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Renewed Focus on Takeover Defenses

Re-Tooling Advance Notice Bylaws and the Return of the Stockholder Rights Plan

By Robert S. Reder, Rachel Fink and Alison Fraser

To say the least, 2008 was a tumultuous time in the financial markets. In addition to failures and bargain-basement sales of major financial institutions, unprecedented governmental intervention in the markets, aborted M&A deals and a record-sized Ponzi scheme, the year witnessed an increased volume of hostile and unsolicited takeover activity. By Sept. 28, 2008, according to Jessica Hall, "Hostile Takeovers Hit Record As Market Swoons," Reuters.com, Sept. 29, 2008, U.S. hostile deal activity was at a record high, representing a 140% increase from 2007.

While attitudes a year ago might have suggested that 2008 would be a year of great stockholder activism with takeover defenses continuing to fade from the scene, the drying up of credit for M&A transactions and plunging stock prices and asset values actually caused public companies to re-examine their preparedness for hostile activity and, ironically, led to the re-emergence of a takeover defense that had fallen out of favor in recent years — the stockholder rights plan (a/k/a "poison pill"). In addition, many public companies re-tooled their advance notice bylaws in response to court decisions arising from proxy contests initiated by activist investors.

Some commentators have predicted that hostile takeover activity will continue to trend upward in 2009. As public companies with depressed stock prices return their focus to protecting themselves from hostile takeover activity, it is important for their boards of directors and managements to evaluate whether their advance notice bylaws and stockholder rights plans remain effective — or whether takeover defenses abandoned in the face of pressure from activist investors and corporate governance advisers should be reinstituted — in view of the changes in practice and developments in case law during 2008. This article describes the more important changes impacting these two key takeover defenses.

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The Treasury Department's Guidelines on Executive Pay

By Angela Marie Hubbell

President Obama and Treasury Secretary Timothy F. Geithner stood together on Feb. 4, 2009, to announce the Treasury Department's new set of guidelines restricting executive compensation at financial institutions that receive governmental money. In his announcement, President Obama called the bonus payments made to senior executives in late 2008 by major financial firms that received bailout money "shameful and intolerable." He indicated that the new Treasury guidelines were issued to ensure public funds are directed toward the public's interest in stabilizing our economy and are designed to align compensation of senior executives in the financial industry with interests of both shareholders and taxpayers.

Specifically, the guidelines indicate that they were designed to strike a balance between the financial industry's need to attract top talent to lead in the current economic climate and the public's interest in requiring transparency and accountability. The guidelines require not only disclosure of but an explanation and justification of the policy supporting certain compensation decisions. The guidelines are divided into two

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Takeover Defenses

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Key Judicial Developments During 2008

In two separate decisions, the Delaware Court of Chancery ruled — somewhat surprisingly — that advance notice provisions contained in corporate bylaws did not preclude stockholder proposals that the companies claimed had not been timely submitted. The effectiveness of certain advance notice bylaw provisions have been called into question as a result of these decisions.

The CNET Networks *and* Office Depot *Decisions*

In *Jana Master Fund, Ltd. v. CNET Networks, Inc.*, 947 A.2d 1120 (Del. Ch. 2008), the court declared a Delaware company's advance notice bylaw inapplicable to a stockholder's independently financed proxy solicitation. Parsing the language of CNET's advance notice bylaw, the court determined that the provision was intended to apply only to a stockholder's attempt to include a proposal in the company's proxy materials pursuant to Rule 14a-8 under the Securities Exchange Act of 1934, but not to independently financed proxy solicitations. Accordingly, the court allowed the investor to proceed with its campaign to elect its own slate of directors even though it had not satisfied the bylaw's deadline for submitting alternative nominations and proposals.

One month later, in *Levitt Corp. v. Office Depot, Inc.*, No. 3622-VCN, 2008 WL 1724244 (Del. Ch. Apr. 14, 2008), the court upheld a stockholder's right to nominate directors without advance notice, even though Office Depot's bylaws purported to regulate the conduct of "business" at annual meetings by requiring advance notice of stockholder proposals. Following receipt of Office Depot's proxy materials for its annual stockholders meeting, a stockholder filed preliminary proxy materials with the SEC announcing its intent to nominate alternative director candidates to Office Depot's board. The court ruled that because Office Depot itself had initiated the process for electing directors by filing its own proxy materials, subsequent nominations of alternative candidates by individual stockholders did not require separate advance notice.

The *CNET Networks* and *Office Depot* decisions demonstrate that Delaware courts will be reticent to disallow stockholder proposals — despite a proponent's failure to comply with advance notice requirements — if ambiguities or contradictions in a company's bylaws can be construed to allow the proposal to be submitted to stockholders. In fact, these decisions emphasize that Delaware courts will generally bend over backward to interpret charter provisions to support the exercise by stockholders of their rights to nominate and vote for directors and submit related proposals.

The CSX *Decision*

In another important decision handed down in 2008, the U.S. District Court for the Southern District of New York considered the issue whether "synthetic" ownership of securities in the form of derivatives constitutes "beneficial ownership" of those securities under Section 13(d) of the Exchange Act. In *CSX Corp. v. Children's Investment Fund Management (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y. 2008), the court ruled that two hedge funds violated the Federal securities laws by using total return equity swaps — a type of derivative that gives the holder substantially all of the indicia of stock ownership other than formal voting rights — in a "plan or scheme to evade" the beneficial ownership reporting requirements of Section 13(d). This strategy has been employed by hedge funds to amass significant economic

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DOJ Antitrust Division Answers Questions Under Leniency Program

By Richard E. Donovan

It would be hard to argue with the success of the revised Leniency Program that the Department of Justice Antitrust Division ("Division") introduced 15 years ago. The program (sometimes referred to as the Amnesty Program) has brought in record fines from corporate defendants, increasing the number and length of jail terms for individuals, and provided free passes for those fortunate enough to qualify.

The Division recently issued an interesting policy paper that clarifies its position on certain issues under the program, which positions previously may have been known only to those who practice regularly in the field of criminal antitrust. The paper, titled "Frequently Asked Questions Regarding the Antitrust Division's Leniency Program and Model Leniency Letter" ("Paper"), was authored by Scott Hammond, Deputy Assistant Attorney General ("DAAG") for Criminal Enforcement, and Belinda Barnett, Senior Counsel in the Division. In the form of answers to 33 questions, the Paper also restates the Division's position on various points regarding the program, and attaches copies of revised individual and corporate model leniency letters used by the Division. Copies are available on the Division's Web site. Mr. Hammond subsequently published an article on the Web site of the Cartel and Criminal Practice Committee of the ABA Section of Antitrust Law, which summarizes the 22-page Paper. The Paper states that "it is meant to be a comprehensive and updated resource" and will be periodically updated with input from the private bar and business community.

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Following are the points most likely to be of interest to corporate counsel:

Who You Gonna Call?

Since only the first company or individual to contact the Division to apply for leniency may receive a complete pass from criminal penalties, time is of the essence. As the Paper notes, "on a number of occasions, the second company to apply for leniency has been beaten by a prior applicant by only a number of hours." Those few hours can cost a company millions of dollars in fines and cost individuals jail time. So it is helpful to the average reader that the Division makes clear as to whom a leniency applicant should contact to initiate the process, and provides the actual phone numbers of the contacts. Mr. Hammond, the Criminal DAAG, reviews all requests for leniency and so should be the first person to call in most cases. However, counsel may also contact any one of the seven Division field offices or the National Criminal Enforcement Section in Washington, especially if counsel knows that there is already an existing investigation in one of those offices involving the subject matter of the application.

The Marker System

The Paper explains the process following the initial call, from market to conditional leniency letter to final letter. Because a company may not know definitively at first whether it has actually participated in a criminal violation of the antitrust laws, the Division developed a marker system to allow a potential applicant to hold a place in line for a finite period of time while its counsel gathers more information to support the application. Once an applicant secures a marker from the Division, no other potential applicant can "leap frog" over the applicant that has the marker. The Paper confirms Division practice that, to obtain a marker, counsel must "(1) report that he or she has uncovered some information or evidence indicating that his or her client has engaged in a criminal antitrust violation; (2) disclose the general nature of the conduct discovered; (3) identify the industry, product, or service involved in terms that are specific enough to allow the Division to determine whether leniency is still available and to protect the marker for the applicant; and (4) identify the client."

As the Paper notes, "the evidentiary standard for obtaining a marker is relatively low … ." However, it would not be enough to state that the client has received a grand jury subpoena or been the subject of a search warrant; there must be some information or evidence to suggest a possible violation. The Paper goes on to explain the factors that determine the length of time an applicant is given to perfect its application, notes that 30 days for an initial marker is common, and confirms that the marker may be extended at the Division's discretion if the applicant can demonstrate a good faith effort to proceed in a timely manner.

The Scope of Leniency

In the Paper, the Division emphasizes that in order to obtain a conditional leniency letter, the applicant must admit to participation in a criminal antitrust violation (*i.e.*, price-fixing, bid-rigging, capacity restriction, or allocation of markets, customers, or sales or production volumes). Because the marker system allows a company to investigate its conduct more thoroughly before receiving a conditional leniency letter, it is no longer sufficient for the applicant to say that there is a "possible" violation.

The Paper also answers a recurring question in affirming that the leniency protection applies not just to the antitrust offense, but to any other offense committed "in connection with the anticompetitive activity being reported." The Paper notes, however, that the leniency letter issued by the Division does not bind other prosecuting agencies. On the other hand, it points out that

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Leniency Program

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since the original leniency program was introduced in 1978, there have been no instances in which another prosecuting agency has prosecuted a leniency applicant for offenses consisting of conduct integral to the commission of the antitrust violation.

The Paper explains that the grant of conditional leniency usually applies to any act or offense committed "prior to the date of" the leniency letter. In the rare case in which significant time has elapsed between discovery of the anticompetitive activity and the report to the Division, the Division reserves the right to grant conditional leniency only up to the date the applicant represents that it terminated its participation in the activity.

Conditions for Leniency

DAAG Hammond represents that the Paper and the revised model letters are an attempt to make as transparent as possible the conditions that must be satisfied to obtain amnesty/leniency, and the process the Division will follow to revoke it as the circumstances require. First, the revised model letter now explicitly states that the burden is on the applicant to prove the accuracy of its representations to qualify for leniency. A letter granting unconditional leniency will follow only after the applicant: 1) establishes its eligibility for leniency; and 2) cooperates in the Division's investigation. The revised letters make clear that the Division may revoke an applicant's conditional acceptance into the program if it determines that either of these conditions have not been met. Before making a final decision to revoke leniency, the Division will provide notice to the applicant of the recommendation of the Division staff and provide counsel an opportunity to meet with the Division regarding the potential revocation.

Learning a lesson from its saga with Stolt-Nielsen (*see* 442 F.3d 177 (3d Cir. 2006)), the Division now requires in its leniency letter that the applicant agree not to seek judicial review of any decision by the Division to revoke conditional leniency "unless and until [the applicant] has been charged by indictment or information." The Division contends that this is not a diminution of an applicant's rights because no defendant has a right to seek judicial review of a Division decision to indict prior to the indictment. If a corporation's conditional leniency is revoked, the Division represents that it would not elect to prosecute individual employees so long as they had fully cooperated prior to the revocation and did not continue to participate in the anticompetitive activity being reported, or obstruct or attempt to obstruct an investigation of such activity.

Applicant's Role in the Offense

A party is disqualified from receiving leniency if it was "the leader in, or the originator of" the anticompetitive activity being reported. The Paper makes clear that just because a company is the largest in the industry or has the greatest market share, this will not disqualify it from receiving leniency on these grounds. Likewise, the Paper gives an example of two ringleaders in a five-firm conspiracy, noting that all of the firms, including the two leaders, are potentially eligible for leniency since there is no single leader.

Termination of the Anticompetitive Activity

Another condition to receiving leniency is that the applicant "take prompt and effective action to terminate its participation in the anticompetitive activity being reported upon discovery of the activity." Questions often arise as to just what steps are required in a particular situation. Discovery of the activity is defined to mean when the board of directors or inside or outside counsel was first informed of the conduct at issue. The Paper then clarifies that a "primary consideration is what steps are taken by management in response to the discovery of the anticompetitive activity being reported." Among other things, the company must not use those individuals who were involved in the activity to conduct the investigation, formulate the company's response, or determine appropriate disciplinary action against the participants.

The Paper states the obvious in instructing that a company must stop further participation in the activity being reported, unless the Division staff request otherwise in order to assist with the investigation (*e.g.*, to monitor and record discussions with other participants). So long as a company stops the activity, it will not be disqualified "merely because the applicant did not take some particular action."

The Division also notes that it would not revoke a company's conditional acceptance into the leniency program because a lower level employee, in a remote office, continued for some short period of time to have conspiratorial contacts with his or her counterpart. The company has not met its burden, however, if it allows the culpable employees to remain in the same position with no repercussions or inadequate supervision and fails to prevent them from continuing to engage in the actual anticompetitive activity.

Other Clarifications

The Paper reiterates the Division's policy, in accord with current DOJ procedure, that the applicant is not required to provide, as part of its cooperation, documents or communications that are protected by the attorney-client privilege or work product immunity. Similarly, disclosures made by counsel in furtherance of a leniency application are not deemed to constitute a waiver of any privilege.

The Paper also warns that unauthorized disclosures about the application or the investigation could constitute obstruction, so an applicant should discuss with the Division staff the details of informing others within the company or outside it. Other topics covered include: 1) what happens when during the investigation the company discovers that the scope of the activity is greater than initially believed, either in duration or markets involved; 2) what happens when individual executives refuse to cooperate; 3)

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The Whole Foods Antitrust Saga

Key Lessons for In-House Counsel

By R. Dale Grimes

A couple of years ago few people would have thought that a socially conscious company that specializes in selling organic groceries would find itself in a knock-down, drag-out brawl with the Federal Trade Commission. But that's just what has unfolded as a result of the FTC's challenge of the merger between Whole Foods Market, Inc. and Wild Oats Markets, Inc. While the twists and turns of the FTC's challenge have captivated antitrust aficionados for over a year and a half, there are important lessons for non-antitrust lawyers that may have a merger in their future.

First, the history of the case demonstrates that just because a merger has been consummated doesn't mean the FTC will pack up and go home. In fact, with the economic downturn and fewer mergers taking place, the FTC may very well focus its resources on completed mergers. Second, while every executive is likely to have a definite opinion about which markets their company competes in, that opinion won't carry the day in a merger challenge. Antitrust litigation is driven by competing expert testimony and economic analysis, and a company's market for antitrust purposes may end up being different than what the industry analysts report. Finally, while questionable e-mails and internal company documents may not lead to a loss in court, they can definitely cause problems in a merger challenge. It is, thus, extremely important for companies to have an antitrust compliance program that addresses document creation.

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A Quick Recap of the Litigation

By December 2008, the Whole Foods merger had evolved into three separate legal proceedings — an FTC administrative proceeding, an FTC-initiated action to enjoin the merger that bounced back and forth between federal district court and the court of appeals, and Whole Foods' federal lawsuit alleging that some of the FTC's actions violated the Constitution. As of September 2008, Whole Foods had already spent $16.5 million to defend its acquisition of Wild Oats even before filing its constitutional lawsuit — that's a whole lot of organic green(s).

A Brief History

The story of these proceedings began in February 2007, when Whole Foods and Wild Oats announced that they would merge. The terms of the deal called for Whole Foods to pay Wild Oats shareholders $18.50 a share and assume $106 million of Wild Oats' debt, for a total price tag of $700 million. In June 2007, the FTC issued an administrative complaint alleging that the merger would violate Section 7 of the Clayton Act, which prohibits mergers that substantially lessen competition or tend to create a monopoly. Simultaneously, the FTC asked the D.C. federal district court to enjoin the merger pending completion of the administrative proceeding. While the FTC did not need the injunction to go forward with its administrative case, without it, the FTC could not stop Whole Foods and Wild Oats from closing the merger and integrating the companies. If this happened, even if the FTC were successful in the administrative proceeding, it would be exponentially harder to unscramble the eggs.

In challenging the merger, the FTC argued that competition would be substantially lessened in the "premium, natural and organic supermarkets" market in a number of cities. Whole Foods, on the other hand, argued that it competed with conventional supermarkets and, accordingly, the relevant market should not be limited to supermarkets specializing in premium organic foods.

In August 2007, the district court announced that it would not enjoin the merger. The court agreed with Whole Foods that its market included traditional supermarkets, a market large enough that the merger would not be likely to substantially lessen competition. The FTC then filed an emergency motion with the D.C. Circuit Court of Appeals requesting that the merger be enjoined pending an appeal, but was rebuffed. Having won (for the time being) in the federal courts, Whole Foods completed the merger at the end of August 2007.

FTC Appeals

Not willing to throw in the towel, in October 2007 the FTC appealed the district court's August 2007 decision to the same Circuit Court that had denied its emergency request to enjoin the merger pending the appeal. While it is not unheard of for the FTC or the merging parties to pursue an appeal or continue an administrative merger challenge after losing at the preliminary injunction stage, practicalities often lead the losing party to call it a day. For the merging parties, a ruling enjoining the merger makes it hard to keep the deal together for the time it takes to complete the administrative hearing. For the FTC, if a merger goes forward, it becomes difficult to untangle the parties. On July 29, 2008, the appellate court reversed the lower court's denial of the injunction, finding that the District Court had analyzed the market issue incorrectly and that the FTC might be able to prove that the relevant market is, in fact, limited to premium, natural and organic supermarkets. The Circuit Court sent the case back to the district court to consider whether the equities supported an injunction.

The Next Step

After its win in the Circuit Court, the FTC decided not to wait for a decision on the remanded case and restarted its long-stayed administrative proceeding. On Dec. 8, 2008,

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Whole Foods

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Whole Foods threw a Hail Mary when it filed a separate federal lawsuit alleging that the FTC's conduct in the litigation and administrative proceedings amounted to a violation of its constitutional due process and equal protection rights. This suit was dismissed on Jan. 26, 2009.

Until late January, the FTC's administrative proceeding was on track for a hearing in April of this year. But, on Jan. 29, almost a year and a half after the merger was completed, Whole Foods and the FTC announced a brief ceasefire to discuss a potential settlement, suggesting that the end of the saga may be near.

What Does It All Mean?

If you're a regular shopper at Whole Foods or Wild Oats, you're likely to have an opinion about which market the companies are in and who their competitors are. But in antitrust litigation, the determination of a "relevant market" will mostly be based on the competing testimony and analysis of economists. The "relevant market" for antitrust purposes includes both the product or service the company sells and the geographic areas in which it sells. What the relevant market is will often be the crucial question in a merger challenge. For Whole Foods, if the product market is the broader traditional supermarket market, then absorbing Wild Oats would probably not have much of an effect on competition. If the market is the "premium, natural and organic supermarkets" market, then the merger could have a big impact on competition in those locations that don't have other organic supermarkets. It is worth noting that Whole Foods is not the first retailer faced with a narrower-than-expected market definition advocated by the FTC. When the FTC challenged Staples' proposed acquisition of Office Depot, it defined the relevant market as "the sale of office supplies through office superstores."

The Whole Foods case starkly demonstrates that a company's market for antitrust purposes may not be (or at least may not be in the mind of the FTC) what the business people think it is. Thus, it is crucial for in-house counsel to get knowledgeable antitrust attorneys involved when a significant merger is being considered.

Words May Not Break Your Bones, But They Can Hurt Your Merger

In its legal filings, the FTC liberally cites to, quotes, and relies on Whole Foods' internal company documents to support its argument that the merger would harm competition in the premium natural and organic supermarket market. Whole Foods and its CEO provided the agency with a good deal of ammunition, including:

- An e-mail from the CEO to the Whole Foods board of directors states, "[b]y buying [Wild Oats] we will … avoid nasty price wars in Portland (both Oregon and Maine), Boulder, Nashville, and several other cities which will harm [Whole Foods'] gross margins and profitability … . [Wild Oats] is the only existing company that has the brand and number of stores to be a meaningful springboard for another player to get into this space. Eliminating them means eliminating this threat forever";
- The valuation workbooks for the proposed merger, unfortunately (in retrospect) named "Project Goldmine," presenting Whole Foods' plan to close a number of Wild Oats stores in areas containing both a Whole Foods and a Wild Oats store, and its projection that Whole Foods would fully retain the sales diverted from the closed stores for at least ten and a half years;
- In various documents, Whole Foods refers to markets that contained a Wild Oats store, but no Whole Foods store, as "non-competitive," "cash cow," and "monopoly" markets for Wild Oats.
- The FTC also cites, as evidence that Whole Foods and Wild Oats operate in a distinct premium, natural and organic supermarket market, numerous internet message board postings made by the CEO (under the pseudonym "Rahodeb," his wife's name spelled backwards) describing how Whole Foods is different from traditional supermarkets.

If this were a John Grisham novel, documents like this would have appeared mysteriously in an unmarked envelope on a first-year FTC lawyer's desk. But in the world of mergers, these can be the very kinds of documents that companies must produce voluntarily to the FTC and DOJ pursuant to the Hart-Scott-Rodino ("HSR") Act before the merger is closed. Item 4(c) of the HSR notification form requires the company to provide documents prepared by or for officers or directors for the purpose of evaluating or analyzing the merger with respect to market shares, competition, markets, and other competition-related subjects. These "4(c) documents" will usually play a big role in shaping the government's first impression of the deal. If the FTC or DOJ decide to look closer at the deal after reviewing the HSR form, the merging parties will be served with a "leave-no-stone-unturned" request for documents and information about their business operations.

Conclusion

Merger cases are not lost solely because a company's internal documents contain damaging statements. The FTC and the courts rely most heavily on the testimony of economic experts to figure out whether a merger is anticompetitive. But lawyers and judges are human, and it is unrealistic to think that smoking-gun statements in company documents will not have some effect. In the Whole Foods case, for example, Judge Tatel's concurring opinion in the D.C. Circuit Court's decision specifically cites the "Project Goldmine" documents and the CEO's email as evidence that Whole Foods and Wild Oats operate in a premium, natural and organic supermarket market.

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Legal Economics

How to Maximize ROI of Legal Expenses While Grappling With Early Case Assessment And eDiscovery

By John F. Brown, Jr.

The upward spiral of legal costs, including the demands of Electronic Database Discovery (EDD) and the impact on early case assessment, puts pressure on departmental legal budgets. Artificial floors created by budgets derived from prior-year expenditures will give way to application of traditional return on investment (ROI) analysis to set appropriate cost levels.

Total Litigation Cost

The relevant metric for cost is total litigation cost (TLC), defined for defense matters as the sum of legal fees, third–party-related litigation costs (fees for experts, EDD vendors, court reporters etc.) and the settlement or judgment paid. To address both the absolute level of cost as well as cost predictability, a targeted approach focused on the interplay between the TLC components and the key cost drivers is superior to rough across the board measures.

Controls must focus on root causes of systemic inefficiencies that drive costs up, not just the outer manifestation. Instead of jawboning, for example, over the size of the annual increase in a law firm's rate schedule or a rebate discount on volume, questioning the paradigm itself could yield far more savings.

What to Ask

Why shouldn't, for example, corporate counsel require firms to adjust rates for individual lawyers on a case-by-cases basis as a function of the complexity, difficulty, and demands of the matter? The common assumption that judicious staffing, appropriate task allocation and quality supervision will deliver overall efficiency and lower costs is belied by recent history. In practice, the client may be left with the Hobson's choice of having a higher-rate lawyer insufficiently attentive to the task at hand, or a lower-rate lawyer lacking the full skill set and experience to strategically weight the firm's time allocations to develop the desired proof.

In addition to challenging accepted paradigms, ROI analytics has to guide and mitigate the temptation to defer or eliminate costs until absolutely necessary or critical. Prudent corporate counsel would not cut early case assessment and related EDD expenses if insight and foresight could demonstrate that a $1 cut in expense would result in more than $1 increase in judgment or settlement cost.

Are the tools available to make such analyses? Poor statistical performance in one baseline indicator would clearly contraindicate a reduction in early case assessment (ECA) expense. Almost all companies today require a budget and initial assessment of the case exposure or value. An agreed-upon litigation management plan (LMP) is the by-product of that process. Deviation between initially targeted outcomes and case budgets on one hand and final results on the other that is frequent and/or of significant magnitude suggests caution before instituting cutbacks that might cause further deterioration in performance and an increase in TLC.

Significant deviation between projections and results is not the only red flag indicator that a company is not getting sufficient ROI on its legal expense dollar. Many companies rely on metrics developed from careful studies of their overall docket and portfolios of matters within different practice areas. Matters within practice areas such as employment, products liability or environmental can be ranked by severity of exposure, into one of 10 decile categories, 1 representing cases for example with a value of under $100,000 and 10 representing catastrophic exposure.

Historical Data

Historical data can be compiled to reflect allocation of a company's legal budget among practice areas and what the average legal fee, cost, and settlement or judgment paid is as distributed through the severity rankings of different portfolios of matters.

Companies incurring nearly the same average legal fees and costs on matters that have a severity ranking of 3 or 4 as they are on 7 or 8 matters know they are not getting the same ROI on their legal expense dollar and should initiate a change in strategic approach from their firm. Similarly, a difference in average legal cost to handle comparable portfolios of matters between two legal service providers with no corresponding difference in the average settlement or judgment paid demands scrutiny. If the explanation for such disparity is a difference in the average time a case is open on the docket, corporate counsel can demand more aggressive case handling.

Metrics

Proper use of metrics can measure performance, but also can serve, as an indicator of what changes might be necessary to achieve a greater ROI from the legal expense dollar. The example of a company whose internal analysis might reflect a troubling deviation between LMP projected assessments and actual results is a good illustration.

Although most all companies claim to perform early case assessments, there are significant differences in the rigor of those assessments, the skills and experience of the lawyers making the initial raw data analyses that form the basis for such assessments, the specificity of the recommendations, and the degree to which clients brings any "teeth" to the expectation that their lawyers will live by those assessments. Foremost among the variables is the level of detail in which the lead trial partner has his or her eye on the ball during the critical initial stages of the matter. Has, for example, the assigned trial partner interviewed key witnesses at the outset as well as personally reviewed the critical initial document population?

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Legal Economics

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Variance in practice styles is a leading reason for vulnerability to common pitfalls throughout the litigation, which drives up costs. Failure to adequately challenge and explore initial conclusions of forensic experts can lead to poor strategic positioning, unwise alliances and focus or joinder on the wrong parties. Presenting initial witnesses for deposition on factual elements upon which your forensic, accounting, or other professional expert may ultimately rely before a thorough vetting of all potentially supportable expert positions has taken place can make for a quite inauspicious beginning. Staking out a position in pleadings, written discovery or deposition that reconciles internal company inconsistencies with desired proof — without a full review of "hot docs" from an early-on EDD assessment performed with vendor assistance — can backfire. Giving short shrift to the early case assessment process and adopting a learn as you go approach often results in a linear checklist type of discovery plan that wastes legal expense dollars on lines of inquiry that may have no impact on the real issues that will control the verdict outcome at trial.

Up-Front Spending

Spending "smarter" up front can save multiples of that expenditure on the back end. Companies would be well served by taking a close look at what kind of early case assessment process they are investing in. Smaller value cases and EDD are challenges to the ECA process but can be addressed by redirecting the focus to the type of information desired to flow from that process to guide future decision making.

Early Case Assessment

In small cases, the product of early case assessment should be a speedy determination as to whether the case should be tried or settled in its early stages. If the case is marked for trial after analyzing the merits and the principles at stake as valued by the company, an LMP needs to be developed proportional to what's at risk. Delaying settlement considerations by waiting until all leverage factors can be brought to bear on an adversary to drive the settlement value down, can result in legal fees and costs increasing the TLC beyond what would otherwise be achieved.

Discovery Costs

A cost-effective approach on EDD (or as is sometimes referred to, Electronically Stored Information (ESI)) should take into account both the strategic needs of ECA and the pragmatic dictates of compliance with discovery obligations. Federal Rule Civil Procedure 26 requires a "meet and confer" between adversary counsel at the onset of a case with the expectation the parties can develop agreed-upon protocols and procedures to facilitate EDD.

Parties in litigation are aware that discovery can eat up to 80% of the cost of litigation with 75% of the discovery cost most likely related to document review. When up to 90% of a matter's document population can be electronically stored information, there is a strong shared interest in taking a pragmatic approach.

Early Interview of Witnesses

Integral to the ECA process, early interviewing of witnesses can help identify the date range, document type, subject matter and author, addressee, copyee information that can be used to model searches for similar documents that will play a pivotal role in the case. Coordination with the company IT staff and appropriate EDD consultants can provide assigned counsel with a grasp of the organization's data map, key custodians, and facilitate initial efforts to organize and group the documents by categories useful to analyzing the issues in the case.

Manual Review of Documents

The practice of conducting protracted manual attorney reviews of successive blocks of documents that may result in classifying as genuinely relevant only 10% of an allegedly responsive document population can be wasteful and unproductive. Even keyword searching document populations on the most typical and popular law-firm database software is notoriously both under- and over-inclusive.

It is often more cost-effective to spend the necessary money up front for a vendor who has proprietary advanced search engine capability along the lines that Google has pioneered, to filter, issue code, and score responsiveness of documents that can then be used to put together a solid LMP from the outset. Rapid identification of "hot docs" and an understanding of where they exist in the data map will facilitate both a more coherent ECA and strategic positioning as well as afford counsel the best opportunity to get agreement on cost-effective EDD protocols at an initial "meet and confer." The company can then make a more informed decision as to what level of human review and risk they are comfortable with and tailor their cost budget accordingly.

Conclusion

Particularly in these economic times, corporate counsel deserve the highest ROI possible from their legal expense dollar. Achieving that return requires first the internal discipline to quantitatively measure performance and then critically examine the processes that drive cost. Equally important is mustering the political will to see the necessary changes through and overcome the business as usual inertia that typifies many company relationships with their outside counsel.

Executive Pay

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broad categories: 1) compliance and certification; and 2) limits on executive compensation.

Due to their limited application, chances are that your company will not be directly impacted by the guidelines. The caps on executive pay apply on a prospective basis and are currently limited to the financial industry. In addition, many of the restrictions can be waived by disclosure to the shareholders. To the extend the disclosure requirements in the guidelines apply, they go beyond

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Executive Pay

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the reporting requirements relating to executive compensation imposed by the Securities and Exchange Commission as part of the rulemaking requirements of Sarbanes-Oxley, but the changes required by the guidelines pale in comparison to the magnitude of changes to the rules governing the design of executive compensation brought about by Code Section 409A.

Importantly, the new Treasury guidelines indicate that they mark the beginning of the President's examination of the relationship between the corporate governance and compensation rules and current financial circumstances. And, the language and tone of the guidelines suggest that the current administration intends further reform of the corporate governance and compensation rules. The guidelines also contain a provision entitled long-term regulatory reform, which further suggests that additional changes to executive compensation are forthcoming.

Compliance and Certification Requirements Under Treasury Guidelines

Under the Treasury guidelines, the Chief Executive Officer of any company who receives financial assistance must certify, on an annual basis, compliance with executive compensation restrictions imposed by statute, Treasury regulation and contractual obligation. Thus, such certification would require affirmation not only of the standards imposed by the guidelines but also of those previously imposed by Code Section 409A and other laws. Additionally, the guidelines require the compensation committee of each company receiving government assistance to explain the ways in which their compensation arrangements are designed to both avert unnecessary risk taking and to reward creation of long-term value.

Although the provision related to restrictions on expenses for entertainment and holiday parties, the use of aviation services, conferences and other events, and office or facility renovations is contained under the broad category of "limits on compensation," the primary force of the restrictions come from the additional required disclosure. The guidelines require the Chief Executive Officer of all companies receiving federal funds to certify the business need for any expenditure that could be viewed as a luxury item or excessive. The guidelines expressly indicate that they are not designed to interfere with or prevent normal expenditures for normal business operations, including performance incentives, staff development, and sales conferences. Companies are also required to post the text of their expenditure policies on company Web sites, thereby mandating the policies be available not only to shareholders, but to the general public as well. This limitation appears to respond directly to the public outcry that resulted last fall when several automakers flew company planes at an estimated cost of $20,000 per round-trip flight between Detroit and Washington, DC, to request government financial assistance.

How Widespread?

Currently, these disclosures are only required by entities in the financial industry receiving government financial assistance. However, as mentioned above, as a consequence of the requirements of Sarbanes-Oxley, the Securities Exchange Commission now requires public entities to report compensation agreements involving executive officers and directors. The SEC also recently overhauled its executive officer and director compensation disclosure rules. Therefore, in light of language in the guidelines relating to long-term reform, it would not be surprising to see the SEC expand the disclosure requirements to include the certification requirements outlined in the guidelines for all public companies.

Conditions on Executive Compensation

The new guidelines distinguish between those entities seeking "exceptional assistance" and those that accept assistance under the generally available capital access program with respect to the conditions placed on compensation. The generally available program is essentially a "one size fits most" standard, with set terms and conditions for all recipients. It has a cap on the amount that each institution can receive and a uniform expected rate of return on taxpayer monies. The Capital Purchase Program announced last fall is an example of a generally available capital access program. Financial institutions that need assistance at a level exceeding what is available under a generally available program can apply for "exceptional assistance." Exceptional assistance programs are specifically negotiated between the institution and Treasury. Some of the entities that currently have such agreements include Bank of America, Citigroup, and AIG.

In addition, the new guidelines contain restrictions that are much stronger than the restrictions put into place last fall. Current tax law permits a business to deduct all salaries that do not exceed $1 million, and performance-based compensation is excluded from this amount. Last fall, this amount was reduced to $500,000 for amounts paid to top executives at certain financial institutions, but the limit applied only when the business had over $300 million in dealings with the government under the bailout program. As such, the restriction applied to very few entities, and the restriction did not cap the amount paid, it only limited the deduction the company could take. In contrast, for entities receiving exceptional assistance, the new guidelines cap the total amount of compensation for senior executives as $500,000. Restricted stock or other similar long-term awards in excess of this amount are permitted, but executives receiving such

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Takeover Defenses

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positions in companies as a prelude to launching a proxy contest.

The *CSX* decision has attracted much attention, both in financial and political circles. Even though the court did not rule that all equity swaps and other derivatives convey beneficial ownership under the Exchange Act as a matter of law, a court, for the first time, determined that activist investors can, based on their motivations and actions relating to those equity swaps and other derivatives, be deemed to have beneficial ownership of the underlying corporate shares. The *CSX* decision also warns activist investors who pursue a coordinated approach with respect to voting and ownership of a company's stock that they may be deemed to constitute a "group," and as a result have beneficial ownership of each other's shares.

Because of this decision, the utility of equity swaps and other derivatives will likely be diminished for activist investors, who will be subject to closer scrutiny by target companies, the courts and the SEC. However, because the *CSX* court did not declare that swaps and other derivatives automatically convey beneficial ownership of the underlying securities as a matter of law, numerous companies have amended their advance notice bylaws and stockholder rights plans to incorporate derivative securities into their definitions of beneficial ownership.

Re-Tooling Advance Notice Bylaws

According to our research of filings made with the SEC between April 1, 2008 and the end of the year, more than 400 companies amended their advance notice bylaws to address the issues raised in the *CNET Networks*, *Office Depot* and/or *CSX* decisions. In particular, we found that companies amended their advance notice bylaws to, among other things: 1) make it clear that they govern stockholder proposals not made pursuant to Rule 14a-8; 2) clearly distinguish between stockholder proposals to nominate a director candidate and proposals for other business; 3) clarify that the company's announcement of the agenda for its annual meeting does not relieve stockholders who wish to nominate director candidates or put forth other proposals from providing the required notice on a timely basis; and 4) require stockholders to disclose any hedging, swap or derivative agreements, or similar arrangements, when they seek to nominate director candidates or propose other business.

Considering the tendency of Delaware courts to strictly construe advance notice bylaw provisions in favor of stockholder proponents, and taking note of the relatively large number of companies that have amended their advance notice bylaws in light of the recent decisions, it certainly makes sense for all public companies to re-examine their advance notice bylaws and consider adopting some or all of the revisions discussed above. In doing so, however, care must be taken to ensure that the drafting does not create further ambiguities or contradictions that will allow a court to adopt an interpretation that actually results in a less effective advance notice bylaw.

The Return of the Stockholder Rights Plan

Stockholder rights plans, which may be implemented by boards of directors without obtaining stockholder approval (assuming the company has sufficient authorized shares), are designed to encourage potential corporate raiders to negotiate with a target company's board of directors rather than accumulating shares on the open market or launching a tender offer. This is accomplished by giving the target company's other stockholders the right to purchase target company stock at 50% of market value if any stockholder (or group of stockholders) purchases shares, without prior board approval, above a designated triggering threshold. In response to pressure from activist investors and corporate governance advisers such as RiskMetrics Group (RMG), which leveraged the accounting scandals of 2001–2002 and the adoption of the Sarbanes-Oxley Act to press their cases for abandonment of rights plans and other takeover defenses such as classified boards, the popularity of rights plans declined significantly. In fact, contrary to the advice given prior to 2002, takeover defense experts began advising their clients to defer adoption of a rights plan until hostile activity or unwanted share accumulations surfaced.

However, our research of filings made with the SEC during 2008 shows that more than 80 companies adopted rights plans last year, signifying a noteworthy shift in attitudes. Indeed, the number of rights-plan adoptions increased dramatically throughout 2008, most noticeably following the market dislocations of last September. Also, as discussed below, the terms of the rights plans themselves have evolved in response to case law and positions taken by stockholder activist groups.

Triggering Thresholds

Rights plans generally have included triggering thresholds of 10%, 15% or 20%. RMG has announced that it will support only those rights plans that incorporate at least a 20% triggering threshold. However, among Delaware companies that adopted rights plans in 2008, the majority used a 15% triggering threshold. Further, of the Delaware companies that amended their rights plans in 2008 to change their triggering thresholds, nearly two-thirds incorporated a triggering threshold of 15%.

Inclusion of Derivative Positions in the Definition Of 'Beneficial Ownership'

Traditionally, a holder of economic interests through derivative positions has not been considered a "beneficial owner" of the underlying company stock, for purposes of rights plans. Consequently, a holder of such interests could accumulate a significant economic interest in a

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Takeover Defenses

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company without worrying about exceeding the triggering threshold under the company's rights plan. However, following the *CSX* decision, the percentage of companies adopting rights plans who have incorporated derivative positions in their definitions of "beneficial ownership" increased. Notably, companies have effected this incorporation in several different ways: some delineate various types of derivative positions; others incorporate an additional defined term, "Synthetic Long Position"; and others use the term "derivative," but do not define it or list which types of derivatives are encompassed by the term.

Expiration Periods

Rights plans customarily have been effective for ten-year terms. RMG has announced that it will support only those rights plans that have two- or three-year terms. However, among Delaware companies that adopted rights plans in 2008, the majority used a ten-year term. Perhaps as a middle ground, some companies adopted three-year independent director evaluation provisions, also called TIDE provisions, under which a committee of independent directors must review and evaluate the company's rights plan, at least every three years, to determine if it remains in the best interests of the company's stockholders. After this review, the committee is required to report its recommendations to the board. Although TIDE provisions have increased in popularity, they were employed only by a minority of Delaware companies adopting rights plans in 2008.

Stockholder Approval Provisions

RMG also has adopted a policy recommending that its clients withhold votes for directors at companies that adopt a rights plan, or amend one to extend the expiration date, without in either case obtaining stockholder approval within 12 months following adoption or amendment. Seeking stockholder approval of a rights plan may create issues for a company, however. For instance, if stockholders reject a plan, the company could very well become a target of a hostile bidder seeking to take advantage of a potentially disaffected stockholder base. Moreover, the board might be reluctant to adopt a rights plan, or might be more susceptible to second guessing if it reinstitutes a rights plan, in response to hostile takeover activity. Stockholder approval provisions did not seem to take hold with Delaware companies adopting rights plans during 2008, with only a small minority incorporating such provisions.

Stockholder approval provisions did not seem to take hold with Delaware companies adopting rights plans during 2008 …

NOL Rights Plans

Section 382 of the Internal Revenue Code may limit a corporation's ability to carry forward its net operating losses (NOLs) and to utilize certain built-in losses to offset future Federal taxable income following an "ownership change" (as defined in Section 382 and its accompanying Treasury Regulations). In an effort to maximize a corporation's use of its NOLs and other tax attributes, the corporation may adopt a rights plan with a triggering threshold of just under 5% to minimize the likelihood of a Section 382 ownership change.

NOL rights plans have become increasingly popular with companies that have incurred significant tax losses in the current economic downturn but anticipate becoming profitable, and therefore benefiting from their NOLs, in the future. For instance, homebuilder Hovnanian Enterprises and building-materials manufacturer and distributor USG Corp. each adopted an NOL rights plan in 2008. Both plans incorporated a 4.9% ownership trigger and both companies stated that the purpose of their plans was not to thwart hostile takeovers, but rather to ensure that they are able to maximize use of their NOLs.

Conclusion

It makes good sense for public companies, and particularly those with depressed stock market prices, to revisit the effectiveness of their takeover defenses. For companies that abandoned takeover defenses under pressure from institutional stockholders and/or corporate governance activists, the recent spate of advance notice bylaw amendments and stockholder rights plan adoptions should provide a measure of cover to corporations who feel the need to enhance their defenses. Moreover, all public companies need to be aware of the judicial decisions handed down during 2008, as well as the continued development of financial products that allow for quiet share accumulations, to make sure that their takeover defenses remain viable and effective. And, as always, advance planning allows a board of directors and its management team to fully address their companies' vulnerabilities and particular needs in a thoughtful and deliberative manner, before an actual threat arises.

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Executive Pay

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restricted stock or long-term incentive compensation will be prevented from cashing in the award until the earlier of two events: the government has been repaid with contractual dividends, or at a specified period of time and according to conditions that account for repayment obligations, stability standards, and protection of taxpayer interests.

Entities that receive exceptional assistance must also change their compensation arrangements to include a provision permitting the entity to recoup bonuses and incentive compensation under certain circumstances. Specifically, the top 25 senior executives must repay incentive pay if the executive is found to have knowingly provided inaccurate information in the financial statements or performance measures used to calculate incentive pay. This is an expansion of the restrictions issued last fall, which included a clawback provision, but limited it to the top five executives. In addition, the top ten senior executives are prohibited from receiving any "golden parachute" payments upon severance, and the next 25 executives are limited to severance payments of no greater than one year's compensation.

For companies that accept funds under the generally available programs, similar restrictions apply, but some of the restrictions can be waived by disclosure. A company can waive the $500,000 cap on senior executive pay by disclosure of the compensation and using a "say on pay" resolution with their shareholders. A company that accepts funds under a standard program will also be required to institute a clawback provision that would require repayment of bonuses or incentive pay by any of the top 25 senior executives in the event the executive is found to have knowingly engaged in providing false information as to the financial statements or performance measures on which their compensation is based. The top five executives are also prohibited from a golden parachute payment that exceeds one year's compensation. All companies accepting future funds will be required to explain how the compensation arrangements for not only senior executives but for all other employees are designed to prevent unnecessary and excessive risk taking.

LONG-TERM REFORM MEASURES: WHAT'S NEXT?

The last section of the guidelines requires efforts to examine how company-wide compensation strategies may have rewarded excessive risk-taking and contributed to the current economic conditions. One of the recommended steps includes requiring all compensation committees of public financial institutions to review and disclose how executive and employee compensation are consistent with promoting sound risk management and long-term value for companies and shareholders. This provision indicates that such examination and disclosure is going to be required of all financial institutions, not just those that are receiving governmental assistance.

The guidelines also make suggestions regarding limits on stock incentives and stronger shareholder say on the policies behind executive compensation. Specifically, the guidelines indicate that serious consideration should be given to a blanket rule requiring top executives at financial institutions to hold stock for several years before being able to redeem the stock for cash payment. They also suggest that shareholders of all financial institutions should have a say on the amount of executive compensation and on how to structure incentive compensation to promote long-term value. The guidelines end by announcing that the Treasury Secretary will host a conference to further address executive pay reform at financial institutions. This further suggests that these guidelines are only the beginning of increased disclosure and accountability requirements.

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Leniency Program

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whether present and former officers, directors, and employees are covered; 4) the need to make restitution; and 5) whether the Division may disclose information from an applicant to a foreign government.

The Division has made efforts to be transparent about its Leniency Program by issuing papers and making speeches from time to time. The Paper is the latest and most comprehensive effort in that direction, for which the Division deserves credit.

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Whole Foods

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For these reasons, in-house counsel must pay close attention to the language used in company documents both on a day-to-day basis and when a merger or acquisition is being considered. Documents that exaggerate or misstate the company's market position or the effect of the deal by using loaded words like "monopoly," battle terms like "crush" and "defeat," or descriptions of the merger's benefits as the ability to dominate a market or prevent new entrants can put the company and its expert witnesses at a real disadvantage in a merger challenge. In-house counsel should consider establishing as part of the company's antitrust compliance program, policies and training regarding the use of competition-related language. Further, when a merger or acquisition is first being considered, it is important to engage knowledgeable antitrust counsel to review all documents that discuss the potential transaction.

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