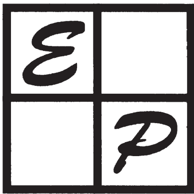

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DEAL LAWYERS

Vol. 7, No. 1 January-February 2013

Billion Dollar Companies: Not Too Big for Hostile Shareholder Activism

By Sanjay Shirodkar and Christopher Giordano of DLA Piper LLP & Paul Schulman of MacKenzie Partners

While the phenomenon of hedge fund activism has been around for some time, the mid-2000's saw a significant uptick in the activity by such entities. And while the 2008 collapse of the financial markets slowed down the surge in these campaigns, the current market recovery begs this question: Has the threat to boards and companies, particularly larger ones, returned?

In mid-September of last year, sharkrepellant.net released a study showing a significant increase in the number of financial and board seat activist campaigns in the U.S. during 2012, a 31% increase compared to the same period in 2011. Moreover, campaigns against companies with a market capitalization over $1 billion had increased for three consecutive years, and 2012 saw a "289 % increase over the same period in 2009.[1]" Similarly, the January 2013 issue of The Activist Report[2] notes that "the trend [of increased shareholder activism] towards larger companies continued with the second year in a row, where the average market capitalization targeted was above $2 billion."

In this article we examine some of the trends we spotted in the 41 campaigns against billion dollar plus companies that commenced in 2012. Based on our review as discussed below, some key take-away points that boards should consider include:

- Big companies need to be prepared to fend off hostile activists. Approximately 44% of activist campaigns that have been resolved led to management ceding at least one board seat, and in approximately 78% of the cases that had reached some resolution, the activist was able to emerge with a seemingly positive outcome.
- Shareholder rights plans continue to play an important role in this arena, even in the absence of a takeover threat.
- Proxy advisory firms ISS and Glass Lewis continue to support activists in most campaigns to some degree, and their recommendations in favor of a campaign correlated strongly to the outcome of the activist engagement.

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[1] Research Spotlight dated September 11, 2012 published by FactSetShark Repellant.net.

[2] A publication of Investor Communications Network, LLC.

* This is the first year we have conducted such a review. If you have any questions, suggestions or would like us to cover additional topics in our next review, please do not hesitate to contact us.

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ISSN 1944-7590

- There were several instances where a company was targeted by multiple activists and there seems to be a trend towards larger more sophisticated repeat activists.
- Companies can be subject to multi-year campaigns.
- It is critical to pay attention to details like filings under the Hart-Scott-Rodino Act and provisions in any confidentiality or standstill agreements.

Methodology

In our data analysis we made some subjective decisions, *e.g.*, when categorizing the levels of shareholder engagement or defining the criteria of success. Our review did not take into account campaigns that were driven by social and corporate governance agendas or were merely suggestions. Also, six companies were subject to multiple independent campaigns during 2012. However, in these situations, one insurgent eventually stepped forward and took the lead and the other parties ostensibly stepped aside or supported the primary activist. Consequently, we focused our analysis only on the lead activist who engaged in some sort of activism aimed at some economic or governance objective, such as board seats or selling the company. We also omitted certain campaigns against companies which we did not believe posed a real threat to the company.

Who are the Activists?

The first step was to classify the activists into groups, based on what we perceived as the primary motivation behind their activism as follows:

1. Activist driven funds. In this group we included entities that had a well established history of taking positions in a stock and then engaging the company to push for change. Many of these funds specifically look for situations where they can acquire a meaningful stake and derive value from a successful activist campaign.
2. Occasional Activists. This category is largely made up of hedge funds that tend to be passive holders but "went activist" in select situations out of frustration with the performance of their investment or when some unique opportunity presented itself.
3. Strategics. These situations principally involved attempts by a company to acquire a competitor, with the activism being in response to the target's initial rejection of the bid.
4. Special Situations. There was only one of these campaigns, involving a director in a dispute with the company.

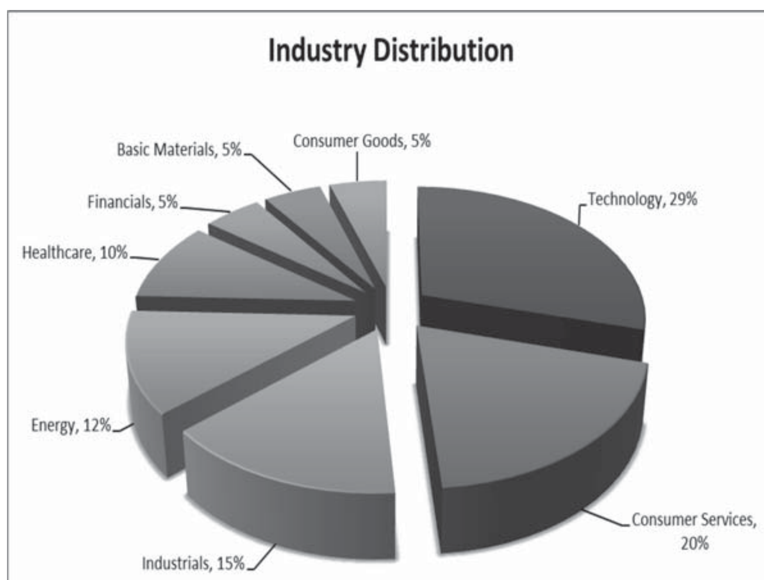
In 37 of the 41 situations, the primary activist was a hedge fund, clearly signaling that these investors are continuing to lead the charge against companies.

The vast majority of the activism events in this arena involved activist hedge funds. Leading this group were entities affiliated with Carl C. Icahn, who were active in seven separate campaigns, while Relational Investors was involved in four campaigns and Corvex Management was involved in three campaigns.

The occasional activists are typically passive funds who turned to activism only when they felt it was necessary in select circumstances, and in many cases they did not buy into the stock with the intent of pursuing an activist agenda to drive value. Smaller funds that had a history of sporadic activist engagements were also included in this group.

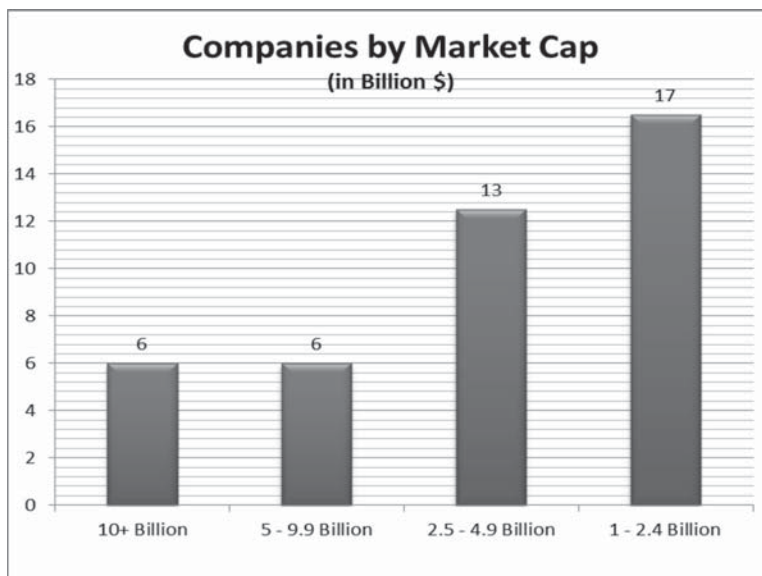
What is the break-down of the different industries?

An industry breakdown of the target companies into discreet segments is depicted below.



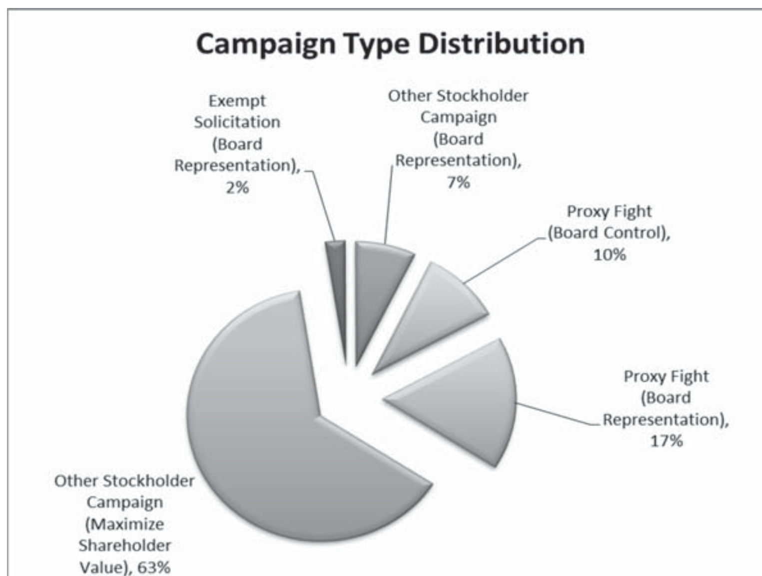
The top five sectors were technology, consumer services, industrials, healthcare, and energy. These sectors accounted for almost 85 percent of the activity we reviewed. Like the IPO market in 2012, the technology sector drew the most attention with 12 companies being subjected to activist campaigns. The consumer services sector was next with eight campaigns, followed by the industrials sector with six campaigns and the energy sector with five campaigns. The financial sector, which was hardest hit by the market events of 2008 and 2009, was only subject to two campaigns, perhaps due to the fact that this sector performed fairly well in 2012 and is more highly regulated than most of the others.

What is the break-down by the market capitalization of these companies?



We noted that the concentration of campaigns was directed primarily at the smaller issuers in the group studied. 30 of the 41 companies had market values below $5 billion. However, six companies, or approximately 15% of the companies we reviewed, had capitalizations greater than $10 billion. To put this in some context, there were less than 400 listed companies in the U.S. with market caps above that level at the end of the year. While not indicative of a trend, we believe that this can demonstrate that there are a select number of activist funds with significant enough resources to mount credible campaigns against very large companies.

Types of Campaigns



The manner in which the campaigns were launched could be broken out into three categories. Instances where the activist submitted a notice of nomination to the company or filed proxy materials with the SEC were categorized into "Proxy Fight." There were 11 such instances. The next category was "Exempt Solicitation." Our third category was a "catch-all" category we dubbed "Other Stockholder Campaign."

There were 29 such instances, which included demands by the activist relating to a wide variety of topics ranging from returning cash to shareholders, changing senior management, executive compensation, considering strategic alternatives, or nominating one or more directors.

Proxy Fights

While the majority of situations resulted in a settlement or withdrawal of the campaigns, a breakdown of the eleven proxy fights revealed the following data points:

- Two companies faced consecutive annual proxy fights from an activist that had unsuccessfully attacked them in 2011. The result of these fights in 2012 was essentially the same as the prior year, with management winning outright in one and losing one seat in the other.
- Four campaigns were for board control, i.e., a majority of the board.
  - Of the four board-control proxy fights, two were waged by entities affiliated with Mr. Icahn.
  - Only one of these campaigns resulted in a full-blown proxy fight culminating with a contested shareholder meeting. This instance involved a strategic pursuing an unsolicited acquisition. Management was victorious in this instance.

The remaining three fights resulted in two settlements and one successful outcome for management.

- Seven proxy fights were for lesser board representation.
  - Here again, just two of the proxy fights went all the way to a contested shareholder meeting, with management being victorious in one and a split decision in the other (activist won one seat).
  - Four resulted in settlement agreements involving some form of concession by the company.
  - One campaign was withdrawn as a result of legal proceedings.

Based on public filings, it was observed that every one of the companies involved in a proxy contest had a shareholder base made up of largely institutional shareholders (75% or higher). With these shareholders generally being traditional "vanilla" institutions, it is reasonable to expect that the influential proxy advisory firms, ISS and Glass Lewis, would be important components to the success of an activist engagement. The data we reviewed showed that in all instances where the activism culminated in a contested vote, the eventual outcome was generally in line with the ISS and Glass Lewis recommendations. In those situations when both firms recommended that shareholders support management's nominees, management won. When they recommended that shareholders support a lesser number of dissident nominees, the outcome was a partial dissident victory—although the actual opposition nominees elected were not necessarily the same individuals recommended by the advisors.

Shareholder Rights Plans

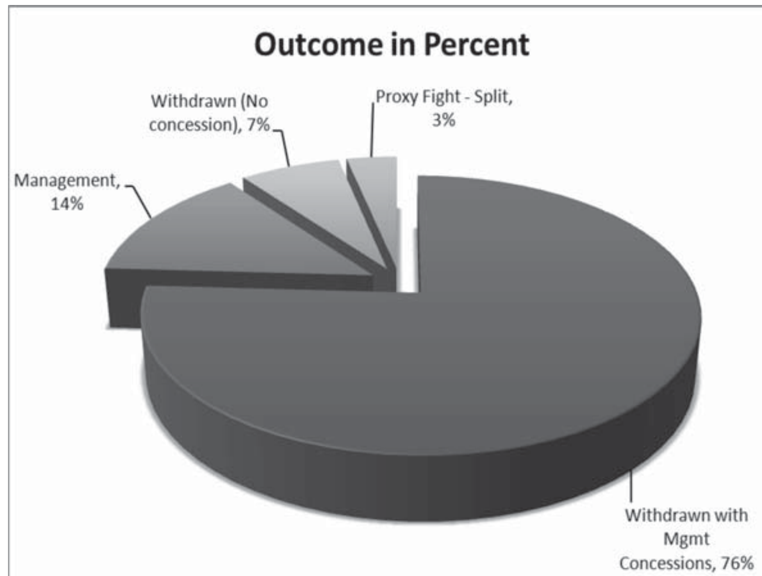
We note that sixteen of the forty-one companies (or 39%) had a shareholder rights plan. Additional details are as follows:

- Twelve companies adopted a shareholder rights plan after the announcement of the activism.
  - Nine shareholder rights plans have a one-year term and three have a three-year term. The one-year terms were likely adopted to fit within the current ISS shareholder rights recommended term without stockholder approval.
  - Three companies were involved in a proxy fight for board control, five companies were involved in a board representation contest, and eight companies were involved in campaign to maximize shareholder value.
- In instances where a company adopted a shareholder rights plan when it was faced with an activist campaign, the threshold to trigger the rights plan was generally set a little bit higher than the amount of shares owned by the activist.

Outcome

Our experience and reading the coverage from various sources regarding the rise of hedge fund activism leading up to 2008 showed that, in close to 60% of cases studied, activists obtained at least some level of success in their campaigns.[3]

Success, either through a proxy contest going the full course or a settlement, is obviously difficult to define. So, for the purposes of our review, we attempted to delineate the outcomes not just in wins or losses, but in some measure by the details of the outcome, as shown in the chart below.



In a broad sense, we found that in approximately 78% of the cases in 2012 that had reached some level of resolution, the activist was able to walk away with a seemingly positive outcome. Most of these gains came as a result of a settlement or some form of engagement between the two sides that satisfied the activist to the point of standing down. However, when the activist went all the way through a proxy contest vote, management was generally successful, winning two out of three proxy fights outright. A possible explanation for this observation is that in situations where management felt they had a high likelihood of winning, they were less likely to settle and make any concessions.

We note that the chart above does not reflect the outcome of 12 campaigns that were still pending as we went to press.

Settlement Details

There were 20 separate instances where a campaign was withdrawn and some form of concession was made by management. The concessions that were attendant to any settlement or discussions were quite varied. Many situations involved more than one, sometimes as many as three, separate provisions. We have charted below each of the most prevalent of these:

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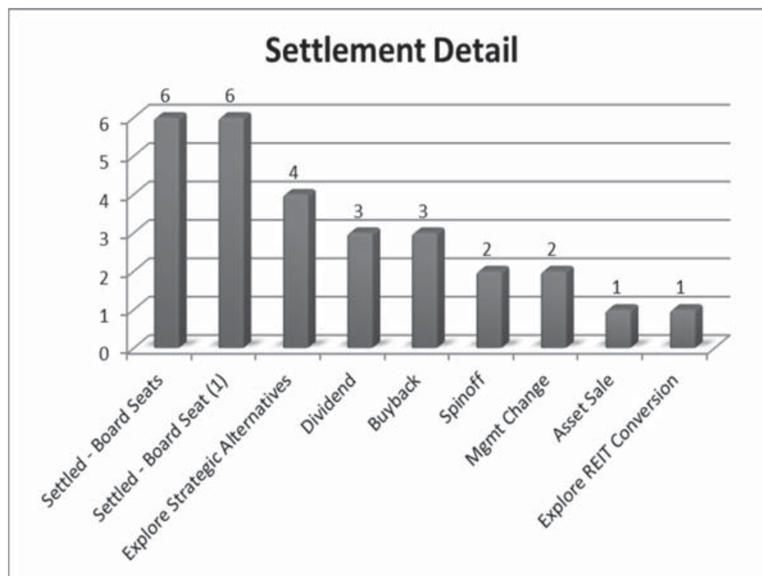
[3] *See generally*, April Klein and Emanuel Zur, *Hedge Fund Activism* (October 2006).



As demonstrated above, achieving board representation was clearly the most common term of settlement and, in such instances, the activist was able to obtain at least one board seat in twelve of the twenty separate instances (60% of the time). The next most common settlement provision involved an agreement to "explore strategic alternatives." There were a number of variations to this, typically involving the retention of advisors as the first step in a potential sale of the company.

Conclusion

While the volume of hedge fund activism has slowed down from its heyday, in looking at the data of the past two years, it is clear to us that certain large hedge funds have hit the "play" button and are fully engaged in the activist playbook. A study reported in the October 2012 issue of the Activist Report[4] noted that out of [illegible] campaigns undertaken by activist hedge funds, the average absolute return was [illegible]% as compared to an average absolute return of the S&P 500 of [illegible]% over the same period. This may explain why three activist hedge funds (Icahn, Relational and Corvex) accounted for fourteen out of the forty-one (34%) campaigns in our sample. And while we only reviewed the domestic U.S. markets, hostile shareholder activism appears to also be on the rise in the Canadian provinces and in the European Union. All of this portends for a fascinating 2013 in which billion dollar market capitalization companies are no longer safe merely due to their size. So, the question that even large companies should be posing to themselves is — are we ready when a hostile shareholder activist comes knocking on our door?

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[4] A publication of Investor Communications Network, LLC.

News from the SEC: Tender Offer Funding Conditions & Dual Track Processes

By Jim Lidbury, a Partner of Ropes & Gray LLP

Michele Anderson, Chief of the SEC Division of Corporation Finance's Office of Mergers & Acquisition, spoke at an ABA meeting in mid-November about a number of issues that her office has been seeing. Two most worthy of note were tender offer funding conditions and dual track processes:

Funding Conditions

The SEC Staff believes that a funding condition in a tender offer should be viewed the same way it views a financing condition. Accordingly, the Staff takes the position that the satisfaction or waiver of the funding condition is a material amendment to the offer that necessitates a five-day extension of the tender offer.

That position creates a hardship on transactions that are attempting to close with the back-end merger on the same day (which is typically a condition of the financing). A bidder must essentially waive the condition five days in advance of the expiration of the tender offer. A practical way to cope as best as possible with this problem is to mirror in the tender offer conditions any funding conditions set forth in the financing papers. That still leaves the bidder at risk in the event that the financing source refuses to close under circumstances where there can be dispute over whether the financing source has violated its commitment.

Dual Track Processes

A difficulty with tender offers that are financed from borrowings secured by the target's assets is the need to simultaneously close the tender offer and the squeeze-out merger so that the buyer owns 100% of the target's stock and can pledge the target's assets to secure the financing. To simultaneously close the squeeze-out merger, the Buyer needs to achieve at least 90% ownership of each class of a Delaware target's stock. A backup plan in case a 90% "minimum condition" can't be achieved through the tender offer is to run a proxy solicitation to approve the merger simultaneously with the tender offer.

When presented with such a "dual track" process, the Staff will review preliminary proxy material that is filed during the pendency of the tender offer, but cautions bidders not to file definitive proxy material and mail before the expiration of the tender offer. The Staff's view is that the mailing of definitive proxy material is an arrangement to purchase securities outside of the tender offer in violation of Rule 14e-5. They believe they are being accommodating by using Staff resources to review a preliminary filing that, in all likelihood, will never be used since the tenders in recent dual track deals all have been successful.

Upcoming Webcasts—Here are critical webcasts coming up soon:

- **TheCorporateCounsel.net's** webcast—"Pat McGurn's Forecast for 2013 Proxy Season: Wild and Woolly" (1/24)
- **Section16.net's** webcast—"Alan Dye on the Latest Section 16 Developments" (1/30)
- **DealLawyers.com's** webcast—"Activist Profiles and Playbooks" (1/31)
- **TheCorporateCounsel.net's webcast**—"Rule 10b5-1 Plans Under Attack: The Latest Practices" (2/5)
- **DealLawyers.com's** webcast—"Projections, Prospects & Other Crystal Ball Provisions: Colliding with 20/20 Hindsight" (2/13)
- **TheCorporateCounsel.net's** webcast—"Conduct of the Annual Meeting" (3/5)
- **CompensationStandards.com's webcast**—"What the Top Compensation Consultants Are NOW Telling Compensation Committees" (3/6)

Runaway MAC Carve-Outs

By Neil Whoriskey, a Partner of Cleary Gottlieb Steen & Hamilton LLP

The definition of "material adverse change" plays a critical role in public company merger agreements, effectively defining the situations in which a buyer may walk away from the transaction. There is significant case law defining what is (or, much more commonly, what is not) a material adverse change, but the case law only serves to interpret the agreed definitions. The agreed definitions, in turn, are typically very vague in defining what is a material adverse change (leaving lots of scope for judges), but explicit in listing the types of changes that may not be considered in evaluating whether a material adverse change has occurred. The use of these carve-outs to limit what may be considered a material adverse change has expanded significantly in recent years—arguably to a point where it may make sense for the pendulum to start to swing back.

It has been traditional for adverse effects attributable to changes in general economic conditions to be excluded in considering whether a material adverse effect has occurred, such that, e.g., a loss of sales attributable to the great recession, no matter how severe, would not give buyer the right to terminate a merger agreement. This carve-out from the material adverse change definition can be grouped with others, such as carve-outs for downturns in the target industry, changes in law or accounting policies, acts of war, etc.—all of which shift to buyer the risks associated with the environment in which the target operates. What is notable is that, over the last several years, not only has the percentage of deals that shift these "environmental" risks to buyer increased significantly, but MAC carve-outs that shift to buyer the risk of the deal, and (anecdotally at least) even the risk of closing the transaction, have also increased markedly.

First, the empirical evidence, courtesy of the annual ABA Deal Points studies.[1] Listed below are various "environmental" MAC carve-outs, with the Deal Points calculation of how frequently these carve-outs appeared in 2004 deals (the year examined in the first Deal Points study) and in 2010 (the year examined in the last Deal Points study).

Carve-out	2004	2010
General Economy	[illegible]	100%
Industry	71%	93%
Change in Law	41%	[illegible]
Change in Accounting Principles	[illegible]	94%
War/Terrorism	[illegible]	[illegible]

As can be seen, "environmental" risks in every category were more likely to be shifted to buyer in 2010 than in 2004. Risks associated with a downturn in the target industry were 30% more likely to be shifted to buyer in 2010. Adverse changes attributable to changes in law or accounting principles were more than twice as likely to be shifted to buyer in 2010. War and terrorism risks were almost four times as likely to be shifted to buyer. It is hard to conceive of a general rationale for buyers as a group to be more tolerant of these risks in 2010 than they were in 2004.

Risks associated with the deal itself also appear to have been, in the aggregate, assumed by buyer much more frequently than in the past. One indication of this is the increased prevalence of a carve-out for any adverse effects arising as a result of the announcement or pendency of the merger. This carve-out serves to protect the target from claims that a material adverse change has occurred due to, *e.g.*, target's employees quitting en masse (because they don't want to work for buyer or see little chance that they will be retained after the merger), or customers defecting or shifting orders to a competitor as a result of the announcement. Leaving aside the question as to whether seller is in a better position than buyer to evaluate and mitigate these risks (a question that will have a different answer in each deal), it is clear that this carve-out has become more prevalent in recent years. In 2004, 69% of merger agreements for

[1] *See* ABA *2007 Strategic Buyer/Public Target Deal Points Study* (Nov. 5, 2007) and ABA *2011 Strategic Buyer/Public Target M&A Deal Points Study* (Dec. 29, 2011).

public company targets included this carve-out; by 2010, the percentage had increased to 90%, a 30% percent increase.

Moreover, while it is perhaps more anecdotal, other carve-outs that have the effect of shifting deal risk to buyer have also become popular—at least in targets' drafts. These include a carve-out from the material adverse effect definition for any adverse effects arising (or reasonably likely to arise) from the consummation of the transaction. While this sometimes defended as a temporal extension of the carve-out for adverse effects arising from the announcement or pendency of the merger (*i.e.*, employees/customers/suppliers are likely to leave, but only if the deal is consummated), there are additional risks associated with the consummation of the merger. For example, consummation of the merger may trigger termination of a critical IP license, while the mere announcement of the merger would not. If buyer has accepted this carve-out, the effect of the termination of this critical license would not constitute (or even contribute to) a material adverse effect.[2] Even more directly, in one recent deal the target managed to insert not only a carve-out for changes arising from the consummation of the merger, but also a carve-out for adverse changes arising as a result of a failure to obtain any consents (regardless of whether those consents were identified by target as being necessary in connection with the transaction).

For further evidence of how far the pendulum has swung in favor of target, consider the increased prevalence of carve-outs that go beyond shifting deal risk, and actually shift the risk of running target's business (pre-closing) to buyer. In this regard, note that a carve-out for the failure of target to meet its projections was included in [illegible]% of public merger agreements in 2004, increasing to [illegible]% of deals in 2010—an increase of almost twofold. This may not be particularly probative, given that a large number of these clauses must have excluded from the carve-out any underlying causes that resulted in the failure to meet the projections—such that the carve-out merely excludes the forward looking measurement of the underlying adverse effect. However, that presumably might have been as true in 2004 as 2010, and the greater willingness of buyers to accept this carve-out is reflective of the broader trend of allowing more risk to be shifted to buyer via the MAE carve-outs.

Again somewhat anecdotally, we have noticed a number of target drafts where target attempts to carve out any adverse effects arising from actions taken with the consent of buyer. It is unclear why, under any circumstances, target should not take responsibility for its own actions, regardless of whether buyer has consented. Moreover, in certain circumstances buyer may be required to consent (*e.g.*, if consent cannot be unreasonably withheld). Imagine a situation where target wants to sell of one of its less important operating subs in a jurisdiction in which buyer does not operate and does not wish to enter. Buyer happily consents. It turns out that the sub has a license to use and sublicense the target's critical and very marketable IP. Buyer has no walk right. Should the risk of diligencing the sale of the subsidiary be so fully on buyer?

Even more surprising are the attempts (accepted in at least one recent transaction) to carve-out any adverse effects arising from the performance of the merger agreement itself. As it is typically an obligation of the target to operate in the ordinary course of business, this carve-out would seem to exclude any adverse changes resulting from operating the business in the ordinary course!

So why have carve-outs expanded to such an extent? It is of course difficult to attribute these changes in the aggregate market to any single phenomenon. Maybe it has just been a long sellers' market. Maybe as the 2001 IBP v. Tyson case[3] has filtered into the market, buyers have become more and more convinced that they will never see a material adverse change that is unforeseen, sustained and severe enough to meet the standard set in that case—making the whole MAC concept close to useless.

Regardless of the cause, the material adverse change definition remains fundamental to the construct of public company merger agreements. If the target business deteriorates severely between signing and closing, or is in significantly worse condition than represented, the buyer has no remedy other than walking

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[2] Note that this carve-out also indirectly has the effect of waiving certain breaches of representations by target. If target has breached its "material contracts" or "no consents" representations by failing to schedule the IP license as a material contract that required consent, the breach will not have a material adverse effect due to the carve-out. Termination rights for breaches of representations in a public company merger agreement generally arise only if the breach would give rise to a material adverse effect. (This was true in 100% of public deals in 2010; 87% in 2004.)

[3] *In re IBP, Inc. S'holders Litig.*, 789 A.2d 14 (Del. Ch. 2001).

tion, and that remedy is triggered only by the occurrence of a material adverse change. When a buyer has been run through a tough auction process and paid top dollar for a company in the hope that it will continue to operate at the top of its game, every assumed risk should be carefully examined, whether it is an "environmental" risk (now almost universally shifted to buyers), deal risk, or risk of running the company. Buyers should ask whether they will be willing to part with as much cash as they have agreed to pay if, e.g., there is a severe downturn in the industry, or a change in law that will affect operating results. This is particularly true in deals where regulatory approvals or other factors will delay closing, allowing greater time for material adverse changes to develop. Hopefully we will see the pendulum swing back before a buyer's CEO is forced to tell its board that yes, there has been an unforeseen, sustained, and severe downturn in target's business, but we are still buying it.

Our Pair of Popular Executive Pay Conferences: A 33% Early Bird Discount

We are excited to announce that we have just posted the registration information—including the agendas—for our pair of popular conferences—"Tackling Your 2014 Compensation Disclosures: The Proxy Disclosure Conference" & "Say-on-Pay Workshop: 10th Annual Executive Compensation Conference"—to be held September 23-24 in Washington DC and via Live Nationwide Video Webcast.

Early Bird Rates—Act by March 8th: Huge changes are afoot for executive compensation practices and the related disclosures—that will impact every public company. We are doing our part to help you address all these changes—and avoid costly pitfalls—by offering a special early bird discount rate to help you attend these critical conferences (both of the Conferences are bundled together with a single price). So register on CompensationStandards.com—or use the attached flyer—by March 8th to take advantage of the *33% discount*.

Delaware Enjoins "Don't Ask, Don't Waive" Standstill Provision But Holds Not Per Se Unenforceable (and Use & Effect Should Be Disclosed)

By Alexandra Korry, Mary Grendell and Jason Tyler, a Partner and Two Associates of Sullivan & Cromwell LLP

In *In re Complete Genomics, Inc. Shareholder Litigation*,[1] the Delaware Court of Chancery (Laster, V.C.), in two transcript rulings on November 9 and November 27:

- Refused to enjoin a merger agreement between Complete Genomics, Inc. ("Genomics") and BGI-Shenzhen ("BGI") for its absence of a termination right in the event of a superior proposal and accompanying break-fee and no-shop provisions; the Court found that the plaintiffs had failed to establish a reasonable probability of success on their claim that the provisions are coercive or preclusive to stockholders;
- Preliminarily enjoined Genomics from enforcing the so-called "Don't Ask, Don't Waive" provision of a standstill/confidentiality agreement Genomics entered into with a potential bidder, finding that the plaintiffs established a reasonable probability of success on their claim that the provision violated the directors' fiduciary duty of care insofar as it impermissibly limited the Board's obligation to evaluate potentially competing offers and determine whether it could continue to recommend the BGI merger to stockholders;
- Conditionally declined to enjoin (on the basis of unripeness) the merger agreement's procedural restrictions affecting the Genomics Board's right to change its recommendation of the BGI transaction to stockholders; the Court requires Genomics to provide the stockholder plaintiffs with prompt notice if its Board in the future considers whether it should change its recommendation;
- Conditionally declined to enjoin the "no waiver" covenant in the merger agreement that restricts Genomics from waiving the standstills in the confidentiality agreements it signed with potential bidders (having enjoined the one "Don't Ask, Don't Waive" provision in the offending confidentiality agreement); the Court requires Genomics to provide the stockholder plaintiffs with prompt notice if a bidder privately seeks a waiver of its standstill with Genomics;
- Granted a limited disclosure injunction to clarify public disclosure about the terms of the BGI merger agreement regarding the calculation of the outside date that triggered Genomics' unilateral termination right.

In another transcript ruling approximately two weeks later in *In re Ancestry.com Inc. Shareholder Litigation*,[2] the Court (Strine, C.):

- Clarified that there is no per se rule in Delaware against the use of "Don't Ask, Don't Waive" provisions;
- Emphasized that because of the potency of "Don't Ask, Don't Waive" provisions, a target board would need to establish a clear record that it reasonably and carefully employed the provision to maximize the target's sale price; and
- Ruled that the use and effect of "Don't Ask, Don't Waive" provisions are material to shareholders in determining how to vote on a proposed merger and thus should be publicly disclosed, especially where the restrictions potentially account for why no superior offers have been made.

Background to the *Complete Genomics* Dispute

In June of 2012, following unsuccessful capital raises and a growing risk of insolvency, the Board of Genomics, a NASDAQ traded company, announced publicly that it was exploring its strategic alternatives.

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[1] *In re Complete Genomics, Inc. S'holder Litig.*, C.A. No. 7888-VCL (Del. Ch. Nov. 9, 2012) (transcript ruling) ("*Genomics I*"); C.A. No. 7888-VCL (Del. Ch. Nov. 27, 2012) (transcript ruling) ("*Genomics II*"). The rulings given by the Court in the two telephonic sessions will be compiled in a formal order to be entered on the docket. The supplemental transcript ruling from November 27 arose from a misunderstanding of the Court of the terms of the existing standstill arrangements with certain bidders, which was later clarified by counsel to Genomics.

[2] *In re Ancestry.com Inc. S'holder Litig.*, C.A. No. 7988-CS (Del. Ch. Dec. 17, 2012) (transcript ruling) ("*Ancestry*").

Genomics canvassed dozens of possible acquirers; nine parties entered into a confidentiality agreement with Genomics, four of which contained a standstill provision, and one of which contained a "Don't Ask, Don't Waive" provision, prohibiting a private standstill waiver request. During the solicitation period, the CEO of BGI, the eventually successful bidder, conveyed to the Genomics CEO that he wanted him to stay on after the acquisition to run Genomics as an independent entity under BGI ownership.

On September 15, 2012, Genomics agreed to be acquired by BGI in a transaction structured as a tender offer (with a majority tender minimum condition) followed by a second-step merger at a price that represented a 54% premium over the closing price of Genomics' shares on the day before the public announcement of Genomics' intention to explore strategic alternatives, and an 18% premium over the closing price of Genomics' shares the day before announcement of the BGI deal. As part of the transaction, BGI agreed to provide Genomics with a bridge loan that could be converted into approximately 22% of Genomics' outstanding shares if an unsolicited topping bid emerged.

Under the merger agreement with BGI, without a breach by BGI, Genomics may only unilaterally terminate the agreement if BGI fails to complete the tender offer by the outside date (which potentially could be as far out as six months after signing, a point at which Genomics would have insufficient cash on hand).[3] Irrespective of whether a superior bid emerges or the Genomics Board changes its recommendation to stockholders, if Genomics exercises its limited outside date termination right under the merger agreement and a topping bid has emerged (and the bid is later consummated or an acquisition agreement is signed), Genomics is required to pay BGI a break fee equal to approximately 4.2% of the equity value of the transaction.

The merger agreement also contains a no-shop provision and increasingly common procedural restrictions on the Genomics Board's ability to change its recommendation of the BGI transaction, including a requirement that Genomics provide BGI with five business days' advance notice (and potentially longer since certain changes to a competing bid restart the clock) of its Board's intention to change its recommendation, during which time Genomics is required to renegotiate in good faith the terms of its BGI transaction to obviate the need for a Board change in recommendation. The BGI merger agreement also prohibits Genomics from modifying or waiving any standstill provision in the confidentiality agreements it has signed with potential bidders.

On September 21, several stockholders of Genomics brought a motion for a preliminary injunction in the Delaware Chancery Court seeking to enjoin various provisions of the BGI merger agreement.

On November 9, 2012, Vice Chancellor Laster issued the Court's first transcript ruling. On November 13, Genomics disclosed that an unsolicited topping bid had emerged that represented a 5% premium over the consideration offered by BGI and that the Genomics Board determined (and reaffirmed on November 26) did not constitute a superior proposal.[4] On November 27, Vice Chancellor Laster supplemented his original transcript ruling because he said he had mistakenly assumed at the time of his original ruling that none of the standstills applicable to bidders for Genomics included a "Don't Ask, Don't Waive" provision, when in fact one of those did contain such a provision.

The Court of Chancery's *Genomics* Opinion

A. "Don't Ask, Don't Waive" Standstill Unenforceable Under the Circumstances

The Court preliminarily enjoined Genomics from enforcing the "Don't Ask, Don't Waive" standstill provision in a confidentiality agreement applicable to one potential bidder for Genomics that would prohibit the bidder from privately asking Genomics to be released from its standstill.[5] The Court observed that a Board has an "ongoing statutory and fiduciary obligation to provide a current, candid and accurate merger recommendation."[6]

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[3] The Court noted that this assertion by the plaintiffs was factually debatable.

[4] Complete Genomics, Inc., Amendment No. 6 to Schedule 14D-9 (Nov. 13, 2012) and Amendment No. 10 to Schedule 14D-9 (Nov. 27, 2012). Illumina, Inc. had later publicly disclosed that it was the topping bidder referred to in the Genomics Schedule 14D-9. Illumina, Inc., Form 8-K (Nov. 16, 2012).

[5] The bidder bound by the "Don't Ask, Don't Waive" standstill provision did not reemerge after Genomics and BGI executed the merger agreement. *Genomics II* at 7.

[6] *Genomics II* at 16.

Noting that "Don't Ask, Don't Waive" standstill provisions can preclude the "flow of incoming information" to a target's Board, the *Genomics* Court, analogizing to the Court's wariness about "no-talk" provisions,[7] found that by agreeing to the provision the Genomics Board "impermissibly limited its ongoing statutory and fiduciary obligations to properly evaluate a competing offer, disclose material information, and make a meaningful merger recommendation to its stockholders."[8] Accordingly, the Court found that the plaintiffs had established a reasonable probability of success on the merits of their claim that enforcement of the "Don't Ask, Don't Waive" provision violated the Genomics directors' fiduciary duties.[9]

The Court made clear that the fact that the Genomics Board recommendation was being made in the context of a federal securities law Schedule 14D-9 requirement rather than the Delaware General Corporation Law Section 251 merger statute was of no moment since a tender into an offer that is part of a two-step transaction is functionally no different than a shareholder vote, as the Court has previously held.

The Court also found that the plaintiffs had met their burden of showing irreparable harm absent a preliminary injunction because the "Don't Ask, Don't Waive" provision "[d]id not prohibit ... incoming information from that bidder under any circumstance" so the Genomics Board would never know if a superior proposal was possible unless the bidder opted to breach the provision.[10] "[T]hat type of provision would create a situation that can't be remedied," Vice Chancellor Laster said.[11]

Finally, citing to *In re The Topps Company Shareholder Litigation*,[12] the Court enjoined only the waiver standstill provision of the confidentiality agreement and not the merger transaction with BGI, noting that it believed that such a limited injunction would not cause the failure of a closing condition or give rise to a termination right under the merger agreement and would be permissible under the severability clause of the merger agreement to the extent that the Court was by injunction narrowing the non-waiver of standstill provision of the merger agreement as it applied to the "Don't Ask, Don't Waive" standstill.

B. Lack of Termination Right for Superior Proposal Not Coercive or Preclusive

The Court declined to enjoin the Genomics-BGI merger agreement on the basis of an enhanced scrutiny challenge to the deal protection provisions in the agreement. The Court found that the plaintiffs failed to carry their burden of reasonable probability of success on the issue of whether the merger agreement was preclusive or coercive because of the absence of Genomics' right to terminate the agreement for a superior proposal, the lengthy period until the outside date (after which Genomics was free to terminate) and the size of the break fee. Citing *Smith v. Van Gorkom* and its progeny, the Court stated that Delaware courts have long held that a company may agree to a merger agreement without a "fiduciary out" if the board of directors is not in breach of its fiduciary duties in entering into the agreement.[13]

The Court stated that so long as a Board or some other party does not take action that has the effect of causing stockholders to vote in favor of a transaction for reasons other than its merits, there is no "wrongful coercion." "If stockholders can reject the transaction and maintain the status quo," the Court stated, "then the transaction is not coercive."[14] Noting that the break fee would not be payable (unless the board changed its recommendation or a topping bidder emerged) if Genomics stockholders declined to tender into the offer and the minimum condition consequently was not met, the Court stated that the Genomics Board worked diligently in the face of a potential bankruptcy to provide its stockholders with an opportunity to receive value for their shares, and the fact that the status quo option could result in Genomics' bankruptcy does not make the merger agreement coercive.[15]

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[7] *Genomics II* at 14-15 (citing *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, C.A. No. 17398 (Del. Ch. Sept. 27, 1999) (transcript ruling); *Cirrus Holdings Co. Ltd. v. Cirrus Indus. Inc.*, 794 A.2d 1191 (Del. Ch. 2001); *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95 (Del. Ch. 1999)).

[8] *Id.* at 18.

[9] The Court's ruling confirms guidance previously given in a settlement hearing in *In re RehabCare Group, Inc. Shareholders Litigation,* C.A. No. 6197-VCL at 46 (Del. Ch. 2011) (transcript ruling), in which the Court observed that "it is weird that people persist in the 'agree not to ask' in the standstill. When is that ever going to hold up if it's actually litigated, particularly after *Topps*?"

[10] *Genomics II* at 20.

[11] *Id.*

[12] *Id.* at 21-22 (citing *In re The Topps Co. S'holders Litig.*, 926 A.2d 58 (Del. Ch. 2007)).

[13] *Genomics I* at 12-13 (citing *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985)).

[14] *Id.* at 13-14.

[15] *Id.* at 14-15.

The Court also found that the merger agreement was not preclusive since competing bidders to BGI were free to launch their own tender offers. However, the Court noted that the deal protection provisions of the merger agreement and the convertible bridge loan BGI had extended to Genomics made this a closer case than it would otherwise be.[16] The Court distinguished the BGI bridge loan, which provided Genomics with a "substantial benefit"—needed, immediate post-signing cash infusion—from the 19.9% stock option (that was triggered only by a topping bid) granted to Viacom in *QVC Network v. Paramount Communications*, which Vice Chancellor Laster noted did not provide any benefit to the target and the exercise of which the *QVC* Court enjoined.[17] Assuming a 5% overbid by a topping bidder and a full draw-down of the bridge loan, the Court found that the combined break fee cost of less than 5% of the transaction value was not sufficient for the plaintiffs to sustain a reasonable probability of success on the issue of preclusiveness.[18]

C. Change of Recommendation & No-Waiver Standstill Limitations Potentially Problematic, But Not Ripe for Adjudication

The Court declined to enjoin the customary change of recommendation provision of the BGI merger agreement that the Court claimed placed "extensive limitations"[19] on the Board's ability to alter its recommendation of the BGI transaction on the grounds that there was no current basis for a change in the Genomics Board's recommendation and therefore the issue was not ripe. However, referencing its prior *dicta* guidance in *Compellent*,[20] the Court noted that "there are . . . significant issues of Delaware law lurking"[21] in the provision, and conditioned its denial of a preliminary injunction on Genomics' providing prompt notice to the plaintiffs if the Board considers changing its recommendation, regardless of its perceived inability to do so under the BGI merger agreement. The Court observed that unlike a target's contractual ability to terminate a merger agreement for a superior proposal, a Board's recommendation of a transaction involves fiduciary duties to target stockholders to communicate truthfully that cannot be contracted around.[22]

Treating the five day advance notice provision as an example of what the Court termed "potentially problematic" aspects of the change of recommendation provision in the BGI merger agreement, the Court noted that the existence of such a provision would not *per se* be a problem, but that if the provision were operative when there was, for instance, only three days left for a tender offer to close, there could be an issue.[23] The Court also noted as potentially problematic the fact that the change of recommendation provision keyed off of a customary "Superior Proposal" definition rather than a broader "Acquisition Proposal" definition, thereby restricting the Board from changing its recommendation to stockholders for a recapitalization or various other transactions that would not fall within the "Superior Proposal" definition.[24]

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[16] *Id.* at 16.

[17] *Id.* (citing *QVC Network, Inc. v. Paramount Commc'ns Inc.*, 635 A.2d 1245 (Del. Ch. 1993), *aff'd*, 637 A.2d 34 (Del. 1994)).

[18] The Court noted in its initial transcript ruling, that even if the plaintiffs had sustained the burden, the Court would still have denied the injunction in light of the absence of a topping bid because of the potential risk that the issuance of the injunction would give rise to BGI's right to terminate the merger agreement. The Court noted that under its reading, the injunction did not give rise to a termination right but that it did not want to take the risk that its reading was wrong. *Genomics I* at 17. The Court noted in its supplemental transcript ruling that the fact that a topping bid had emerged, while relevant to the balancing of equities, did not "alter the underlying fiduciary analysis", the principal basis supporting the Court's denial of the plaintiff's application to enjoin the merger agreement. *Genomics II* at 13.

[19] *Genomics I* at 17. The "limitations" to which the Court referred are (i) the provision of five business days' advance notice to BGI of the Board's intention to change its recommendation (which notice period would be renewed upon a material change to the intervening event or superior proposal that gave rise to the change of recommendation), (ii) the obligation to renegotiate the BGI merger agreement in good faith during the notice period to obviate the need for a Board change of recommendation and (iii) after taking into account the results of the renegotiations, a good faith determination by the Board, after consultation with its legal and financial advisors, that a failure to change its recommendation would reasonably be expected to breach the Genomics' directors' fiduciary duties to stockholders.

[20] *Genomics I* at 18 (citing *In re Compellent Techs., Inc. S'holder Litig.,* C.A. No. 6084-VCL, 2011 WL 6382523 (Del. Ch. Dec. 9, 2011)). In *Compellent*, Vice Chancellor Laster in *dicta* questioned the stockholders' ability to receive a current, candid and accurate board recommendation, given the four business day advance notice period contractually required once a board had determined to update its recommendation. *Compellent*, at *13.

[21] *Genomics I* at 5.

[22] *Id.* at 18.

[23] *Genomics II* at 24.

[24] *Id.* at 24-25.

Similarly, the Court denied the plaintiffs' request to enjoin the merger agreement's prohibition on Genomics' waiving or modifying standstills (including the Court-modified "Don't Ask, Don't Waive" standstill) in confidentiality agreements with other potential bidders, as no party to a standstill had requested such a waiver. And, as with the Board change of recommendation limitation, the Court conditioned its denial on Genomics' providing prompt notice to the plaintiffs if a bidder privately seeks release from a standstill provision.

D. Limited Disclosure Injunction Granted

Finally, the Court enjoined BGI from closing its tender offer until the earlier of (i) a post-trial decision on the merits or (ii) ten business days after Genomics issued curative public disclosure regarding the Genomics CEO's discussions of post-transaction employment with BGI and the disjunction between the Schedule 14D-9 description of the outside date provisions of the merger agreement and the actual outside date provisions of the merger agreement.[25]

Citing to *Atheros*,[26] the Court noted that discussions about post-transaction employment between the CEOs of Genomics and BGI were material and should have been disclosed to stockholders. The Court also observed that the merger agreement provisions relating to the outside date were sufficiently important to Genomics' stockholders as to warrant clarification.

Background to the *Ancestry* Dispute

In May 2012, the board of directors (the "Board") of Ancestry.com Inc. ("Ancestry")—a NASDAQ traded company—initiated a sale process/auction, after having received a number of private unsolicited expressions of interest earlier in the year. By June, at least 12 parties, comprising a mix of strategic and financial suitors, had entered into confidentiality agreements with Ancestry as a condition to receiving due diligence. All of those agreements contained "Don't Ask, Don't Waive" provisions.

Only the three highest bidders, which included Permira Advisors, LLC ("Permira"), the winning bidder, advanced to a second round of bidding. Citing problems uncovered during diligence, each finalist either lowered its initial bid or withdrew from the auction. Permira, however, indicated that it remained interested in a deal at $32 to $34 per share in cash, but only with participation from other equity sources of at least $100 million.

In October, Ancestry's largest shareholder—Spectrum Equity Investors ("Spectrum"), which held approximately 30% of Ancestry's shares and a right to designate two directors to the nine-member Board—offered to roll $100 million worth of its existing equity into the surviving company to facilitate Permira's offer for the remaining outstanding shares. Senior management made a similar offer of approximately $30 million. Relieved of the need to acquire 100% of Ancestry, Permira made a firm offer of $32 per share in cash; the final merger agreement and all ancillary documents were executed on October 21.

Following the public announcement of the Permira merger, several Ancestry public shareholders filed suit in the Delaware Court of Chancery alleging breach of the Ancestry directors' *Revlon* duties and seeking to enjoin the shareholder vote on the Permira merger scheduled for December 27. More specifically, the plaintiffs argued, among other things, that the "Don't Ask, Don't Waive" provisions impermissibly precluded the Board from being fully informed of possible superior offers.

On December 11, apparently in response to the litigation, Ancestry informed the non-winning bidders it was waiving the "Don't Ask, Don't Waive" provisions of their confidentiality agreements. The plaintiffs argued that the proximity to the shareholder vote made the December 11 waiver ineffective and that therefore their argument that the "Don't Ask, Don't Waive" provisions were preclusive continued to have force. The plaintiffs also argued that the Ancestry proxy statement to shareholders was materially incomplete for not disclosing the existence and import of the "Don't Ask, Don't Waive" provisions.

The Court of Chancery's *Ancestry* Opinion

[25] *Genomics I* at 21. Genomics provided the curative disclosure in an amendment to its Schedule 14D-9 on November 13, 2012. *See* supra note 4.

[26] *Genomics I* at 20 (citing *In re Atheros Commc'ns, Inc. S'holder Litig.,* C.A. No. 6124-VCN, 2011 WL 864928 (Del. Ch. May 12, 2011)).

Without reaching any conclusions with respect to the effect of "Don't Ask, Don't Waive" provisions in all cases, Chancellor Strine expressed disagreement with the seemingly categorical conclusion of the *Genomics* ruling, noting:

> Per se rulings where judges invalidate contractual provisions across the bar are exceedingly rare in Delaware, and they should be. . . . I know of no statute, I know of nothing, that says that ["Don't Ask, Don't Waive"] provisions are per se invalid. And I don't think there has been a prior ruling of the Court to that effect. I know people have read [the *Genomics* transcript ruling] that way. I think there was a lot going on in that case. Again, there is a role that bench opinions play, and I don't think it's to make per se rules.[27]

Chancellor Strine acknowledged that he could see how a "Don't Ask, Don't Waive" provision could serve a value-maximizing purpose by inducing potential bidders to put their highest bid forward or risk being shut out of the opportunity to top the winning bidder after a definitive agreement is reached.[28] The Chancellor emphasized, however, that if targets "are going to do something that's this potent, there is some responsibility to actually attend to it."[29] Recognizing that "there are a lot of dangers with this kind of tool, and it can't be just embedded in every deal in the marketplace,"[30] the Chancellor raised the question of whether winning bidders should, for example, be asking for—and targets should be prepared to give them—assignments of the right to enforce the restrictions against all of the non-winning bidders, if they are trying to establish that the provisions actually enhance value. In the circumstances of this case, however, where Permira did not request such an assignment and the Board did not immediately waive the restriction for all other bidders of its own accord, the Court found that "this [B]oard was not informed about the potency of this clause" and thereby probably violated its duty of care.[31] Because Ancestry eventually and voluntarily waived the restrictions, however, the mooted issue did not require additional injunctive relief and the finding effectively was dicta.

During oral argument, the Court also gave short shrift to the notion that there is any difference between a prohibition on a private request versus a public request for an opportunity to approach a target board, saying "[t]here is no such thing as [a] public/private" distinction[32] for a company that is subject to the federal securities laws.

Finally, the Court ruled that the proxy statement sent to shareholders impermissibly failed to disclose the import of the "Don't Ask, Don't Waive" provisions. Chancellor Strine found that these omissions "created the false impression that any of the [non-winning bidders] who signed the standstill could have made a superior proposal."[33] Reasoning that shareholders are entitled to know what "comfort they should take" from the absence of better offers based on bidders' "ability to make a superior proposal,"[34] the *Ancestry* Court enjoined the shareholder vote on the pending merger agreement until the company disclosed the effect of the "Don't Ask, Don't Waive" provisions and when those provisions were waived.

Take-Aways

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[27] *Ancestry* at 223-24. The *Ancestry* plaintiffs also relied on *dicta* in *In re Celera Corp. S'holder Litig.*, in which Vice Chancellor Parsons concluded in approving a class action settlement that the plaintiffs had "at least a colorable argument that ['Don't Ask, Don't Waive' standstills coupled with a no solicitation provision] collectively operate to ensure an informational vacuum." C.A. No. 6304-VCP, 2012 WL 1020471, at *21 (Del. Ch. Mar. 23, 2012), *aff'd in part and rev'd in part*, No. 212, 2012 (Del. Dec. 27, 2012). The *Celera* Court, however, also stated, "I do not find, either in the circumstances of this case or generally, that provisions expressly barring a restricted party from seeking a waiver of a standstill necessarily are unenforceable," *id.* at *22, a caveat that Chancellor Strine reiterated, *Ancestry* at 224 ("the Celera case expressly went out of its way to say it's not making a per se rule").

[28] Vice Chancellor Parsons made a similar observation in *Celera*: "Viewed in isolation, these Don't-Ask-Don't-Waive Standstills arguably foster legitimate objectives" by giving "'the corporation leverage to extract concessions.'" *Celera*, 2012 WL 1020471, at *21 (quoting *In re The Topps Co. S'holders Litig.*, 926 A.2d 58, 91 (Del. Ch. 2007)).

[29] *Ancestry* at 171.

[30] *Id.*

[31] *Id.* at 227.

[32] *Id.* at 69.

[33] *Id.* at 228.

[34] *Id.* at 230.

The *Genomics* and *Ancestry* decisions—which are bench rulings that Chancellor Strine stressed "are limited rulings," necessarily "time-pressured," and "shouldn't make broad law"[35]—provide the following insights into the Delaware courts' approach:

- Following *Ancestry*, "Don't Ask, Don't Waive" standstill provisions, in which a bidder is prohibited from seeking a waiver from standstill restrictions in order to make a competing offer, are not invalid per se under Delaware law; however, a board that utilizes such provisions must at a minimum be fully informed about the provisions' potent effects to support a claim that they were aimed at ensuring the highest bid from prospective bidders in the *Revlon* context. *Ancestry* and *Genomics* are not easy to reconcile but could be reconciled as follows: an inference from *Ancestry* is that if a board has used the "Don't Ask, Don't Waive" provisions properly, the duty of care does not require directors to be open to later approaches from participants who have had a full opportunity to bid their highest price in the sales process; short of such a proper utilization, *Genomics* suggests that the provisions impermissibly preclude the flow of information to a board that is charged with evaluating competing offers and making current recommendations to shareholders.

- In light of *Genomics* and *Ancestry*, "Don't Ask, Don't Waive" provisions are likely to engender greater scrutiny by the Court of Chancery of the facts and circumstances surrounding their use in any particular case. Because in practice the provisions usually are negotiated well in advance of any transaction without the oversight of the target board and before any decision necessarily has been made as to the type of auction, if any, the target is likely to engage in, sell-side practitioners will need to counsel boards during the sale process as to the import of "Don't Ask, Don't Waive" provisions.

- Because the Court of Chancery views "Don't Ask, Don't Waive" provisions as particularly "potent," parties to M&A transactions and their counsel should take care to ensure that the import and effect of "Don't Ask, Don't Waive" provisions are disclosed in proxy statements distributed to shareholders.

- By analogy to "force the vote" provisions that have been statutorily blessed, Delaware courts will respect merger agreements that do not contain a termination provision for superior proposals where the company has been shopped extensively prior to the target's entering into the agreement, even where the exclusivity could be a lengthy period (*i.e.*, six months).

- Delaware courts are unlikely to find "wrongful coercion" in the preliminary injunction context where stockholders have the right to maintain the status quo, even if the status quo alternative arguably could be worse as a result of the passage of time.

- As Vice Chancellor Laster previewed in *Compellent*, the now-familiar procedural provisions surrounding a change of Board recommendation provision in merger agreements likely will be subject to particular scrutiny from Delaware courts where they infringe on a director's duty to communicate with stockholders.
  - In particular, the *Genomics* Court previewed that an advance notice provision would not *per se* be problematic but that if it restricted a Board from timely changing its recommendation, *e.g.*, if the provision called for five days' advance notice and the tender offer was scheduled to close in three days, there could be an issue.
  - The Court also noted that a change of recommendation provision that keyed off of a customary "Superior Proposal" definition rather than a broader "Acquisition Proposal" definition, thereby restricting the Board from changing its recommendation to stockholders for a recapitalization or other transactions that would not fall under the "Superior Proposal" definition, also could be problematic in some circumstances.

- The *Genomics* Court's decision to conditionally deny the injunctions rather than to strike the change in recommendation and no waiver of standstill provisions of the merger agreement may signal a new approach by the Delaware courts—one that could be seized on by plaintiffs who may be emboldened to sue in order simply to ensure notice of future developments at the Board level with respect to a transaction.

[35] *Id.* at 222.

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