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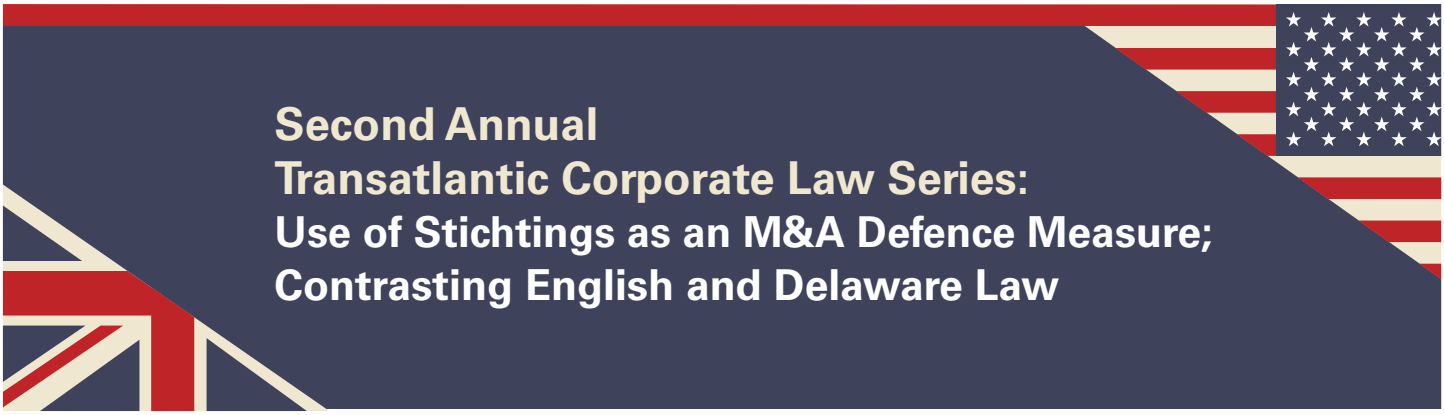

Second Annual Transatlantic Corporate Law Series: Use of Stichtings as an M&A Defence Measure; Contrasting English and Delaware Law

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Skadden and Erskine Chambers recently hosted a series of comparative corporate law events in conjunction with the University of Pennsylvania Law School; Queen Mary University of London School of Law; New York University School of Law; Wachtell, Lipton Rosen & Katz; Slaughter and May; Morris, Nichols, Arsht & Tunnell; and Richards, Layton & Finger.

The mock trials held at Inner Temple, London, offered new insights into contrasting English and U.S. advocacy and judicial opinions on complex cross-border M&A issues. Arguments were made by Richards, Layton & Finger partner Greg Williams and Morris, Nichols partner Bill Lafferty for the Delaware mock trial before Chancellor Andy Bouchard of the Delaware Court of Chancery, and by Erskine Chambers' James Potts QC and Michael Todd QC for the English mock trial before The Right Hon. Lord Justice David Richards of the Court of Appeal of England and Wales.

Each of the mock trials was based on a hypothetical takeover scenario, involving competing bids, a "poison pill" defence in the form of the Dutch stichting and shareholder litigation brought by an activist investor. Edward Rock (professor of business law at The University of Pennsylvania Law School, and now professor of law at NYU) moderated the trials and discussed the first instance decisions with Delaware Supreme Court Chief Justice Leo Strine and Court of Appeal of England and Wales judge The Right Hon. Lady Justice Gloster.

The following day, Skadden hosted an interactive panel discussion with Skadden partners Michael Hatchard and Scott Simpson; Wachtell, Lipton partner David Katz; Chief Justice Strine; and Slaughter and May partner William Underhill. The discussion was moderated by Prof. Rock and Centre for Commercial Law Studies at Queen Mary University of London Prof. Rodrigo Olivares-Caminal.

Fact Pattern

The fact pattern for both mock trials was based on the same hypothetical takeover scenario, involving some alternative facts relevant for the analysis under Delaware or English law, as applicable.

The target, Inverted Industries, is a pharmaceutical company created by an inversion transaction (alternatively incorporated in Delaware and England) and listed only on the NYSE. Inverted Industries chose to adopt in its articles a stichting as a hostile takeover defence mechanism.

The stichting had an irrevocable call option over preference shares that would trigger upon the threat of a change of control, giving the Inverted stichting voting power over 50 percent of the votes of Inverted Industries.

For the purpose of the Delaware moot, the preference shares could be redeemed by Inverted Industries' shareholders at a general meeting called by the board or by shareholders owning at least 10 percent of the share capital. For English purposes, the preference shares could be redeemed by the board of Inverted Industries.

MedTech Corporation, a shareholder in Inverted Industries, appears to have been in discussions with Captain America Activism (a U.S. hedge fund and another shareholder of Inverted Industries) about a MedTech takeover of Inverted Industries.

Inverted Industries announces that it is interested in pursuing a combination with China Consolidator PRC. For the Delaware argument, China Consolidator PRC announces that if its bid succeeds, it intends to keep Inverted Industries' management team, and at least half of the board. For the English argument, China Consolidator PRC announces that if its bid succeeds, it will retain the existing board of Inverted Industries.

In response to the Inverted Industries announcement, MedTech decides to make a takeover bid for Inverted Industries at a 25 percent premium. MedTech announces that it does not intend to retain the current Inverted Industries management team or board.

Inverted Industries opposes the MedTech bid and the Inverted stichting board exercises the call option, acquires the preference shares with the effect of controlling 50 percent of the voting power of Inverted Industries and confirms full support of the combination with China Consolidator PRC. Despite Medtech raising its bid to a 75 percent premium, the Inverted stichting board fails to support the MedTech bid.

For the Delaware argument, the Inverted Industries board declares that it is unable to influence or dissolve the stichting and refuses to call a meeting of shareholders to vote to redeem the preference shares controlled by the Inverted stichting, because it believes that the continued maintenance of the stichting is increasing its leverage with the bidders. For the English argument, the Inverted Industries board fails to resolve to redeem the preference shares held by the stichting for the same reasons.

Captain America brings litigation challenging the call option granted to the stichting and the actions of the Inverted Industries board, asserting that the Inverted Industries board has breached its fiduciary duties by not taking steps to redeem the preference shares controlled by the Inverted stichting. For the English argument, Captain America complains that the stichting defence was not adequately disclosed to shareholders when they voted to approve the articles of Inverted Industries.

Delaware Court of Chancery Mock Trial

Arguments were presented on behalf of the plaintiff, Captain America, by Mr. Lafferty, of Morris, Nichols, and on behalf of the defendants, Inverted Industries Corporation and its board of directors, by Mr. Williams, of Richards, Layton & Finger.

Mr. Lafferty asserted on behalf of Captain America that voting of the preference shares held by the stichting should be enjoined for two reasons:

1. **Illegality**

   The call option granted to the Inverted stichting was in violation of Section 141(a) of the Delaware General Corporation Law, which provides that the business and affairs of a corporation should be managed by the board of directors.

2. **Improper Application**

   Even if the grant of the call option is legal, the defendants had failed to discharge their burden of proving that the Inverted stichting was reasonable in relation to an actual threat posed by MedTech's bid.

To rebut the illegality reasoning, the defence relied on the statutory exception to the rule under 141(a), that the board of directors shall manage the business and affairs of the corporation unless otherwise provided in the corporation's certificate of incorporation. The defence submitted that Inverted Industries' certificate of incorporation did provide otherwise by including the stichting that was approved by the stockholders.

Arguments were also heard in relation to whether there was a public policy limitation on the scope of the statutory exception and whether the negotiations had reached an "end point", such that it may be appropriate to grant relief.

High Court of Justice of England and Wales, Chancery Division, Mock Trial

Mr. Potts, of Erskine Chambers, represented Captain America, and Mr. Todd, also of Erskine Chambers, represented the defendants.

Captain America sought an order from the High Court setting aside the stichting on the following grounds:

1. **Nondisclosure**

   Whereas the plaintiffs in the Delaware mock trial presented an illegality argument, claiming that the stichting was by its nature contrary to Delaware law, the claimants in the English moot submitted that the Inverted board failed to make adequate disclosure of the nature of the stichting arrangement to Inverted's shareholders prior to the general meeting that approved the inclusion of the stichting in Inverted's articles of association.

2. **Improper Purpose**

   The claimants further submitted that, even if the stichting was validly established, the board members of Inverted were acting in breach of their duties by failing to exercise the fiduciary power vested in them to redeem the shares issued to the stichting. In particular, it was submitted that the directors refused to redeem the shares for an improper purpose.

The defendants did not argue that the claimant's action should be struck out (for shareholders' lack of standing or otherwise), but they did rebut the nondisclosure allegation, on the basis that the shareholder circular had expressly disclosed the proposed changes to Inverted Industries' articles and that such disclosure was adequate to enable shareholders to make an informed investment decision. Mr. Todd, on behalf of the defendants, also argued that the claimants could not discharge the burden of showing that, in failing to exercise their power to redeem the preference shares, the directors had acted for an improper purpose.

Decisions and Discussion

After the arguments had been heard, a panel comprised of Chancellor Andy Bouchard; Lady Justice Gloster; Lord Justice David Richards; and Chief Justice Strine delivered their decisions.

Delaware Decision

Our first instance Delaware Court of Chancery upheld the authority of Inverted Industries to implement the stichting but granted the injunction sought by Captain America to allow the Inverted shareholders an opportunity to vote on the MedTech bid.

Chief Justice Strine indicated he might overturn such a decision on appeal on the following procedural grounds: (i) an interim injunction in this context may have the same effect as a mandatory injunction, and (ii) there would be difficulties in proving irreparable harm, given that, on the facts, shareholders owning at least 10 percent of Inverted Industries could call a meeting to redeem the preference shares.

It was also noted that the Delaware court would exercise caution in allowing shareholders who have approved a stichting to later claim that its application is inequitable.

The argument seemed to establish that a stichting defence could under certain circumstances be deployed by a U.S. company.

English Decision

The claim was dismissed at first instance and also on appeal.

In relation to the "inadequate disclosure" claim, Lord Justice Richards held that the adoption of the power in the articles was not invalid — on the facts, a circular had been circulated to Inverted Industries' shareholders prior to the meeting. This circular stated that the preference shares could be redeemed by Inverted Industries. It was noted that under general principles of English company law, powers are conventionally exercisable by the board. A shareholder reading the circular could reasonably be expected to assume that it was the board, not the shareholders, who would exercise the power to redeem.

Although the "improper purpose" claim also failed on our fact pattern, Lord Justice Richards suggested that the key question was not whether the power had been exercised for a proper purpose, but rather whether the Inverted board members were exercising their powers in good faith in the best interests of the company. If it could be proved that they were exercising their powers only to retain their remuneration packages, they would be acting in bad faith. On the facts, this was a hurdle that the claimants were unable to overcome; an inference that the Inverted board may have been influenced by China Consolidator's announcement that they intended to retain the current directors was insufficient to conclude they had acted in bad faith. Moreover, the defendants had presented a perfectly valid explanation for the failure to redeem the stichting's shares, namely to keep China Consolidator in the game.

Lady Justice Gloster highlighted that the English court is reluctant to interfere with strategic decisions of directors, unless there is real evidence that directors are improperly motivated and acting in bad faith, and stressed that there would be practical challenges in obtaining such evidence in the context of an urgent injunction to restrain a corporate transaction.

Interactive Panel Discussion

Panel's Views on the Mock Trial

Delaware Mock Trial

- If shareholders blessed a Dutch-style "poison pill" in conjunction with the implementation of a transaction, or otherwise approved its implementation, this structure could be used in Delaware as an alternative to the usual Delaware-style "poison pill".
- The timing of the application may influence the result: The court would be reluctant to grant final relief unless it was satisfied that the auction has reached an "end point".
- Much like the English court, the Delaware court saw no room for public policy arguments in this case, given that the board or 10 percent of shareholders could requisition a meeting to vote on redeeming the preference shares.

English Mock Trial

- The legitimacy of "poison pill" structures in England is an open question that has been debated for some time; it was enlightening that two Court of Appeal judges had indicated that a "poison pill" structure would be acceptable if it were duly enshrined in, or authorised by, an English company's constitution.
- Although public policy arguments against the arrangement were made on the basis that, by analogy, the principles underpinning the Code are contrary to the ability to frustrate a bid, such public policy concerns were given short shrift by the English judges.
- Mere inference that directors may have been influenced by remuneration or retention packages is insufficient to support a claim that they have exercised their powers for improper purposes; rather, it would be necessary to establish that they had acted in bad faith, which is a much higher evidentiary hurdle to overcome.
- No arguments were presented that the claim should be struck out, most likely as this is an order of last resort, used only in plain and obvious cases.

Establishing a Stichting as a Defensive Measure

The panel discussed the alternative means of establishing a stichting: (i) in connection with an initial transaction or (ii) subsequent to a transaction. There was consensus among the panellists that a board would face strong opposition from shareholders should they attempt to put such a defensive mechanism in place subsequent to a transaction; a stichting would be more likely to be approved in connection with an initial transaction, even if voted on separately under the SEC "unbundling" rules, or upon an initial public offering.

Governance Structure of a Stichting

Prof. Rock invited the panellists to consider who, in their opinion, should be appointed as directors of the stichting. The following points were raised:

- The "traditional" view is that distinguishing the stichting board members from the board room facilitates the independent operation of the stichting and minimises the exposure of the target's directors. On the other hand, the board may not feel comfortable granting a large voting stake to an independent body and may also face challenges in finding appropriate independent individuals whom they would wish to appoint to the stichting board.
- In Delaware, however, there may be a legal vulnerability in appointing entirely independent directors to the stichting board: If the board appoints only independents to the stichting board, the court may ask (i) why and on what basis the board has delegated control and authority to this entity, and (ii) to whom the stichting is accountable.
- From an English perspective, it was suggested by some panellists that the stichting board ought to mirror the board of directors, provided mechanisms are in place to mitigate any conflicts of interest.

Invoking Defensive Mechanisms

The panel discussed the protections that have been built into the constitutions of companies that are products of inversions, absent the jurisdiction of the Takeover Panel and the protections afforded by the Takeover Code. The panel noted that, from an English perspective, there may be other mechanisms (such as a stichting) that may be legitimately incorporated into a company's constitution to repair some of the issues in the defence packages that were implemented in the past. One complicated issue, however, is the extent to which directors of public companies would be constrained when implementing such a mechanism. Currently, there is no English jurisprudence on this point, whereas U.S. case law indicates that directors ultimately have a duty to maximise value in the context of an auction.

Putting a Target in Play and Contesting Control

The panellists discussed the relative value of the stichting to a strategic bidder and an activist shareholder on the basis of the fact pattern. It was noted that "poison pills" in the U.S. have ceased to have powerful deterrent value and therefore now tend to be put in place in response to a bid. It was generally agreed, however, that the stichting could be used to deter bidders or elevate price, especially if there is the additional pressure point of the threat of a shareholder meeting being convened to redeem the preference shares, as was the case in the fact pattern.

The panel also discussed the influence of activist or institutional investors who might seek to exercise their powers to call a meeting to take down the structure or to change the board — it was noted that in the U.K., shareholders would likely exercise such powers before bringing an action against the target or its directors.

Key Takeaways

There were a number of common threads that ran through the arguments heard and the points discussed over the course of this year's Transatlantic Corporate Law Series:

- There is currently no English jurisprudence on the use of stichtings as a defensive "poison pill".
- In both our Delaware and English mock trials, it was held that the stichting had been legally and validly established by amending the company's articles of association at the time of the inversion transaction. In practice, it would be challenging to seek shareholder approval for such a defensive mechanism other than upon an initial public offer or an initial transaction, such as an inversion or similar cross-border merger.
- Neither the panel nor the appellate judges found arguments against the stichting based on public policy to be persuasive.
- The timing of an application for relief is critical: Courts will be reluctant to grant relief if such relief would unduly prohibit an auction or bidding process from playing out.
- Claimants face a high bar of proving irreparable harm absent the granting of relief. If it cannot be shown that action has been taken in bad faith and where shareholders have already approved the structure at a general meeting, it may be difficult to successfully argue that injunctive relief should be granted.
- Granting shareholders power to convene a meeting at which they could vote to reverse the mechanism is an important safety net that could help protect the target board if faced with shareholder litigation challenging the board's decision to retain and implement the defence.
- There may be advantages, in certain circumstances, in aligning the board of the stichting with the target board. This is a departure from Dutch established practice.

A unifying theme is that on both sides of the Atlantic, the fundamental rights and power of shareholders results in a market-driven environment. Against this backdrop, securing initial shareholder approval and permitting shareholders to unwind a stichting are likely to be crucial prerequisites for implementing this defence in practice.