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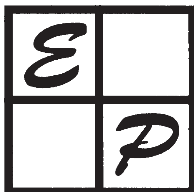

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"But I Just Work Here!": The Rise of Corporate Officer Fiduciary Liability

By John Jenkins, a Partner of Calfee, Halter & Griswold LLP

Corporate lawyers typically focus a lot of attention on the liability risks faced by corporate directors, but much less on the risks faced by corporate officers. The emphasis on directors is not surprising; after all, most of fiduciary duty lawsuits have been brought against board members, and most of the case law surrounding these issues involves the liabilities of directors and the protections available to them.

In recent years, however, corporate officers have increasingly found themselves on the firing line, facing claims premised on alleged breaches of their fiduciary duties. Officers are learning that even if they do not have a board seat, they may nevertheless find themselves on the hot seat based on an outsider's allegation that they did not do their job properly.

Officers and Directors Have the Same Fiduciary Duties, But Not the Same Protections

Despite the fact that cases targeting officers for breach of fiduciary duties represent a relatively recent phenomenon, there has long been a consensus among commentators that officers and directors owe identical fiduciary duties to the corporation.[1] That view was confirmed by the Delaware Supreme Court in 2009, when it expressly held that corporate officers have fiduciary duties of care and loyalty identical to those imposed on directors.[2]

While directors and officers have the same fiduciary duties, they do not have the same legal protection. Much of what lawyers take for granted in terms of the statutory and common law protections against liability afforded to directors are either not available to officers, or uncertain in their application.

[1] See, *e.g.*, American Bar Association, Fiduciary Duties and Potential Liabilities of Directors and Officers of Financially Distressed Corporations, apps.americanbar.org/buslaw/newsletter/0003/materials/tip3.pdf (2003): ("Although there is little law and commentary on the subject of the duties and liabilities of corporate officers, most authorities suggest, as a general proposition, that officers owe the corporation the same fiduciary duties as directors. See, *e.g.*, William M. Fletcher, Fletcher Cyc Corp § 846 (perm. ed. 1994). The Revised Model Business Corporation Act also states that non-director officers must discharge their duties with the same standards of care as directors. Revised Model Bus. Corp. Act § 8.42. Thus, officers may be said to owe the corporation and its shareholders a duty to exercise due care and a duty of loyalty parallel to the directors' duties discussed above.")

[2] *Gantler v. Stephens*, 965 A.2d 695, 708-708 (Del. 2009)

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Exculpation Statutes Usually Don't Apply to Officers

Exculpation statutes provide perhaps the most striking example of the differences in the protections provided to directors and those provided to officers. In 1986, Delaware added Section 102(b)(7) to its General Corporation Law.[3] That statute was enacted in response to the perceived director liability crisis arising out of the Delaware Supreme Court's decision in *Smith v. Van Gorkom*, and allows corporations to adopt amendments to their certificates of incorporation eliminating the personal liability of directors for breach of the duty of care.[4] Other states quickly followed Delaware's lead, and enacted their own exculpatory statutes,[5] some of which went well beyond Delaware in the protection that they provided to directors.[6] However, while all 50 states currently provide some form of exculpation from damages to directors, only seven states extend that protection to corporate officers.[7] That means that from a statutory perspective, corporate officers face greater exposure to damage claims for alleged breaches of their fiduciary duties than do corporate directors.

Important Distinction: Officers are Agents, But Directors are Not

The failure to include officers in the coverage of most exculpation statutes may simply reflect the fact that officers are statutory orphans—they generally do not merit much attention in most corporate statutes.[8] For supporters of greater officer liability, a better reason for excluding officers from the reach of these statutes is that unlike directors, corporate officers are "agents" of the corporation and the nature of their fiduciary relationship should be governed by agency law principles.[9]

Under those principles, an agent can be liable to its principal for breaches of its duties, including its failure to act with ordinary care.[10] According to those who advocate holding officers to a more demanding standard than directors, "since executive officers undoubtedly are agents, the default and baseline standard for the fiduciary duties they owe should be drawn from agency law, the body of law traditionally governing that subject. Those who find this objectionable, for whatever reason, must make a compelling case as to why these standard default rules, including the generally applicable standard of "normal" or ordinary care, do not apply to officers."[11]

Suggesting that officers should be subject to standards of ordinary care in the performance of their duties has implications that extend far beyond the applicability of exculpation statutes. The use of the term "ordinary care" means that a negligence-based standard of liability should apply to corporate officers, which in turn calls into question whether the business judgment rule should apply to them.

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[3] 8 Del. Code §102(b)(7) (2012).

[4] Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) imposed liability for damages on directors for breaching their duty of care in approving a merger agreement. Section 102(b)(7) provides a mechanism by which that liability may be eliminated. Section 102(b)(7) does not allow corporations to eliminate personal liability of directors for: (i) breach of the duty of loyalty; (ii) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) unlawful dividends; or (iv) any transaction from which the director derived an improper personal benefit. Id.

[5] Today, all 50 states have some form of director exculpation statute. For a description of the various approaches states have taken to exculpation statutes, see Bryn R. Vaaler, 2.02(b)(4) or Not 2.02(b)(4): That is the Question, 74 Law and Contemporary Problems 70, 82 n. 19 (2011).

[6] For example, Ohio's statutory protection extends to the duty of loyalty, and provides that in order to hold a director liable for monetary damages, a plaintiff must prove by *clear and convincing evidence* that the director's "action or failure to act involved an act or omission undertaken with *deliberate intent* to cause injury to the corporation or undertaken with *reckless disregard* for the best interests of the corporation." Ohio Rev. Code. §1701.59(E) (2012).

[7] Those states are Louisiana, La. Rev. Stat. Ann. § 12:24(c)(4) (2012), Maryland, Md. Code Ann., Corps. & Ass'ns §§ 2-104(b)(8), 2-405.2 (2012); Nevada, Nev. Rev. Stat. § 78.138(7) (2012); New Hampshire, N.H. Rev. Stat. Ann. §293-A:2.02(b)(4) (2012); New Jersey, N.J. Stat. §14A:2-7(3) (2012); Utah, Utah Code §16-10a-840(4) (2012); and Virginia, Va. Code. §13.1-692.1 (2012).

[8] As one article put it, "[c]orporate statutes typically say relatively little about officers, in contrast to the numerous provisions addressing directors and shareholders." Lyman Johnson and Dennis Garvis, *Are Corporate Officers Advised About Fiduciary Duties?* 64 Bus. Law. 1105, 1106 (2009).

[9] Lyman P.Q. Johnson and David Million, *Recalling Why Corporate Officers are Fiduciaries*, 46 Wm. and Mary L. Rev. 1597, 1605-1607 (2005).

[10] RESTATEMENT (THIRD) OF AGENCY § 8.08 ("Subject to any agreement with the principal, an agent has a duty to the principal to act with the care, competence, and diligence normally exercised by agents in similar circumstances.")

[11] Lyman Johnson and Robert Ricca, *Reality Check on Officer Liability*, 67 Bus. Law. 75, 85 (2011).

What About the Business Judgment Rule?

As applied to directors, the business judgment rule contemplates a deferential standard of review under which board decisions "will be respected by courts unless the directors are interested or lack independence relative to the decision, do not act in good faith, act in a manner that cannot be attributed to a rational business purpose or reach their decision by a grossly negligent process that includes the failure to consider all material facts reasonably available."[12]

In other words, in the absence of a breach of the duty of loyalty or a lack of good faith, directors' business decisions will be subject to judicial second-guessing only if they act in a grossly negligent fashion. Requiring officers to perform their obligations with "ordinary care" implies that instead of the more deferential gross negligence standard associated with the business judgment rule, courts might be willing to impose liability on officers for business decisions that were merely negligent.

Like most aspects of the officer liability issue, the availability of the business judgment rule is a topic that has provoked considerable academic debate. Professor Lyman Johnson, who is probably the leading academic opponent of applying the business judgment rule to corporate officers, argues that in light of their significant compensation, access to information and the power and status associated with their positions, officers should be held to the same ordinary care standard as is applied to other agents.[13] Johnson suggests that the case for denying officers the protection of the business judgment rule is particularly compelling in cases brought by the board of directors against corporate officers. In these situations, Johnson believes that application of the business judgment rule would undermine directors' oversight authority.[14]

Proponents of applying the business judgment rule to corporate officers point out that while corporate officers may be well-compensated, there is a vast difference between even the most generous pay packages and the potential liability to which an officer may be exposed under an ordinary care standard.[15] They submit that exposing officers to liability for their own negligence would almost certainly discourage officers from choosing and implementing relatively risky but valuable corporate decisions.[16] As for concerns about undermining directors' authority, these commentators suggest that a "default rule that would place officers at substantially greater risk of care-based liability than the risk faced by directors would impinge upon the board's managerial prerogative. . . . [S]uch a 'liability' would simply encourage officers to place more decisions in the hands of the board, and to take fewer and less risky initiatives on their own so as to avoid liability."[17]

Litigation Targeting Officers

Despite the academic interest this topic has generated, until recently, courts have had little to say about the standard to apply in fiduciary duty suits against corporate officers. The relative absence of litigation against corporate officers has been attributed to several factors, but it seems that two of the more important ones are the traditional composition of corporate boards, and uncertainties about the extent of the Delaware chancery court's jurisdiction over corporate officers.

The past decade has seen significant changes in both of these areas. First, among public companies at least, changes in exchange listing standards have seen boards transformed from a model in which most directors were also corporate officers, to one in which the board is composed primarily of outside directors, with only a small number of insiders. Under the old regime, most officers against whom plaintiffs would want to bring fiduciary duty claims were already directors. With today's outsider dominated boards,

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[12] *Brehm v. Eisner*, 746 A.2d 244, 264 n.66 (Del. 2000).

[13] Lyman P.Q. Johnson, *Corporate Officers and the Business Judgment Rule*, 60 Bus. Law. 439, 460 (2005) ("Officers work for the company full time, possess extensive knowledge and skill concerning company affairs, have access to considerably more and better information than directors, enjoy high company and social status, and exercise great influence over the lives of many people—both inside and outside the corporation. They should be held to the same standard of care as are all other persons who serve as agents of companies—a duty of ordinary care.")

[14] *Id.* at 465.

[15] Lawrence A. Hammermesh and A. Gilchrist Sparks III, *Corporate Officers and the Business Judgment Rule: A Reply to Professor Johnson*, 60 Bus. Law. 865, 871 (2005).

[16] *Id.* at 873.

[17] *Id.* at 875.

that is less likely to be the case. Second, while Delaware has long provided the chancery court with personal jurisdiction over directors of Delaware corporations, the statute did not expressly provide for personal jurisdiction over corporate officers until 2004.[18]

The Delaware Supreme Court finally addressed some of the critical issues surrounding corporate officer liability in 2009, when it decided *Gantler v. Stephens*. [19] In that case, the court not only decided that officers and directors owed the same fiduciary duties, but also strongly implied that officers of Delaware corporations were entitled to the protection of the business judgment rule.[20] On the other hand, the court acknowledged that the exculpatory provisions of Section 102(b)(7) did not extend to corporate officers.[21]

The absence of exculpation makes officers attractive targets for plaintiffs, since a breach of the duty of care by an officer could result in a damage award that could not be obtained against a director. In the wake of Gantler, fiduciary duty claims against officers in their capacity as such have made their appearance in several cases involving Delaware corporations.[22] However, it seems fair to say that, so far, the driving force behind efforts to expand the liability of corporate officers has not been the plaintiffs' bar, but the Federal Deposit Insurance Corporation.

The FDIC has closed 463 insured financial institutions since January 2008, and as of October 2, 2012, has filed 33 director and officer liability lawsuits in connection with these bank failures.[23] When the FDIC sues corporate fiduciaries, it must generally comply with state law standards of liability, unless those standards provide for something more lenient than a "gross negligence" standard.[24] The FDIC has summarized its authority to bring these lawsuits as follows:

> Professionals may be sued for either gross or simple negligence. The Supreme Court has ruled that the FDIC may pursue simple negligence claims against directors and officers if state law permits (Atherton v. FDIC). Federal law preempts state law that insulates directors and officers from gross negligence or worse conduct. Bank directors are allowed to exercise business judgment without incurring legal liability.[25]

In light of its authority to bring fiduciary duty claims based on "simple negligence" if state law permits, and the notable omission of the word "officers" from the parties who may exercise business judgment without incurring legal liability, it is not surprising that the FDIC has asserted negligence claims against corporate officers, and has made the related argument in many jurisdictions that these officers are not entitled to rely upon the business judgment rule.

In two separate cases brought in a California federal court against former officers of IndyMac Bank, the FDIC persuaded the court that California's version of the business judgment rule did not extend to corporate officers, and that those officers could be held liable for negligence in connection with certain lending transactions.[26] A North Carolina federal court also accepted the viability of FDIC claims against officers based on simple negligence.[27]

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[18] See 10 Del. Code §3114(b). ("Every nonresident of this State who after January 1, 2004, accepts election or appointment as an officer of a corporation organized under the laws of this State, or who after such date serves in such capacity ... by such acceptance or by such service, be deemed thereby to have consented to the appointment of the registered agent of such corporation ... as an agent upon whom service of process may be made in all civil actions or proceedings brought in this State. . . in any action or proceeding against such officer for violation of a duty in such capacity.")

[19] See note 2, supra. For a description of the limited pre-*Gantler* Delaware authority on officer liability, see Note, *Gantler v. Stephens: Big Epiphany or Big Failure? A Look at the Current State of Officers' Fiduciary Duties and Advice for Potential Protection*, 35 Del. J. Corp. Law 563, 569-571 (2010).

[20] Gantler v. Stephens, 965 A.2d at 708-709.

[21] *Id*. at 709 n.37

[22] See *e.g.*, *In re Celera Corporation Shareholder Litigation*, C.A. No. 6304-VCP (Del. Ch. Mar. 23, 2012); *Dweck v. Nasser*, C.A. No. 1353–VCL (Del. Ch. Jan. 18, 2012); *Scheidt v. DRS Technologies*, 36 A.3d 1082 (N.J. Supr. 2012) (applying Delaware law).

[23] Statistics concerning bank closures and pending litigation are available at the FDIC's website, www.FDIC.gov.

[24] See 12 U.S.C. §1821(k) (2012).

[25] http://www.fdic.gov/bank/individual/failed/pls (visited Oct. 30, 2012).

[26] *FDIC v. Perry*, No. 11-5561 (C.D. Cal. Dec. 13, 2011); *FDIC v. Van Dellen*, No. 10-4915 (C.D. Cal. Oct. 5, 2012).

[27] *FDIC v. Willetts*, No. 7:11-cv-165-BO (E.D.N.C. Apr. 16, 2012)

The FDIC does not always prevail in these cases, and it has unsuccessfully asserted similar contentions in cases involving Georgia, Florida and Illinois entities.[28] However, the point is that whenever the law in a jurisdiction is unclear, the FDIC will not hesitate to advocate for a negligence standard for corporate officer liability.

The FDIC's advocacy is a potentially critical development for the future course of officer liability. The FDIC is an attractive plaintiff, and its willingness to contend that the business judgment rule should not apply to corporate officers has the potential to reshape the law in this area–particularly in light of how few jurisdictions have addressed these issues before now.[29] Accordingly, even though most FDIC litigation settles before trial, the precedents concerning the standard of care to which officers will be held that are set in its preliminary actions may significantly increase the risk of liability that corporate officers face in private litigation going forward.

Protecting Corporate Officers

Since the risk of liability faced by corporate officers appears to be increasing, corporations are likely to want to make sure that the protections provided to their officers are appropriate. Unfortunately, that presents some more challenges than you might imagine.

Corporate indemnification statutes and charter provisions are typically the cornerstone of the protections provided to directors and officers. All jurisdictions authorize corporations to indemnify corporate officers and to advance their expenses, but indemnification statutes generally require an officer to have acted in "good faith" and in a manner he or she "*reasonably believed* to be in or not opposed to the best interests of the corporation," and, with respect to any criminal action or proceeding, "had no *reasonable cause* to believe" that his or her "conduct was unlawful."[30]

If officers are liable for negligence, the use of terms like "reasonably believed" and "no reasonable cause to believe" can significantly muddy the waters concerning whether indemnification will ultimately be available. That makes D&O insurance–which can be available even if indemnification is not–even more important. However, there are complex issues that need to be taken into account in structuring an appropriate insurance program. For example, most policies contain an insured v. insured exclusion that can come into play in certain derivative actions and in situations where a regulator, such as the FDIC, becomes the receiver for a particular entity.[31]

One approach for addressing these potential D&O policy issues is through the purchase of "Side A" or "Side A only" coverage, which provides directors and officers with coverage for non-indemnifiable losses, and can be customized to eliminate or substantially curtail potentially problematic coverage exclusions. A "Side A only" policy has the additional advantage of not having the limits of liability diluted by other proceedings covered by the company's policy.

Conclusion

The fiduciary duties owed by corporate officers and the standard of care to apply to them are topics that have generated a lot of academic attention, but until recently not much case law. As a result of fundamental changes in board composition, an increased ability to claim jurisdiction over corporate officers, and the attractiveness of being able to assert duty of care claims against non-exculpated defendants, that is beginning to change.

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[28] *FDIC v. Skow*, No. 1:11-CV-0111-SCJ (N.D. Ga. Aug. 14, 2012); *FDIC v. Briscoe*, No. 1:2011-cv-002303 (N.D. Ga. Aug. 14, 2012); *FDIC v. Price*, No. 2:12-cv-00148-UA-DNF (M.D. Fla. Aug. 8, 2012); *FDIC v. Saphir*, No. 1:10-cv-07009 (N.D. Ill. Sept. 1, 2011).

[29] As one commentator recently noted, the FDIC has several advantages when it brings a case against corporate fiduciaries. Courts and jurors "are inclined to assume that the FDIC must know why a bank failed," while jurors dislike "well paid (or independently wealthy) directors and officers," and "have little sympathy" for large dollar transactions. Rosemary Stewart, *FDIC Professional Liability Lawsuits Deserve Close Scrutiny*, The Metropolitan Corporate Counsel (July/August 2012) at 28.

[30] See, *e.g.*: Cal. Corp. Code § 317(b); 8 Del. Code Ann. § 145(a); Ill. Bus. Corp. Act § 5/8.75(a); *New York:* N.Y. Bus. Corp. L. § 722(a); Ohio Rev. Code §1701.13(E). Indemnification rights are typically more limited in derivative claims than they are in third party actions.

[31] Regulatory exclusions may also come into play here. For a discussion of the insured v. insured and regulatory exclusions in the context of FDIC litigation, see Kevin LaCroix, *FDIC Litigation and the Insured v. Insured Exclusion*, The D&O Diary, November 9, 2011 (http://www.dandodiary.com/2011/11/articles/failed-banks/fdic-failed-bank-litigation-and-the-insured-vs-insured-exclusion/

To date, the driving force behind officer liability has not been the plaintiffs bar, but the FDIC, which is an attractive plaintiff that may be able to create precedents in many jurisdictions that will prove to be a boon to future private plaintiffs, and may significantly increase the risks associated with service as a corporate officer.

As the risks associated with their jobs increase, providing appropriate protection against liability for corporate officers will become increasingly important. Traditional mechanisms for protecting corporate fiduciaries, such as indemnification and insurance, remain the cornerstone of that effort. However, the growth in potential negligence-based liability increases the uncertainties associated with indemnification, and increases the importance of D&O insurance. In turn, some of the traditional exclusions from coverage contained in those policies mean that Side A or Side A only policies may become an increasingly important component of the protection program.

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When Companies Combine: Object Lessons in Managing Leadership Succession

By Ed Batts, a Partner of DLA Piper LLP

Managing leadership succession in the misnomered "merger of equals" or the more common combination of two large public companies of different sizes can often be tricky. To the extent that both the buyer and the target agree that one or more members of a target's management team are to transition to management positions in the combined company, merger contracts often specify who shall become what.

But such provisions are rarely drafted to be effective for any period of time beyond the closing. Further, buyers are loath to have a target's stockholders become third-party beneficiaries to a merger contract between the buyer and the target and thereby give individual target stockholders, and the plaintiff law firms who may eagerly seek out such individual stockholders, standing in court to sue.

As a result, if management positions are not apportioned as contemplated in the merger contract, there is not necessarily anyone left following the closing to pursue the buyer. Buyers are equally loathe to delegate authority over future management decisions to some subset of legacy target directors, an act which would directly cede oversized power over management selection to a minority of the merged company's board.

The circumstances in the merger of Duke Energy and Progress Energy—titans in the Southeastern energy production market—illustrate the awkwardness of such arrangements. On January 10, 2011, Duke and Progress announced their proposed marriage with an all-stock dowry for Progress valued just shy of US$14 billion. Two eminently reputable law firms were involved: Wachtell, Lipton Rosen & Katz represented Duke, while Hunton & Williams represented Progress.

Section 1.07(b) of the merger contract[1] stipulated that:

> Duke's Board of Directors shall cause the current Chief Executive Officer of Progress (the "Progress CEO") to be appointed as the President and Chief Executive Officer of Duke, and cause the current Chief Executive Officer of Duke (the "Duke CEO") to be appointed as the Chairman of the Board of Directors of Duke, in each case, effective as of, and conditioned upon the occurrence of, the Effective Time, and subject to such individuals' ability and willingness to serve.

The CEO of smaller Progress thus was to become CEO of the combined company. The combined board of 18 consisted of 11 directors from Duke and 7 from Progress.

Following a lengthy regulatory approval process, the merger closed on July 2, 2012. In the corporate equivalent of a nanosecond after the closing—reportedly about 20 actual minutes—the Duke directors unanimously voted on a conference call to oust the "current" CEO (from Progress) and bring back Duke's CEO. As best understood from media reports, all five legacy Progress directors present on the call voted against this change, but to no avail. The Progress CEO officially "resigned" from the combined company effective midnight on July 3 and was sent packing, with a not-too-shabby total severance package worth US$44 million.

Progress was based in Raleigh and Duke in Charlotte. Following the deal, the members of the North Carolina Public Utilities Commission publicly decried what they believed was an outcome different from what had been presented to them. They quickly hauled in the parties to explain, thereby granting deal observers a rare expedited view of the boardroom tactics in this transaction.

Accusations from Duke (of a supposedly "dictatorial but also hands-off" Progress CEO who purportedly fumbled with issues at the company's nuclear plants—cracked containment structures can be a costly thing as Duke continues to discover) and countervailing assertions from the CEO of Progress (that Duke got cold feet about the deal price, leading to eagerness to avoid a closing and sudden antagonism toward the leadership at Progress) have flown. While it remains hard to separate the wheat from the chaff, ultimately, absent a grand, and unjustified, governmental intervention from the North Carolina PUC, it seems likely the ouster will stand. Two legacy Progress directors have already resigned in a huff.

[1] Available at http://www.sec.gov/Archives/edgar/data/1094093/000119312511004870/dex21.htm.

One cannot really fault Duke. As buyer, it lived up to the Spartan terms of the merger contract. And, as Duke's old (er, new) CEO was quick to point out, the post-closing board had a fiduciary duty to change leadership if they believed in good faith that the Progress CEO was no longer the best leader.

Could a Different Contracting Approach Have Avoided This Predicament?

In private company mergers, the answer is simple. A voting agreement could have been executed as a condition to closing under which large stockholders would agree to vote in favor of board nominees who support a particular management member or team, or at least allow legacy stockholders a blocking right (probably with the usual "reasonableness" proviso). That voting agreement could not be amended without the consent of the stockholders or board members from the smaller target company.

However, because of the large turnover in a public company's stockholder base, public company voting agreements (absent a large majority holder or the like) are not feasible, just the same as with public company escrow distributions. There are other exotic potential ways to address this issue. One could hypothetically combine a dual-class structure with separate voting or blocking rights for management. But that is impractical as well as unrealistic—the complexity far outweighs the potential problem.

What about the actual merger contract? To prescribe a given minimum time (six months? A year?) for the new CEO to have an essentially unfettered right to remain in place is thorny in and of itself. If anything, it creates the ideal conditions for a lame-duck CEO who can operate with impugnity. More important remains the issue of standing. Any buyer almost certainly would reject such a third-party beneficiary clause outright.

An interesting example of another path that could be taken is the combination of United Airlines and Continental Airlines, first announced in May 2010. Its merger contract specified that the CEO of United would become chairman of the board of the combined airline for two years, while the CEO of Continental would become CEO of the combined company and eventually chairman of the board. In contrast to the Duke/Progress transaction, and despite size inequalities in the two companies, the board of the combined company was much more evenly drawn—seven members came from each company and two were union representatives.

There is no indication that United regretted this setup—in fact, to the contrary, commentators indicated that United viewed a pivotal part of the Continental deal as the ability to nab the talent of a dynamic and young Continental CEO to help chart the troubled waters of commercial aviation. One wonders if Progress had the leverage (or fortitude) to insist on a more evenly cleaved successor board for its deal, à la United/Continental—and if it had, whether the same leadership outcome would have ensued. We have no way of knowing (at least as of yet) how much the dueling sets of counsel and business principals negotiated the CEO provision and the board composition pre-signing.

Lest the Duke/Progress situation seem one of a heavy-handed Goliath adhering to a narrow and strict legal duty under the merger contract with nary a second thought, it is worth considering the practical, non-legal disincentives that would dissuade a buyer from casually ejecting a CEO immediately post-closing. Specifically: (a) no board wants a public food fight immediately following closing, thereby inviting intense scrutiny from both media and regulators; (b) the Progress CEO's US$44 million severance package, while dwarfed by the roughly US$30 billion market capitalization of the combined company, was a hefty payout; and (c) any level of enmity and mistrust among the remaining directors (even if two of them quickly bid their indignant farewells) is clearly sub-optimal.

So, what happened in Duke/Progress? A public company buyer is a buyer. A "merger of equals" or a "partnership" are wonderful terms for building employee morale post-integration, but unfortunately a bit feckless from a purely legal leverage analysis. The Duke/Progress deal highlights yet again the benefits of the control premium. Legacy Duke directors controlled the board and did what they thought best. The Progress board had every opportunity to alter the board balance as part of its pre-signing contractual negotiations.

But any pre-signing reassurances from the buyer, no matter if made in entirely good faith at the time, should not dissuade a target's board from the reality that control means control. And rightfully, the sanctity of a contract is most often unimpeachable.

Vintage Deal Tools Reemerge

By David Shine and Robert Blum of Fried, Frank, Harris, Shriver & Jacobson LLP

David Shine is co-chair of the mergers and acquisitions group and Robert Blum is a corporate associate at Fried, Frank, Harris, Shriver & Jacobson LLP. [1]

In the third quarter of 2012, a number of deals utilized tools not often seen in the current dealmaking environment. These tools include crown jewel lock-ups, force-the-vote provisions and joint public company bids. The appearance (or reappearance) of these tools illustrates the continuing focus of buyers on limiting risks in the context of public company transactions.

Apple's Asset Lock-up

On July 27, 2012, Apple Inc. agreed to buy AuthenTec, Inc., a fingerprint sensor technology company, for $356 million in cash, or $8 per share, representing a 58% premium to market. In connection with the acquisition, the parties entered into an asset lock-up, pursuant to which Apple was granted an option to acquire certain AuthenTec intellectual property for a fee of $20 million in addition to an agreed-upon purchase price. Such an arrangement is intended to prevent a third-party interloper from disrupting Apple's offer since, in such event, Apple would have the opportunity to purchase the target company's key assets.

Asset lock-ups generally fell out of use after the late 1980s, when Delaware courts expressed disfavor. Several shareholder suits have been filed in connection with Apple's acquisition of AuthenTec, and it remains to be seen whether Apple's use of an asset lock-up in the transaction will ultimately be called into question.

Force-the-Vote Provisions

Force-the-vote provisions require a target company's board to submit the proposed transaction to a shareholder vote regardless of whether the board continues to recommend the transaction. Although force-the-vote provisions had fallen out of favor for some time, their use has increased in recent years, and the trend has continued in 2012. At about the midpoint of the third quarter of 2012, approximately 44% of transactions in 2012 valued at over $100 million featured a force-the-vote provision.

Buyers utilize force-the-vote provisions to provide an additional measure of deal protection. Third-party bidders contemplating a superior offer may be deterred if they know that a solicitation process must occur before the existing merger agreement can be terminated.

Bristol-Myers' and AstraZeneca's Joint Bid

On August 9, 2012, Bristol-Myers Squibb Company acquired Amylin Pharmaceuticals, Inc. for $31 per share. The transaction price represented a 10% premium to market and an increase of 51% over Bristol-Myers' original bid for Amylin in February 2012, which had been rejected by Amylin's board. The Amylin acquisition was, in effect, a joint bid of Bristol-Myers and AstraZeneca plc. As structured, Bristol-Myers first paid $5.3 billion in cash to Amylin stockholders and also assumed another $1.7 billion in debt and other liabilities. Bristol-Myers then contributed the company to a joint venture with AstraZeneca, in exchange for approximately $3.4 billion in cash. Through the joint venture, each of Bristol-Myers and AstraZeneca will have an interest in profits from Amylin's future sales. AstraZeneca also intends, subject to the receipt of applicable antitrust approvals, to pay Bristol-Myers an additional $135 million to exercise an option to acquire additional governance rights over key strategic and financial decisions regarding Amylin's portfolio.

[1] This article was originally published in the October 2012 issue of Fried Frank's M&A Quarterly™.

Analysis: Say-on-Golden-Parachute Voting

_By_ Oguz (Oz) Tolon, ***ISS' U.S. Compensation Research***

The issue of golden parachute payments and advisory votes on such exit packages has come to the fore in recent weeks following the decision by Xstrata plc to decouple its Glencore merger vote from that of attendant payments to executives, and as new research from Harvard University Law School Professor Lucian Bebchuk and others questions the efficacy of such payments on long-term shareholder value. This article explores say-on-golden-parachute votes in 2012, examining the components of certain payments deemed problematic by shareholders based on failed votes.

Looking Back at 2012

Through October 4, ISS tracked 94 say-on-golden-parachute proposals in 2012, of which 34 were Russell 3,000 (R3K) companies, two were S&P 500 constituents, and 58 were other firms, including large caps Aon plc and Sunoco. Of these, ISS is tracking just three that failed to garner majority support.

The first say-on-golden-parachute proposal to fail in 2012 was at Advance America, Cash Advance Centers, a Spartanburg, South Carolina, payday loan company, where ISS recommended shareholders oppose exit payments due to what it deemed "problematic" modifications to change-in-control agreements with the company's executives. Specifically, in connection with the merger agreement, on Feb. 15 the company amended agreements previously entered into with its president and CEO J. Patrick O'Shaughnessy and chief financial officer James Ovenden, to provide modified single-triggered retention payments to those executives in lieu of their prior double-triggered severance payments. In addition, the company also made special equity grants and adjustments to the executives' base salaries, without a disclosed rationale and subsequent to the announcement of the merger agreement, which raised significant concerns.

Concerns about the proposed payments resonated with shareholders, who opposed the resolution with 52.1 percent of the votes cast against. Notably and by comparison, the merger proposal received near unanimous support (99.6 percent), suggesting that many investors clearly viewed the say-on-golden-parachute resolution as discrete from the underlying change-in-control transaction.

In another example, Ariba shareholders voting at an Aug. 29 special meeting failed to back the advisory golden parachute proposal, though strongly endorsed the related merger agreement whereby German technology giant SAP would buy the cloud networking company for $45.00 per share in cash. Among shareholder voting, 99.9 percent supported the merger deal with SAP, while just 49.5 percent supported the related exit payments. As in other cases, a number of problematic provisions were added prior to the merger vote, including the possibility of paying Ariba's CEO's cash severance without a qualifying termination of employment and deeming performance share metrics achieved at the 200 percent level solely because the company entered into a merger agreement.

A third failed say-on-golden-parachute vote this year also occurred on August 29 at Interline Brands, a marketer and distributor of broad-line maintenance, repair, and operations products, where shareholder opposition marked the highest level recorded, at nearly 62 percent, since implementation of the golden parachute vote in the spring of 2011. At Interline, the CEO's double-triggered cash severance had been recently modified to single trigger, and the outstanding performance-based equity was being paid out at maximum attainment level without regard to the achievement of underlying goals.

A significant difference evidenced this year between support levels on the merger transaction and the related say-on-golden-parachute proposal suggests some investors are choosing to abstain on exit pay ballot items, despite rendering a vote in favor of the transaction, while others may simply vote against parachute proposals as a matter of course, irrespective of voting decisions on the underlying mergers.

Specifically, during the period studied, the average support on parachute proposals across ISS' coverage universe was approximately 81 percent, while the underlying merger transactions averaged above 95 percent of votes cast. Given average shareholder support across the R3K on management say-on-pay proposals during the 2012 proxy season stood above 90 percent, the relatively lower level of support on parachute proposals warrants scrutiny.

Parachute Payments in Practice

Of the 94 companies studied, CEO cash severance was double-triggered at 57 companies (60.6 percent). By comparison, the cash severance for NEOs other than the CEO was double-triggered at 60 companies, representing 64 percent. At 10 companies examined, there were no existing, legacy agreements in place, and executives were not entitled to traditional severance payments. For CEOs, a total of 20 companies maintained single- or modified single-trigger legacy arrangements, while seven had entered into new agreements with their CEOs containing what ISS deemed to be problematic features during the most recent year under review.

Meanwhile, 11 companies did not maintain or pay any severance to NEOs other than the CEO in transactions that came to a shareholder vote in 2012; however, 18 maintained single- and modified single-triggers in legacy arrangements and five of those had adopted them in 2012. Within this universe, 39.4 percent of companies maintained or newly enacted (cash) severance triggers of concern to investors.

In terms of triggers for the acceleration of unvested, outstanding equity awards held by NEOs, the prevalent practice appears to be the single-trigger, i.e., automatic vesting acceleration; however, the most prevalent arrangement is that boards maintain discretion to determine the outcome in cases of change-in-control/merger transactions, and it appears that boards exercise this discretion to provide automatic accelerated vesting of equity awards a majority of the time, since that was the outcome at 80 out of 94 companies studied (85 percent).

Excise tax provisions in existing agreements were observed at 34 out of the 94 companies. However, just 16 actually paid excise taxes to NEOs, as the rest did not trigger 280G tax liabilities.

In addition to potential severance, retention payments to NEOs were seen at 21 out of the 94 companies. While single-triggered in most cases, these payments were generally reasonable in magnitude, and accompanied double-triggered severance payments. Retention bonuses replaced severance payments in at least two instances.

As noted above, the most prevalent practice of some concern to investors is the single-trigger acceleration of unvested equity awards held by NEOs, seen at 80 out of the total 94 companies. Companies which in practice disclosed two or more problematic features in their golden parachute proposals made up of 41.5 percent of the entire universe, while companies with at most one problematic feature represent a majority at 58.5 percent.

Shifting Investor Focus: Single-Trigger Equity Acceleration

Notably, ISS tracked a few cases this year where investors displayed opposition to golden parachute payments despite double-triggered cash severance payments and no excise tax gross-ups. At Delphi Financial Group, for example, the say-on-golden-parachute resolution passed with just 56 percent support even though no executive was entitled to a cash severance payment. They were, however, entitled to $34.8 million on a combined basis, $33.5 million of which was comprised of single-trigger equity acceleration and related excise tax gross-ups.

At [illegible], meanwhile, the golden parachute proposal squeaked through with [illegible] percent of votes cast, despite a double-triggered cash severance arrangement with the CEO. However, $[illegible] million of the total potential golden parachute payments to all NEOs (in the amount of $[illegible] million) was generated from single-triggered acceleration of unvested, outstanding equity awards held by [illegible] NEOs.

While some argue that single-trigger equity acceleration provides executives an incentive to pursue transactions with potentially a higher premium to shareholders, there has been growing concern that such golden parachutes are not necessarily beneficial, and some investors, as evidenced by voting in 2012, appear to view these payments as windfalls without the loss employment.

Checklist: How to Handle Stockholder List Requests

By Broc Romanek, Editor of Deal Lawyers

A. Determine Legitimacy of Request

1. Decide who inside the company should receive a copy of the request to help determine what to do. At a minimum, the general counsel and corporate secretary should be notified, but probably also the CEO, CFO, investor relations head and securities counsel. A stockholder list request typically precedes a hostile takeover or other contested solicitation.
2. Contact outside counsel who advises on takeovers, etc. to help gauge the true intent of the requester as well as advise on how to battle a contested solicitation.
3. Contact a proxy solicitor to get their guidance on the requester's intent, as well as advice on how to battle a contested solicitation.
4. Contact counsel for the state in which the company is incorporated (e.g. Delaware lawyer for a Delaware corporation) for their guidance on the process should be followed and to help evaluate whether the request is legitimate including the scope of the request. State law counsel often spot issues that other advisors don't see. Although there are a few limited rights under federal law for shareholders to make requests, the primary source of law in this area is state law.
5. Don't take the request lightly. Get as many of your advisors to help assess the request as possible. For example, the request could potentially trigger an ERISA violation because of the way that employee-shareholders hold shares through a plan.
6. Review your charter & bylaws to help assess whether the requester followed the proper process—and scope—in making the request.
7. Don't contact the source of the request to ask why the request was sent in. This likely is a hostile situation and all exchanges should be made in writing.

B. Inappropriate Request: Process for Rejecting the Request

1. If there is a basis to reject the request, double check to ensure the basis is sound as it may very well be the subject of a lawsuit. In Delaware, companies have five business days to respond to a request—and most companies use all five days even if the request asks for a call to inform them of a defect as soon as it's spotted.
2. Some practitioners recommend drafting the letter rejecting the request so that it is short and just notes that the "request didn't comply with the law" and not much more. Details—such as what is specific basis for rejecting the request—should not be included in the rejection letter.
3. Send the rejection letter via a method that can prove that the rejection was received.

C. Appropriate Request: Process for Providing a Stockholder List

1. Before sending the list, send a letter requesting that a non-distribution agreement be signed before the list is handed over, as well as a check to cover the proxy solicitation expenses of sending materials on behalf of the requestor (if sending materials is part of the request).
2. Review the stockholder list before turning it over to assess whether it is accurate.
3. Often, the request is for the list in electronic form—and most often that is provided on a thumb drive. If the stockholder list is sent via email, ensure the email is encrypted so that the list isn't intercepted.

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