxury of months or even weeks of deliberation—such as a large, premium offer—or lose it altogether."

that *Revlon* duties are not animated simply because a target company is put "in play" (in this case by the Basell affiliate's Schedule 13D filing). The duty to seek to obtain the best price reasonably attainable arises only when the target company initiates a sale of control transaction or does in response to an unsolicited change-in-control transaction (which, in the latter scenario, also could under certain circumstances independently animate the so-called *Unocal*[7] standard of judicial review). Accordingly, *Revlon* duties attached only once Lyondell's directors began the negotiating process to sell Lyondell to Basell and their "wait and see" posture, adopted in response to the Schedule 13D filing some months earlier, was simply a proper exercise of the directors' business judgment.

Secondly, the Delaware Supreme Court reiterated that (as articulated in myriad prior Delaware decisions), once *Revlon* applies, there is no prescribed course of action, "blueprint" or formulaic means for Delaware directors to seek to obtain the best price reasonably attainable. The directors are the sole architects, under the totality of prevailing facts and circumstances, of how best to achieve their value maximizing objective and ensure their understanding of the company's value before agreeing to a sale of control. The Delaware Chancery Court improperly suggested that, in the absence of palpable evidence of the directors' impeccable knowledge of the market (and, concomitantly, Lyondell's intrinsic value), a pre-sign market check, formal auction, a post-sign "go shop," or more seller-favorable amalgam of merger agreement deal protections, was required as a matter of Delaware law before Lyondell's directors agreed to sell control of the company. The Delaware Supreme Court counseled that "no court can tell directors exactly how to accomplish [the value maximizing] goal, because they will be facing a unique combination of circumstances, many of which will be outside of their control."

Lastly, the Delaware Supreme Court held that the Delaware Chancery Court incorrectly conflated the directors' duty of care with their duty of loyalty. To the extent Lyondell's directors, in discharging their *Revlon* objectives, embarked on a flawed, less than optimal, or even negligent, sale process, such process failure could not be equated with a conscious disregard for the directors' fiduciary duties, their knowing violation of positive law, their willful failure to undertake their responsibilities, their deliberate failure to act in the face of a known duty to act, or an actual intent to harm Lyondell. Put differently, irrespective of whether Lyondell's directors could have (or should have) taken different steps to seek to maximize stockholder value or negotiate a more favorable merger agreement deal protection package, their failure to do so, without more, could not give rise to any plausible inference of bad faith (*i.e.*, disloyalty).

Thus, the Delaware Supreme Court noted that the Delaware Chancery Court approached its summary judgment review from the wrong perspective by focusing on the substantive quality, reasonableness and completeness of the process undertaken by Lyondell's independent and disinterested directors to sell the company (*i.e.*, a duty of care analysis), in lieu of simply determining whether Lyondell's directors consciously ignored their fiduciary obligations and "utterly failed to attempt to obtain the best sale price" (*i.e.*, deliberate abdication of any process). Interestingly, in *dicta*, the Delaware Supreme Court nevertheless did offer that even if the case before it were presented as a duty of care case, it would be inclined to find in favor of the defendant-directors based on the limited factual record.

The Upshot

Indeed, the Delaware Supreme Court's *Lyondell* decision is a good result, and in this author's view, the correct result. It should go a long way to quell any fears lingering in the wake of the Delaware Chancery Court decision as to the ambit and efficacy of a DGCL Section 102(b)(7) charter provision and provide comfort to Delaware directors that where their "independence" and "disinterestedness" are not controverted and where the company's certificate of incorporation does contain such an exculpatory provision, absent evidence of egregious director conduct (*e.g.*, a conscious and knowing disregard for their fiduciary duties) personal monetary liability will not (and should not) be imposed.

Moreover, Lyondell reinforces oft-cited Delaware cases decided during the previous "M&A boom era" (and earlier) that *Revlon* is a flexible and contextual doctrine and that there is no singular method or judicially mandated course of action required when selling control of a company.On a cautionary note, the decision also should not be overread. As sometimes occurs in the wake of a high profile litigation decision, there is a tendency to lose sight of the procedural context of the decision (if not a trial decision on the

[7] *Unocal Corp. v. Mesa Petroleum Company*, 493 A.2d 946 (Del. 1985).

merits) and overreact or underreact to *dicta*, evidentiary presumptions, complex Delaware judicial review standards and an undeveloped factual record. The Delaware Supreme Court decision, therefore, should be read in the context of defendants' interlocutory appeal from the Delaware Chancery Court's failure to dismiss plaintiff's breach of loyalty (bad faith) claims on the defendants' summary judgment motion in a non-conflict of interest transaction. It should not be relied on by M&A professionals and principals in potential future deals as an absolute judicial endorsement of the particular sale process employed by Lyondell's directors and management.

Some Lessons Learned

As noted above, the Delaware Supreme Court's reversal of the Delaware Chancery Court's decision was correct in the context of the issues presented on appeal. That written, there are certain observations from the lower court decision which should not be "lost in the shuffle" and, therefore, bear repeating, together with important lessons articulated by the Delaware Supreme Court:

1. No Blueprint—There is no judicial blueprint for Delaware directors to properly discharge their *Revlon* obligations in a sale of control.

   A formal auction, a more limited pre-sign canvass of prospective financial and strategic buyer candidates, a limited exclusive negotiation, a passive post-sign market check or, in some instances, an affirmative "go-shop" period (with a subsequent "window shop" period) may be appropriate or inappropriate, depending on the totality of facts and circumstances.

   Vice Chancellor Noble conceded that the absence of a competing bid after a couple of months following the deal's announcement may well evidence (albeit, with hindsight) that the best deal was, in fact, obtained--but that such an inference simply could not be drawn to support the defendants' motion for summary judgment.

2. Directors Should Get Involved from the "Get Go"—Directors (or an appropriate committee) should be proactively involved throughout all stages of a sale of control process. This includes all decisions to design and execute the negotiating strategy, deal terms, timing and structure. Even where a majority of the board is "independent" and "disinterested" and where the transaction does not involve a non-management buyout or controlling stockholder take-private or sale to a third party, enabling the target's CEO to substantially run solo with a potential sale process, with only sideline or late-stage direction, input and advice from the board could (in a duty of care litigation where an action to enjoin the transaction is brought) remain suspect on judicial review and is not an advisable approach.[8]

3. Directors Must "Show Their Work"—Document, to the maximum extent practicable and on a real time basis, all board and committee meetings convened since inception of the sale process. Directors should request, receive and review management and outside advisor presentations and reports to help understand fully the merits and risks of continuing to execute management's business plan and to understand all reasonable alternative strategies to enhance and maximize value.[9]

4. If You're Selling Control, A "Fair Price" is Not Synonymous with the "Best Price"—A sell-side fairness opinion merely helps support the conclusion that the buyer's proposed merger price falls within a range of implied fair values, based on methodologies and assumptions used by the company's financial advisor—nothing more and nothing less. A fairness opinion is not dispositive of whether the merger price agreed to by the seller's directors is the best price that was reasonably attainable under all of the circumstances. Where no pre-sign market check or auction is conducted and no post-sign go shop or seller-favorable set of deal protections (*i.e.*, passive, post-sign market check) is obtained, in a future duty of care case seeking to enjoin a transaction, defendants may have a harder time demonstrating that they received and reviewed all information reasonably available to fully understand the target's value before agreeing to sell control.

[8] *See e.g.*, *In re Lear Corp. S'holders Litig.*, 926 A.2d 94 (Del. Ch. 2007).

[9] *See e.g.*, *In re Netsmart S'holders Litig.*, 924 A.2d 171 (Del. Ch. 2007).

5. Why Sell the Company Today?—Before initiating a sale process, directors should request and receive a comprehensive report from management and the company's outside financial advisor on all operating, strategic and financial alternatives reviewed by the company to support why commencing the sale process is appropriate at that stage of the company's business plan and corporate cycle.

   By way of illustration, directors may first seek to understand, based on a careful review of specific information requested and received from management and the company's outside professional advisors (i) the relative risks and benefits of a "stay the course" strategy, as well as the estimated impact of possible modifications to management's current business plan to enhance stockholder value over the mid-term and long-term; (ii) the availability on commercially favorable terms of equity capital or debt financing to address capitalization and cash needs; (iii) whether the sale or spinoff of a non-core subsidiary, a divestiture or other restructuring is likely to unlock long-term value; (iv) whether an M&A growth strategy can be successfully executed; and (v) whether a strategic alliance or joint partnering type arrangement is viable and likely to enhance value.

   The implied (mid-term and long-term) enterprise and equity per share values that reasonably could be generated from the foregoing hypothetical alternatives would be considered in relation to the per share sale price range under consideration by the board and management.

6. A Blockbuster Price Doesn't Always Carry the Day—A preemptive merger price (in relation to the target's unaffected stock price), even if a very substantial premium to the target's historical high, does not justify taking process or negotiating short cuts.

   To this point, both the Delaware Supreme Court and the Delaware Chancery Court observed that Basell offered a "blowout" 45% premium. However, a facially strong price (especially in today's dislocated market, where a 100% premium might not constitute a "blowout") does not, in itself, validate or cleanse an otherwise truncated or inadequate sale process, and will not necessarily justify an assumption that "no one else is capable of matching or topping this great price." The Delaware Chancery Court correctly counseled that *Revlon* duties "do not ebb and flow on the fortuities of an offered deal premium and the ability to secure an expensive fairness opinion that...concludes that the offer is 'fair' to [stockholders]."

   Remember, there is a common sense way to deal with an aggressive purchaser (with bargaining leverage in a buyer's market) and properly balance the discharge of fiduciary duties and the risk of losing what appears to be a great (or even once in a lifetime) deal. The job of experienced M&A attorneys and financial advisors is to help the board and management effectively strike this delicate balance. On the other hand, the goal is not to be so "process-centric" that you risk scuttling or unduly protracting good deals for stockholders out of litigation paranoia or decisional paralysis.

7. A Few Words about Deal Protections—Vice Chancellor Noble briefly addressed the rationale of deal protection measures from the perspective of both the buyer (*e.g.*, "I'm not a stalking horse who will risk losing this deal to an interloper offering a marginally higher price and get merely a break-up fee for my troubles—I really want to own the company") and the seller (*e.g.*, "Sure, you are entitled to some reasonable deal protections, but first, you're going to have to pay for them with your highest and best price and, in all cases, we need a fiduciary termination right for a superior deal that you don't top or match, and let's not get greedy with the break-up fee").

   Curiously, he questioned whether deal protections should always be viewed through a *Unocal* lens. In that he raised this issue in *dicta*, it is unclear whether Vice Chancellor Noble intentionally sought to undercut, or inadvertently created ambiguity with respect to, the Delaware Supreme Court's 2003 *Omnicare*[10] decision (where, among other things, that court held that *Unocal* is the appropriate judicial review standard for merger agreement deal protections, irrespective of whether the target company is in a "*Revlon* mode"). Vice Chancellor Noble employed both a *Unocal* (*i.e.*, a proportionality-coercion-preclusion) analysis and a *Revlon* (*i.e.*, related to the

[10] *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

goal of obtaining the best price reasonably attainable) analysis in his examination of the merger agreement deal protections.

At the end of the day, it is important to understand that there is a general correlation between (x) the sufficiency and extent of the directors' pre-sign sale process and, thus, the reliability and magnitude of the information available to the directors to enable them to be fully informed as to the intrinsic value of the company when they definitively agree to sell control and (y) the interrelated package of covenants, conditions and remedies (comprising the deal protections) the directors agree to in the definitive merger agreement.

The Delaware Chancery Court cautioned, however, that "[u]ltimately, the reasonableness of a particular mix of deal protections is context-specific and not [an] algebraic formulation such that 'x' amount of market check, knowledge or raw premium to market entitles the board to agree to 'y' level of deal protections as a matter of course."

8. A Word About "Disinterestedness" and "Independence"—Generally, under Delaware law a director is deemed to be "interested" in a transaction where he or she will receive a personal benefit (that is material to the director) that is not available to the company's stockholders generally in their capacity as such. "Independence" (which is a state of being) requires that the director's decision is based entirely on the corporate merits and risks thereof—the impact on the enterprise—and not based on other extraneous or personal influences or biases.

   One point confirmed by Vice Chancellor Noble in this regard, which bears repeating, is that ownership of stock options (with a favorable exercise price and accelerated vesting upon consummation of a change-in-control) does not automatically create impermissible director "interest" in a transaction. To the extent the directors are not treated any differently in the transaction from the company's stockholders at large (*i.e.*, they simply receive at or after closing the spread between the option strike price and the per share merger price) and the options were not granted "surreptitiously…on the eve of a merger," Vice Chancellor Noble instructed that there is no disabling conflict of interest as a matter of law. That written, it is not an uncommon disclosure practice (out of an abundance of caution and in response to SEC line-item disclosure instructions) for companies to describe such option ownership in the merger proxy statement under the heading "Conflicts of Interest" or "Material Interests in the Transaction," together with descriptions of other more overt potential conflict arrangements such as post-closing employment, "parachute" and retention agreements for management, equity rollover arrangements (if applicable), and the like.

9. A Fair Summary of the Financial Advisor's Work is Required—The directors' duty of disclosure requires a fair summary of the substantive work performed by the financial advisor upon which the directors relied to approve the deal and recommend the same to stockholders.

   However, this does not require the board to disclose every piece of information relied on by the banker in reaching its fairness conclusion, or every conceivable bit of data necessary to enable a stockholder to conduct its own independent valuation of the company. In a nutshell, the *TSC v. Northway*[11] standard of disclosure is alive and well.

   This is mentioned because, although in *Lyondell* the plaintiff's duty of candor claims were not a subject of the defendants' appeal (*i.e.*, the appeal was limited to plaintiff's bad faith claims), the Delaware Chancery Court examined whether Lyondell's merger proxy statement should have disclosed the reasons why Deutsche Bank failed to use management's 8.25% WACC estimate to perform its DCF analysis, and instead, used a higher WACC estimate derived from Lyondell's comparable peer group. Deutsche Bank relied both on management's (more optimistic) forecasts and consensus "street" (more conservative) estimates for deriving its DCF, but it applied a higher discount rate (ranging from 9.5% to 11.5%) to the terminal value (*i.e.*, at the end of the forecast period) of Lyondell's operating cash flows than it otherwise would have, had it used management's WACC estimate. This had the effect of lowering the implied equity per share value range

[11] *TSC v. Northway*, 426 U.S. 438 (1976).

(and making Basell's $48 per share price arguably look "more fair" from a financial point of view, or, higher in the valuation range). Accordingly, in *dicta*, Vice Chancellor Noble stated that disclosure might have been required as to why Deutsche Bank deemed management's WACC unreliable.[12]

10. Possible Increase in Actions to Obtain Equitable Relief—In that the Delaware Supreme Court's *Lyondell* decision reaffirms that, unless there was a conscious disregard of fiduciary duties, directors will not be tagged with personal liability (assuming the charter contains a DGCL Section 102(b)(7) provision), this may result in an increase in pre-closing suits to enjoin transactions. However, in such a case, the customary standards for relief would still pertain; namely, a balancing of the relative hardships and a determination of the (i) likelihood of irreparable harm if injunctive relief is not granted, (ii) probability of success at trial on the merits and (iii) absence of an adequate remedy at law (*i.e.*, monetary relief).

11. So, What About DGCL Section 102(b)(7)?—If a company's certificate of incorporation does not contain a DGCL Section 102(b)(7) provision, by all means adopt one. This proposition speaks for itself but, of course, it will be far easier to do so before a company goes public. Moreover, the recent decision of the Delaware Chancery Court in *Gantler v. Stephens*, No. 132,2008, 2009 WL 188828 (Del. Ch. January 27, 2009), confirmed that Delaware officers owe the same fiduciary duties to stockholders as directors. However, DGCL Section 102(b)(7) does not exculpate officers from personal liability for breach of their duty of care. Officers typically are covered by external D&O insurance policies and may be the beneficiary of indemnity provisions contained in employment agreements, but the lack of organic protection may enable plaintiffs, in the future, to craft unique and distinct causes of action against officers. Whether the Delaware legislature will find a policy justification to amend DGCL 102(b)(7) remains to be seen.

[12] *See e.g., Globis P'ers L.P. v. Plumtree Software, Inc.*, C.A. No. 1577-VCP, 2007 WL-4292024 (Del. Ch. Nov. 30, 2007); *In re Topps Co. S'holders Litig*, 926 A.2d 58 (Del. Ch. 2007); *In re Pure Resources, Inc. S'holders Litig*, 808 A.2d 421 (Del. Ch. 2002).

Going In-House: Stewart Landefeld On His Time at Washington Mutual

The following is an interview Broc Romanek conducted with Stewart Landefeld. Stewart is the head of the Business Group at Perkins Coie LLP. Beginning in December 2007, Stewart served as Interim Chief Legal Officer—among other roles—at Washington Mutual and just recently returned back to Perkins Coie.

BROC: Stewart, please tell us about how you came to be the Interim Chief Legal Officer at Washington Mutual.

STEWART: Perkins Coie, the firm at which I am a Partner, had been advising Washington Mutual's Board of Directors and Audit Committee for about seven years when the CEO and the then-Chair of the Audit Committee called to ask me to serve as Interim Chief Legal Officer. They were looking for someone who could help with the search for a permanent CLO, manage a 200-person law department, and advise the Board and senior management team on the rapidly developing issues that were arising for WaMu and other financial institutions.

All in all, I was excited about the possibility of helping a leading U.S. retail financial institution at a critical time. I also saw it as a unique opportunity to see to what extent the corporate governance theories about which I wrote and talked—as well as the advice that I gave to in-house counsel, executives and directors - rang true when I sought to apply it in practice.

BROC: So how was your thinking about corporate governance altered as a result of the time you spent in-house?

STEWART: I learned a lot of lessons—but perhaps the biggest was the critical role and responsibility that in-house counsel has in translating industry language and marshalling internal information for the board of directors.

Plain English plays a key role in corporate communication—and in-house counsel have a special role, as the professionals best trained to assimilate masses of complex information and communicate their conclusions in plain English. Inside any U.S. economic or industry niche, people—including management—use a lot of technical language and jargon, as the way that professionals in that niche describe their business and communicate with one another. But intelligent and thoughtful outsiders who need to understand the business, such as a director, regulator, analyst or retail investor reading an MD&A, have a harder time understanding the jargon.

Lawyers are trained to render complicated information meaningful to a lay reader, and in-house counsel knows more than any external counsel ever could about what is happening inside the company. So, in-house counsel plays a critical role in assuring that the organization communicates critical facts to its board and other outside constituencies in an understandable manner. They can add a lot of value by encouraging insiders to communicate in plain English both verbally and in writing.

A best practice that I would recommend to lawyers when reviewing or preparing board materials is to ask: "What six to ten questions about this topic would a board member ask if they knew all that you know?" and then to think through whether the materials provide the resources to answer those questions in a plain English way.

BROC: You just described a very special role played by in-house counsel; what is your view of the role played by outside counsel?

STEWART: If in-house counsel brings to the table his or her unique knowledge of the business, so outside counsel brings another special asset: the world of experience. While those diverse experiences very rarely exactly match the facts facing a company, they provide a good framework for developing thinking about an issue by analogy. Of course in-house and outside counsel need to share a common knowledge of the law.

BROC: What was it like for you to work with outside lawyers while you were Interim General Counsel?

STEWART: I kept thinking about the image of Mike Mulligan and his steam shovel. As in-house counsel, I felt like Mike Mulligan sitting in the cab of a noisy steam shovel. The role of outside counsel is more like an architect at the edge of the pit calling out instructions. On the inside you do the best you can to listen and assimilate those instructions, but events are changing quickly and you are trying to listen while keeping your steam shovel moving.

BROC: As Interim CLO of Washington Mutual, what did you look for when reaching out to external counsel for advice?

STEWART: Because we so often needed to act quickly, I had to look for counsel who was both familiar with the situation and able to provide a correct and practical answer.

I would try to call someone who not only would understand the substantive legal issues involved, but was also already generally aware of the facts involved—either because they were already a trusted advisor, like Lee Meyerson and Maripat Alpuche of Simpson Thacher & Bartlett LLP, or were otherwise closely following the organization. It was also very important to be able to talk to a person right away or have confidence that my call would be returned promptly, like Rebecca Hoskins and Andrew Moore of Perkins Coie.

I was often facing highly critical issues with institutional imperative that had to be addressed without much delay. Frequently, delay in responding was in itself a decision. For example, if the question was what could be said to a reporter and that question was not answered before the reporter's deadline, then it would turn into a "no comment."

BROC: What were some other resources that you frequently reached for while you were at WaMu?

STEWART: I often consulted with other General Counsel. I was impressed by how very generous they were in answering my questions and sharing their approaches with me. I am especially grateful to Tom Stevens of Key Bank, Jim Strother of Wells Fargo & Company, and Brad Smith and John Seethoff of Microsoft.

Being a General Counsel is very different from being a partner at a law firm; it's much lonelier. The lawyers who are your colleagues at the company ultimately report to the CLO. Talking with general counsel peers provides collegiality, support and a reality check from time to time. On some specific matters, I would also access what I found to be a very helpful wealth of experience that is searchable in the Q&A Forum of TheCorporateCounsel.net.

BROC: Thanks, Stewart! Getting back to your thoughts on corporate governance, are there any things that did not work as well as you expected they would?

STEWART: Great corporate governance and compliance programs only go so far.

I think that good governance and compliance programs enable ethical decision-making that keeps corporate ships stable. Sometimes even when governance and compliance are at their best, however, it is not enough to prevent a corporation from being overwhelmed by the economic storms that we have experienced in the last 18 months.

BROC: What positions other than Interim CLO did you hold at Washington Mutual?

STEWART: After about six months of being the Interim CLO, Michael Solender (now Americas Vice Chair and General Counsel at Ernst & Young LLP) joined Washington Mutual as Chief Legal Officer, and I stepped into another interim role -- as Interim Chief Compliance Officer. I held this role for about three months, during which time I was working with the compliance team on a remediation of Anti-Money Laundering compliance, and to identify a permanent Chief Compliance Officer.

Then, just as I was days away from returning to Perkins Coie, the Office of Thrift Supervision (OTS) placed Washington Mutual Bank into receivership with the Federal Deposit Insurance Corporation (FDIC). At that time, I became the sole Seattle-based officer and employee of the holding company, where I stayed for the first five weeks or so of its bankruptcy.

BROC: Can you tell us how you happened to enter that last position?

STEWART: I was at the WaMu headquarters offices in Seattle with all the members of WaMu's representatives of the Board and management at 6:00 p.m. on the evening of Thursday, September 25th, when the OTS and the FDIC sat down with us to formally place the bank into FDIC receivership.

A key question in all of our minds was what would happen to WaMu's employees. When the FDIC explained that they all would become employees of JPMorgan Chase the next morning, I elected to stay a Washington Mutual employee and not become employed by JPMorgan Chase.

As a result, I had the strange experience of being the only person going to work for the next few weeks at the headquarters' office as an employee of Washington Mutual. Very soon, I was working to hire back key senior members from JPMorgan Chase to manage the holding company though its bankruptcy; a process they continue.

BROC: Has your approach to practicing law changed since your return to private practice?

STEWART: It was a humbling experience to work with such superb professional colleagues. I'm still learning the lessons. I have begun to focus even more on providing plain English solutions to clients that are practical and susceptible to easy explanation to board members, the outside world and auditors. And, as Chair of the Business Group of Perkins Coie, I have developed a more objective point of view to my own workplace than I had before.

BROC: Thank you for sharing your thoughts with us, Stewart.

STEWART: Thank you for interviewing me, Broc. It's been a pleasure!

The Shareholder Activist Corner: Mario Gabelli's GAMCO

By Don Duffy and Michael Fox of ICR and Ken Squire of 13D Monitor

A new Presidential Administration, heavily depressed stock prices, growing concerns about executive pay and more receptive corporate boards has already made 2009 an inflection point for activist shareholders. While 2007 and early 2008 witnessed activists push for such actions as asset sales, outright sales or share buybacks, these value enhancement proposals are essentially off the table due to the current economic tsunumi.

Despite these trends, more non-traditional activists are flexing their muscles and pushing for board representation, improved governance and abolishment of anti-takeover measures, like poison pills. In fact, recent Schedule 13D activity suggests the most active filer continues to be GAMCO, headed by well-known money manager Mario Gabelli.

Who is GAMCO?

GAMCO Asset Management, Inc. (GAMCO), a publicly traded entity, was formed in 1977 to provide discretionary investment services to a broad spectrum of investors. GAMCO currently manages in excess of $20 billion. Their principal objective is to seek long-term capital appreciation, primarily through the equity markets. In the tradition of Senators Graham and Dodd, GAMCO utilizes fundamental research to identify undervalued companies with dominant industry positions. This approach has enabled GAMCO to deliver superior returns to their clients through investments in public company securities.

GAMCO is not an activist investor by today's standards. They file Schedule 13Ds for all of their 5% positions and have not filed a Schedule 13G in four years. While they hardly ever take Item 4 action, when they do, they are taken seriously by the target company and other institutional investors. While GAMCO's Item 4 actions have generally been to redeem poison pills or oppose mergers, they amended 14 of their Schedule13D filings this past September to disclose that they were considering contacting individuals concerning their interest and qualification to serve on the board of those companies. GAMCO is a "reluctant activist" in that they would prefer not to have to commence proxy fights or sit on boards—but will do so when they feel there is no better option to enhance shareholder value.

GAMCO announced 18 activist campaigns against U.S. companies in 2008. In addition, GAMCO made a very public statement in September 2008 by issuing the following statement via a broadly distributed press release:

> GAMCO Investors, Inc. announced today that it is considering contacting individuals concerning their interest and their qualifications to serve on the Board of Directors of public companies. This inquiry is likely to result in feedback to companies in which we have 13D filings, as well as further dialogue with these companies concerning the use of cash flow, and corporate governance such as poison pills. Accordingly, we thought it better for us to disclose that we are considering undertaking this activity "en masse."

Below is a list of the companies that GAMCO recently has expressed an interest in, with an indication of the actions they have taken since they issued a related press release:

Company	**Action Taken by GAMCO**
CH Energy Group Holding	– Nominated three directors
Pennichuck Corp.	– Nominated three directors
Cablevision Systems Corp.	
Telephone & Data Systems	– Nominated four directors
Fisher Communications	– Nominated three directors
Standard Motor Products	
Media General	
Gaylord Entertainment	– Nominated four directors; settled for 2 seats
	– Submitted shareholder proposal to redeem poison pill—company increased threshold from 15% to 22% as part of settlement
Myers Industries	– Nominated four directors
Alpharma	– Submitted shareholder proposal to redeem poison pill
	– Withdrew proposal and consideration of directors when company announced acquisition by King Pharmaceuticals
US Cellular Corporation	
Sonesta International Hotels Corporation	
Trans-Lux Corporation	

Are We There Yet? Issuer Debt Tender Offers and Offering Period Requirements

By Michael H. Friedman and Joshua Ashley Klayman of Pepper Hamilton LLP[1]

Despite the straightforward, 20-business-day offering period requirement set forth in Rule 14e-1(a), determining a tender offer period for a given transaction is not always simple. Issuers that are considering repurchasing their debt securities should be aware that some of the most mechanical features of issuer debt tender offers also can be some of the least understood. To tailor an issuer debt tender offer to complement an issuer's individual needs and concerns, one must examine the subtleties—and potentials for missteps—that exist under the securities laws.

The SEC, in various no-action letters issued between 1986 and 1993, has noted that a tender offer by an issuer for any and all of a particular class of non-convertible debt securities involves different factors, and may warrant different treatment, than would a tender offer by such issuer for convertible debt securities.[2] One notable divergence is that, under certain circumstances, a straight debt tender offer may not need to be held open for a full 20 business days and may be permitted to expire in as few as 7 calendar days.

Specifically, the SEC's Division of Corporation Finance has expressed, in multiple no-action letters, that the Division:

> believes that issuer debt tender offers for any and all non-convertible debt securities of a particular class or series may present considerations that differ from any and all or partial issuer tender offers for a class or series of equity securities or non-investment grade debt.… For example, because of the modest premiums typically offered in an Issuer Debt Tender Offer, it is not clear that participation in the tender offer by individual non-institutional debtholders would be materially increased by requiring that the tender offer be held open for twenty business days.[3]

The no-action letters further state that the Division will not take enforcement action under Rule 14e-1(a) or (b) against issuers conducting cash tender offers for straight debt securities with offering periods of less than 20 business days, if the tender offer meets certain criteria set forth in such no-action letters. Additionally, the Division has noted in such no-action letters that it will not take enforcement in certain instances where the offering period is less than ten calendar days, provided that the means by which to tender are submitted to debt holders on an "expedited" basis.

As noted by in the book *U.S. Regulation of the International Securities and Derivatives Market*:

> There are, however, no withdrawal rights under Section 14(e). Thus, although a tender offer for debt securities (where the Regulation 14D rules do not apply) generally must be kept open for 20 business days, the bidder (often the issuer) can purchase the debt securities as they are tendered, rather than waiting until the offer expires. In addition, the SEC has issued no-action letters allowing certain issuer debt tender offers for nonconvertible, investment-grade debt securities to be kept open for fewer than 20 business days provided that the offer (i) is for any and all such securities, (ii) is open to all holders of such securities, (iii) is conducted in a manner designed to afford all record holders a reasonable opportunity to participate and (iv) is not made in anticipation of or in response to other tender offers for the issuer's securities. See Salomon Brothers Inc (avail. March 11, 1986), Goldman Sachs & Co. (avail. March 26, 1986), Goldman Sachs & Co. (avail. December 3, 1993) and Salomon Brothers Inc (avail. October 1, 1990) (adding the investment grade requirement)[4]

While the Division's no-action positions have never been formally codified into the tender offer rules, issuers regularly conduct cash debt tender offers with offering periods of as few as seven calendar days.

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[1] Michael H. Friedman chairs the Corporate and Securities Practice Group of Pepper Hamilton LLP, and Joshua Ashley Klayman is an associate in the Corporate and Securities Practice Group of Pepper Hamilton LLP.

[2] *See* FN 4, *infra*.

[3] *See, e.g.*, Goldman, Sachs & Co. No-Action Letter (avail. Dec. 3, 1993) and Merrill Lynch, Pierce, Fenner & Smith Inc. No-Action Letter (avail. July 19, 1993).

[4] *U.S. Regulation of the International Securities and Derivatives Market*, Edward F. Greene (2003), FN 93.

Indeed, recent issuer requests for no-action letters on unrelated matters refer to, and rely upon, the exceptions to the 20 business day rule as settled precedent.[5]

Lucky Number 7? Complexity in Counting Seven Calendar Days

Although issuer debt tender offers for straight debt are governed by Regulation 14E and not Regulation 14D,[6] Rule 14d-1(g)(3) sets forth the procedure for counting days in all tender offer contexts, stating,

> The term "business day" means any day, other than Saturday, Sunday or a federal holiday, and shall consist of the time period from 12:01 a.m. through 12:00 midnight Eastern time. In computing any time period under section 14(d)(5) or section 14(d)(6) of the Act or under Regulation 14D or Regulation 14E, the date of the event which begins the running of such time period shall be included *except that* if such event occurs on other than a business day such period shall begin to run on and shall include the first business day thereafter….

Rule 14d-2(a), in turn, states:

> *Date of Commencement*. A bidder will have commenced its tender offer for purposes of Section 14(d) of the Act and the rules under that section at 12:01 a.m. on the date when the bidder has first published, sent or given the means to tender to security holders. For purposes of this section, the means to tender includes the transmittal form or a statement regarding how the transmittal form may be obtained.

In practice, the "means to tender" refers to the Offer to Purchase and the accompanying Letter of Transmittal. Historically, when issuers had to transmit thousands of Offers to Purchase to individual holders, which could take several days to complete, there was an accepted concept that the "date of commencement" was the date on which the mailings had substantially begun.

Present day issuer debt tender offers often "look" somewhat different. For example, the establishment of The Depository Trust Company (DTC) in 1973 and the advent of new communication forms, such as e-mail, have changed the way in which issuer debt tender offers are executed and even have changed the way in which days are counted.

Now, an issuer may decide to launch its issuer debt tender offer immediately after the market closes on a given day and, instead of having to mail thousands of Offers to Purchase and Letters of Transmittal, the issuer may only need to e-mail DTC two PDFs, one containing the Offer to Purchase, and the other containing the Letter of Transmittal. Indeed, DTC may be the only party that needs to receive the "means to tender."

Nevertheless, to count that first day for purposes of a seven-day offering period, an issuer that needs only to deliver to DTC the "means to tender" must deliver to DTC the Offer to Purchase and the Letter of Transmittal prior to the close of DTC's business, which, in practice, means that DTC must receive the e-mail before 5:00 P.M. (Eastern). In practice, this ability to count, as a full day, the period after the market closes on the day on which the tender offer is announced means that an issuer debt tender offer can span only six calendar days, yet still meet the seven calendar day requirement![7]

However, in the event that an issuer suffers a delay and does not deliver to DTC the "means to tender" until after DTC's close of business, then, for purposes of counting the seven-day period, Day One will be the following day on which DTC is open for business.

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[5] *See, e.g.*, Eaton Vance Management No-Action Letter (avail. June 13, 2008), which contains the following footnote:

> See the series of investment grade debt tender No-Action Letters that, among other things, granted relief for tenders that were open for less than ten calendar days and tenders at a fixed spread over U.S. Treasury securities: Times Mirror Co., SEC No-Action Letter, 1994 WL 637182 (Nov. 15, 1994); Goldman, Sachs & Co., SEC No-Action Letter, 1993 WL 497126 (Dec. 3, 1993); Merrill Lynch, Pierce, Fenner & Smith Inc., SEC No-Action Letter, 1993 WL 270676 (July 19, 1993); Salomon Brothers Inc., SEC No-Action Letter, 1990 WL 286946 (Oct. 1, 1990); Shearson Lehman Brothers Inc., SEC No-Action Letter, 1986 WL 67463 (Dec. 3, 1986); Goldman, Sachs & Co., SEC No-Action Letter, 1986 WL 66561 (Mar. 26, 1986); First Boston Corp, SEC No-Action Letter, 1986 WL 65408 (Apr. 17, 1986); Kidder, Peabody & Co. Inc., SEC No-Action Letter, 1986 WL 66825 (May 5, 1986).

[6] See Rule 14d-1(a).

[7] See Form 8-K (and Press Release) filed December 12, 2008, by Prologis, and Form 8-K (and Press Release) filed January 22, 2009, by Brandywine Realty Trust and Brandywine Operating Partnership, L.P., for examples.

Additional complexity exists at the end of the counting period. For example, many issuers specify that their respective issuer debt tender offers will close at 5:00 P.M. (New York time) on the final day of the tender offer. However, for counting purposes, issuers may not count the final day of the tender offer unless the tender offer closes at 11:59 P.M.

In practice, issuers announce on the launch date of the issuer debt tender offer the date and time at which the offer is expected to close. If an issuer's failure to deliver to DTC the "means to tender" prior to DTC's close of business on the day on which the issuer announces its tender offer means that the issuer cannot count the announcement date as Day One, then one might wonder why an issuer ever would choose a 5:00 P.M. closing time, instead of an 11:59 P.M. closing time that would permit the issuer to count the final day, just in case.

Consider the following scenarios, the first two of which comply with the tender offer rules, and the third of which does not comply.

Day 1	**Day 2**	**Day 3**	**Day 4**	**Day 5**	**Day 6**	**Day 7**
Friday: Launch 4:30 P.M.	Saturday	Sunday	Monday	Tuesday	Wednesday	Thursday Close: 11:59 P.M.

Day 0	**Day 1**	**Day 2**	**Day 3**	**Day 4**	**Day 5**	**Day 6**	**Day 7**
Friday: Launch 6:00 P.M.	Saturday	Sunday	Monday	Tuesday	Wednesday	Thursday	Friday Close: 11:59 P.M.

Day 0	**Day 1**	**Day 2**	**Day 3**	**Day 4**	**Day 5**	**Day 6**	
Friday: Launch 6:00 P.M.	Saturday	Sunday	Monday	Tuesday	Wednesday	Thursday	Friday Close: 5:00 P.M.

Although an expiration time of 11:59 P.M. may seem to provide issuers with increased flexibility without any attendant drawbacks, one reason for which issuers nonetheless may select a 5:00 P.M. closing time is to avoid administrative burdens on such issuers' management. For instance, if an issuer decides to extend the expiration time of its debt tender offer (for instance, if too few notes were tendered), then such issuer must make that extension determination prior to the opening of the market on the first business day after the expiration time and must release a corresponding press release. An 11:59 P.M. (New York time) expiration time requires that issuers' management scramble in the middle of the night to determine the tender offer results and whether to extend the tender offer period. Accordingly, many issuers choose the 5:00 P.M. (New York time) expiration time.

As noted above, issuers that are planning to repurchase their respective debt securities should be aware that some of the most fundamental aspects of an issuer debt tender offer may involve greater complexity than immediately is apparent. To implement an issuer debt tender offer that best fits an issuer's individual needs and concerns, it is important to understand the nuances, potential traps and flexibility that may or may not exist under the securities laws.

Private Equity in 2009: "Back to Basics" Practice Tips

By Jason Boyea and Christopher Mozingo of Finn Dixon & Herling LLP[1]

This is Part 1 of a two-part article. Part 2 will appear in the July-August issue.

Many investment professionals are expecting a difficult and challenging 2009. According to the third annual National Venture Capital Association 2009 Predictions Survey, 93% of venture capitalists believe it will be more difficult to sustain existing portfolio companies in 2009 and 96 percent believe new companies will have a more difficult time raising equity financing.[2]

Many articles have been - and will continue to be - written on the current down market and global financial crisis from a private equity perspective, ranging in topics from causes of the crisis and its conditions to market trends and outlook for the future. This article is not intended to be a spotlight on the 2009 private equity market, but instead seeks to provide a timely sampling of some "back to basics" practice tips in the context of a typical private equity deal. The practical tips should be carefully considered and addressed in light of the current economy and market conditions. The challenging market conditions that private equity funds will face in 2009, in an already Darwinian industry, cannot be ignored. This article intends to give proper attention to some fundamentals or "best practices" that will help protect a private equity investor's investment, its contracted-for rights and its designated directors.

During a down market such as the 2009 market, the tension between the interests of the various stakeholders in a company is typically at its greatest. For instance, the members of a portfolio company's board and its stockholders may have to consider potential sale events earlier than planned or a significant restructuring in light of the lack of financing opportunities. Also, the current market conditions may require a company, its directors and its stockholders to decide whether or not to pursue a "down round financing" (a financing completed at a pre-money valuation that is lower than the post-money valuation of the prior round—a topic that will most assuredly receive a lot of attention this year).

It is at these times of increased tension that the deal terms of the investor's preferred stock are often put to the test. It should be expected that the other stakeholders will review the terms of an investor's preferred stock very carefully with the intent of constructing an interpretation, or identifying loopholes, that will help these other stakeholders promote their own economic interests and achieve their desired outcome, in most cases at the expense of the preferred stock investor. An oversight or loophole can result in lengthy and expensive intra-company disputes. It may also have the unintended consequence of the company, or the other stakeholders in the company, actually having a better deal, and the investor having a worse deal, than the investor had thought it had negotiated at the time of its investment.

Below are nine "back to basics" tips to keep in mind when negotiating the terms of a private equity investment in the current climate. The tips below assume the portfolio company is a Delaware corporation and that the investor is a "venture capital" or "growth equity" type private equity fund (referred to in this article as an "investor") that focuses on preferred stock investments with board representation and not with the intent of acquiring such companies, although the tips in this article will likely prove useful for buyout, mezzanine and other types of private equity as well. Underlying all of the tips is the goal of drafting an investor's powers, rights and protections clearly and with a healthy respect for the Delaware General Corporation Law and the well-developed private equity/preferred stock principles developed by the Delaware courts.

With a majority of the private equity investments in 2009 expected to be follow-on investments in existing portfolio companies (as noted in the NVCA survey), investors and their counsel should carefully review the existing provisions of their investments. A follow-on financing serves as an excellent opportunity to clean up any inconsistencies, ambiguities or loopholes in the existing deal terms in order to properly capture and protect the investment.

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[1] Jason Boyea is a Partner and Chris Mozingo is an Associate at Finn Dixon & Herling LLP in Stamford, Connecticut. The authors thank Henry Baer, Jr., a partner at Finn Dixon & Herling LLP, for his assistance with Tip #9.

[2] http://www.nvca.org/pdf/09PredixRelease.pdf.

Tip #1: The Written Contract Should Be Clear and Comprehensive

Typically, when a private equity fund makes an investment it does so in a form of preferred stock or in a strip of preferred stock and common stock. The contractual rights and protective provisions of the preferred stock negotiated for by an investor establish not only the economic attributes of its investment but also serve to protect the investment. A fundamental principle of Delaware law that is codified in Section 151(a) of the DGCL is that "any rights, preferences and limitations of preferred stock that distinguish that stock from common stock must be expressly and clearly stated."[3] The Delaware courts have consistently applied this principle and have steadily maintained that any special rights afforded the preferred stock are rights of contract and will not be presumed.[4] Preferred stock provisions should be drafted with this in mind.

- *Don't Rely on Anti-Impairment Clauses to Create Rights*—In certain cases, investors have relied on an "anti-impairment" clause for protection of their rights. Typically, an anti-impairment clause states that the portfolio company will not seek to avoid or impair the rights of the preferred stock. Investors should not place significant reliance on this general provision as Delaware courts have typically construed anti-impairment clauses narrowly.[5] In a recent decision, the Delaware Chancery Court has stated that "no independent right springs from [an anti-impairment clause]."[6] In other words, an anti-impairment clause will only protect those rights and protections that are otherwise "expressly and clearly stated" in the documents. These Delaware decisions, along with not wanting to provide disgruntled minority shareholders with a basis, albeit a very weak basis, for a claim, are among the reasons the NVCA has not included an anti-impairment clause in its Model Certificate of Incorporation.[7]

- *Watch Out for Differences in Opinion*—A main objective of a contract is to clearly and accurately reflect the understanding of the parties while avoiding ambiguity. When a contract provision does not clearly set forth its purpose and application within the four corners of the document, a court will look to extrinsic evidence to determine the meaning of the contractual provision—a judicial exercise that is costly and subjective. A telltale sign of an ambiguous contract provision is when the other party has expressed, or has clearly signaled, a different interpretation.

  In its recent decision in *United Rentals*, the Delaware Chancery Court applied what has come to be known as the "forthright negotiator principle," an extraordinary judicial tool that allows a court to impose what one party subjectively believed a disputed contractual provision to mean if the other party knew, or should have known, of such belief. This tool is available if the extrinsic evidence does not resolve an otherwise ambiguous provision.[8] Interestingly, in *United Rentals*, the court found both parties' arguments and interpretations of the disputed specific performance-related provisions to be reasonable. An argument can be made that Cerberus (the private equity sponsor of the buyer that walked away from the deal and who was trying to avoid application of the specific performance provision) and its counsel may have been lucky with the final judgment; however, Cerberus was not lucky enough to avoid litigation.

  The lesson from this case is to be alert to a difference of interpretation of contract provisions by the other party. First, this is a sign the provision is not clearly drafted. Second, an investor's silence in the face of a differing interpretation can be later used against the investor. Ideally, the contract provision should be revised to remove any ambiguity. If this is not possible, the investor should seriously consider expressing its disagreement with the interpretation of the other party and set forth its own interpretation of the provision.

- *Don't Rely Entirely on Redlines*—You are less likely to catch an old mistake in the drafting when reviewing a redlined document, as the legacy mistake will not be highlighted. This could easily

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[3] *Benchmark Capital Partners IV, L.P. v. Vague*, No. Civ. A 19719, 2002 WL 1732423 (Del. Ch. 2002), aff'd, *Benchmark Capital Partners IV, L.P. v. Juniper Financial Corp.,* 822 A.2d 396 (Del. 2003).

[4] *Id.*

[5] *Kumar v. Racing Corp. of Am., Inc.,* No. Civ. A 12039, 1991 WL 67083 (Del. Ch. 1991).

[6] *WatchMark Corp. v. ARGO Global Capital, LLC*, No. Civ. A. 711-N, 2004 WL 2694894 (Del. Ch. Nov. 4, 2004).

[7] NVCA Model Certification of Incorporation, http://www.nvca.org/model_documents/Certificate_of_Incorporation _V5.doc.

[8] *United Rentals, Inc. v. RAM Holdings, Inc.*, 937 A.2d 810 (Del. Ch. 2007).

lead to a "small" mistake involving a handful of words resulting in a significant impairment to the investment after the closing. In the recent case *Lapoint v. AmerisourceBergen Corp.*, there was a "small" drafting error in the earn-out provision where the final provision stated that the sellers could deliver an objection to the buyer's calculation of the final earn-out payment "*no less than*" 20 business days after buyer's calculation of the earn-out payment.[9] Consistent with the literal meaning of the provision, the sellers delivered an objection 26 business days after the buyer's calculation.

The buyer argued to the court that the earn-out objection was untimely, as the term "*no less than*" was really intended to mean "*no more than*." The court noted that the buyer and sellers were sophisticated parties and refused to reform the plain meaning of the final provision. In addition to "cold reading" revised documents, counsel should have a best practice of having a colleague also proofread selected draft versions, including the final version. The "no less than"/"no more than" mix-up may have been avoided with a fresh pair of eyes reviewing the agreement. When it comes to proofreading, four eyes are exponentially better than two eyes.

- *Don't be Afraid to Include Examples*—Examples are a great way of documenting the parties' intent, especially for complex provisions or provisions dealing with multiple variables. In particular, examples can prove to be helpful when the parties are reviewing a provision several years after the fact when their economic motives and agendas may not be aligned or the people originally involved in the deal are no longer around.

  There appears to be hesitancy in the legal profession to include examples in legal documents. We can only assume this is due to legacy factors, including that old drafting habits are hard to break (absent, of course, a landmark judgment in case law). The hesitancy in using examples is representative of the larger struggle in the legal profession between the trend of reforming drafting techniques to use plain English and concise sentences, versus the traditional practice of honing and perfecting classic contract prose. The unfortunate reality is that a number of legal professionals believe plain English provisions, including the use of examples, "dumbs down" a legal document. While this topic is beyond the scope of this article, we would argue, as would Delaware case law, that it would be rather dumb not to "dumb down" a legal document if it results in clearer provisions.

- *If There is an Issue, Address It*—It is inevitable that deal-specific issues will arise after the term sheet stage and before the closing of an investment. The most common issues arise from the due diligence review that typically takes place after the term sheet is executed. As a general rule of thumb, it is in the best interests of the investor to attempt to address these issues directly and clearly in the investment documentation. Without clear and express language addressing the issue, there is a significant risk that an ambiguous or a general provision will be interpreted to the detriment of the investor.

  This practice point may be a difficult lesson to apply to deals, as there is a noticeable tendency in deal negotiations for the parties to dance around issues—with potentially a misguided hope of the investor that the "general" rights negotiated for during the term sheet stage will equally apply to the specific concern or issue identified after the term sheet was finalized. While the general term sheet provisions may indeed cover this concern or issue, an investor should confirm this with its counsel. If the term sheet rights don't clearly and expressly address the issue or concern, the investor should seriously consider re-opening negotiations in light of the identified concern and require a specific protective provision that clearly addresses the concern.

Tip #2: Draft Preferred Stock Consent Rights with Care and Specificity

Private equity investments in growth-oriented companies often involve a minority investment in the target company. In these situations, the investor typically has one or two board seats, but does not usually have the right to designate a majority of the members of the portfolio company's board of directors. In this type of a minority investment, the investor does not have the ability to affirmatively control the portfolio company, which places great importance on the protective provisions and other consent rights of the pre-

[9] *Lapoint v. AmerisourceBergen Corp.*, 2007 WL 2565709 (Del. Ch. Sept. 4, 2007), aff'd, 956 A.2d 642 (Del. 2008).

ferred stock (which are typically negotiated at the term sheet stage). These contractual provisions provide "negative control rights" over the company's actions. The inherent risk in negative control rights is that there may be inadvertent loopholes or unanticipated situations after the closing that can be exploited by the company or other stakeholders after the closing.

As previously discussed above in *Tip #1*, these consent rights or negative control rights need to be drafted as clearly and comprehensively as possible. Delaware courts will not read rights into unclear or overly broad language and have been consistent in refusing to imply or presume preferred stock powers, rights or preferences from other provisions of the charter. In *Benchmark*,[10] the Delaware Chancery court held that protective provisions of an investor providing for a class vote with respect to certain amendments to the company's charter do not protect the investor against alterations or modifications resulting from a merger unless expressly provided for in the charter. The court held that the changes to the existing preferred stock were a result of the merger, which the investor did not have a sufficient consent right for and would not be deemed to be an amendment of the charter of the company that was merged out of existence.

The *Benchmark* case is a great example of how Delaware court decisions can transform private equity drafting practices. From this case came the phrase "whether by merger, consolidation or otherwise," as suggested by the court in its holding to protect against indirect amendments to the charter.[11] It is typical today to see this magic phrase liberally inserted into an investor's protective provisions.

Similarly, in *WatchMark*, a company was faced with the necessity of completing a "down-round" financing that was opposed by an investor holding a series of senior preferred stock. The series of preferred stock held by the objecting investor had a protective provision with respect to adverse charter amendments. Similar to the *Benchmark* case, the protective provision did not expressly cover amendments to the charter effected through a merger.[12] Consequently, the court affirmed the ability of the company, which had the approval of the other investors who supported the financing, to remove the separate protective provisions of each series of preferred stock by completing a merger of the company with and into a wholly-owned subsidiary.[13]

As a result of the merger, the certificate of incorporation of the surviving corporation (*i.e.*, the subsidiary) was nearly identical to that of the former parent, the only material changes being the elimination of the separate class votes of the former preferred stock and the insertion of a "pay-to-play provision." The pay-to-play provision provided that an investor's preferred stock would be automatically converted into common stock to the extent it did not participate up to its pro rata share of the financing. This is a sobering case for all investors and shows how a loophole can be manipulated into a gaping hole in the negative control rights arena, resulting in severe, unintended consequences to the investor.

In *Watchmark*, the investor believed it had bargained for a water-tight consent right on adverse charter amendments, but, after an expensive trial process, was made painfully aware that there was a loophole in the contracted-for language that the company was able to take advantage of to not only deprive the investor of its ability to veto a financing but also, in a cruel twist of irony, subject the investor to a pay-to-play provision that would extinguish all of the investor's preferred stock rights if it did not participate in the financing it opposed.

It should be noted that each of the *Benchmark* and *WatchMark* cases involve disputes from the last down market of early 2000. These cases demonstrate that investors in preferred stock did not have the negative control rights that they believed they had bargained for due to loosely drafted protective provisions that created unintended limitations on the scope of the consent rights. Note that the merger-related loopholes described above are addressed in the Revised Model Business Corporation Act (RMBCA) (adopted by a majority of the states—Delaware not being one of them), which provides that a merger can't amend

[10] *Benchmark*.

[11] *Id.*

[12] It is interesting to note that the objecting investor unsuccessfully attempted to distinguish the case at hand from *Benchmark* by arguing that the broadly worded anti-impairment clause created a consent right on the subsidiary merger. Not surprisingly, in accordance with the caveats in *Tip #1*, the court refused to interpret the anti-impairment clause as granting additional rights not otherwise contained in the charter.

[13] *WatchMark*.

provisions in the charter without the proper consent that would have been required had the changes been effected through an amendment.[14]

- *Be Careful When Relying on Statutory Consent Rights*—Although Section 242(b)(2) of the DGCL provides for a class vote on any amendment that would "alter or change the powers, preferences, or special rights of the shares," the Delaware courts have consistently held that the authorization, designation and issuance of a senior stock, by itself, does not trigger a consent right in the existing classes of securities because it does not "alter or change the powers, preferences, or special rights of the shares" of the existing classes and series of stock.[15] This is not the case in New York and those states which have adopted the RMBCA, each of which provides for a class consent on the issuance of a senior security that is senior to the existing preferred in either dividend preference or liquidation right.[16]

  With a Delaware corporation, if an investor wants the right to block a company from creating a senior class of preferred, specific language to that effect must be included in the documents. As a general rule of thumb, an investor should not rely entirely on statutory consent rights and should contractually provide for such rights as well. Statutes are notorious for poor drafting (much of this due to the Frankenstein approach of the legislative process) and are subject to changing interpretations by the courts and amendments by the legislative authority, some of which may be completely unexpected and detrimental to the rights of the investor.

- *Protect Against Junior Stock that is "Super Participating"*—It is not uncommon that the protective provisions in favor of the investor's preferred stock are limited to amendments to the charter that adversely affect the rights of the preferred and, separately, to the authorization, designation or issuance of senior or *pari passu* stock. Depending on the exact language used, this may inadvertently leave a loophole for the issuance of junior preferred with unusual provisions that wouldn't trigger a consent right under either protective provision described above. For instance, a clever company, acting with supportive stockholders, could attempt to issue a junior preferred with a multiple liquidation preference or increased participation rights that would eat away at the proceeds that would have otherwise gone to the investor's senior preferred stock and common stock upon a liquidation or deemed liquidation event (such as a sale of the company). This is just one example of how a company can creatively take advantage of loopholes in negative control rights.

- *Protect Against Pari Passu Securities*—The practice tip above assumes that the investor has already negotiated for a consent right on the authorization, designation or issuance of *pari passu* securities. As is evident in the case law described in this article, assumptions can lead to trouble, so we believe this tip deserves its own practice point. The lack of a consent right on *pari passu* securities not only raises the same concerns as a "super participating" junior preferred stock described in the practice point directly above, but also creates the opportunity for the company to issue additional shares of the same series of preferred stock held by the investor with the effect of diluting or eliminating the series consent rights previously enjoyed by the investor.

  For instance, an investor holding 55% of the Series A Preferred Stock of a company may have negotiated a list of protective provisions and one board seat that are vested in the holders of at least 50.1% of the issued and outstanding Series A Preferred Stock. If the investor does not have a consent right on the issuance of *pari passu* securities, and the investor either does not have preemptive rights or does not want to (or is financially unable to) exercise them, the company has an opportunity to dilute the investor below 50.1% by issuing additional shares of Series A Preferred Stock to other investors.

  Of course, this practice point, as with most of the practice points in this article, assumes that the investor has the negotiating ability to obtain these contractual provisions. If the investor is unable to negotiate for comprehensive consent rights with respect to future issuances of equity, this will place even more importance on the content of the investor's preemptive rights. The investor should make sure it has sufficient preemptive rights that allow it to participate in the subsequent

[14] *See* RMBCA §11.04(3).

[15] *Hartford Accident & Indemnity Co. v. W.S. Dickey Clay Mfg. Co.*, 24 A.2d 315 (Del. 1942).

[16] NY Bus Corp Law § 804(a)(3) and RMBCA §§ 10.04, 11.04(3).

equity issuances—an admittedly weaker form of protection that requires the investor to use new money in order to help protect its existing investment.[17]

- Protect Against Actions Directed Through Subsidiaries—In *In re Sunstates Corp. Shareholder Litig.*, the Delaware Chancery Court held that a repurchase of shares of a junior stock of the parent company that would have otherwise required consent of the holders of a series of preferred stock was permitted because the purchase was made by a subsidiary of the corporation.[18] Again construing rights of the preferred stock narrowly, the court held that the language in the charter requiring consent if "the Corporation" had purchased the shares would not apply to actions by a subsidiary thereof. The court did, however, suggest that the ruling may have turned out differently had the subsidiary been formed specifically for the repurchase and had it not had its own operations. This subsidiary loophole can affect many standard protective provisions. As a general rule of thumb, protective provisions should be drafted to specifically include actions by the portfolio company's subsidiaries.
- *If the Intent of a Negative Control Right is to be All-Inclusive , Don't Draft to the Contrary*—All too often the intent of a negative control right is to be comprehensive and broad, but the language is drafted to the contrary, leaving unintended loopholes. Two classic examples are: (1) if the investor is looking for a negative control right on any change to the charter or bylaws—don't qualify the consent right so it applies only to those changes that "adversely affect" the preferred stock, and (2) if the investor has negotiated a negative control right on the designation or authorization of any new class or series of capital stock—don't limit it to senior or *pari passu* securities.

Tip #3: Don't Miss Obvious Provisions

An article focusing on "back to basics" tips would not be complete without a brief focus on some fundamental protections for investors expressly provided in Delaware law that should be incorporated into most private equity deal terms. The trap for unwary investors and their counsel is when a company is conducting its first institutional financing round with a sophisticated investor and the business parties have agreed to use existing investment documents as the template for the new financing round. What seems like a token gesture by the investor to move the new relationship in the right direction has the potential for meaningfully negative, unintended consequences. This situation calls for extreme vigilance in determining what, if anything, the existing documents may be missing and remedying provisions that are otherwise deficient.

- *Section 102(b)(7)) of the DGCL: Director Exculpatory Provision*—This provision (referred to in this article as the 102(b)(7) exculpation provision) protects directors from claims for monetary damages for breaches of the fiduciary duty of care (but not claims involving a breach of the duty of loyalty, acts or omissions not in good faith or involving intentional misconduct or a knowing violation of law and certain other specified conduct). This is an "opt in" charter provision, but from an investor's perspective, especially an investor who is appointing a director, it should be considered an unconditional "must have" provision.
- *Section 122(17) of the DGCL: Waiver of Corporate Opportunities*—This provision permits a Delaware corporation to renounce, in advance, the corporation's interest or expectancy in specified business opportunities. Directors and officers of a company have a fiduciary duty of loyalty to that company and its stockholders. Among other things, this duty prohibits self-dealing by directors and officers. The corporate opportunity doctrine requires that a director or officer, when presented with a business opportunity that could be advantageous to the corporation, make that opportunity available to the corporation before pursuing the opportunity for his or her own or an affiliate's account.

  A concern for an investor is that a company may invoke the corporate opportunity doctrine to claim that a subsequent investment made by the investor should have been first presented to the company's board of directors. Even if an investor was willing to agree to this principle, it can be

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[17] As a last bit of advice on this subject, an investor should consider having overallotment rights to the extent other stockholders don't participate, thus allowing an investor to increase its percentage interest in the company.

[18] *In re Sunstates Corp. Shareholder Litig.*, 788 A.2d 530 (Del. Ch. 2001).

very difficult to comply with in light of the many business plans and potential investments that an investor receives and the different personnel of the investor that may review these potential investment opportunities. In light of all of this, an investor should consider taking advantage of Section 122(17) and require the company to waive the company's interest in corporate opportunities involving the investor or its director designees.

As noted in *Tip #1*, this charter provision needs to be carefully drafted and there does not currently appear to be any relevant case law setting forth how expansive this waiver provision can be while still being (i) enforceable and (ii) not a breach of a director's duty of loyalty. The tension is that Section 122(17) refers to waiving "specified business opportunities" while most charter provisions provide for a "general" advance waiver of unspecified business opportunities. The NVCA Model Certificate of Incorporation attempts to address this apparent tension by excepting out of the general advance waiver those opportunities brought to a director "expressly and solely" in such person's capacity as a director of the company. The notes in the NVCA Model Certificate of Incorporation caution that the model waiver provision is "very pro-investor."

- *Right to Designate Members of the Board of Directors*—An investor should consider securing its right to designate a director directly in the certificate of incorporation, as well as setting forth a specific voting agreement for the election of directors in a stockholders' agreement or voting rights agreement. By placing the designation rights into the charter, it truly becomes a "direct" designation right that attaches to the shares and not a contractual provision as it would be if board composition matters were only included in a stockholders' agreement or other similar voting agreement. The inherent weakness of a stand-alone contractual right is that a board appointment provision in a stockholders' agreement simply acts as a voting agreement among the contracting stockholders. This results in a situation where an investor with a director designation right must rely on the other contracting stockholders abiding by their obligation to appoint the investor's director designee in order to satisfy the required voting threshold for appointing directors, as set forth by the default DGCL rules or as otherwise set forth in the charter or bylaws.

  In contrast, a clearly drafted direct designation right in the charter will allow an investor, or a class of stockholders, to have the ability to simply designate the director amongst the defined class and avoid reliance on the affirmative vote of other stockholders. The practical advice here is that it would be optimal to have complementary board composition provisions in both the charter and a stockholders' agreement or voting rights agreement. First, a provision in a stockholders' agreement or voting rights agreement, unlike a charter provision, provides the investor with a clear contractual right to designate a director; which is considered a safe harbor for claiming the venture capital operating company (VCOC) exemption under ERISA. Second, if there are multiple investors with the same series of preferred stock, the charter provision can provide for the number of board seats designated by the series of preferred stock, while the stockholders' agreement or voting rights agreement can set forth the particulars of how the holders of the series of preferred stock will nominate and vote for the director designees.

- *Section 202 of the DGCL: Make Sure Transfer Restrictions are Enforceable*—There are three notable potential missteps when it comes to transfer restrictions in private equity transactions. First, if the restrictions on shares of stock are not fully set forth on the company's stock certificate, there must be a legend on the stock certificates referring to the certificate of incorporation, stockholders' agreement and any other agreements containing restrictions and obligations on the holders of the shares. This is consistent with the requirements in Section 202(a) of the DGCL and protects against a subsequent holder of the shares claiming that the shares are not subject to restrictions because they did not have actual knowledge of the restrictions.

  Second, the stockholders' agreement should clearly provide that any transfer in violation of the transfer restrictions is not simply void but *void ab initio*—a legal nuance that has been developed over the years. The exact phrase used can be the difference between a transfer in breach that is upheld by the courts with damages as the remedy and a transfer that is treated as "invalid from the outset."

Third, if any new transfer restrictions are to be added to the charter, any existing stockholders that the company or the investor desires to be bound by such restrictions must vote in favor of the transfer provisions—otherwise any stockholder not consenting to the amendment will not be bound by the new transfer restrictions. Section 202(b) of the DGCL clearly states: "No restrictions so imposed shall be binding with respect to securities issued prior to the adoption of the restriction unless the holders of the securities are parties to an agreement or voted in favor of the restriction."

- *Section 242(b)(2) of the DGCL: Remove Class Consent Right of Common Stock on Increases (and Decreases) in the Number of Authorized Shares of Common Stock*—Section 242(b)(2) of the DGCL provides that a separate class vote is required to increase or decrease the number of authorized shares of such class. Section 242(b)(2) goes on to allow a certificate of incorporation to expressly eliminate the class vote. Typically, investors would want this provision eliminating the class consent right with respect to the common stock included in the charter, so that if the company needs to approve more common stock, it would not be required to obtain the separate consent of the holders of common stock to do so. See related *Tip #4* below.

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