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SEC's "Unbundling Rule" Interpretation

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The SEC has issued two new compliance and disclosure interpretations on the so-called "Unbundling Rule." The SEC appears to have been motivated to issue the CDIs as part of the political reaction against, and desire to deter, inversion transactions.

The CDIs relate to proposed M&A transactions in which an acquiror would be issuing its equity securities to the target stockholders and the transaction agreement requires the acquiror to make material changes to its organizational documents (such as corporate governance changes). The SEC staff has established a new requirement for separate, precatory (i.e., non-binding) target stockholder votes on material changes to the acquiror's organizational documents ("unbundled" from the target vote on the transaction itself)—which is designed to heighten the visibility to target stockholders of proposed acquiror corporate governance changes.

As discussed below, *while the CDIs create new procedural and disclosure-related requirements, they do not impose any new substantive requirements*. In our view, the new requirements are not likely to have any practical effect on inversions or other transactions. Transactions generally are driven primarily (if not exclusively) by the economics of the transaction—in the case of inversions, the tax benefits derived. In our view, it is unlikely that administrative action by the SEC (or, as occurred last year, by the IRS)—without legislative change that reduces the economic benefits of inversions—will be effective in deterring inversions.

The Unbundling Rule

The Unbundling Rule (Rule 14a-4(a)(3) of the Exchange Act) requires that proxy statements "identify clearly and impartially each *separate matter* intended to be acted on" at a stockholder meeting (emphasis added). The SEC's guidance under the Rule is intended to clarify—in the context of a proposed M&A transaction in which the acquiror will issue its equity securities to the target and the transaction agreement requires that the acquiror make material changes to its organizational documents (such as material corporate governance changes)—whether the corporate governance changes must be voted on as "separate matters" (i.e., "unbundled") from the vote on the transaction itself. Each separate vote, of course, requires separate disclosure in the proxy statement and a separate box on the proxy card.

How the new CDIs differ from the past guidance.

*The CDIs do not change past guidance with respect to the required vote by stockholders of the**acquiror**, but add a new requirement that there be a non-binding vote by **target** company stockholders.*The previous guidance relating to the Unbundling Rule is contained in the SEC's "September 2004 Interim Supplement to the Publicly Available Telephone Interpretations." The new guidance (CDIs 201.01 and 201.02) was issued on October 25, 2015.

Acquiror's stockholder votes.

Under the previous guidance—and as confirmed in the new guidance—proposed material corporate governance changes must be presented to the acquiror's stockholders as *separate* proposals from the vote on the transaction itself. As in the former guidance, CDI 201.01 provides the following examples of amendments to an acquiror's organizational documents that would be material (and thus must be presented separately): adoption of a classified or staggered board; limitations on the removal of directors; adoption of supermajority voting provisions; delaying the annual meeting for more than a year; eliminating the ability to act by written consent; and changes in minimum quorum requirements. The following are provided as examples of amendments that in most cases would *not* be considered to be material: name change; restatement of a charter; and technical changes such as those resulting from anti-dilution provisions.

Target's stockholder votes—*New requirement* for non-binding *target*stockholder vote on acquiror's material governance changes.

CDI 201.01 provides that, if an acquiror is required to present corporate governance changes to its stockholders as separate matters for a vote, and if the target stockholders are to receive equity securities of the acquiror in the transaction, *then the target company must present the same set of amendments separately on the target company's form of proxy and submit them to a vote of the target company stockholders*. The staff explains in the CDI: "This is because the amendment, which is a term of the transaction agreement that target stockholders are being asked to approve, would effect a material change to the equity security that the target stockholders are receiving in the transaction." In the CDI, the staff notes its position that target company stockholders should have an opportunity to express their views separately on those material provisions that will establish their substantive rights as stockholders, even if they would not otherwise be entitled to vote on these matters under state corporate law, exchange rules or otherwise. Importantly, the new, separate vote of the target stockholders on the acquiror's material corporate governance changes would be precatory and not binding, and (absent agreement of the parties to condition the transaction on approval of the governance changes by the target stockholders) the acquiror would have all necessary legal and other authority *without target stockholder approval* to effect the corporate governance changes so long as its own stockholders approved them.

Transaction can be conditioned on approval of corporate governance changes.

The CDI confirms that, in all cases, the parties can condition closing of the transaction on acquiror and/or target stockholder approval of any or all of the separate proposals. The CDI does not *require* the parties to condition the transaction on approval of the governance changes by the target stockholders—and it appears that generally parties would be unlikely to do so, given that the acquiror would have all necessary legal and other authority to effect the corporate governance changes without target stockholder approval of them so long as its own stockholders approved them. It remains to be seen whether there may be future developments that would encourage parties to condition the transaction on target stockholder approval of the governance changes—such as, say, proxy advisory firms adopting policies for withhold campaigns against acquiror directors if they proceed without target stockholder approval of the governance changes. (In the event of such developments-which we view as unlikely-the new vote requirement could have a substantive impact.)

Technical clarifications.

The CDIs provide the following technical clarifications:

- **Formation of new acquisition vehicle.** CDI 201.02 provides that, as was true under the former guidance, if the parties form a new entity to act as an acquisition vehicle that will issue securities in the transaction, the party whose stockholders are expected to own the largest percentage of equity securities of the new entity following the closing would be considered the acquiror for purposes of the Unbundling Rule. The CDI appears to provide that the new entity's organizational documents will be compared to the acquiror's organizational documents to determine whether there are material changes.
- **Amendment to increase authorized shares.** CDI 201.01 clarifies that, if the acquiror submits for approval of its stockholders an amendment to increase the number of authorized shares, that amendment need *not* be submitted by the target to its stockholders so long as the increase is limited to the number of shares reasonably expected to be issued in the transaction.
- **Conditions.** As noted, the parties can agree to condition any one or more of the proposals on which action is to be taken on the approval of any one or more of the other proposals. If the parties condition the transaction or any of the separate matters on approval of any other matter, the conditions must be clearly disclosed and indicated on the form of proxy.

Practical Effect of the New Requirement

In our view, the new, separate vote required by target stockholders on material corporate governance changes to be made by the acquiror represents *process without substance* and is unlikely to have a practical effect, for the following reasons:

- **Target stockholder vote is not substantive.** The separate votes of the *acquiror's stockholders*on the transaction, the issuance of equity, and the proposed corporate governance changes *are*substantive, in that acquiror stockholder approval is required under state law and/or exchange rules to effect each of them. Because the votes are separate, the acquiror stockholders can approve the transaction and at the same time in effect veto corporate governance changes that they do not support. Thus, the acquiror stockholder votes on the governance changes provide the acquiror stockholders with meaningful leverage with respect to the transaction, as their approval is required for the contemplated governance changes to be effected. By contrast, the separate votes of the *target's stockholders* on the governance changes are *not* substantive. The target stockholder votes on the governance changes do not provide the target stockholders with any leverage with respect to the transaction—because their approval is not required for the contemplated governance changes to be effected. The target stockholders can in effect veto the governance changes that they do not support only by holding the transaction hostage and not approving it. Without target stockholder approval of the governance changes, the transaction and the governance changes still can proceed (absent the parties having agreed that they would not proceed without target stockholder approval of the governance changes).

- **Separating matters has no effect when they can be conditioned on each other.** Given that target stockholder approval is not required to effect the acquiror's governance changes, it appears that there would be no reason for the parties to decide to condition the transaction on obtaining that approval. Even if the parties *were* for some reason to condition the transaction on target stockholder approval of the governance changes, however, generally, there would be no substantive difference between a single vote on the transaction agreement with the governance changes embedded in it (as has been the case in the past) as compared to separate votes on the transaction and each of the governance changes (as now required by the CDIs).

- **Stockholders will focus primarily on the economics of the proposed transaction.** We expect that target stockholders will be *primarily* motivated by the economics of the proposed transaction. If they regard the economics as favorable, in our view, they are unlikely to try to use any leverage that they have to vote against the transaction in order to veto the governance changes because they will not want to jeopardize the deal happening.

- **Inversions.** There has been speculation that the CDIs are the SEC's effort to respond to the political and public displeasure with inversion transactions (in which a U.S. company merges with a non-U.S. company to obtain the tax-related benefits of being reincorporated in the acquiror's jurisdiction.) Inversions have continued notwithstanding the U.S Treasury's changes last year in the tax-related benefits that drive inversions. (See our article, *Recent IRS Pronouncement Aims to Stem Tide of Tax-Motivated Inversions—But, In the Absence of Legislative Change, These Administrative Measures Are Not Likely to Prevent Future Inversions*, Fried Frank M&A Quarterly, 4th Quarter 2014.) The heightened visibility of the governance changes resulting from the new requirements might be expected to have an impact if it were *the general public* (which generally has a negative view of inversions) voting on the proposed transaction rather than *the stockholders* of the acquiror and the target. As noted above, however, we expect that target stockholders will be primarily motivated by the economics of the transaction. Moreover, it is usually large companies that engage in inversions, and they typically have large, sophisticated institutional investors for whom heightened visibility of corporate governance changes through a separate vote (rather than a vote on the transaction agreement that encompasses those proposed changes) is not likely to affect their knowledge of, focus on, or degree of support for, those changes. We note that the imposition of more substantive limitations on inversions can be effected only by state or federal legislation.