21ST ANNUAL All Hands Meeting 2009

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Corporate Counsel Update: Corporate Governance, Securities Compliance & M&A

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Recent Corporate Governance and Securities Compliance Developments

- Elimination of broker discretionary votes for directors (Rule 452)
- Reform initiatives in the works:
  - Proposed Federal Legislation
    - Shareholder say-on-pay vote
    - Majority voting for directors
    - Compensation committee and advisor independence
    - Chairman independence
  - SEC Proposals
    - Proxy disclosures
    - Shareholder access to proxy
    - Governance disclosures
- Amplified Influence of Institutional Investors and Proxy Advisors
- Enhanced SEC Enforcement Efforts
- IPO Window

Elimination of Broker Discretionary Votes for Directors under NYSE Rule 452

- NYSE Rule 452 amended to eliminate "broker discretionary votes" in uncontested director elections effective January 1, 2010
- Prior Situation favored management:
  - brokers were permitted to vote clients' shares on "routine" matters if the beneficial owner had not provided contrary voting instructions to the broker
  - most brokers voted in favor of board's nominees, but some brokers recently adopted practice of voting in proportion to voted shares
- In 2008, broker votes typically ~ 15-25% of the votes cast
- Impact: this change will most affect companies where a shareholder or vote advisory service mounts a "withhold" or "vote no" campaign against certain directors
  - especially companies with majority voting standards

Impact on Issuers

- Consider Effect of Retail Holders:
  - Determine % of shares held by retail holders (Rule 452 does not affect institutional shareholders, holders of record, or management holders)
  - Expect low participation by retail holders
- Recommended Responses:
  - Include other routine matters, such as ratification of auditors, on annual meeting agenda (broker discretionary votes on same help ensure a quorum)
  - Anticipate influence of institutional shareholders
  - Anticipate impact of advisory firms on hot button issues

Proposed Legislation

Shareholder Bill of Rights Act of 2009 (Senate) (introduced 5/19/09)

- Shareholder "say-on-pay"
- Approval of golden parachutes
- Majority voting for directors
- Shareholder access to proxy
- Annual election of directors
- Independent chairman
  - Not a prior executive officer
- Requires a Risk Committee

Corporate and Financial Institution Compensation Fairness Act (House) (passed 7/31/09)

- Shareholder "say-on-pay"
- Approval of golden parachutes
- Independent compensation committee
- Independent Comp Advisors

Restoring American Financial Stability Act of 2009 (introduced by Sen. Chris Dodd Nov 10, 2009)

- 1,136 page bill would federalize major elements of corporate governance and executive compensation
- Proposes overhaul of regulation of financial institutions
- Contains provisions applicable to all US public companies
- Governance provisions similar to Sen. Schumer's proposed Shareholder Bill of Rights Act of 2009
- Compensation provisions similar to Corporate and Financial Institution Compensation Fairness Act of 2009 passed by House in July
- Hearings by Senate Banking Committee held on Nov. 19
- Expect a mark-up in early December
- Passage is uncertain, but legislation of some type likely

Dodd Bill: SEC Corporate Governance and Executive Compensation Authority

- Corporate Governance:
  - Would direct SEC to make rules that would w/in one year require nationally-listed companies to adopt specified corporate governance standards
  - SEC could make exemptions based on size/market cap etc. & establish transition rules
- Executive Compensation:
  - Would amend 1934 Act to add new disclosure as well as new substantive provisions
  - Would direct SEC to make additional rules relating to compensation part of national listing standards

Dodd Bill: Corporate Governance

- Majority Voting: majority of votes cast in uncontested elections; director must tender resignation; Board must accept or unanimously decline and state the reasons w/in 30 days
- Staggered Boards: prohibited unless shareholders approve (at next annual meeting) by same % needed to amend charter or bylaws
- CEO and Chairman: Requires proxy to disclose why same (or different) persons hold these roles
- Proxy Access: Authorizes and requires SEC to issue rules permitting shareholders to use issuer's proxy materials to nominate directors

Dodd Bill: Executive Compensation

- Say on Pay: nonbinding annual vote on exec compensation and vote on golden parachutes
- Comp Committee: must be independent and advisors must be independent per SEC rules; SEC to do 3-5 year study on comp consultants
- Additional Disclosures: of relationship between exec comp and financial performance over 5 yrs
- Clawback: mandates clawback of incentive-based compensation of exec officers w/in 3 years of restatement, if based on erroneous data
- Employee Hedging: disclose if can hedge equity

Impact on Issuers

- Some legislation is likely; content uncertain
- Areas of greatest impact on issuers: no broker discretionary votes, majority voting for directors, annual elections (i.e., no staggered boards), shareholder access to proxy, perhaps leading to more shareholder activism
- Areas of minimal impact on issuers: independent chairman, risk committee, independent compensation advisors, clawbacks

Shareholder "Say-on-Pay" Vote

- Non-binding advisory vote on executive compensation programs and policies as a whole
- >100 U.S. public companies received proposals this year with average support of 45%
- Approx. 25 agreed to hold a say-on-pay vote, in response to shareholder activism
  - Including Apple, Intel, HP, Microsoft
- Required for >500 U.S. TARP recipients
- Included in all proposed legislation

Impact on Issuers

- "Say-on-pay" voting is a likely feature of the future governance landscape in 2010 or 2011
- No immediate need to adopt prior to legislative requirement, but shareholder proposal to require say-on-pay is possible in 2010 proxy season
  - May want to adopt in advance
- Anticipate potential proxy advisor influence when formulating executive compensation
  - Will be part of RiskMetrics voting guidance

Majority Voting for Directors

- Historical situation: directors have been elected by plurality vote
- Pfizer: In 2005, in response to shareholder activism, Pfizer adopted a "**plurality plus resignation**" policy requiring directors who do not receive a majority to tender resignation
- Intel: In 2006, Intel adopted a bylaw requiring a **majority vote**, and tender of resignation by those who do not receive a majority
- S&P 500:
  - 50% thereof have majority voting like Intel,
  - 18% have a "plurality plus resignation" like Pfizer;
  - 55% of Russell 1000 and 75% of Russell 3000 still have traditional plurality voting

Impact on Issuers

- Majority voting for directors may become the required standard for corporate governance
- No urgency to adopt prior to being required
- Broker discretionary vote rule changes suggest that majority voting for directors may be difficult for companies with a high proportion of retail investors

Compensation Committee Independence

- All members of compensation committee must be independent
  - "Independence" requires that any fees paid to the members must be for committee or board duties
- Committee must have authority, funding and sole discretion to retain compensation advisor
- Compensation Advisors
  - Engagement and potential conflicts of interest must be disclosed
  - Further independence standards to be established by the SEC

Impact on Issuers

- Emphasis on increased committee independence
- Payments to members in other capacities may prevent independence
- Review of services provided by compensation advisors

SEC Proposals

- Intent is to enhance proxy statement disclosure about compensation and governance
  - Proxy disclosures
  - Shareholder access to proxies
  - Governance disclosures

SEC Proposal: Proxy Disclosures

- Include in CD&A a discussion of compensation policies as related to risk management
  - Only required if risks from those policies may have a "material" effect
  - "Principles-based" disclosure: specific to each company and its particular programs
  - Intended to help investors understand whether excessive risk is being incentivized
  - Tracks to Treasury Dept. view that pay should be aligned with sound risk management
  - Consistent with increasing use of a mix of performance and time based awards for executives

SEC Proposal: Proxy Disclosures (cont.)

- Comp. consultant fee & conflicts disclosure
- Changes to Executive Compensation Tables:
  - report total Black-Scholes value of an equity award,
  - rather than amount recognized under SFAS 123R for the year

SEC Proposal: Shareholder Access to Proxy

- Proposed Rule: SEC would give shareholders the right to include board nominees in proxy:
  - Shareholders of:
    - 1% for large companies (>$700M)
    - 3% for mid-cap companies (>$75M)
    - 5% for others
  - Who have held shares for at least one year
  - May nominate up to 25% of board members
  - If no intent to change control of company
- Dodd Bill would clarify SEC authority

SEC Proposal: Governance Disclosures

- Why is a particular leadership structure in place?
  - E.g., Chairman/CEO and Lead Independent Director
- What is the Board's role in the Company's risk management process?
- List a nominee's particular qualifications to serve
  - plus board memberships for past 5 years and legal proceedings for past 10 years
- Rapid disclosure of election results:
  - results would be filed on Form 8-K within 4 business days of meeting instead of with next 10-Q

SEC Proposal: Governance Disclosures (cont.)

- Additional "Activist Friendly" SEC Changes
  - "Just Say No" campaigns much easier
    - activists would be able to send blank proxy card to shareholders, with a request to return it to management
    - saves activist the time and cost of preparing and filing a proxy statement
  - "Rounding out" short slates
    - currently can only "round out" with management nominees
    - would be able to "round out" with nominees of another 3rd party
    - codifies *Carl Icahn* no-action letter
    - could result in more contested elections given the SEC shareholder proxy access proposal

Amplified Influence of Institutional Investors and Proxy Advisors

- The loss of broker voting on director elections will amplify the voting impact of institutional investors, hedge funds and shareholder activists and provide proxy advisory firms with greater influence over the director election process
- The recommendation of RiskMetrics Group or Glass Lewis will carry more weight
- Most institutional shareholders follow guidelines, and understanding these guidelines, including when institutional shareholders will withhold votes or vote against directors, will be important
- Special interest groups or other large shareholders with a particular agenda to challenge an incumbent board my also see increased influence, possibly at the expense of smaller shareholders

Director Voting Results in 2009

- In 2009, 93 directors at 50 US companies failed to receive majority votes (vs. 32 @ 17 in 2008)
- None had adopted Majority Voting
- 2 companies had resignation policies, but decided to retain the directors.
- Most frequent reasons for withhold votes:
  - Compensation issues at 50 companies
    - Tax gross-ups; option repricing
  - Poison pills; staggered board; majority voting

Proxy Fight Results in 2009

- Through 9/30, 39 proxy fights (vs. 35 in 2007)
- Dissidents sought control in 4 cases (vs. 9 in '08)
- Activist shareholders favor "short slates"
- Outcomes:
  - Dissidents won all seats sought in 13 cases
  - Dissidents won partial victories in 9 cases
  - Incumbents prevailed in only 17 cases
- Plus 36 settlements before RM recommendation

RiskMetrics Predictions for 2010

- Activists will file ~100 say-on-pay proposals
- Will also target compensation practices: tax gross-ups, death benefits, "bonus banking"
- AFL-CIO intends to file proposal to prohibit multiple outside CEOs on Comp Committee
- Labor unions will seek to split CEO and Chair
- Proposals for 10% to call shareholder meeting

RiskMetrics
Corporate Governance Policy Updates

- On Nov. 19, RiskMetrics Group (ISS) published its 2010 Corporate Governance Updates and FAQ
- They cover:
  - Voting on Directors in uncontested elections
  - Director independence definitions
  - Board-related shareholder proposals
  - Shareholder rights and defenses (eg, Poison Pills)
  - Capital restructurings
  - Compensation
  - Board diversity
- RiskMetrics to hold webcast on updates Dec. 10.

Risk Metrics: Voting on Directors

- If non-shareholder approved Poison Pill:
  - Vote against **all** nominees (except new nominees) if Board adopts Pill *with term > 12 mos* or renews any Pill w/o SH approval; *case-by-case if < 12 mos*
  - *Review every 3 years (annually if classified board), and vote against if still in place*
- *For extraordinary circumstances, vote against if:*
  - *Material failure of fiduciary responsibilities,*
  - *Failure to replace management as appropriate, or*
  - *Egregious actions regarding service on other Board*

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Risk Metrics: Director Independence

- Based on market trends, RMG updated its definitions of director independence to reflect a more pragmatic approach:
  - Materiality for related party transactions will follow *NYSE ($1M/2% of revenues)* or NASDAQ ($200K/5% of revenues) tests, as applicable
  - Clarifications to $10K de minimis test for professional services; definitions of "advisory in nature" services.

Risk Metrics: Shareholder Actions

- Shareholder Ability to Call Special Meeting/Act by Written Consent: Vote against restrictions; Vote for enabling based on: *minimum threshold (10% preferred), investor ownership structure, any limitations, response to previous shareholder proposals, use as antitakeover device.*
- Supermajority Vote Requirements: Vote against; Vote for reducing threshold *unless being used by investor to take control of distressed company where supermajority vote protects minority shareholder interests.*

RiskMetrics: Changes to Capital

- Common Stock Increase or Blank Check Preferred Stock:

  Vote case-by-case based on:

  - *Company's use of shares during last 3 years,*
  - *1 and 3 yr total SH return (TSR),*
  - *specific reason for change,*
  - *dilutive impact based on RM formula,*
  - *risk to shareholders of not approving*
  - *whether can be used for takeover defense*

RiskMetrics: Compensation

Vote against MSOP, Comp Comm, equity plan if:

- Pay for Performance: *misalignment of CEO pay with performance over 5 year TSR.*
- Problematic Pay Practices:
  - *Multi-year guaranteed pay increase, bonus, equity*
  - *Perquisites for former or retired executives*
  - *CIC payments > 3X base plus target bonus*
  - *Single trigger CIC payments; or walk-away rights*
  - *Excise tax gross-ups or tax reimbursements*
  - *Repricing of options without shareholder approval*
  - *Executive use of company stock in hedging activity*

Compensation Trends

- Equity awards moving from 100% options to mix of options and RSUs for public companies:
  - Rank and file now typically 100% RSUs
  - Executive grants a combination of
    - Options, with time-based vesting
    - RSUs, half with time-based vesting; half with performance hurdles (Performance Based RSUs)
- RSUs also used for late-stage private companies
  - Consider the 500 shareholder limit (no action letter)
- Private companies adopting employee liquidity programs
  - Consider impact on 409A valuations

Enhanced SEC Enforcement Efforts

- Step up in SEC enforcement: prompted by the events of the last 12 months, especially the market collapse, the TARP bail outs, the Madoff scandal and the new administration
  - Areas of Focus:
    - revenue recognition and earnings management
    - insider trading and market manipulation (Galleon Group)
    - FCPA and Reg. FD
  - Faster and more robust investigations
  - More strategic target selection
  - Enhanced prosecutorial tools and settlement discretion

SEC Enforcement--Clawbacks

- Section 304 of Sarbanes-Oxley requires reimbursement to company of all bonuses, other incentive/equity compensation and any profits realized from the sale of the issuer's securities
  - by CEO and CFO
  - over past 12 months
  - if restatement of financials due to **misconduct**
- CSK Auto Corp. enforcement action: SEC action against CEO seeking reimbursement of $4M in bonus and stock sale proceeds
  - SEC brought suit in federal court under Section 304
  - Argued that proceeds to CEO following CSK's fraudulent financial reporting should be returned to CSK and CEO should not earn money while the company was misleading investors
  - *First time this has been used against a CEO or CFO not personally accused of wrongdoing or a securities law violation*

SEC Enforcement--Disclosures

- Bank of America example: SEC brought charges against Bank of America for allegedly misleading investors about billions of dollars in Merrill Lynch bonuses
  - Report: "[The bank's law firm] has come under intense scrutiny for the advice its lawyers gave... about disclosing Merrill bonus agreements only in a secret schedule that was not available to shareholders."
  - Judge rejected a $33M penalty settlement with SEC as inadequate and unfair, ordered a trial and asked why SEC did not bring charges against bank executives (as state AGs did).
  - Bank waived privilege, CEO retired and, earlier, GC was abruptly terminated
- Ensure disclosures focus on "real world" not "technical" considerations and that all material facts are disclosed

SEC Enforcement--Impact on Issuers

- Adopt and enforce robust policies and procedures
  - Revenue recognition
    - Internal controls
    - Sox certification procedures
    - Follow up on red flags
  - Foreign Corrupt Practices Act
    - Training of executives and sales/operational staff
    - Diligence over third party intermediaries
    - Guidelines for travel and entertainment expenses
    - Follow up on red flags
  - Insider Trading
    - Enforce written policies and procedures
    - Consider adoption of trading plans
    - Update Regulation FD and IR policies

IPO Window

- Mostly non-tech IPOs in 2009 YTD
- Notable exceptions: OpenTable, Solar Winds, A123, FortiNet (first Silicon Valley IPO in 22 months)
- Expect many tech IPOs to be filed in Q4'09/Q1'10
  - Clean Tech
  - Social Networking
  - Life Sciences
- Duration of IPO window unclear
- To succeed, focus on growth, predictable profits, team

M&A Developments Overview

- Trends: Down Market Issues
- Tougher Antitrust Environment
- Increased M&A Litigation
- Fiduciary Duty Issues
  - Business Judgment Rule Affirmed, MAE Developments, "Just Say No" OK, Troubled Company Issues
- Acquisition Method of M&A Accounting
- Anticipating Earnout Disputes

Trends: Down Market Issues

- M&A Timing/Currency issues
  - Credit crisis impact: made borrowing to do deals less viable, except for extremely credit-worthy buyers, and made using up balance sheet cash seem less appropriate
  - Stock market volatility impact: made using stock as consideration seem unwise until stock prices fully rebound and become less volatile
  - Stock deals disfavored: stock deals still unattractive to targets, especially if buyer shareholder vote required
    - Report: only 34% of deals offered stock consideration either alone or with cash and 9.2% of those had a collar
  - Time to buy? Market indices are rising, targets may not be any cheaper, so perhaps time to buy is now, or perhaps the recent run up means it's too late

Trends: Down Market Issues (cont.)

- Cash Tender Timing Advantages
  - Given that currencies are depressed, contested deals are more likely, and HSR scrutiny is greater, timing advantages of cash tender offers are even more critical
- Hedge Fund Activism
  - As market values tumbled, activist hedge funds became more aggressive about pushing for a sale
  - Hard to resist if market cap is below cash
- Reduced Private Equity Activity
  - PE funds mostly sidelined due to lack of credit
    - recent Silver Lake/eBay/Skype exception

Trends: Down Market Issues (cont.)

- Increase in Hostile Bids for Public Companies
  - Data Domain/EMC (NetApp)
  - Yahoo/Microsoft
  - Samsung/SanDisk
  - Microchip/Atmel
- Increase in Low Valuation Deals
  - Desperate sellers? Closed IPO window and VC portfolio pruning has led to many low value private target sales that gave only a partial return of investment to VCs and little, if anything, to founders; some sales of public targets at only a modest premium to their cash

Trends: Down Market Issues (cont.)

- Reverse Termination Fees
  - More frequent? Financing difficulties resulting in increased use of reverse termination fees, even absent a financing condition
  - Ability to opt out? Does capped termination liability really give the buyer an option to buy?
    - Brocade example: Brocade had right to pay $85M (2.8%) to terminate upon a financing failure
  - Size/Scope Trends: some trend towards bigger (6% of deal value) reverse than forward termination fees, some provisions give buyer a narrow basis for opting out, some give seller a right to seek specific enforcement against lenders

Trends: Down Market Issues (cont.)

- Effect of Declining Market Caps
  - Hostile bids more likely
  - Increased hedge fund activism
  - Need to sell if can't pay off or restructure debt?
  - Less time to implement a rights plan
    - Since HSR threshold is now $65.2M, a bidder could quietly acquire up to 16% of a $400M company, for example, without the need for HSR pre-clearance, within the 10 days leading up to a 13D filing obligation, leaving little opportunity to adopt a plan

Trends: Down Market Issues (cont.)

- Greater Need to Update Strategic Defenses
  - Check charter provisions as to notice of director nominations and shareholder proposals, rights to call special meetings or remove directors, rights plan adoption
  - Sign indemnity agreements in light of cases denying advancement of defense expenses to former directors due to bylaw change (Schoon v. Troy Corp.)
    - But: recent DGCL 145(f) amendment prohibits changes to charter/bylaws after event giving rise to need to indemnify
  - Update valuation metrics reflective of strategic plans rather than running such valuations after receiving a hostile bid, making them more subject to challenge
  - Adopt rights plan, or discuss in advance and have "on the shelf", ready for quick adoption if hostile threat emerges

Tougher Antitrust Environment?

- U.S.: Obama administration promising more activity
  - Announcements re more active antitrust enforcement and retraction of Bush policies
  - New leadership applying expanded theories of potential competitive harm from mergers of close competitors
  - Expect greater HSR scrutiny and more uncertain timing and outcome
- EU: increased aggressiveness (Oracle/Sun delay)
- China: new Anti Monopoly Law showing teeth (Coca-Cola deal stopped)

M&A Litigation Update

- "Plaintiffs' Bar" is:
  - Chasing ever smaller M&A deals
  - Seeking ever larger settlements
    - Typically settled with enhanced disclosure and payment of attorney's fees
    - Negotiation often starts with request for price increase and changes to allegedly preclusive deal terms ("high" break up fee, right to match)
  - Increasingly sophisticated as to arguments relating to "Revlon" breach (i.e., inadequate shopping) and the need for additional disclosure

M&A Litigation Update (cont.)

- Plaintiff threatens injunction to slow deal, claiming:
  - Breach of duty of care by target directors based on insufficient shopping, failure to obtain adequate deal value, or improper agreement to preclusive deal terms
  - Breach of duty of loyalty by target directors by favoring their own interests rather than doing what is right for all shareholders
    - Allegation is often that there is a "hidden agenda" to improperly favor a particular buyer
  - Lack of adequate disclosure, for example, as to:
    - fairness opinion valuation methodology
    - background summary
    - banker's fee (implying that the "independent" fairness opinion was compromised by the large fee paid)

M&A Litigation Update (cont.)

- Reduce risk by:
  - Adequate shopping where appropriate, due board consideration of all alternatives and consultation with legal and financial advisors
  - Avoiding deal terms that preclude unsolicited bids or unduly favor one bidder (it is in neither party's interests to have the deal enjoined)
  - Having full proxy disclosure and minutes that demonstrate full and fair process and render inadequate disclosure arguments moot
  - Excluding strike suit and its unilateral settlement from MAE so buyer does not have an "opt out"

Fiduciary Duty Issues Overview

- Business Judgment Rule Affirmed
- MAE Developments
- "Just Say No" OK
- Troubled Company Issues

Business Judgment Rule Affirmed

- In a "change of control" transaction the board's duty is to seek highest value reasonably available
- "No single blueprint" for obtaining highest value
- Possible alternative strategies used by target boards:
  - Avoid or limit no shop
  - Conduct pre-signing market check
    - contact other potential bidders prior to signing a deal
  - Conduct an auction
  - Obtain a fiduciary out
    - permits an unsolicited superior bid to prevail post signing
  - Post-signing market check
- Reasonable process is key: board need not make a perfect decision when establishing the process, just a reasonable one

Business Judgment Rule Affirmed (cont.)

- Lyondell Chemical Co. v. Ryan reversal
  - Lower court ruling raised question of whether directors could be held liable for a (non-indemnifiable) breach of the duty of loyalty for not conducting a pre-signing market check, taking a "wait and see" approach to a 13D filing made when the company was not for sale, and otherwise setting a record that made them seem "indolent"
  - Surprising case given the 45% deal premium and deal approval by 99%+ of voted shares

Business Judgment Rule Affirmed (cont.)

- Delaware Supreme Court Reversed:
  - Court emphasized the disinterested and independent nature of the directors, their awareness of the company's value and prospects, and their consideration of the offer with the assistance of bankers and counsel
  - Court characterized situation as, at most, a due care issue, noting that there was no evidence that directors knowingly ignored responsibilities and thereby breached their fiduciary duty of loyalty
  - "[In M&A context] an extreme set of facts is required to sustain a disloyalty claim premised on the notion that disinterested directors intentionally disregarded their duties" and as to such a claim the judicial inquiry should be "whether those directors utterly failed to attempt to obtain the best sale price"

Business Judgment Rule Affirmed (cont.)

- Pre-signing market check required?
  - Pennaco and MONY cases also held that a pre-signing market check is not necessarily required in certain cases
  - Compare: Netsmart. Held that a micro-cap company, because of limited analyst following, should not rely only on a post-signing window shop provision but instead should conduct a pre-signing market check involving both strategic and private equity buyers

MAE Developments

- Hexion v. Huntsman
  - Proving an MAE is difficult
    - Must be a severe, lasting change in the target's earning power vis-à-vis its past performance
  - Asserting party has burden of proof
  - Critical to carefully define MAE & exclusions
    - Such as, a failure to achieve projections or guidance, the effect of HSR delays (Oracle/Sun) or the deterioration of equity and credit markets
    - If worried about the difficulty of proving an MAE, Buyer can add a provision stipulating events "deemed" to be an MAE or that are a closing condition

"Just Say No" OK (absent self dealing)

- Gantler v. Stephens was a challenge to a board's decision to reject a merger proposal
- Deferential business judgment rule analysis applies to decision to "just say no" unless plaintiff can show that directors acted in their self-interest, in which case the entire fairness standard may apply

Troubled Company Issues

- Once nearing insolvency, directors and officers have a duty to maximize value for the whole enterprise (including creditors) and not take long shot risks to maximize return for shareholders
- Directors should look for warning signs of insolvency, ensure adequate process for decisions, document good faith exercise of business judgment, consult counsel and restructuring and valuation experts, demand management accountability, consult creditors and avoid insider transactions
- Director indemnification rights may not be enforceable against a debtor in bankruptcy, so it is important to have D&O insurance with non-rescindable Side A coverage to mitigate bankruptcy and rescission risks. Critical to obtain such coverage pre-insolvency

Acquisition Method of M&A Accounting

- SFAS 141R re Business Combinations, effective 12/15/08, dictates expanded use of fair value in acquisition accounting
- Deal costs must be expensed as incurred, not capitalized, so a buyer may want to defer closing to defer booking deal costs
- Stock issued in a deal is valued on the acquisition date, so deal price could fluctuate based on movement in trading price pre-closing, so buyer may push to close quickly
- In addition to being recorded as a liability at fair value on the acquisition date, earnouts must be marked to market each period through earnings, so it may be wise to shorten earnout periods to lessen post-deal earnings volatility
- In-process R&D intangible assets can no longer be immediately written off. Now, IPR&D must be recognized as an intangible asset at the acquisition date, then tested for impairment until projects are completed or abandoned
- These changes will increase earnings volatility, make accretive/dilutive effects more uncertain at closing and impact financial statements going forward as balance sheet amounts are re-measured based on current fair values

Anticipating Earnout Disputes

- Earnouts are contingent payments in a merger to narrow a valuation gap and help ensure retention
- Usually based on achievement of product, technology or financial milestones
- "Earn-outs are inherently difficult creatures":
  - Hard to anticipate every potential ambiguity and dispute
  - Hard to avoid diverging agendas and lack of incentive for new hires and buyer staff cooperation
  - Hard to reconcile target's concerns that post-closing operational decisions will adversely impact the earnout, and buyer's reasonable need for continued operational flexibility without regard to impact on the earnout

Anticipating Earnout Disputes

- Because of these difficulties, earnouts are "seldom earned but often paid"
  - Recent deal: $500M+ paid to settle, though targets unmet
- Favor technology/product, vs. financial, milestones
- If must use financial milestones:
  - Use bookings rather than revenue or net income
  - Anticipate future issues such as: revenue recognition complexities, contracts that will not qualify as a "booking", derivative products, bundling, discounts and impact of changes in reserves on earnings
- Use precise technology milestones:
  - Ensure clear, objective definitions and a 100% completion requirement

Anticipating Earnout Disputes

- Consider whether it is possible (or wise) to attempt to reconcile target's desire to keep current course, budget and headcount and buyer's need for operational flexibility
- Avoid promising "best efforts" obligation to maximize earnout and consider disclaiming any such express or implied obligation
- Avoid metrics that may cause a divergence of goals
- Avoid resentment and ensure integration by insisting that deal value include a deduct for a bonus pool to incentivize new hires and buyer personnel who must cooperate to achieve milestones
- Have a well thought out dispute resolution mechanism
- Don't do an earnout with a party you don't trust to be reasonable