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SEC Issues Formal Interpretation Regarding Proxy Unbundling Rule in Merger & Acquisition Transactions

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On September 20, 2004, the Securities and Exchange Commission Division of Corporate Finance (the "SEC") issued the fifth supplement to its Telephone Interpretations Manual which provided specific interpretative guidance regarding the application of Rule 14a-4(a)(3) (commonly called the "Unbundling Rule") in the context of merger and acquisition transactions.

The Unbundling Rule requires that the form of proxy used in stockholder voting must identify clearly and impartially each separate matter intended to be acted upon, whether or not related to or conditioned upon the approval of any other matter. The Unbundling Rule, thus, allows stockholders to choose between approval, disapproval and abstention of each separate matter. The rule was designed to protect stockholders against being coerced into voting for proposals combining stockholder-friendly and stockholder-unfriendly features. In response to recent investors' criticism that the SEC should do more to enforce the Unbundling Rule, the SEC issued specific interpretative guidance which clarifies the circumstances under which unbundling of stockholder proposals is required in merger and acquisition transactions.

When Unbundling is Required

Generally, the SEC interprets the Unbundling Rule to require that when stockholders vote on a merger or acquisition transaction, the proxy materials must include as a separate voting proposal each corporate matter implemented through the merger (e.g., charter or bylaw amendment) if state law, securities exchange listing standards or the company's charter or bylaws would require shareholder approval of the proposal if it were to be considered independently of the merger transaction. According to the SEC, unless immaterial, matters should be unbundled on the stockholder proxy if:

- the provisions in question were not previously part of the charter or bylaws of the voting stockholders' company;
- the provisions in question were not previously part of the charter or bylaws of a public acquiring company; and
- state law, securities exchange listing standards, or the company's charter or bylaws would require shareholder approval of the proposed changes if they were presented on their own.

Applying these guidelines, the SEC has indicated that corporate governance-related and control-related proposals should generally be set out as separate proposals. Examples include the following:

- classified or staggered board;
- limitations on the removal of directors;
- supermajority voting provisions;
- delaying the annual meeting for more than a year;
- elimination of ability to act by written consent; and
- changes in minimum quorum requirements.

If more than one of these types of proposals is affected by the merger and acquisition transaction, each affected proposal (or group of related proposals) should be clearly identified as a separate proposal.

Companies may still condition completion of a transaction on stockholder approval of separate proposals. However, any of these conditions must

be prominently disclosed in the proxy statement and should be clearly indicated on the form of proxy.

When Unbundling May Not Be Required

Unbundling would not be required where an acquiring public company's charter or bylaws differ from the acquired company's charter or bylaws, but the acquiring company's charter or bylaws will not be changed in connection with the merger. The SEC believes that requiring separate approval in that context would be tantamount to unnecessary re-approval of a public company's pre-existing charter or bylaw provisions.

Unbundling also would not be required when the company whose stockholders are voting on the transaction already had the same or comparable provision in its charter or bylaws before the transaction. For example, if Target Company A already has a staggered board of directors, and a staggered board of Acquiring Company B is included as part of the merger proposal, Target Company A's stockholders would not need to separately approve the staggered board provision. However, if Acquiring Company B's stockholders were voting on the merger and Acquiring Company B did not have a staggered board, the staggered board provision would have to be separately presented for Acquiring Company B's stockholders approval.

Other provisions that would not need to be unbundled include the following:

- bylaw changes that may be adopted solely by the board of directors;
- shareholder rights plans adopted in connection with a merger;
- name changes;
- immaterial restatements of charters;
- technical changes (such as those resulting from anti-dilution provisions);
- the form of merger consideration; and
- other potential forms of consideration, such as break-up fees.

Also, unbundling would not be required in an all-cash transaction so long as the target company stockholders' rights would not be adversely affected by provisions that will become applicable as a result of the transaction.

Finally, the SEC made it clear that companies may not avoid the application of the Unbundling Rule by structuring transactions through the use of shell entities.

Special Care in Structuring Voting Provisions in Acquisition Agreements

The SEC's guidance on the application of the Unbundling Rule in acquisition transactions would require special care in drafting stockholder voting provisions in acquisition agreements. In addition to paying close attention to the drafting of closing conditions and covenants related to submitting stockholder proposals for a vote in acquisition agreements, the Unbundling Rule would also require special focus on the structure of voting agreements and irrevocable proxies which are common in the acquisition context.

If you have any questions about the supplement or its implications, please feel free to contact any of the following members of our Mergers & Acquisitions Group:

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