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DIGEST FOR CORPORATE & SECURITIES LAWYERS

ABSTRACTS OF INSIGHTFUL CURRENT ARTICLES FROM LEGAL PERIODICALS

COUNSELING EARLY-STAGE AND GLOBAL FIRMS

Top 10 Legal Mistakes Of Early-Stage Tech Companies

By James Greenberger
Schwartz Cooper Greenberger & Krauss, Chicago, IL
Business Law Today
Vol. 10, No. 3, Pgs. 8-15

Overview: *Reviews the mistakes that early-stage companies commonly make regarding corporate governance, equity distribution, and intellectual property. Advises on simple steps counsel can take to avoid those mistakes.*

A real company with real records. Corporate counsel can help an early-stage company prepare for success by avoiding certain mistakes. Some errors involve the failure to discover, protect, or properly license intellectual property; others entail corporate governance and equity distribution. One of the most common lapses by early-stage companies is failing to maintain the corporate records properly. Courts examine whether a company has observed the formalities of corporate governance when deciding whether to pierce the corporate veil and impose personal liability on the shareholders. Failing to keep good records of outstanding equity can also cause confusion at the time of an attempted IPO. A good shareholder agreement is invaluable. Majority shareholders will benefit from a drag-along provision, under which they can force all other shareholders to sell their shares to a third party at the same time.

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Equity mistakes. If the company grants below-market options or restricted stock, it may face a cheap-stock problem when it tries to go public. Should the SEC decide that the company has not accounted for the fair market value of stock and option awards, it will demand that the company restate earnings to reflect a higher compensation expense. This restatement can devastate the company's attempt to go public. To avoid the problem, carefully document the value of any stock or option grants at the time they are made. Compare option prices to those of contemporaneous sales to outside investors, and chronicle events that caused the share price to increase from the time of the option grant to the date of the IPO. Granting options or restricted stock before adopting a proper stock option plan is an error. The company can reduce its tax burden and that of its employees by adopting a qualified incentive stock option plan. ISOs permit an employee to postpone recognizing income until the employee actually sells the underlying stock.

The 83(b) election. Companies sometimes err by precluding their employees from making an IRC Section 83(b) election, which reduces the tax burden on restricted stock grants. Normally, recipients are taxed on the value of restricted stock at the time it vests, usually over a period of time. However, because the stock's value (hopefully) increases during that period, the tax burden may be significant and, since the stock may still be illiquid, the recipient may have no means to pay the tax. Under Section 83(b), the recipient can choose to be taxed on the grant immediately, when the share value is low (although the employee will still be paying tax on the gain when selling the restricted stock). To elect under Section 83(b), file a written election with the IRS within 30 days following receipt of the restricted stock; missing the deadline waives the election forever. Curiously, employees and counsel to technology companies miss this requirement with astonishing regularity.

Sailing out of the safe harbor. Early-stage companies create trouble for themselves by selling stock to unaccredited investors. Most early-stage firms try to take advantage of Regulation D's safe harbor, but it imposes

particularly stringent conditions on securities sold to unaccredited investors. Rule 501 of the regulation states that someone is an unaccredited investor unless the person is a director, executive officer, or general partner of the issuer; has a net worth over $1 million; or has income in excess of $200,000 ($300,000 for joint returns) in each of the two most recent years. In an offering exceeding $1 million, the issuing company must provide unaccredited investors with specific, extensive, written information about the company and about the offering. Companies can sell stock to unaccredited investors under other 1933 Act exemptions, but none gives the certainty of a safe harbor.

Editor's Note: For a website with substantial educational content and other useful materials on pre-IPO stock options and restricted stock, visit *www.myStockOptions.com.*

Establishing A Company Presence Around The World

By Brian Olson and Scott Squillace
Grand Circle LLC, Boston, MA
ACCA Docket
Vol. 19, No. 2, Pgs. 32-47

Overview: *Analyzes the decisions a US company faces when setting up a foreign subsidiary or branch. Charts the legal steps chronologically from preliminary investigations through structure, tax, and governance issues.*

Form a branch. Corporate counsel trying to establish an overseas branch for a US company faces a plethora of choices and decisions. In a hub-and-spoke organization (where foreign offices provide support services but not direct sales or production), the only practical choices are an unincorporated branch or a locally incorporated subsidiary. Within the European Union, the branch of a member-state parent can function effectively without legal hindrance; in most situations, however, only a locally incorporated sub will satisfy the host country's laws on management behavior and revenue requirements. Since the sub's separate incorporation also shields the parent from liability, this form is the most popular. The parent often can structure the foreign sub less formally, such as by creating a French SARL or German GmbH, forms similar to the US limited liability company. This may result in some loss of liquidity when transferring ownership interests but nevertheless yields greater operational flexibility.

Governance formalities. Local counsel must undertake the registration for the sub and, in so doing, resolve questions over signature authority. In most situations, the local manager should have day-to-day authority; only major corporate events and financial transactions should necessitate home-office involvement and consent. Many jurisdictions require multiple shareholders, so local managers or even other subs might have to act as shareholders. Several countries also require that local nationals serve as officers and directors, and that they also hold shares. The parent usually must indemnify them from liability, which most local laws either require or permit, but not in the corporate charter documents. The parent must therefore generate a separate indemnification agreement.

Incorporate carefully. The incorporation process for a foreign sub is much more involved and formal than in the US. Be prepared for paperwork delays. Corporate counsel may have to proffer passports and other personal identification for officers and directors of both parent and sub; evidence of clean criminal records; and evidence of the sub's initial capitalization. In many countries, documents must be signed by every director, plus notarized and sealed by a notary. To avoid the requirement that the notary be licensed in the foreign jurisdiction (and thus avoid having every director take an unexpected plane ride overseas), US companies can follow the Hague Convention and attach an *apostille* (an official certification of the notarization, issued by the domestic state's Secretary of State).

Taxation of parent/sub relations. US tax regulations now permit election to treat a foreign sub as a branch for tax purposes, a procedure that is reasonably flexible but that requires close attention to time schedules. The parent must also, for a services-only sub, consider local tax requirements that the sub make a profit to avoid taxation of the parent's income. Management services agreements can generate an intercompany payment flow to provide the requisite local income and demonstrate arm's-length dealing between parent and sub. Often the parent funds the local office on a cost-plus basis, showing a 5%-10% profit to the sub.

CORPORATE GOVERNANCE

Ending The Stalemate: Taking A Second Look At The SEC's Latest Shareholder Proposal Release

By John Wilcox
Georgeson Shareholder Communications
Corporate Governance Advisor
Vol. 9, No. 1, Pgs. 1-7

Overview: *Notes universal dissatisfaction with the SEC's rule on shareholders' proxy proposals. Advocates reforms, and recommends ways to operate more constructively under the rule.*

Universal discontent. SEC Rule 14a-8 on shareholders' proxy proposals pleases no one. Under this rule, the SEC must reject any shareholder's proposal that is not relevant to the company's business or that deals with ordinary business operations. The SEC complains that, under tight deadlines and without bright lines, reviewing each proponent's argument and each company's response—it processed almost 500 no-action letters in 2000 and predicts over 600 in 2001—takes time away from weightier regulatory duties. Issuers complain that the SEC interprets the standards too leniently, which allows activists to second-guess management, and too inconsistently, which creates uncertainty. They also resent the annual submission of identical proposals, a problem exacerbated by the low threshold for resubmission under Rule 14a-8(i)(12) and the lack of a sunset provision. Despite the SEC having substantially reformed corporate governance in the last 15 years, stockholders think that the Commission interprets the standards too strictly and that proposals receiving majority support should be binding, even though this is a question of state law.

Revisiting reform. In 1997, the SEC proposed radical changes, trying to rectify the rule's inflexibility, but stockholder groups and issuers alike attacked the reform initiative. Lacking a mandate, the Commission scaled back its efforts and barely made a wave with much-diminished amendments. Discontent might make everyone more receptive now, although the SEC has declared it will not make another attempt soon (so shareholders or issuers must make the first move). The proposed reforms would have raised the resubmission thresholds on the second, third, and fourth tries from 3%, 6%, and 10% respectively of the votes cast to 6%, 15%, and 30% respectively. In view of vote levels for shareholder proposals since 1997, these thresholds should be higher. The SEC would also have let owners of 3% of the outstanding stock override an issuer's exclusion of certain proposals; this percentage should be higher. To prevent abusive tactics, a cap on the number of shareholder proposals in any single proxy statement might also be necessary.

Chiding for issuers. Both issuers and stockholders merit criticism for their opposition to reform. Each side could operate more constructively under the current Rule 14a-8 if they chose. Instead of rigidly opposing all shareholder proposals, the company could negotiate compromises. When a proposal seems likely to pass, the issuer ought to analyze its ownership base and institutional investors' voting policies, gauge the strength of the opposition, and round up enough votes to win. Since the era of so-called clean proxies is long gone, management would be wise to develop a thick skin against the activist stockholders' outspoken dissatisfaction.

Scolding for proponents. For their part, stockholders should be selective, targeting companies with deplorable governance practices and performance rather than those with high visibility; making proposals that could actually alter company behavior, not just garner high votes; and using publicity to embarrass management only when forced. Since proposals are referendums and not tools to bypass management, stockholders should stress dialogue over micromanagement and focus on long-term goals instead of the current year's vote total. Institutional proponents must practice what they preach and not violate governance standards that they seek to impose on companies. Without resorting to Rule 14a-8, stockholders can still wield influence by voting against management's proposals, withholding votes from management's board candidates, or nominating their own candidates. Organizing on the Internet makes all these alternatives feasible.

Editor's Note: Another article from the same issue on a related topic is "Scope Of The Ordinary Business Exclusion Involving Employee Compensation Shareholder Proposals" by Catherine Dixon, Theresa Regan, and P.J. Himelfarb, Pgs. 8-11.

Corporate Governance: Current Trends And Likely Developments For The Twenty-First Century

By Michael Goldman and Eileen Filliben
Potter Anderson & Corroon, Wilmington, DE
Delaware Journal of Corporate Law
Vol. 25, No. 3, Pgs. 683-713

Overview: *Extrapolates from recent trends in corporate governance to forecast the likely ramifications. Predicts the roles of technology and globalization, and perceives an emphasis on the private ordering of business relationships.*

Technology drives governance. The Internet has freed corporate governance from the corporeal. The computer-tech revolution in instant communications has dramatically affected investor relations, largely with the SEC's blessing. At the same time, state regulators are permitting corporation/investor interaction, including the annual shareholder meetings, to proceed electronically. The confluence and extension of these trends is that virtually all corporate communications to, from, and between investors will transpire in virtual space, using fully electronic notices, consents, proxies, document deliveries, and reporting, plus webcast conferences and meetings. Quorums, not now counted electronically, surely will become so. Electronic communication

between shareholders will facilitate the monitoring roles of institutional investors.

Evolution of investors' input. The increased activism of institutional investors in the name of managerial accountability portends the creation of new structures and even an accountability industry. As technology promotes transparency, monitoring of management can become systematized. Professional monitors may intermediate between shareholders and companies, for example, to nominate slates of directors and disseminate governance information and analysis. Investors who wish to concentrate on economic concerns can still receive timely notice of governance issues that detract from performance.

Globalizing companies. The globalization of business and finance, accelerated by the advent of the euro, will foster mergers and consolidations, may create a global currency, and might mark the dissolution of national boundaries for corporate organization. The long-debated European company charter may prove merely a way-station for an even more globally standardized form. At the same time, standards of corporate governance, now largely a function of national structures and customs, are already beginning to cross national borders. European investor groups now study the methods used by US institutional shareholder activists; thus, the communications revolution will extend to cross-border corporate monitoring and governance standards. Companies in developing countries may be able to harness cross-border communications and technology to compete more equally with enterprises in developed countries.

Making up new rules. In parallel with globalization, promoters have sparked a renewed interest in private solutions to governance issues, exemplified by the emergence of the limited partnership and the limited liability company. These business forms glorify—in ways upheld by the courts—the contractual resolution of fiduciary issues and the fine-tuning of management liabilities. In a curious reversal, the trend toward privately ordered arrangements may clash with and eventually trump the elaborate corporate monitoring and governance mechanisms that institutional investors so far have favored. Investors may eventually decide that they prefer economic performance to supervisory franchise. Contractually delimited management rights may then replace legislated and court-ordered duties, in exchange for more precisely defined economic performance guarantees by management.

MERGERS & ACQUISITIONS

Employee Benefit Issues In Mergers And Acquisitions

By Richard Nix, McAfee & Taft, Oklahoma City, OK; and Timothy Verrall, Morrison & Foerster, Irvine, CA
Oklahoma City University Law Review
Vol. 25, Nos. 1-2, Pgs. 435-490

Overview: *Surveys how employee-benefit liabilities pass in stock and asset sales. Offers advice on structuring the deal, conducting due diligence, and negotiating the purchase agreement.*

Structure and due diligence. The inclusion of employee-benefit plans can have considerable influence on the structure and costs of acquisitions. In a stock purchase, the buyer automatically assumes all liabilities under plans not terminated by the seller before the closing; in an asset purchase, the buyer usually chooses which liabilities to assume and might require the seller to discontinue its plans. The parties must determine whether they belong to a controlled group of companies, since certain employee-benefit liabilities could extend to the whole group. For example, the Internal Revenue Code provides that a parent/sub group exists if a parent has a controlling interest or 80% voting power in a sub. Due diligence should cover formal documentation, including in-force and proposed amendments, and correspondence for all effective or terminated employee-benefit plans (as the term is defined in ERISA) and all other plans, programs, and contracts concerning compensation.

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Pension and severance plans. For tax-qualified plans, due diligence should focus on disqualifying violations of defined-contribution 401(k) plans (such as excess contributions) and underfunding of defined-benefit plans. The seller's financial statements usually show funding liabilities but often include unrealistic or out-of-date assumptions. The purchaser could terminate a defined-benefit plan after assuming it, if IRS rules on nondiscrimination permit. The IRC bars the purchaser from making distributions under either type of plan before a participant's "separation from service," which is more difficult to determine but more likely to occur in an asset sale than in a stock sale. The seller could also have severance plans, including golden parachutes, large enough to kill the deal. The payment trigger is the frequently undefined "termination of employment." A stock sale would generally not trigger payments, but an asset purchaser should require the seller to amend an unclear plan, specifying that no payments are due to individuals employed by the purchaser.

Health plans. The parties must allocate responsibility for pre- and post-closing claims under the seller's health-and-welfare plans. Pre-closing claims (e.g., for AIDS treatment or premature births) could be huge. The seller's funding vehicles might disguise the fact that it pays claims itself while representing that it has fully insured them. The buyer must be sure that the seller gives certificates of coverage to terminated employees, as the Health Insurance Portability and Accountability Act of 1996 requires. The seller will usually not fully fund a plan providing for retirees' medical benefits nor reflect this liability on its financial statements, so the purchaser must ascertain which current and future retirees are eligible and whether it can reduce benefits, terminate the plan, or increase premiums.

Union and COBRA issues. A merger could trigger the seller's withdrawal liability under a union's underfunded, multiemployer pension or health-and-welfare plan, or the buyer could become liable by assuming the seller's obligations and subsequently withdrawing. The plan trustees can quantify this liability. Under COBRA, an asset sale resulting in the employees' loss of health coverage generally results in their right to continued coverage. A stock sale ordinarily does not, unless the seller ceases all coverage. COBRA allocates responsibilities between the parties, if the purchase agreement does not otherwise specify. The purchaser could also become liable for the seller's pre-merger COBRA infractions. The buyer should require the purchase agreement to include the seller's representations and warranties that all employee-benefit plans comply with all applicable law, together with appropriate indemnities; an escrow from which to pay claims; and, if the parties can quantify liabilities in advance, purchase-price adjustments. The seller will request a materiality limitation, although the IRS could terminate a qualified plan for even a nonmaterial defect.

All Dressed Up With Somewhere To Go: How To Succeed In Selling Your Business Without Really Trying (Too Hard)

By Fredric Tannenbaum
Gould & Ratner, Chicago, IL
Practical Lawyer
Vol. 46, No. 8, Pgs. 17-37

Overview: *Recommends basic steps to facilitate the sale of a business. Highlights legal issues to be considered in the sale process. Outlines the pitfalls for each party.*

Prepare to sell. Before negotiating the sale of a business, a seller can take certain steps to facilitate the sale and increase the price. Begin by putting together a team of experienced attorneys, investment bankers, and accountants. The attorneys will review the legal issues and oversee preparation of an organized, complete data room to house the due diligence materials. The bankers and accountants will assist in valuing the business and preparing a confidential information memorandum, which describes the company to potential acquirors. Consider how to retain employees throughout the sale process, perhaps by providing information about the sale on a need-to-know basis and offering retention bonuses to important employees. Because private companies often reduce taxes by reporting lower profits, consider revising financial statements to make them comparable to those of public companies. Revisions might include reducing insiders' salaries to market levels and depreciating rather than expensing capital items.

Before doing the deal. The seller may wish to negotiate a letter of intent (often nonbinding) to gain comfort on the potential buyer's commitment to the deal. The letter of intent typically sets out the assets and liabilities to be included in the sale, a deposit (refundable under certain circumstances), important post-closing details, and the seller's agreement to deal exclusively with the buyer for a specified period of time. Upon signing, the buyer can begin reviewing the target company's legal, financial, and business status.

Structuring for value. To value the transaction accurately, look at recent sale prices of comparable businesses or use a formula, such as a multiple of earnings or revenue. The parties might also discount future cashflows to determine an appropriate value. How the deal is structured carries corporate, securities, and tax

implications. A stock sale transfers the entire business intact, perhaps thereby avoiding certain third-party approvals, but the buyer cannot choose the assets or liabilities it wishes to assume. The buyer can if the deal is structured as an asset purchase but may pay a higher purchase price because it benefits from a step-up in basis for the assets.

Items for the P&S. The purchase-and-sale agreement includes representations and warranties about the business. The typical representations about financial condition rarely provide a buyer adequate comfort on the company's future cashflow prospects. Look at potential liabilities, including those for copyright infringement, tax withholding, and barter obligations, as well as review the status of major contracts. In negotiating indemnification provisions, set the time period when damages may be asserted, a damage amount that must be reached before a claim can be made, and a cap on the amount for which the seller is responsible. Negotiate the buyer's right to terminate the deal before closing if a material adverse change occurs in the business, financial condition, assets, or properties. Consider the time period, geographic scope, and breadth of products included in a noncompetition agreement.

Are Dead Hand (And No Hand) Poison Pills Really Dead?

By Prof. Peter Letsou
University of Cincinnati College of Law
University of Cincinnati Law Review
Vol. 68, No. 4, Pgs. 1101-1156

Overview: *Considers the legality of dead-hand and no-hand features of poison pills. Argues that dead-hands are still viable under Delaware law. Includes suggestions to enhance and insure the validity of these provisions.*

The evolution of pills. Flip-in shareholder rights plans, developed during the 1980s, remain the standard in antitakeover devices to this day. In a hostile takeover, these plans allow shareholders to acquire substantial equity in the surviving company at a steep discount, thus eliminating the economic advantage. Because the target's board can redeem the shareholder rights at nominal cost prior to certain triggering events, acquirors began to couple deals with a proxy contest to elect directors to the target board, which would then redeem the pill so the acquiror could proceed with its stock acquisition. To counter this possibility, companies have adopted so-called dead-hand or no-hand features as part of their rights plans. Dead-hand provisions require that the only directors who can vote to redeem the pill are the continuing directors—those who were in office when the pill was adopted or who were elected with the support of incumbent directors. No-hand provisions suspend, limit, or eliminate the board's ability to redeem a pill once a majority of the board has been replaced. However, recent decisions void certain features and cast doubt on all dead-hand and no-hand provisions.

Delaware speaks. Two 1998 Delaware cases—*Carmody v. Toll Brothers* and *Quickturn Design Systems v. Shapiro*—were the first to address the issue. In *Carmody*, plaintiffs challenged the dead-hand provision incorporated into the defendant's poison pill. The chancery court held that the plaintiffs had stated a cognizable claim under two theories. First, the dead-hand provision illegally restricts the power of future boards to redeem the pill, contravening the mandate under Delaware Corporate Law Section 141(a) that the board manage the corporation. Second, the provision violates the board's fiduciary duties to shareholders under the *Unocal* and *Blasius* standards. In *Quickturn*, the no-hands provision prevented the Quickturn board from redeeming a poison pill for 180 days after a successful proxy contest, but only with respect to transactions with interested parties (the party that sponsored the proxy contest). The Delaware Supreme Court held that this provision unlawfully curtails the board's powers under Section 141(a). The board could be relieved of such fundamental management powers only by a specific provision of Delaware law or a provision in the corporation's charter.

Hand of the living dead. Although many assume that *Carmody* and *Quickturn* invalidate dead-hand as well as no-hand provisions, that may not be the case. *Quickturn* should be read narrowly to invalidate only no-hands, because all poison pills restrict the power of future boards in some fashion. A narrow reading is the only way to reconcile *Quickturn* with years of Delaware law validating poison pills. In addition, dead-hand pills do not oust the board's power to sell the corporation. They merely place certain limits on the structure and timing of the transaction. Furthermore, even if dead-hand pills do eliminate the full board's power to sell the company, the group of continuing directors can be considered be a committee of the board. Section 141(c) specifically permits the board to delegate to a committee. Delaware case law indicates that boards can delegate even the most fundamental powers (except for certain exceptions specifically listed in the statute) and that the full board can even delegate irrevocably—without retaining the power to take back its delegation.

After *Quickturn*. Corporations can take steps to make their pills more defensible and effective. First, increase the power of the full board to mitigate the effects of the

pill and sell the company. Amend the pill, for example, to permit the target company to self-tender for the poison-pill rights. This would give all future boards the ability to circumvent the pill (albeit at a considerable cost, since they would have to purchase the rights at market price, but Delaware courts have consistently refused to invalidate corporate provisions simply because they would be expensive). Second, recast shareholder rights plans by issuing new poison pills in the form of convertible preferred stock. This gives the plan a foundation in Delaware law. Section 151 gives the directors the power to establish the terms of preferred stock. Furthermore, it provides that when the board sets the terms of preferred stock, it must spell out the terms in a certificate of designations, which has the effect, when filed, of amending the corporation's charter. Finally, to insure effectiveness, amend the pill to apply to all merger and asset sales, not just (as is commonly the case) those that take place after a bidder acquires sufficient shares to render the pill nonredeemable.

Editor's Note: Another important M&A issue for directors is discussed in "Directors' Duties In Sale Of Delaware Corporations With Controlling Shareholder" by Dennis Block and Jonathan Hoff, *New York Law Journal*, Dec. 28, 2000, Pgs. 5-6.

DIRECTORS' FIDUCIARY DUTIES

Toward Transaction-Specific Standards Of Directorial Fiduciary Duty In The Tracking-Stock Context

By Jeffrey Schick
Washington Law Review
Vol. 75, No. 4, Pgs. 1365-1397

Overview: *Surveys criteria for duties to holders of tracking stock and rejects most across-the-board standards. Argues for an approach based on the type of transaction involved.*

Tracking the director's dilemma. Tracking stock is a security whose dividend and liquidation rights (and therefore whose market performance) depend on individual businesses within a larger corporate enterprise. It creates novel fiduciary concerns for the directors, whose obligation is to enhance the performance and value of the entire corporation. Internal transactions, even asset and funding allocations—decisions that in a conventionally capitalized company pass easily as an exercise of standard business discretion—become fraught with fiduciary significance when a subset of the stockholders may view them as prejudicial. If the directors themselves are not proportionally invested in all the tracking stock, they theoretically risk losing the protection of the business judgment rule, should the law deem them personally interested in one or the other side of an internal transaction.

Courts not much help. The Delaware courts have said little on tracking concerns. Only two cases deal with fiduciary problems alleged to have arisen in tracking-stock companies. In *General Motors Class H Securities Litigation* in 1999, the chancery court applied conventional fiduciary rules to reject contentions that a conflict of interest between classes of stockholders voided the directors' business judgment protection, at least so long as the imbalance in the directors' financial interests was not materially large. The court reaffirmed this position in *Solomon v. Armstrong,* which the Delaware Supreme Court affirmed in 2000. The court noted that the directors' actions must promote, on the whole, the interests of all classes of stockholders and also of each individual class. The statement begs the question whether this is possible in many circumstances, and it does not clarify how directors can balance loyalties when making even routine transactions.

Alternate theories not much better. Scholars and litigants have advanced other bases on which to evaluate the relationship between the board and the holders of tracking stock. One suggestion is the essentially contractual analysis Delaware courts use on preferred stockholders' rights, in which fiduciary rights apply only insofar as the preferred stockholders' interests coincide with those of common stockholders. The courts in both *General Motors* and *Solomon* mentioned the contractual nature of tracking-stockholders' rights without directly comparing them to preferred stockholders. Another analytical path is the entire fairness standard often arising when a parent deals with a non-wholly-owned subsidiary to the prejudice of the sub's minority stockholders, although the *Solomon* court explicitly rejected this line of reasoning. Both alternatives seem flawed: the contractual approach offers little or no protection of the preferred or, by extension, tracking-stockholders; and the entire fairness standard arguably offers too much, hamstringing the directors when they are making day-to-day business decisions.

Proper approach blends standards. None of the standards adequately protects tracking-stockholders from forced expropriation of corporate opportunities, or directors from impossibly conflicting obligations to different classes of stockholders. However, it should be possible to combine the best elements of each standard and emphasize those principles suitable to particular types of transactions, based on the degree of board discretion involved and the reasonable expectations of a tracking-stockholder. Thus, purely contractual,

nonfiduciary analysis would apply to dividend, voting, liquidation, exchange, and similar rights attaching to the tracking stock. Allocation of corporate assets, opportunities, and similar mundane but discretionary decisions could reasonably remain the province of traditional fiduciary standards of care and loyalty. The *Solomon* caveat would remain in place, that a director's materially disproportionate financial interests adverse to a class of tracking stock might eliminate the business judgment rule's cover. In transactions between business units, to the extent it is possible to ascertain an arm's-length market standard, the entire fairness standard would be appropriate.

A Guide To Challenging Option Repricing

By Prof. Amanda Esquibel
University of Memphis Humphreys School of Law
San Diego Law Review
Vol. 37, No. 4, Pgs. 1117-1163

Overview: *Discusses the legal issues and obstacles faced by a stockholder hoping to challenge the company's repricing of options. Suggests that the influence of institutional investors may be a more effective means than shareholder derivative litigation to discourage the repricing of options.*

The problem with option repricing. In many companies, stock options are an important piece of compensation. When the company's market price is significantly below the price at which stockholders may exercise their options, the board may motivate employees to remain with the company by resetting the exercise price or exchanging the options for others with a lower exercise price. Outside shareholders may feel that the repricing decision is unfair because the employee/shareholders get the benefits of stock ownership without the risk of a price downturn. They may view repricing as rewarding management for a job poorly done. Repricing will cause the outside stockholders to suffer greater dilution, because the employee is more likely to exercise the repriced options. It also affects the company's capitalization, since the exercising employees will pay the company less for their stock.

Directors' duties when repricing. As a result of their decision to reprice options, the directors may be liable for breach of their duties of care and loyalty. If they act in a grossly negligent manner, failing to inform themselves adequately about the decision, they will fail to meet a procedural duty of care. To avoid this liability, set a separate repricing policy for executives, using outside experts to evaluate whether employees actually would leave in the absence of repricing, and assess what consideration the corporation will receive for the repricing. The directors must also comply with a substantive duty of care, which bars the repricing if doing so would result in a waste of corporate assets. To comply with their duty of loyalty, directors must make corporate decisions by putting the company's interest before their own. Complying with this duty may be particularly problematic if the board is responsible for the drop in the stock price that led to the decision to reprice. In that instance, the directors, unlike other participants in the option plan, receive both the benefit of a lower exercise price and a pardon for their earlier mismanagement.

Hurdles for the plaintiff. Courts will use the business judgment rule in evaluating the decision. A plaintiff/shareholder must rebut the presumption that the decision was a valid exercise of business judgment by alleging that the directors' acts were fraudulent or self-interested, or that the directors had failed to use due care. Where the directors are independent and use the requisite care—and assuming the corporation received adequate consideration—the business judgment rule usually will validate the decision to reprice options. Shareholders attempting to challenge a repricing decision must also hurdle two sections of Delaware corporate law. Section 144 lets directors approve corporate transactions in which they have an interest if the interested directors disclose all material facts about the conflict and a majority of the disinterested directors or the shareholders approve the transaction. Section 157 permits directors (although perhaps only disinterested directors) to make the determination, absent fraud, as to the consideration's adequacy.

Pressure from institutional investors. Given the difficulty of challenging the board's decisions to reprice options, institutional investors have used their economic power to contest these choices. They have gone directly to the boards of companies in which they hold substantial investments and asked those boards not to reprice options. In at least one case, an institutional investor proposed an amendment to the company's bylaws, which would require stockholder approval for any repricing decision. As both these stockholders and boards appreciate, if the institutional investors withdraw their investment, the company's stock price may fall and the company will face significant public relations issues.

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