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How to Respond to Shareholder Proposals Seeking Board Declassification

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One of the more challenging situations that a public company can face today is to receive a non-binding shareholder proposal for board declassification. Such proposals, usually made by activist shareholders and supported by proxy advisory firms, present companies with a choice between being responsive to shareholders who demand greater accountability from directors[2] and a stronger voice in corporate affairs or maintaining the company's protection against unsolicited takeover bids.

Classified (or staggered) boards[3] have been the focus of many shareholder proposals in recent years,[4] in part, because the combination of a classified board and a shareholder rights plan creates a strong takeover defense.[5] Classified boards force acquirers to wage and win two separate proxy contests for the election of directors one year or more apart in order to gain control of a company's board.[6] Only after winning a majority of board seats in two separate elections can an acquirer rescind a company's shareholder rights

[1] The opinions expressed in this article are those of the authors and not necessarily those of Jones Day or any of its clients.

[2] See, *e.g.,* Glass Lewis, U.S. Proxy Paper Policy Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice for U.S. Companies (2010) (asserting that "staggered boards are less accountable to shareholders than annually elected boards.").

[3] Classified boards are comprised of directors divided into two or more, but typically three, separate classes, usually with each class having an equal or nearly equal number of directors. In contrast with unified boards in which directors are elected annually, only one class of directors of a classified board is elected each year. Classified boards are typically enabled by state corporate statutes and provisions for their existence usually appear in companies' charters, or less commonly, their by-laws. Effective staggered boards (*i.e.,* those which may not be circumvented): (a) are established in a company's charter (not by-laws, which are susceptible to amendment by shareholders), (b) may not be "packed" by shareholders through charter provisions that permit a shareholders to increase the number of board seats and fill the resulting vacancies and (c) have directors who are not vulnerable to removal as a result of state statutes or charter provisions that permit removal without cause.

[4] In 2009, 63 companies were subject to board declassification proposals. RiskMetrics Group Governance Group Flash Update, *U.S. Season Preview: Takeover Defenses* (March 1, 2010). In 2010, 37% of S&P 500 companies had a classified board, down from 63% in 2000. *Id.* Approximately half of all U.S. public companies, 52% of S&P 1500 companies and 63% of S&P 500 companies have unified boards. RiskMetrics Group, *RiskMetrics Group 2010 U.S. Governance Client Conference Powerpoint Presentation* (2010); *cf.* Erik Krusch, *Proxy Disclosure: Boards Stagger to Declassification*, Westlaw Business Center (March 4, 2010) ("[T]he overwhelming trend in corporate governance has been towards the declassification of boards . . .").

[5] Effective staggered boards almost double the odds of a target remaining independent in the face of a hostile tender or exchange offer. Lucian Arye Bebchuk, John C. Coates IV and Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 Stan. L. Rev. 887 (2002).

[6] Because charters and by-laws of public companies commonly prohibit shareholders from calling special meetings or acting by written consent, hostile acquirers are frequently forced to use proxy contests at a company's annual meeting to replace incumbent directors. Also, under many states' laws, unless a company's charter provides otherwise, directors on classified boards may be removed only for cause, a difficult and time-consuming undertaking, so removing a director through a shareholder vote usually is not practical alternative. *See, e.g.,* 8 Del. C. §141(k)(1); *cf. Rohe v. Reliance Training Network, Inc.*, 2000 WL 1038190, at *3, n. 6 (Del. Ch. July 21, 2000) (describing matters constituting "cause"); *cf.* John Mark Zeberkiewicz & Blake Rohrbacher, *Winning the Class Struggle: Acquirer Strategies for Declassifying Classified Boards*, *Corp. Gov. Advisor*, Jan/Feb 2008 (comparing declassification of boards that are classified through their certificates of incorporation and bylaws).

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plan, approve a merger, sell key assets or replace management. This delay deters hostile acquirers because it is costly to conduct a takeover battle over such a long time, creates uncertainty about whether the takeover will be successful, provides opportunities for other bidders to emerge and introduces a significant element of business risk as the target's operation of the business during the intervening period may reduce its value to the bidder. Institutional investors and shareholder activists also have targeted classified boards based on the argument that the classified board is a mechanism for entrenching management that depresses stock prices and deters potentially profitable takeovers.[7]

Recent declassification proposals have attracted strong shareholder support.[8] Consequently, how a company responds to a declassification proposal can have important repercussions not only on its ability to defend against a hostile bid, but for the company's shareholder relations, including the balance of power between its shareholders and the board.[9] Some boards are unprepared for the resulting drama that unfolds on the public stage. This article provides an overview of considerations for the board of a company that receives such a declassification proposal.

Obtain Information About the Proponent

After receiving a declassification proposal, a company should assess the nature and size of the proponent's shareholdings, as well as the proponent's level of sophistication, financial resources and objectives.[10] It may be advisable to speak with the proponent shortly after receiving the proposal to learn whether he or she is intent on declassification or would be willing to withdraw the proposal in exchange for a concession on another matter. Although such conversations are often fruitless, they do permit a company to better understand the shareholder proponent's concerns and many boards are be eager to understand the proponent's character, tenacity and motives.

Exclude the Proposal Under Rule 14a-8, if Possible

A company should consider whether it can exclude a proposal from its proxy under Rule 14a-8 of the Securities Exchange Act of 1934 (the "Exchange Act"), which sets forth the list of substantive and procedural bases on which such proposals can be excluded.[11] If the proposal otherwise satisfies the procedural requirements discussed below and the company intends to exclude the proposal for one of the substantive reasons, it must seek a no-action letter from the Securities and Exchange Commission no later than 80 calendar days before it files its definitive proxy statement.[12] In most cases, Rule 14a-8 will not provide a basis for excluding a declassification proposal because the majority of shareholder declassification proponents routinely make such proposals and are careful to comply with both the Rule's procedural and substantive requirements. Nevertheless, a company should carefully examine these requirements to determine whether there is a basis for exclusion.

Procedural Bases for Exclusion

The procedural requirements of Rule 14a-8 include, that, to be eligible to submit a proposal, a shareholder must (a) have continuously held at least $2,000 in market value or 1% of the company's securities

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[7] *See, e.g.,* Jolene Dugan, *ISS, 2007 Background Report: Classified Boards of Directors* (April 2007).

[8] The authors' review of declassification proposals in 2008, 2009 and the first quarter of 2010, revealed that declassification proposals received support from a majority of the shares cast approximately 81% of the time and, on average, 73% of shares voting voted in favor of such proposals.

[9] Some have argued that the central problem presented by a classified board is its restriction on the prerogative of shareholders to remove directors (a corporate governance matter relating to the dichotomy between "director primacy" and "shareholder primacy") and the irrevocable nature of classified boards, an issue that implicates the principle-agent relationship between shareholders and the board. *See, e.g.,* Rivka Weill, *Declassifying the Classified*, 31 Del. J. of Corp. L. 891, 899, 900, 906 (2006).

[10] In recent years, a small number of shareholder activists who hold shares in a large number of publicly traded companies have routinely submitted and have been responsible for a majority of all declassification proposals. One activist, Gerald R. Armstrong, was the proponent in 68 declassification proposals in 2008, 2009 and the first quarter of 2010 and accounted for 54% of all such proposals during that period. *Cf., Activist Profile: Gerald R. Armstrong*, August 12, 2008 at www.sharkrepellent.net/pub/rs)20080812.html.

[11] Shareholders typically do not have the authority under state law to submit a charter amendment directly to the shareholders for a vote. To avoid having a proposal excluded for violating state law, shareholder proponents submit precatory or nonbinding shareholder proposals that, if approved, simply recommend that the board take the necessary action to submit to the vote of the shareholders a charter amendment that declassifies the board. A company must include a precatory proposal that complies with Rule 14a-8 (and is not otherwise properly excluded) in its proxy statement at its own expense. If the proposal is approved by shareholders holding a majority of votes cast, it is considered by proxy advisory firms to have been approved even though the vote will not be binding on the company or the board. *See* Rule 14a-8 under the Exchange Act.

[12] Rule 14a-8(l) under the Exchange Act.

entitled to be voted on the proposal for at least one year by the date the proposal is submitted, (b) hold such securities through the date of the meeting, (c) provide the company with a written statement that the shareholder intends to hold such securities through the date of the meeting, (d) submit no more than one proposal to the company for any particular shareholders' meeting, (e) limit the proposal to 500 words, (f) have delivered the proposal to the company before the deadline for delivery of such proposals (usually not less 120 calendar days before the date on which the company's proxy statement was released to shareholders in connection with the previous year's annual meeting) and (g) appear either personally or through a representative at the shareholders' meeting to present the proposal.[13] Before excluding a proposal based on these procedural requirements, a company must notify the proponent of the deficiency (unless the deficiency cannot be cured) and provide the proponent with an opportunity to cure.[14]

Substantive Bases for Exclusion

If the proponent satisfies the procedural requirements, the Commission may agree to take no action against the company if it seeks no-action relief to exclude the proposal for substantive reasons. The most relevant substantive bases for excluding a precatory proposal are that (a) the company has already substantially implemented the proposal,[15] (b) the proposal duplicates a proposal previously submitted by another shareholder for the same meeting, or (c) the proposal is substantially the same as one previously submitted within the preceding five calendar years and such proposal received poor shareholder support.[16]

Evaluate Whether To Oppose Declassification Initially

If the proposal is incapable of being excluded for the reasons described above, the board should evaluate whether to take no action in response to the proposal, oppose the proposal or propose a declassification resolution and submit the matter to a shareholder vote at the upcoming annual shareholders' meeting.[17] Boards commonly seek to initially avoid declassification by including opposition statements in the first proxy statement that contains the declassification proposal and deferring further board action until the results of the initial shareholder vote are known.[18] Institutioinal Shareholder Services ("ISS") and other proxy advisory firms nearly always recommend that shareholders vote in favor of declassification proposals,[19] and while such proposals generally receive strong shareholder support, the effect of any such recommendations will be highly dependent on the constitution and identity of a company's shareholders.

As an initial matter, a board should take steps to understand the composition of its shareholder base and how its shareholders are likely to vote as this information can be critical to making an informed decision and developing a longer term strategy regarding board declassification. Together with its advisors, a company should consider whether to engage directly with shareholders regarding a declassification proposal. Regulation FD and the proxy rules restrict the ability of public companies to selectively disclose material non-public information or to solicit proxies and votes prior to the filing of a definitive proxy statement. Nevertheless, regular and open communication with shareholders, or the implementation of a carefully constructed shareholder engagement plan upon receipt of a declassification proposal, can provide a company with valuable information regarding the governance views of its shareholders in general and any resistance it might face in particular if the board opposes or continues to oppose board declassification.

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[13] Rule 14a-8 under the Exchange Act.

[14] A company desiring to exclude a proposal must follow the procedural requirements of Rule 14a-8(f) under the Exchange Act. The company will bear the burden of persuading the Commission that it is entitled to exclude a proposal. Rule 14a-8(g) under the Exchange Act.

[15] If both a company and a shareholder have advanced proposals to declassify a board, the Staff typically grants no-action relief for omitting the shareholder's proposal from the company's proxy because the shareholders' proposal will be deemed to be "substantially implemented" by the company. *See, e.g.,* SEC No-Action Letter re: MeadWestvaco Corporation (available Feb. 13, 2006) (the Staff granted relief to omit a shareholders' proposal where a shareholder proposed immediate declassification and the company proposed phased-in declassification).

[16] Rule 14a-8(i) under the Exchange Act.

[17] In the latter case, the company would need to negotiate with the shareholder proponent to have the proposal withdrawn or seek no-action relief from the Commission based on the fact that the proposal has been substantially implemented.

[18] The authors' review of declassification proposals in 2008, 2009 and the first quarter of 2010 revealed that in only 7% of the cases (nine instances), boards made no recommendations, and in 1.5% (two instances) of the cases, boards supported declassification proposals.

[19] Mutual funds usually vote in accordance with ISS recommendations. James Cotter, Alan Plamiter and Randall Thomas, *ISS Recommendations and Mutual Fund Voting on Proxy Proposals*, 55 Vill. L. Rev. 1, 2, 8 (2010) (finding that mutual funds tend to vote in line with ISS recommendations more often than do all shareholders and more often than with management recommendations, but conceding that there is some question about whether proxy advisory firms lead institutional voting or merely follow existing mutual fund voting attitudes).

Assess the Shareholder Vote and Determine the Company's Response

If a declassification proposal does not receive support from a majority of outstanding shares or, if the company's charter requires a supermajority vote for amendment (as is commonly the case for companies with classified boards) and vote falls far short of the number of votes that would be needed (if the vote was binding) to amend the charter, the board may elect to take no action and wait to see whether the proponent resubmits a declassification proposal at its next annual shareholders' meeting; the company may wish to use these results during the period following the vote but prior to the receipt of a subsequent shareholder proposal to canvas the views of its shareholders, to persuade its shareholders to support management's position or to simply demonstrate responsiveness and enhance support generally for management and the board.

In most cases, however, shareholders strongly back non-binding declassification proposals.[20] If a proposal receives the support of a majority of votes cast and the company's board does not submit a declassification proposal to a binding shareholder vote at the next annual meeting (or otherwise take steps to declassify the board), the proponent shareholder can be expected to re-submit the proposal in the next and subsequent proxy seasons.[21] Boards faced with such results typically decide to either take no action in response to the proposal or submit a resolution recommending that the company's shareholders vote at the next annual shareholders' meeting to declassify the board. A board's decision is often informed by (a) its assessment of whether proxy advisors will recommend "withhold votes" against the company's directors and the affect of such a vote, (b) its view of the shortcomings and merits of classified boards, (c) how the company's takeover defense posture would be affected by declassification, and (d) whether the company has plurality or majority voting for the election of directors or provides for cumulative voting. These considerations are discussed below.

Consider the Consequences of "Withhold Votes" and the Erosion of Shareholder Support

If a company's board fails to submit a proposal for declassification at the following annual shareholders' meeting, then one or more proxy advisors may recommend a "withhold vote" against the directors who opposed declassification. ISS' policy is to advocate withhold votes against an entire board (except for new nominees who are considered on a case-by-case basis), if the board fails to propose declassification following a shareholder proposal that receives approval by (a) a majority of the shares outstanding the previous year or (b) a majority of the votes cast for the previous two consecutive years.[22] Although some other proxy advisors for institutional investors do not issue withhold vote recommendations as a matter of policy, it is possible that they may nevertheless recommend withhold votes in a particular circumstance.[23]

If the company's directors are elected by plurality voting, "withhold votes" for any class of directors standing for election will not prohibit their reelection to the board and the board may simply consider whether their effect on shareholder relations weighs in favor of submitting its own proposal for declassification. However, a significant number of "withhold" votes could signify an erosion of shareholder support for the board and the company's management. If the company's directors are elected by majority voting, a "withhold" vote recommendation from proxy advisors could mean that the company's directors incur a significant risk of not receiving the votes necessary for their reelection at the company's next annual

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[20] *Supra,* note 8.

[21] For example, nine of the companies that reported majority support (based on either shares outstanding or shares cast) for a declassified board proposal in 2009 were the subject of a board declassification proposal for at least two consecutive years. A declassified board proposal appeared in the proxy statement of The Stanley Works every year from 2003 to 2009, Boston Properties Inc. every year from 2004 to 2009 and Pulte Homes Inc. and McGraw-Hill Companies every year from 2006 to 2009. In 2009, board declassification proposals for 35 companies received support of at least a majority of the votes cast. Georgeson, *2009 Annual Corporate Governance Review* (2009).

[22] Based on a sampling of ISS recommendation reports, ISS has followed this policy in all but one case in the 2008 and 2009 and the first quarter of the 2010 proxy seasons. One must question a monolithic "one-size-fits-all" approach to governance in light of recent empirical evidence that reflects that there is no consistent relationship between scores on governance indices and measures of corporate performance. Sanjai Bhagat, Brian Bolton and Roberta Romano, *The Promise and Peril of Corporate Governance Indices*, 108-8 Colum. L. Rev. 1803, 1857 (Dec. 2010) (concluding that, of all the measures of governance quality evaluated in one study, only directors' stock ownership was related to various performance measures, profitability and disciplinary management turnover as a result of poor performance).

[23] Fidelity's FMR Investment Proxy Research and Glass Lewis generally support proposals to repeal classified boards. While it is FMR's policy to vote in favor of incumbent and nominee directors except where they clearly appear to have failed to exercise reasonable judgment, FMR's policy does not specifically address withhold votes for directors based on their failure to act on a shareholder proposal that received majority support. Similarly, Glass Lewis & Co.'s general policy is to vote for the election of directors, but will recommend a withhold vote in a number of specific situations, none of which is failure to act on a shareholder proposal that received majority support in the past.

meeting.[24] This risk is frequently sufficient to induce a board to recommend that shareholders approve declassification.[25]

The board also should consider whether its failure to recommend declassification could induce its shareholders to reject upcoming board proposals on important compensation or operational matters, including proposals to increase the number of authorized shares, approve a stock incentive plan or issue shares in a merger, or, of less concern, cause shareholders to vote "no" on non-binding "say on pay" matters. In addition, the board should consider whether a hedge fund or other insurgent might take advantage of the resulting strained relations between shareholders and the board during the pendency of an unsolicited bid. Finally, the board should consider whether refusing to submit a declassification proposal will induce shareholders to nominate their own directors in a proxy contest.

Understand the Arguments For—and Against—Classified Boards

Opponents of classified boards typically support their position with the following arguments:[26]

- Directors serving on classified boards are less accountable to shareholders. Because classified boards protect the incumbency of current directors, the incumbency of current managers appointed by such directors is also protected.[27] Conversely, the annual election of directors allows shareholders to approve or disapprove of the performance of an individual director or the entire board every year, thus fostering greater accountability.
- Classified boards deter potentially attractive acquisition proposals. Some studies have concluded that because board classification deters potential acquirors, classification can lead to lower takeover premia in friendly acquisitions and lower shareholder value, both in the long and short term.[28]
- Although some more recent studies contest these conclusions,[29] and other studies have found significant association between classified boards and higher takeover premia. Institutional

[24] Under a majority voting standard, in an uncontested election, a director must receive a majority of the votes cast in his or her election to be elected. Non-votes and withhold votes are not counted in the election. In a contested election, plurality voting applies. A new director nominee will not be elected in an uncontested election if he or she does not receive the required majority vote. In the case of an incumbent director nominee, if the director does not receive the requisite vote for re-election, a "failed election" occurs, and the director would not be elected to a new term. The incumbent director would continue, however, to serve as a holdover director until his or her successor is elected and qualified. A majority voting standard is typically coupled with a resignation bylaw under which a holdover director would tender a conditional resignation for consideration by the board of directors. Accordingly, this approach ensures that even in a failed election, the board would have the ability to reject the holdover director's tendered resignation and allow that director to continue to serve as a holdover director. Activist shareholders generally support majority voting provisions because directors must actively receive a majority of the votes cast in their election every year, instead of just receiving more votes than other candidates for a seat. Activist shareholders have become increasingly willing to withhold votes for directors to influence the ultimate selection of a director or, at a minimum, to demonstrate displeasure with a board. For this reason, majority voting is more risky for incumbent directors and those nominated by a company than plurality voting.

[25] *See, e.g.,* John F. Olson et. al, *Excerpt from Recent Developments in Federal Securities Regulation of Corporate Finance as of August 30, 2004*, Practicing Law Institute (Nov. 2004) ("the pressure of majority votes on shareholder resolutions [to declassify] played a significant role in getting companies to [declassify in 2004].")

[26] *See generally,* Jolene Dugan, *supra,* note 7.

[27] *But see* Thomas W. Bates, David A. Becher and Michael L. Lemmon, *Board Classification and Managerial Entrenchment: Evidence from the Market for Corporate Control*, Journal of Financial Economics (2008) vol. 87, issue 3, pages 656-677 (citing empirical evidence that classified boards neither entrench managers in the context of a takeover nor facilitate management self-dealing in competing bids) (hereinafter "Bates, Becher and Lemmon").

[28] *Cf.* Lucian A. Bebchuk and Alma Cohen, *The Costs of Entrenched Boards*, J. of Fin. Econ. (Nov. 2005) (presenting evidence that staggered boards reduce firm value); Michael D. Frakes, *Classified Boards and Firm Value*, 32 Del. J. of Corp. Law 113 (2007) (finding evidence of a negative and statistically significant association between classified boards and company value); Morgan J. Rose, *Heterogeneous Impacts of Staggered Boards By Ownership Concentration*, J. Corp. Fin. (Feb. 2009) (concluding that staggered boards have no significant negative effect on market value in firms with a low probability of receiving an unsolicited bid, but are associated with decreases in value as the probability of a hostile bid increases); *but see* Seoungpil Ahn, Vidhan K. Goyal and Keshab Shresthat, *Differential Effects of Classified Boards on Firm Value*, preliminary draft (Apr. 2009) at http://www.business.smu.edu.sg/disciplines/finance/Research%20Seminars/papers/VidhanGoyal_27Apr09.pdf (concluding that classified boards increase firm value for firms that have low monitoring costs and high advising requirements).

[29] *See, e.g.,* Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 Stan. L. Rev. 845 (2002) (arguing that takeover defenses allow directors to provide extra-contractual benefits to executives and employees who in turn make extra-contractual contributions that benefit shareholders, and arguing that ex post costs of classified boards tell us little about whether takeover defenses are good or bad for target shareholders; ex ante costs and benefits must be considered also); Bates, Becher and Lemmon (concluding that the empirical evidence is inconsistent with the conventional wisdom that board classification is an anti-takeover device that facilitates managerial entrenchment).

investors and their advisors have continued to support board declassification and often view a board's failure to pursue declassification as a sign that the goals of the board are not aligned with those of shareholders.

Supporters of classified boards argue that such boards provide companies and their shareholders with several benefits[30] and they dispute some of the studies and empirical data cited in support of unified boards:[31]

- Classified boards offer stability and continuity to a company's board of directors and allow the board and management to focus on long-term shareholder interests.[32]
- Classified boards provide a degree of "institutional memory" that boosts shareholder value.
- Staggered boards are an important and effective takeover defense if paired with a poison pill and incentivize hostile acquirers to negotiate with the target's board.[33]
- Recent studies have concluded that board classification allows a company's managers to negotiate vigorously with acquirers, thereby increasing the incidence of multi-bid auctions, and resulting in a larger proportional distribution of total bid returns to target shareholders. This is consistent with studies, based on data from the 1990's that show that companies with poison pills receive higher stock price premia in takeovers.
- The evidence does not suggest that managers of companies with classified boards are more likely to engage in self-dealing in connection with takeovers, thus raising doubts about arguments that board classification generally insulates management from accountability.[34]

Evaluate the Company's Takeover Defenses

In considering how to respond to a proposal, a board should understand the effect of declassification on a company's takeover defenses. As discussed above, if the company has an effective classified board and a shareholder rights plan in place (or a "shelf pill" ready for implementation), then its defensive posture is formidable, but declassifying the board will significantly weaken its defenses generally regardless of other takeover defenses at its disposal.[35]

When assessing the company's post-declassification vulnerability, the board may consider, among other things, the takeover activity in the company's peer groups, the prospects, size and strength of the company relative to its competitors, the company's other takeover defenses, the number and nature of credible acquisition overtures the company has received in recent years and whether those overtures might have resulted in a proxy contest if the company had a unified board.

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[30] *See* generally, Richard H. Koppes, Lyle G. Ganske and Charles T. Haag, *Corporate Governance Out of Focus: The Debate Over Classified Boards*, 54 Bus. Law 1023 (1998-99);

[31] *See, e.g.,* John C. Wilcox, *Two Cheers for Staggered Boards*, Corporate Governance Advisor (Nov./Dec. 2002).

[32] By ensuring that the entire board of directors may not be replaced at a single shareholders' meeting, classification increases the stability of a company's leadership structure and discourages drastic changes based on overreactions to recent or one-time events and pandering to the needs of hedge funds and day-traders for short-term results at the expense of the company's long-term strategic objectives. *But see* Olubunmi Faleye, *Classified Boards, Firm Value and Managerial Entrenchment*, J. of Fin. Econ. (2006) (concluding that classified boards have no significant effect on board turnover, *i.e.,* do not promote board stability, and that classified boards significantly insulate management from market discipline, thus suggesting that the observed reduction in value is due to managerial entrenchment and diminished board accountability).

[33] *See* Bates, Becher and Lemmon at 673 (classified boards, the authors concluded, are effective in deterring hostile bids. Controlling for other factors, the authors concluded that a classified board statistically reduces the likelihood of a takeover bid by 1.0%, which the authors found to be statistically significant given that the average annual takeover bid rate is 3.6% for companies with classified boards. The authors demonstrate that, once a bid has been initiated, targets with classified and unified boards are about equally successful in remaining independent.)

[34] *Id.* (citing evidence that classified boards neither entrench managers in the context of a takeover nor facilitate management self-dealing in competing bids).

[35] Even if the company has other charter and by-law provisions typically characterized as takeover defenses (including, for example, blank check preferred stock, plurality voting in director elections, the board establishes the number of directors and fills vacancies, shareholders may remove directors only for cause, supermajority shareholder vote to remove directors, shareholders cannot call a special meeting, shareholders must provide advance notice of proposed business at shareholders' meetings, shareholders cannot act by written consent, locked-in charter and by-laws (amendment by supermajority shareholder vote), adoption of mergers by supermajority shareholder vote and provisions enabling share repurchases), unless the company can pair a shareholder rights plan with a classified board, such provisions are not likely to prevent a determined bidder from acquiring the company. At most, they will delay a takeover or make a takeover more costly and time-consuming for the acquirer.

Make Declassification Contingent on the Elimination of Cumulative Voting for Directors, if Applicable

When a company with cumulative voting for directors declassifies, it risks magnifying the voice of minority shareholders unless it simultaneously replaces cumulative voting with plurality voting for directors.[36] Under a cumulative voting scheme, shareholders vote a total number of shares equal to the number of their shares multiplied by the number of board seats to be filled, and shares may be aggregated and voted for one director or spread among numerous directors.[37] Thus, cumulative voting makes it easier for minority shareholders, whether individually or as a group, to elect one or more representatives to a board and makes a company considerably more vulnerable to shareholder activism and unsolicited bids.[38]

Declassification increases the number of directors up for election in any given year and therefore permits a minority shareholder to cumulate its votes in favor of one or more directors, effectively increasing the likelihood that a nominee it favors will be elected to the board. Consequently, when the boards of companies with cumulative voting for directors submit a declassification proposal to shareholders, the proposal is often paired with a proposal to eliminate cumulative voting.[39]

Further Thoughts

If a board decides not to declassify, it should be prepared to reassess its decision annually in response to future declassification proposals. Depending on its circumstances, a board may ultimately resolve to declassify when, in its judgment, the costs of maintaining a classified board outweighs the benefits. If the board decides to declassify,[40] it may declassify immediately so that upon the effectiveness of its charter amendment all directors are elected annually, or it may phase-in its declassification over a period of time (*i.e.,* each year, one class would be eliminated).[41]

Conclusion

As discussed above, boards that face a board declassification proposal can pursue a number of different alternatives, including supporting immediate declassification, opposing declassification both before and after a shareholder vote, and initially opposing a declassification proposal and later supporting the proposal if it receives strong shareholder support. The alternative selected by a board will depend on the facts and circumstances faced by the company, including, for example, the nature of the company's shareholder base, its vulnerability to a takeover, whether the company has majority voting for the election of directors and the board's willingness to endure potential withhold vote campaigns in subsequent elections. Many boards initially oppose declassification but, if shareholders approve declassification by a sufficient margin (which many boards assume will be the case), most such boards are willing to support declassification at the company's next annual shareholders' meeting. This approach ensures that the board will be classified for a year after the shareholder vote on the non-binding declassification proposal, and permits a board to be ultimately responsive to its shareholders.

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[36] Plurality voting is recognized as the safest option for incumbent directors and those nominated by a company because each director needs to receive just enough votes to defeat any challengers (even if such number is fewer than a majority of votes cast), and incumbent directors generally garner strong support from shareholders. In an uncontested election, a nominee needs to obtain only one vote to win the seat.

[37] Cumulative voting represents a significant weakness in a company's takeover defenses because it may facilitate the election of candidates nominated by an insurgent shareholder who, once elected, can exert influence over the remaining directors or generally disrupt the effective operation of the board.

[38] For example, if the company has nine board seats and directors are classified into two classes with three directors each and one class with four directors, in a year when a class of three directors stands for election, a shareholder or group of shareholders must hold more than 25% of the company's shares to ensure that such shareholder or group is able to elect one director to the board. By contrast, if the company had nine board seats and all directors are elected annually, then a shareholder or group of shareholders need only hold more than 10% of the company's shares to ensure that such shareholder or group would be able to elect one director to the board.

[39] *See, e.g.,* Definitive Proxy Statement on Schedule 14A of Qualcomm Inc., filed with the Commission on January 12, 2006 (coupling a declassification proposal with a proposal for plurality voting and making declassification contingent on the replacement of cumulative voting with plurality voting).

[40] *Cf.* Mira Ganor, *Why Do Managers Dismantle Staggered Boards?*, 33 Del. J. Corp. L. 149 (2008) (finding statistically significant evidence that the likelihood of destaggering increases due to precatory shareholder declassification proposals and the number of unvested options held by a company's CEO).

[41] *See* John Mark Zeberkiewicz and Blake Rohrbacher, *Destaggering with Class: A Plan for Potential Targets in Troubled Times*, Deal Lawyers (Nov.-Dec. 2009) (describing a method for declassifying over time so that the incremental takeover protection of a staggered board is preserved for the maximum period possible).

The ABCs of Board De-Staggering

By Jim Honaker of Morris, Nichols, Arsht & Tunnell LLP[1]

Stockholder activists continue to urge public company boards of directors to eliminate their three-class staggered structures. To date, these efforts have been fairly successful. Currently, 146 of the companies on the S&P 500 have staggered boards.[2] This is down from 300 companies ten years ago. But, the struggle over de-staggering is far from over. Each proxy season brings a wave of Rule 14a-8 proposals targeting new companies and urging their boards to de-stagger. In the 2010 proxy season, sixty-three companies received proposals urging boards to de-stagger.[3] This article briefly outlines what company counsel of a Delaware corporation might think about in deciding whether, and how, to eliminate the staggered board.

The Basics—In a typical staggered board structure, directors are elected to one of three classes. Directors serve three-year terms, and only one class faces election each year. So, at a given annual meeting, stockholders may elect only one-third of the board, and typically stockholders would need to participate in two successive annual meetings to elect a new majority of the board.

For Delaware corporations, the staggered board appears either in the company's certificate of incorporation (or "charter") or in its initial bylaws or in a bylaw adopted by the stockholders.[4] There is an additional governance feature that goes hand-in-hand with the staggered board: the Delaware General Corporation Law (the "DGCL") provides that directors serving on a staggered board are removable only for cause unless the charter provides for removal without cause.[5] Directors serving on a non-staggered board are removable with or without cause.

Rule 14a-8 Proposals Often Catalyst—In many instances, a company will place a de-stagger proposal on its board's agenda because the company recently received a precatory Rule 14a-8 proposal from a stockholder urging the board to de-stagger. If the proposal is approved by a majority of the stock outstanding, or if two de-stagger proposals are approved by a majority of the votes cast at two prior annual meetings, then there is a significant risk that ISS (and perhaps other proxy advisory firms) will recommend a "withhold" or "against" vote for directors in the next annual meeting cycle if the board "fails to act" on the proposal.[6] A "failure to act" in this context usually means that the board risks a withhold or against recommendation if the board does not take action to de-stagger the board.

Actions Required to De-Stagger—If the company's staggered board is provided in its charter, then under Delaware law action to de-stagger will require a charter amendment. Charter amendments must be (i) declared advisable by the board and (ii) approved by the stockholders.[7] The required "advisability" declaration by the board means that the board may not initiate a process to de-stagger unless it makes its own independent determination that de-staggering is in the best interests of the corporation and all of its stockholders. The board should not just defer to the views of stockholders who passed the Rule 14a-8 precatory proposal. Under Delaware law, the board is obligated to do what it thinks is best for the corporation, even if the stockholders disagree with the board's decision. The board should weigh the benefits and costs of retaining the staggered board.

Governance Benefits of Retaining a Staggered Board—A staggered board fosters director independence. When directors are elected to three-year terms, they are arguably provided breathing room to oversee the management of the company. A director may feel less pressure to conform to the wishes of manage-

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[1] The views expressed in this article belong only to the author, and do not necessarily represent the views of his firm or its clients.

[2] See www.sharkrepellant.net.

[3] *Id.*

[4] 8 Del. C. § 141(d). Because most staggered board provisions appear in the charter, this article does not discuss companies that are staggered only through a bylaw provision.

[5] 8 Del. C. § 141(k)(1).

[6] Institutional Shareholder Services Inc., 2011 U.S. Proxy Voting Guidelines Summary 13 (Dec. 16, 2010).

[7] 8 Del. C. § 242(b)(1).

ment and other directors if the director is not subject to reconsideration each year. Staggered boards also provide for continuity in management and promote director experience because, at any one time, at least two-thirds of the board will possess more than one year's experience as a director.

Takeover Defense Benefits—The staggered board plays a central role in a takeover situation because the principal takeover defenses available to a corporation, *i.e.,* a "poison pill" stockholder rights plan and protective statutes (such as Delaware's Section 203 business combination statute), are much less effective if an acquiror can gain control of the board at a single annual meeting.[9] These devices are potent defenses to a takeover offer: they can provide a corporation with significant leverage in negotiating better terms with a hostile acquiror and can provide time to search for alternative transactions. However, these devices can be eliminated if a majority of the directors are replaced with pro-acquisition nominees who will terminate the rights plan and waive the Section 203 restrictions. Because the staggered board forces a would-be acquiror to participate in two annual meetings to elect a pro-acquisition majority, the board can more effectively respond to the takeover offer.

Director Accountability Issues—Some institutional investors and other governance commentators contend staggered boards are disadvantageous because they reduce director accountability to stockholders. Directors who face the stockholder electorate each year, under this reasoning, may be more responsive to stockholder wishes and concerns.[10] Of course, responsiveness to stockholders can be a good thing or bad thing, depending on your perspective (e.g., a stockholder majority may have special interests or short-term goals that are not shared by all stockholders).

Practical Disadvantages of Retaining a Staggered Board—The board may also want to consider the negative consequences that might arise from not de-staggering. The company risks drawing the ire of activist stockholders and the negative publicity and distraction from managing the company that can accompany a "withhold" or "against" recommendation directed at director nominees at future stockholder meetings.

Implementing a De-Stagger Amendment—If the board decides that de-staggering is advisable, there are a few transition issues to consider. Unfortunately, the Delaware statute does not provide express mechanics for eliminating the staggered board. However, a practice has developed for taking the board from a staggered structure to an annual election structure.

Four Transition Methods—There are generally four alternative methods for transitioning to a non-staggered board. Each of them differs slightly depending on when the company stops electing directors to three-year terms and whether the company wants directors to resign from their current three-year terms so they are subject to annual election sooner. Assuming a corporation wants to adopt a charter amendment at its 2011 annual meeting to de-stagger, here are what the options look like:

1. Three-Year Phase Out—Under this approach, director nominees of the class standing for election at the 2011 annual meeting would be the last class of directors elected to three-year terms. The charter amendment would provide that, at each annual meeting on and after the 2011 annual meeting, directors would be elected to one-year terms as the incumbents' three-year terms expire. To avoid ambiguity, the charter amendment would specify that directors elected before 2011 serve out their three-year terms. With this approach, the de-stagger amendment is filed in Delaware (and becomes effective) after the conclusion of the 2011 annual meeting.

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[8] *See e.g.,* R. Koppes, L. Ganske and C. Haag, *Corporate Governance Out of Focus: The Debate Over Classified Boards,* 54 Bus. Law. 1023, 1052 (May 1999); J. Wilcox, *"Two Cheers for Staggered Boards,"* Corporate Governance Advisor, Vol. 10, No. 6 (Nov./Dec. 2002).

[9] A stockholder rights plan effectively prevents an acquiror from buying over a threshold amount of stock (typically 15%) without board approval by providing that, if the threshold is crossed, stockholders other than the acquiror have the right to buy common stock at half the market price. The rights plan would dilute the acquiror's interest in the company. Section 203 of the DGCL provides that, unless certain narrow exceptions are satisfied, if an acquiror buys 15% or more of the company's stock without prior board approval, then it cannot effect certain broadly defined "business combinations" with the company (including mergers) for a three-year period without getting approval from two-thirds of the stock that the 15%-or-more stockholder does not own.

[10] Academics have debated whether a staggered board has a negative effect on stockholder value. For a recent study, see M. Murphy, Attacking the *Classified Board of Directors: Shaky Foundations for Shareholder Zeal,* 65 Bus. Law. 441 (Feb. 2010).

2. Two-Year Phase Out—Under this approach, the director nominees of the class standing for election at the 2011 annual meeting would be elected to one-year terms, but the directors in the two remaining classes would serve out the remainder of their three-year terms until the 2012 and 2013 meetings, respectively. The charter amendment would provide that directors elected at and after the 2011 annual meeting serve for one-year terms. As with alternative 1, the charter amendment would typically specify that directors elected before 2011 serve out the remainder of their three-year terms. The amendment would probably need to be approved as the first item of business at the 2011 annual meeting and would be filed in Delaware during the annual meeting so that it is effective before directors are elected to one-year terms at the meeting.

3. One-Year Phase Out—Under this approach, all directors will be subject to election for one-year terms beginning at the 2012 annual meeting. As with alternative 1, the charter amendment would provide that directors elected at and after the 2012 annual meeting serve for one-year terms to replace directors serving out current three-year terms. If adopted by stockholders, the amendment would be filed and become effective shortly after the conclusion of the 2011 meeting. Incumbent directors would be asked to resign from their three-year terms, effective at the 2012 annual meeting.[11]

4. Immediate De-Stagger—Under this approach, all directors would face election for one-year terms at the 2011 annual meeting. The charter amendment would provide for the election of directors to one-year terms at and after the 2011 annual meeting. The amendment would probably need to be approved as the first item of business at the 2011 annual meeting and would be filed in Delaware during the annual meeting so that it is effective before directors are elected at the meeting. Incumbent directors would be asked to resign from their current three-year terms, effective at the beginning of the 2011 annual meeting.

Removal Issues—If the board opts for a transition that does not involve an immediate de-stagger, it should also consider how director removal should work during the transition period. As noted above, directors serving on a staggered board are removable only for cause unless the charter provides otherwise. Section 141(k) of the DGCL provides that directors can be removable only for cause, but only if the board is "classified" as provided in Section 141(d) (*i.e.,* the provision providing for a staggered board). In other words, if the board is not "classified" as provided in Section 141(d), then directors are removable without cause.

Unfortunately, Section 141(d) does not expressly provide for transitions to a de-staggered board, so the interplay between Sections 141(d) and 141(k) is not clear in the transition period. To try to preserve removal only for cause, the charter amendment should expressly specify who is removable only for cause and should include language attempting to clarify that directors remain divided into classes during the transition period. Alternatively, if the board wants all directors to be removable without cause from and after the adoption of the charter amendment, the charter should expressly provide for that rule.[12]

[11] With this alternative 3, and alternative 4, the charter amendment would also typically provide that stockholders can elect directors to fill vacancies (or alternatively that stockholders can fill vacancies if permitted by the board) and that directors who fill vacancies serve for one-year terms in office. This provision would clarify that, when directors resign from their three-year terms, they can stand for election for one-year terms to fill the vacant seats on the board created by their own resignations.

Alternatives 3 and 4 also rely on director resignations from current three-year terms. If directors are not willing to resign, it is possible to provide for stockholder action to remove directors from their current three-year terms in connection with de-staggering the board. See the discussion below. However, in practice, de-stagger proposals are typically supported by the entire board.

[12] There is Delaware case law holding that, even though a director is elected to a staggered term when removal is permitted only for cause, that director can be removed without cause if, after his election, the staggered board provision is eliminated and the charter expressly provides for removal of all directors without cause. *See Roven v. Cotter,* 547 A.2d 603 (Del. Ch. 1988).

Acquiring U.S. Companies with Foreign Subsidiaries: Relevant Issues

By Michelle Gourley and Bill DuFour of Foley & Lardner LLP *

As the mergers and acquisitions market continues to gain force following the downturn experienced in 2008 and 2009, more and more companies are engaging in foreign investment as a means to expand operations, take advantage of lower labor and materials costs, and otherwise enter foreign markets through the acquisition of United States targets with existing foreign operations. Whether the objective for such an acquisition is horizontal or vertical integration, market extension, diversification or establishment of economies of scale, the success of a potential acquisition depends in large part on the acquirer's knowledge of the limits placed on the foreign operations by local governments. Such knowledge can help an acquirer embrace existing foreign operations and minimize future exposure to traps for the unwary.

This article seeks to explore some of the more relevant issues found in transactions involving the direct and indirect acquisition of foreign operations. While the majority of examples set forth herein will focus primarily on targets with India- and China-based operations, the overarching issues should provide the reader with a guide to asking the right questions to ensure a successful transaction and post-closing transition.

Appropriateness of an Acquisition

The first question to ask when considering an acquisition of a foreign subsidiary as part of a larger United States-based transaction is whether an acquisition is the best vehicle to achieve the desired goals of the prospective acquirer. An early breakpoint in considering an acquisition is evaluating whether a joint venture or a contractual arrangement for services may be more appropriate with the foreign subsidiary.

While a detailed evaluation of the merits of joint ventures and other types of contractual arrangements is beyond the scope of this article, a prospective acquirer should consider a joint venture or other contractual arrangement for services in the following circumstances: (1) when the acquirer only desires specific assets of the foreign subsidiary and such assets are difficult to separate, (2) when a full acquisition of the foreign subsidiary will impose significant management costs on the acquirer, (3) when valuation is difficult, or (4) when legal or regulatory constraints make an acquisition difficult. However, joint ventures and other contractual arrangements have countervailing issues, such as agreeing on control and management of the joint venture company, the costs for the services provided, oversight of the services and protecting confidential information and intellectual property. Nonetheless, the evaluation of the benefits and obstacles of effectuating an acquisition should be first on the prospective acquirer's checklist.

Structure

The three basic ways to structure an acquisition in the United States—stock purchase, asset purchase and merger—are generally available as options to structure international acquisitions as well. However, some governmental regimes provide for additional structures that may provide the acquirer with a broader range of options in obtaining the desired outcome of the transaction, such as the "business purchase" in India described below.

Traditionally, offshore holding companies have been the norm for foreign investment, particularly for investment in emerging markets countries due to the existence of favorable treaties between the jurisdiction of the offshore vehicle and the jurisdiction of the foreign target. For example, Mauritius, Qatar, Barbados and Hong Kong are often used as the offshore vehicles for carrying out business in India and China. However, as further discussed in the section entitled "Tax" below, the holding company route is, in certain instances, no longer a viable way to carry out the goals of a transaction while avoiding taxation in India or China. Thus, today, increased importance is placed on the structure of an acquisition.

Given India's regulatory framework, there are clear benefits and obstacles to each type of acquisition structure. For example, merging two companies by following the procedure under the Companies Act, 1956, as amended, can save capital gains tax that may otherwise be applicable in an asset or share acquisition deal.[1] However, the required court procedure to effectuate such a merger can be protracted and requires compliance with a number of procedural formalities.

[1] *See generally* Companies Act, 1956, as amended from time to time.

Alternatively, although a share purchase transaction can be completed fairly quickly, it requires a much deeper level of due diligence because, as in a transaction governed by United States laws, the purchaser of the shares inherits all liabilities of the acquired company. Also, while post-closing corporate clean-up is an accepted practice in the United States and can generally be carried out by ratification, in India certain issues such as the proper issuance of stock may require the approval of regulatory bodies and a lack of compliance carries significant penalties and may even prevent the effectiveness of the transaction. As such, it is imperative to require the seller to resolve all company compliance matters before closing. Further, an acquisition of a listed company can trigger the Securities Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (the "Takeover Regulations"), in which case the Takeover Regulations have to be followed and an open offer has to be made to at least 20% of a target company's existing shareholders.

An asset purchase transaction is also an option and may be the easiest type of transaction to close. However, it attracts capital gains tax and value-added tax on the asset based on the value attached to each asset by the parties. Indian law, however, provides an acquirer with an additional structure option that does not have an analogous concept under United States laws: a "business purchase." A business purchase permits the acquirer to purchase the existing business of a target without acquiring the corporate body holding the business. The purchase must be made for a lump sum consideration without attributing or placing specific values on the underlying assets of the business. The acquirer is permitted to exclude assets and liabilities as would be the standard practice under an asset purchase, but without incurring the capital gains tax and value-added tax payable under the asset purchase model.

In comparison, the acquisition of a business in China is a relatively new prospect for most United States companies.[2] In general, the structure of an acquisition in China is primarily driven by the Chinese government's classification of the type of business being acquired, as further discussed in the section entitled "Investment Controls" below. The two most common types of investment vehicles used to structure deals are joint ventures and wholly foreign-owned enterprises ("WFOEs").[3] Furthermore, the choice of business arrangement has different results regarding control of the business and choice of law and forum, as further discussed in the section entitled "Choice of Law" below. United States companies typically choose to establish a WFOE to have maximum control in hiring employees and dictating company policy, while enjoying limited liability.[4]

In the end, the proper vehicle for an acquisition of a foreign target in any country ultimately will depend on the goals of the acquirer and the evaluation of the benefits and obstacles of the acquisition structures, with the key considerations being timing, taxes and regulatory constraints.

Taxes

The boom in cross-border mergers and acquisitions has given new urgency to understanding and managing the complex tax consequences of international expansion. There are very few globally accepted norms regarding tax law legislation. A critical aspect of any merger or acquisition is structuring the transaction to take advantage of the most tax-efficient structure.

For example, it has been the practice of foreign investors who buy or invest in Indian companies to do so through offshore entities to prevent the imposition of capital gains taxes by the Indian government. However, in September 2010, the Bombay High Court held that Indian Income Tax Department had jurisdiction to seek capital gains tax on a transaction through which a non-Indian buyer purchased a 100% share interest in a non-Indian company which in turn directly and indirectly owned a 67% share interest

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[2] *See* James M. Zimmerman, China Law Deskbook: A Legal Guide for Foreign-Invested Enterprise 81 (2d ed. 2004) (noting that 1980s regulations limited the types of direct investments businesses could undertake in China, but today China has relaxed some standards to make a wholly foreign-owned enterprise more common).

[3] *See* Jie Chen, *Guide to Establishing a Subsidiary in China*, The Licensing Journal, Nov.-Dec. 2005, at 8. Other business arrangement options include the following: Representative Office (RO), Joint Stock Company/Company Limited by Shares, China Holding Company and Regional Headquarters Company.

[4] *See* Chen, *supra* note 3, at 7 (asserting that choosing a WFOE model for investment in China is becoming more popular as foreign companies become comfortable with doing business in China, and China becomes comfortable with allowing foreign businesses in); *see also* Zimmerman, *supra* note 2, at 79 (noting that after China's accession to the WTO, United States companies have greater flexibility and meet less resistance when setting up WFOEs, leading to the WFOE being the preferred entity of foreign investors).

in an Indian company.[5] Commonly known as the *"Vodafone"* ruling, if the ruling is upheld following a February 2011 hearing, Vodafone Group Plc. may owe the Indian government as much as $2.6 billion in taxes and foreign investors may have to start carrying out their business under a whole new regime.

Under Section 195 of the Indian Income Tax Act, 1961, as amended, where the sale of a capital asset is subject to tax in India, the buyer generally is required to withhold the tax from the purchase price. The jurisdiction of India's Income Tax Department to tax any non-resident is predicated upon the existence of a nexus between that party and India.[6] The nexus is established if the party to be taxed (i.e., the seller) has a physical presence in India or if the source of the taxable income originates in India. More specifically, tax may be imposed on income which: (1) is received in India, (2) accrues in India, or (3) is deemed to accrue or arise in India.[7]

In *Vodafone,* Indian tax authorities took the position that Vodafone should have withheld capital gains taxes from the purchase price it paid to the seller because the assets sold were based in India. Vodafone contended that it does not owe any tax on the transaction because the transaction took place outside of India, between non-Indian entities.

On September 8, 2010, the Bombay High Court held that the transaction between Vodafone and the seller had "sufficient territorial nexus to India"[8] to require a withholding of Indian capital gains tax. The court held that such nexus was established by the acquired entity's share interest and associated rights in the Indian company, which had assets in India. Thus, proceeds of the share sale were deemed to arise in India.

If the ruling is upheld, the India Supreme Court will establish a strong precedent that curbs the use of offshore tax havens to shield income derived from transactions with a "nexus" from taxation. The precedent could extend to transactions with an India "component," at which point additional questions will arise as to (1) the amount of the purchase price that will be subject to taxation in India (i.e., the full purchase price or only the portion allocated to the India component) and (2) the extent of the reach of India's Income Tax Department with respect to "related" transactions (i.e., concurrent transactions involving a foreign parent and the India entity or assets). Until the *Vodafone* ruling is final, acquirers should ensure that the governing purchase agreement includes, at a minimum, indemnity coverage for a determination by any governmental entity that additional amounts were required to be deducted or withheld from any consideration paid or otherwise delivered by the buyer pursuant to the agreement under applicable tax laws.

India is not the only country trying to curb the use of structures that shield transactions from taxation. For example, China recently issued a similar rule as that proclaimed in *Vodafone:* the sale of a stake in a Chinese company by offshore entities is generally taxable in China unless the transaction is a sale of shares traded on a public stock exchange.[9] In China, the most heavily-affected type of transaction that is subject to the new reporting obligation is the transfer of an offshore special purpose entity ("SPE") that holds a single Chinese subsidiary. Such SPEs normally lack substance, and generally seek to achieve two tax advantages: (1) to reduce withholding taxes on dividends paid by the Chinese subsidiary by taking advantage of a suitable tax treaty, and (2) to avoid capital gains tax on exit by transferring the SPE instead of the Chinese subsidiary.[10]

Investment Controls

Foreign investment has become a matter of necessity for developing countries in the world. Thus, laws friendly to foreign investment are likewise a necessity. However, there are limits to the "friendliness" of

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[5] *Vodafone International Holdings B.V. v. Union of India and Anr.*, Writ Petition No. 1325 of 2010, The High Court of Judicature at Bombay O.O.C.J.

[6] *Id.* at 91.

[7] *Id.* at 182.

[8] *Id.* at 36.

[9] *Notice of the State Administration of Taxation on Strengthening the Administration of Enterprise Income Tax on Income From Transfers of Equity Interests by Non-resident Enterprises*, Guoshuihan [2009] No. 698, dated 10 December 2009 ("Notice 698"). Notice 698 establishes that China may tax a foreign company that "indirectly" transfers an equity interest in a subsidiary in China. An indirect transfer occurs when a foreign company transfers the shares of a subsidiary outside China that in turn holds a subsidiary in China.

[10] *See Notice on Issues Relevant to the Implementation of Dividend Provisions in Tax Treaties*, Guoshuihan [2009] No. 81, dated 20 February 2009 (addressing the first tax avoidance purpose); *see also* Notice 698 (addressing the second tax avoidance purpose).

such laws. Accordingly, in cross-border acquisitions, it is vital to be aware of and comply with the government's foreign investment regulations.

For example, in 1991, the Indian Government amended its Industrial Policy, whereby many industrial sectors were opened to investment.[11] Since then, India has continued to move forward; today, foreign corporations are allowed to incorporate wholly-owned subsidiaries in many sectors in India. Although significant controls have been removed and foreign companies can freely acquire Indian companies across most sectors, acquisitions are subject to strict pricing and reporting requirements imposed by the Reserve Bank of India, the country's central bank.[12] Furthermore, various industry sectors in India—such as telecommunications, banking, insurance, aviation, and defense—are restricted to foreign investment, and compliance with sector-specific guidelines is imperative. The Vodafone deal is a classic example of the importance of complying with foreign investment regulations and obtaining the requisite government approvals from the outset as well as identifying potential contingencies in the transaction due to governing law principles. Otherwise, foreign investors run a high risk of post-closing scrutiny, which may last for years such as in the case of Vodafone.

For foreign companies seeking to invest in businesses in China, the threshold investment consideration is the classification of the business activity that the foreign investor wishes to engage in, as classified under the current version of the Catalogue of Industries for Guiding Foreign Investment (Revised) (the "Catalogue").[13] The Catalogue classifies businesses into the following four categories: (1) prohibited, (2) restricted, (3) permitted, or (4) encouraged. Once the business is classified, certain structuring parameters come to the fore. For example, the "Internet" and "telecommunications" business sectors are classified as "prohibited," which means that foreign investors are prohibited from owning equity in or running a "telecommunications" or "Internet" business in China. If a business falls within the "restricted" category, then the foreign investor must enter into a joint venture with a domestic Chinese partner. Businesses classified as "permitted" may be 100% owned by foreign investors. Similar to permitted businesses, "encouraged" businesses also may be 100% owned by foreign investors and, additionally, are given preferential treatment, which may include tax and other financial incentives.

Since the Catalogue was first introduced in 1995, Chinese policymakers have revised it several times to harness foreign investment to help China meet its evolving policy goals. Foreign investors will want to study the Catalogue, not just to see how their investment plans may be affected, but also to align future investment strategies more closely with China's development goals. Such revisions may seem like a zero-sum proposition to investors, *i.e.,* some industry sectors will see more support and openness, while other sectors will find ownership or other restrictions on new investments. Thus, it is important to note that the Catalogue likely will be subject to future revisions and prospective investors must be mindful of such revisions.

Employee Benefits

In the thirty-seven years since the passage of the Employee Retirement Income Security Act of 1974 ("ERISA"),[14] greater attention has been placed on the existence and treatment of employee benefit plans in corporate mergers and acquisitions in the United States. Employee benefit plans and employee benefits, in general, may be the source of significant off-balance sheet liabilities that must be addressed in negotiating and structuring a transaction.

Concerns regarding employee benefits are not limited to domestic transactions. For example, in India there are several employment laws that regulate the employer-employee relationship and the benefits accruing to employees under such laws must be addressed in transactions involving an Indian target. With respect to the acquisition of an Indian company, it is important to note that there are no specific

[11] *See generally* Industrial Policy Statement of 1991, *available at*: http://siadipp.nic.in/publicat/nip0791.htm.

[12] *See* Nishith Desai Associates, *Mergers & Acquisitions in India* 24 (2010), *available at*: http://www.nishithdesai.com/.

[13] *See* Catalogue of Industries for Guiding Foreign Investment (Revised) (2007), *available at*: http://www.fdi.gov.cn/index.htm.

[14] Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406.

provisions relating to termination benefits under the applicable employment laws.[15] However, the retention of employees following the closing of the transaction may be strongly impacted depending on how the acquirer treats the employee benefits. The acquirer should expect to address concerns regarding the continuation of existing employee benefits and the contribution levels to the various funds summarized below, among others, with the employees that will remain with the acquirer following the closing of the transaction. Additionally, while not extensively discussed below, the failure by an employer to comply, whether prior to or following the closing of the transaction, with the employee benefits regime established by the Indian government, may result in the imposition of fees and penalties on the employer and as such, requires sufficient diligence on the part of the acquirer to assess the potential liability that it will assume in connection with the proposed transaction.

This section is meant to provide perspective regarding the different benefits that may be available under the laws of India. The following is a general overview of the primary statutory benefits required to be given by a company in India to its employees:

<u>Provident Fund</u>—The Employees' Provident Fund and Miscellaneous Provisions Act, 1952 (the "EPF Act"), as amended, is the Indian equivalent of Social Security in the United States. The benefit provided under the EPF Act has three pillars: (1) an in-service death benefit element, (2) a life pension element, and (3) a savings element available as a lump sum at the time of exit. The EPF Act is applicable to all establishments that employ a minimum of 20 persons.[16] All employers subject to the EPF Act are required to contribute a sum equal to 12% of the aggregate of each employee's basic wages, dearness allowance[17] (including the cash value of any food concession) and retaining allowance, if any, to the provident fund, and the employee has to contribute an equal amount.[18] However, an employee may opt out of the provident fund scheme if she is earning more than Rs. 6,500 per month (or approximately US$143.05).[19]

If an employer maintains an Employees' Provident Fund ("EPF") account, the employee will be entitled to withdraw the full amount standing to her credit in such EPF account, upon termination of her services.[20] However, upon termination, if the employee intimates to the employer that she will obtain re-employment at another establishment to which the EPF Act applies, then the employer may arrange to transfer her EPF account credit amount to such establishment, if the employee desires to do so and if the rules of the new employer's EPF permit such transfer.[21]

<u>Payment of Gratuity Act</u>—The Payment of Gratuity Act, 1972 (the "Gratuity Act"), as amended, provides a scale for the payment of gratuity to employees upon their exit from employment. The Gratuity Act requires employers with more than 10 employees to pay a gratuity benefit to employees who have five or more years of continuous service at the time they leave employment.[22] The minimum benefit statutorily required is calculated as follows: for every completed year of service or part thereof in excess of six months, the employer has to pay gratuity to an employee at the rate of 15 days' wages based on the

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[15] The Industrial Disputes Act, 1947, provides for retrenchment compensation, but may not apply to all employees. In addition, the Karnataka Shops and Commercial Establishments Act, 1961, provides that if an employee is terminated before she avails of any leave she is entitled to, the employer will be under an obligation to pay her for the unavailed leave at the rate of the daily average of such employee's wages.

[16] Section 1(3)(a) of the EPF Act.

[17] A dearness allowance is a pay increase to meet a rise in the cost of living.

[18] Section 6 of the EPF Act. *See also* Employees' Provident Funds Scheme, 1952.

[19] Section 2(f)(ii) of the Employees' Provident Fund Scheme, 1952.

[20] *See* Employees' Provident Funds Scheme, 1952.

[21] Section 17-A of the EPF Act.

[22] Section 4(1) of the Gratuity Act. The completion of continuous service for five years is not necessary where the termination of employment results from death or disablement, as defined in the Gratuity Act. Section 4(1)(c) of the Gratuity Act.

rate of wages last drawn by the employee.[23] The amount paid under the Gratuity Act to an employee is subject to a ceiling of Rs. 1,000,000 (or approximately US$22,058.01),[24] and is tax-free to the employee. Companies can provide a benefit calculated on a different basis, but any benefit paid above the minimum required by the Gratuity Act is treated as taxable income to the employee. The ceiling applies to the total benefit payable and therefore applies to benefits that have already accrued, as well as to future accrual of benefits.

The provisions of the Gratuity Act apply only to establishments employing 10 or more employees on any day of the preceding 12 months.[25] However, a shop or establishment to which the Gratuity Act has become applicable will continue to be governed by it, even if the number of employees falls below 10.[26]

<u>Payment of Bonus Act</u>—The Payment of Bonus Act, 1965 (the "Bonus Act"), as amended, requires employers of certain establishments to pay bonuses to its employees on the basis of profits, production or productivity. Under the Bonus Act, the definition of an employee[27] includes any person receiving salary not exceeding Rs. 3,500 per month (or approximately US$77.02)[28] who has worked 30 days or more in an accounting year for the employer.[29] Bonuses paid under the Bonus Act are subject to a maximum of 20% and a minimum of 8.33% of an employee's wages. In any event, bonuses shall be no less than Rs. 100 (or approximately US$2.20), regardless of whether the employer has any allocable surplus in the accounting year.[30]

<u>Employees Insurance</u>—The Employees State Insurance Act, 1948 (the "ESI Act"), as amended, provides benefits for employees in the industrial sector in case of sickness, maternity, disablement, employment injury, medical and funeral expenses or other similar matters. In sum, the ESI Act seeks to guarantee reasonably good medical care to workers and their immediate dependents. The ESI Act is applicable to factories where 20 or more persons are employed or were employed for wages on any day of the preceding 12 months and in any part of which a manufacturing process is carried on without the aid of power.[31]

<u>Maternity Benefit Act</u>—The Maternity Benefit Act, 1961 (the "Maternity Act"), as amended, regulates the employment of women before and after childbirth and provides for maternity leave, medical bonuses and certain other benefits. The Maternity Act applies to every shop or establishment in India in which 10 or more persons are employed, or were employed, on any day of the preceding 12 months.[32] The Maternity Act is not applicable to women covered under the ESI Act. Subject to the provisions of the Maternity Act, every woman is entitled to, and her employer is liable for, the payment of a maternity benefit at the rate of the average daily wage for the period of her actual absence.[33] The maximum period for which any woman is entitled to a maternity benefit is 12 weeks of paid leave, not more than six of which shall precede the date of her actual delivery.[34] Furthermore, under the Maternity Act, no employer may knowingly employ a woman in any establishment until six weeks following the day of her delivery.[35]

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[23] Section 4(2) of the Gratuity Act.

[24] Section 4(3) of the Gratuity Act. Effective May 24, 2010, this ceiling was increased from Rs. 350,000 (or approximately US$7,702.23) to Rs. 1,000,000 (or approximately US$22,058.01). According to a survey conducted by Towers Watson in 2008, about 30% of companies surveyed provided the benefit without a ceiling, and therefore they were not affected by the change, except that they are now able to pay more of the benefit tax-free. However, the survey showed that around 50% of companies provided only the statutory minimum gratuity benefit. As a result, such companies saw an immediate increase in the amount of gratuity benefit liability accrued for current employees. Kulin Patel and Chris Mayes, *India: Employers Face Higher Gratuity Benefit Costs*, Towers Watson, June 2010, *available at*: http://www.towerswatson.com.

[25] Section 1(3)(b) of the Gratuity Act.

[26] Section 1(3A) of the Gratuity Act.

[27] Section 2(13) of the Bonus Act.

[28] Employees earning a salary up to Rs. 10,000 (or approximately US$220.58) are eligible under the Bonus Act, but their salary will be limited to Rs. 3,500 (or approximately US$77.02) for the purpose of calculating such bonus.

[29] Section 8 of the Bonus Act.

[30] Sections 10 and 11 of the Bonus Act.

[31] Section 2(12) of the ESI Act. If a manufacturing process is being carried on with the aid of power or is ordinarily so carried on, the threshold for application of the ESI Act is 10 or more employees.

[32] Section 2(1)(b) of the Maternity Act.

[33] Section 5(1) of the Maternity Act.

[34] Section 5(1) of the Maternity Act.

[35] Section 4(2) of the Maternity Act.

Governing Law

When considering the acquisition of a foreign entity, the importance of the choice of law that governs all applicable contracts cannot be understated. In the United States, choice of law has been subject to discussion and debate for over a hundred years. Although once disfavored in the United States, it is now recognized that the parties to a contract may freely select a forum, and such clauses are *prima facie* valid and enforceable unless shown to be unreasonable and unjust.[36]

It is common for companies entering into contracts with Indian companies to stipulate that the agreement be governed by non-Indian law and be enforceable in a non-Indian court. The Bombay High Court upheld the validity of a contract wherein the parties had expressly agreed that disputes would be settled under English law in English courts.[37] However, on the issue of jurisdiction of Indian courts in respect of an agreement specifying a non-Indian court as having exclusive jurisdiction, an Indian court may nevertheless assert concurrent jurisdiction to entertain a suit if the cause of action arises wholly or in part within its local limits of jurisdiction.[38]

However, Indian courts have created the following two broad principles for enforceability of forum selection clauses in contracts: (1) for exclusion of jurisdiction of courts having concurrent jurisdiction, there has to be a clear, unambiguous and specific ouster of jurisdiction of other courts in the contract and unless absence of a meeting of the minds can be shown, the other courts should avoid exercising jurisdiction;[39] and (2) all parties to the agreement must be aware of and have consented to the forum selection clause in the contract. Under Indian law the parties cannot confer jurisdiction on an Indian court where no jurisdiction exists; however, this principle does not apply when the parties agree to submit to the exclusive or non-exclusive jurisdiction of a non-Indian court which is a "neutral court" or a "court of choice."[40] Thus, the forum selection clause should be specifically drafted to provide access to an agreed-upon court with the consent of all parties. In sum, under Indian law, parties to a contract can confer jurisdiction on a foreign court that is a "neutral court" or a "court of choice," but they cannot confer jurisdiction on an Indian court that is not a court of natural or concurrent jurisdiction under the provisions of the Code of Civil Procedure, 1908, as amended.

By comparison, Chinese law regarding choice of law is more restrictive and less evolved than that of the United States or India; the issue of choice of law did not even gain attention until the late 1970s, when China adopted an open door policy for foreign investment. Contract law in China allows parties to a "foreign-related" contract, whereby one party is not a Chinese legal person, to choose either Chinese law or foreign law as the basis for resolving disputes.[41] Chinese law considers the joint venture enterprise that results from the partnership between a United States company and a Chinese company to be a Chinese legal person, which means that such joint venture must apply the laws of China.[42] Similarly, China considers a WFOE a Chinese legal person and, thus, the United States company does not have a choice of law or choice of forum under such a structure.[43]

However, the WFOE structure may provide some flexibility in choice of law and choice of forum where the United States parent company enters contracts on behalf of the WFOE, as the parent company is not considered a Chinese legal person.[44] For example, if the United States parent company, not the WFOE, employs Chinese workers, the employment contract may be considered a foreign-related contract and the United States company may choose the law and the forum to govern the relationship. While contract

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36 *See M/S Bremen v. Zapata Off-Shore Co.*, 407 US 1 (1972).

37 *See Rhodia Ltd. v. Neon Laboratories Ltd.*, AIR 2002 Bombay 502.

38 Section 20(c) of the Code of Civil Procedure, 1908. An Indian court also has jurisdiction to try all cases of a civil nature, unless expressly or impliedly barred from doing so. *See* Section 9 of the Code of Civil Procedure, 1908.

39 *See A.B.C. Laminart Pvt. Ltd. v. A.P. Agencies, Salem*, A.I.R. 1989 S.C. 1239.

40 *Modi Entertainment Network v. WSG Cricket Pte. Ltd.*, 2003 A.I.R. SCW 733.

41 Mo Zhang, *Choice of Law in Contracts: A Chinese Approach*, 26 Nw. J. Int'l L. & Bus. 289, 298 (2006) (explaining that only when a contract is "foreign" under Chinese law does "the question as to which law shall govern the contract become relevant" because "[i]f a contract is domestic in nature, it is without question that the contract will be subject to Chinese law only.").

42 Zhang, *supra* note 41, at 320.

43 Carrie Greenplate, Comment, *Of Protection and Sovereignty: Applying the Computer Fraud and Abuse Act Extraterritorially to Protect Embedded Software Outsourced to China*, 57 Am. U.L. Rev. 129, 141 (2007).

44 Greenplate, *supra* note 43 at 142.

law in China provides for some flexibility in choice of law and choice of forum, if protective terms are not included or are not sufficiently clear then the contracts will not protect the United States company.[45] Nonetheless, for the majority of transactions a WFOE conducts, the United States company does not have a choice of law or choice of forum as between Chinese law and United States law.[46]

Conclusion

The acquisition of a United States company with foreign operations may provide a variety of benefits to a potential acquirer, including already established operations, governmental permits and licenses, and the avoidance of the start-up costs and regulatory applications that are associated with establishing a foreign subsidiary. However, as with any acquisition undertaken in the United States, it is vital that the acquirer become familiar with the foreign regulatory framework to which the transaction will be subject and to which the acquirer will become subject following the closing of a proposed acquisition.

Structuring, taxation, investment controls, employee benefits and governing laws, as summarized above, are just some of the issues that an acquirer should closely study with the aid of local counsel to determine the best approach to fulfilling the goals of acquiring foreign operations. A cautious and thorough approach to any such transaction will provide the acquirer with a myriad of benefits, two of which are (1) limited liability post-closing based on adequate due diligence and regulatory compliance and (2) a solid understanding of the rights and obligations to which it will become subject post-closing.

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[45] Greenplate, _supra_ note 43 at 141.

[46] Some interactions between the WFOE as a subsidiary to a United States company may be governed by United States law. "[A] state may exercise jurisdiction to prescribe for limited purposes with respect to activities of foreign branches of corporations organized under its laws." _Restatement (Third) of Foreign Relations Law of the U.S. § 414_; _36 Am. Jur. 2d Foreign Corporations § 448_.

The Window Closing Pill: One Response to Stealth Stock Acquisitions

By Peter Golden, a Partner of Fried Frank Harris Shriver & Jacobson LLP

The recent announcement of accumulations of stock in J.C. Penney and Fortune Brands substantially in excess of the five percent Schedule 13D reporting threshold prior to any public disclosure has focused attention on possible inadequacies in the regulatory system in providing companies, their stockholders, and the trading markets with advance notice of significant ownership by activist investors or bidders. Although the reporting requirements of 13D, the ownership limitations of the Hart-Scott-Rodino Antitrust Improvements Act, state merger moratorium statutes, and traditional rights plans afford U.S. companies some protections against rapid and secret stock acquisitions, the current state of law may provide opportunities for activists or raiders to obtain a sizable stake in a U.S. company before they are obligated to make any disclosure:

– For a non-passive investor, a Schedule 13D reporting ownership of more than five percent of a class of stock need not be filed with the SEC until ten days after ownership exceeds the five percent threshold. During this ten-day period, the acquirer may purchase additional stock without any restriction under the federal securities laws. Although there are no pending or proposed SEC rule changes to close or shorten this ten-day purchasing window, the recently adopted Dodd-Frank Wall Street Reform and Consumer Protection Act authorizes the SEC to shorten the deadline for filing a Schedule 13D.

– In calculating whether a person beneficially owns five percent of a class of stock for purposes of 13D, a number of types of derivative securities may be excluded under current rules. Options, warrants and other securities that are not exercisable or convertible within 60 days do not give rise to beneficial ownership of the underlying stock.

  Similarly, the SEC staff has stated that securities futures contracts that provide for cash settlement do not result in beneficial ownership of the stock covered by the contract regardless of the ownership of the stock by the counterparty. (In certain circumstances in which there are actual or tacit understandings between the parties regarding voting or holding of the shares, futures contracts might create beneficial ownership, as was the case in the *CSX/Children's Investment Fund* litigation.) On the other hand, once a person is otherwise required to file a Schedule 13D, it must report contractual arrangements relating to stock, including derivatives.

– The Hart-Scott-Rodino Act generally requires a filing with the Department of Justice and Federal Trade Commission and the expiration or termination of waiting periods before non-passive investors may acquire more than approximately $63 million of voting stock. However, the HSR Act does not apply to the acquisition of options, warrants and other derivatives until they are exercised or converted into the underlying voting stock. Moreover, certain investment or hedge fund managers who oversee multiple funds may be able to acquire up to approximately $63 million of voting stock in each of the funds they manage without triggering the HSR thresholds because these funds often are treated under the HSR Act as separate, independent acquiring entities not under common control. Consequently, activist investors using multiple funds may be able to acquire stock greatly in excess of the HSR reportable limits.

– Many states, including Delaware, have so-called business combination or merger moratorium statutes that restrict the ability of parties acquiring a specified amount of stock, such as ten or fifteen percent, without prior approval of the issuer's board of directors from engaging in mergers and similar transactions with the issuer without waiting a number of years or, in some cases, complying with procedural or fair price requirements. These statutes, however, do not address the conduct of an activist investor seeking to force the sale or restructuring of a company without itself being the acquirer. Additionally, these statutes generally do not expressly include derivatives not providing investment or voting control over stock within the definition of beneficial ownership of stock and, as a result, may not restrict the ability of the holder of the derivatives to engage in transactions with the issuer.

– Traditional rights plans effectively impose maximum ownership levels on stockholders by means of "flip-in" provisions. The ownership ceilings generally range from 10% to 20% (although so-called NOL plans, which seek to preserve the value of net operating losses, impose a five percent limit on ownership). Some plans include derivatives within the calculation of ownership and, therefore, attempt to address unorthodox ownership arrangements. However, these plans do not seek to compel public disclosure by acquirers. Moreover, many companies have responded to stockholder and proxy advisory service opposition to typical plans by not having plans in place; rather, they have a plan on the "shelf" ready to be adopted rapidly once a threat becomes known. Consequently, in many instances, traditional plans may not prove to be much of an obstacle to significant secretive stock acquisitions.

In light of the ability of activists or raiders to use the ten-day window for filing a Schedule 13D and to purchase shares before their stake in a company is required to be disclosed and the use of derivatives to defer or avoid a 13D reporting obligation, companies should consider a new form of rights plan the purpose of which is to compel disclosure by acquirers of stock and derivative ownership in excess of five percent and block acquisitions of stock until the disclosure is made. In essence, the plan would close the ten-day purchasing window that currently exists under Rule 13d-1 and include all derivatives in the definition of beneficial ownership of stock. Specifically, this rights plan would feature:

- *Transitory Five Plus Percent Flip-In Trigger*: If a person exceeds five percent ownership, including derivatives, and does not wait until ten days after it has filed a Schedule 13D with the SEC, regardless of whether the SEC rules require a filing, before it purchases additional shares or derivatives, then it would be an "acquiring person" under the plan, trigger the flip-in provision, and suffer the dilution caused by triggering the pill. (Persons who are eligible to file a Schedule 13G, passive investors, would be exempt from the plan.)

  However, after the tenth day following the filing of a Schedule 13D, the acquirer would be free to acquire additional shares or derivatives without triggering this pill. (Obviously, the ownership limitations of more traditional rights plans then in place would still apply.) This logistic is analogous to the SEC's rules prohibiting purchases of additional stock by a 13G filer that either no longer has a "passive intent" or exceeds 20% ownership until the expiration of the tenth day from the date of the filing of a Schedule 13D. The acquisition resulting in greater than five percent ownership would not trigger the pill; only subsequent purchases before a Schedule 13D is filed would be implicated. Accordingly, the trigger level for the flip-in would not be fixed at an absolute number: it could vary from slightly above five percent to much greater levels if an acquirer is able to purchase a large stake from a single source.
- *Expanded Definition of Beneficial Ownership*: The plan would attribute beneficial ownership of stock to a person who owns options, warrants, futures contracts or other arrangements that provide a "long" financial interest in the stock regardless of whether these securities or ownership arrangements give rise to beneficial ownership of the underlying stock under federal or state law. Derivative positions acquired as part of "ordinary course" market-making, hedging or trading activities would be excluded. As a result of this expanded definition of beneficial ownership, the plan could have the effect of requiring the filing of a Schedule 13D even if filing is not required by the SEC's rules.
- *Reload*: The plan would provide that it remains in effect after it has been triggered so that it continues to provide protection against the person that triggered the plan or others acquiring interests in the company.

This rights plan has a limited objective that of compelling disclosure so that a board of directors, stockholders and the trading markets can evaluate the ownership position of a substantial non-passive investor. The plan is benign because the acquirer is not precluded from acquiring more than a five percent voting or financial interest in a company and it would not create an impediment to purchasing shares pursuant to a tender offer. Nevertheless, the acquirer might no longer be able to acquire stock as cheaply as it would absent the rights plan because the accelerated disclosure obligation likely would result in an increase in the market price of the shares. Presumably, most would agree that this benefits stockholders who would otherwise have sold at a lower price while the acquirer was surreptitiously purchasing shares. (Arguably, the plan might deter some activists from undertaking an acquisition program because the expected profit from the program could be reduced.) The plan can stand alone or be incorporated into an existing plan.

As is the case with the adoption of any rights plan, the reaction of institutional shareholders and proxy advisory firms, such as ISS, is a consideration. Although this form of plan does not fit within the announced guidelines of these firms, the relatively modest impact of the plan on acquirers due to its temporary applicability and no ownership restriction once appropriate disclosures have been made, suggests that these firms may not object to the plan as detrimental to shareholders.

If the SEC amends the 13d rules to close the ten-day purchasing window and to include derivatives within its definition of ownership, then this rights plan would no longer be necessary. Until then, it can provide notice to boards of directors and stockholders of aggressive stock acquisitions before being presented with a *fait accompli*. Consequently, we suggest that companies consider a plan of this type as a supplement to other elements of their preparedness planning.

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