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Rebalancing the System

Institutional Investors Fight For Corporate Governance Reform

By Amy Miller

Corporate directors and senior executives, together with aggressive corporate and legal advisors, have always sought to push the balance of power in corporations in their favor. Recently, however, institutional investors have been pushing back more aggressively by pursuing legal action as a means to reform corporate governance practices. As public pension funds and other institutional investors recognize, a meaningful result in such actions can not only provide significant benefits to the company involved in the suit, but also serve as an example for other companies to follow. This article takes a look at some of the most notable successes in achieving corporate governance reforms over the past year.

The *Pfizer* Derivative Action

In a derivative action, shareholders can assert a lawsuit on behalf of a corporation against its management or board of directors for their breach of fiduciary duties. Derivative actions provide good opportunities to improve corporate governance practices at public companies because these lawsuits can target improper conduct by directors or senior executives specifically related to their management of a company and, if successful,

can directly affect how a company is run going forward. The recent success by institutional investors in forcing corporate reforms at the drug company Pfizer following years of illegal marketing activities provides a prime example of the potential for significant changes achievable through derivative litigation, even in a company that had repeatedly resisted reform.

Institutional investors filed a derivative action against Pfizer's senior management and board to stop Pfizer's systemic marketing violations and prevent more in the future.

***Result:** In a landmark settlement, Pfizer is required to create a new regulatory and compliance committee with a broad mandate to oversee and monitor Pfizer's compliance and promotion practices funded by the litigation's $75 million settlement.*

For nearly a decade, Pfizer engaged in illegal marketing practices to sell its drugs. In 2002, Pfizer was forced to pay $49 million to settle allegations concerning the payment of illegal kickbacks to promote its anti-cholesterol drug "Lipitor." Pfizer also entered into a corporate integrity agreement that increased the responsibilities of Pfizer's senior management and board of directors to oversee drug promotion. In 2004, one of Pfizer's subsidiaries pled guilty to criminal charges related to illegally marketing another Pfizer drug, "Neurontin," for uses that were not approved by the U.S. Food and Drug Administration ("FDA"). Pfizer also agreed to pay $430 million in criminal and civil fines, and entered into an even more extensive corporate integrity agreement, making the board directly responsible for overseeing Pfizer's drug promotion. Notwithstanding these prior penalties and corporate integrity agreements, in 2009 Pfizer agreed to pay $2.3 billion in fines and civil settlements — including the largest criminal fine in U.S. history ($1.3 billion) — to resolve allegations that, over a seven-year period, Pfizer promoted at least four of its drugs for uses that were not approved by the FDA, and nine others by paying illegal kickbacks to doctors. This pattern of misconduct, and the resulting felony pleas, put Pfizer at risk of being excluded from contracting with the federal government, including Medicare and Medicaid, thereby subjecting Pfizer and its shareholders to potentially devastating consequences.

In September 2009, several institutional investors filed a derivative action against Pfizer's senior management and board to stop Pfizer's systemic law-breaking and ensure that management and the board would take appropriate steps to prevent similar drug marketing violations in the future. As the court noted in denying defendants' motion to dismiss the action, the complaint alleged "misconduct of such pervasiveness and magnitude, undertaken in the face of the board's own formal undertakings to directly monitor and prevent such misconduct, that the inference of deliberate disregard by each and every member of the board [was] entirely reasonable."

Following intense litigation, including the review of millions of pages of documents, the taking of 35 depositions, the presentation of hundreds of pages of expert reports (including reports by two former Chairmen of the SEC), and the briefing of summary judgment motions,

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the plaintiffs achieved a landmark settlement. Under the terms of the settlement, Pfizer is required to create a new "Regulatory and Compliance Committee of the Board of Directors" with a broad mandate to oversee and monitor Pfizer's compliance and promotion practices, and a specific charge to evaluate whether patterns of improper marketing exist that suggest systemic misconduct. The Regulatory Committee will receive detailed information about the promotion of Pfizer's most important drugs and any serious allegations of wrongdoing. The Committee can retain its own experts, consultants and counsel to properly evaluate this information and to take the necessary steps to stop any wrongdoing. The settlement also requires the defendants' insurance carriers to pay $75 million into a separate fund for the exclusive use of the Regulatory Committee. In addition to overseeing Pfizer's drug promotion practices, the Regulatory Committee must also review Pfizer's compensation policies and recommend a possible clawback of incentive compensation for any wrongdoers and their supervisors in the case of any future misconduct. Moreover, the settlement requires the defendants to create an ombudsman program that will provide Pfizer employees with an alternative channel to voice work-related concerns, including, for example, any complaints of pressure from supervisors to engage in improper promotional activities. Each of these reforms was directly responsive to the institutional plaintiffs' allegations and deep concerns about management's commitment to Pfizer's long-term interests.

In sum, the settlement created a self-funded corporate governance mechanism that is directly aimed at improving Pfizer's system of checks and balances and the company's corporate culture by ensuring that the board has the time and resources to focus on a critical element of Pfizer's operations: compliance with drug marketing laws. The Pfizer derivative lawsuit demonstrates that derivative actions can force changes in a large corporate structure — even at a company that has resisted change for years. The settlement has received very favorable coverage in the press, in particular concerning the settlement's unprecedented creation of a board committee charged with direct responsibility for the company's regulatory compliance as opposed to general oversight responsibility, and the advance funding of the settlement's corporate governance reforms with $75 million. Accordingly, corporate governance experts expect the settlement to set an industry standard for pharmaceutical companies and other companies in heavily regulated industries by encouraging them to create board committees that are directly responsible for their companies' regulatory compliance practices before shareholders assert derivative actions that force them to do so.

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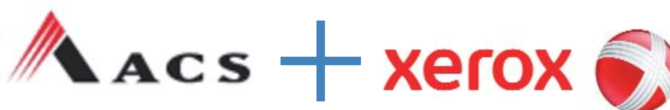
Improving Corporate Governance Practices in the Merger & Acquisition Context

Institutional investors have also achieved substantial results in their efforts to bring about better corporate governance practices in the context of a board's decision to sell a company. Recent shareholder class actions brought by institutional investors have made significant progress by challenging: (1) disparate merger consideration for different classes of stock; and (2) deal protections that make it more difficult, if not impossible, for third parties to pursue a successful bid for a company.



Institutional investors filed suit challenging special payments to controlling shareholder.

Result:* *ACS's public shareholders succeeded in negotiating a settlement under which the controlling shareholder was required to personally contribute nearly 20 percent of a $69 million cash fund in additional consideration for ACS's public shareholders.

In the recent litigation concerning the sale of Affiliated Computer Service, Inc. ("ACS") to the Xerox Corporation, shareholders challenged certain deal terms that provided ACS's controlling shareholder, who also served as the company's chairman, with hundreds of millions of dollars in additional consideration for his high-vote stock (i.e., a class of stock that provides a shareholder with multiple votes per share of stock) at the direct expense of ACS's public shareholders. After a hard-fought litigation, ACS's public shareholders succeeded in negotiating a settlement under which the controlling shareholder was required to personally contribute nearly 20 percent of a $69 million cash fund in additional consideration for ACS's public shareholders. This victory for shareholders sent a clear message to corporate boards that shareholders will not tolerate the payment of a premium to high-vote shareholders at the expense of other investors.

Similarly, institutional investors challenged the fairness of a merger transaction between the DirectTV Group, Inc. and Liberty Media Corporation in which the chairman of both merging companies — who was a high-vote stockholder in each company — tried to use his high-vote stock to extract a large personal premium at the expense of other shareholders in a subsequent acquisition of the merged companies. Shareholders were ultimately able to secure a settlement that ensured the fairness of the transaction by, among other things: (1) requiring the merger and any subsequent acquisition to be approved by a majority of the public shareholders; (2) implementing restrictions on the high vote stockholder's ability to purchase additional common stock; and (3) providing the public shareholders with increased power to require the board of directors to call and hold a special meeting of stockholders. The results in these two cases send a powerful warning to the holders of high-vote stock in other companies not to extract additional consideration at the expense of public shareholders in mergers and acquisitions.

Institutional investors challenged the fairness of a merger transaction in which the chairman tried to use his high-vote stock to extract a large personal premium at the expense of other shareholders.

Result:* *The settlement ensured the fairness of the transaction and sent a powerful warning to the holders of high-vote stock in other companies not to line their own pockets at the expense of public shareholders.

Institutional investors are also improving corporate governance practices by challenging deal protections in merger agreements to ensure that boards maximize value for their shareholders when they decide to sell their companies. Through the years, many courts have approved the use of deal protections in merger agreements. Deal protections allow a company to favor a preferred bidder. Deal protections can take many forms, such as a termination fee, which is paid to a preferred bidder if the target company accepts another bidder's offer, or a matching right, which provides a preferred bidder with the right to match another bidder's offer to remain the preferred purchaser of a company. In circumstances where a board has either conducted a market check or an auction before agreeing to such deal protections, these protections may be appropriate. In many cases, however, boards agree to deal protections without adequately ensuring that they are maximizing value for shareholders in the transaction.

Several recent cases demonstrate how institutional investors are beginning to force corporate boards to change the way they view deal protections, providing more opportunities to maximize shareholder value. In the Landry's Restaurants Inc. ("Landry's") class action and derivative litigation, an institutional investor sued Landry's board, including its special committee, and the company's CEO, chairman, and controlling shareholder, Tilman Fertitta, for breaching their fiduciary duties in connection with Fertitta's attempts to take Landry's private. Among other things, the suit challenged the special committee's grant of numerous deal protections to Fertitta, its preferred bidder. Following more than a year of litigation, the parties reached a settlement, which included many important corporate governance reforms to these deal protections in order to correct the flawed sales process conducted by the special committee. First, defendants agreed to institute a new 45-day "go-shop" period, a time to allow other bidders the opportunity to bid for Landry's under new sales terms. Second,

the settlement eliminated the required payment of a termination fee to the preferred bidder and provided cost reimbursement incentives of up to $500,000 for the two highest bidders if Landry's ultimately decided to proceed with a deal with the preferred bidder instead of those bidders. In addition, the settlement allowed plaintiff's counsel to monitor the go-shop process and provide comments on proxy disclosures to further ensure the fairness of the sales process. These changes to the deal protections fixed a seriously flawed sales process and ultimately allowed Landry's public shareholders to receive merger consideration that increased from $14.75 to $24.50 per share in cash. Institutional investors have also had recent success in modifying or eliminating unwarranted deal protections in actions against Alberto-Culver (relating to its merger with Unilever) and the J. Crew Group, Inc. (relating to its leveraged buy-out).

Corporate advisors and public companies are clearly taking notice of recent successes by institutional investors in challenging deal protections. For example, shortly after the announcement of the J.Crew settlement, the board of directors of BJ's Wholesale Warehouse ("BJ's") — which had received an expression of interest in acquiring BJ's from a private equity firm nearly six months earlier — decided that it would conduct a full auction to maximize shareholder value in any potential sale. Media reports hypothesized that BJ's decision to conduct a full auction was intended to prevent a repeat of the perceived flaws in the J. Crew sale process.

J.CREW

Alberto Culver

Unilever

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Result:* *The Landry's settlement ultimately allowed public shareholders to receive merger consideration that increased from $14.75 to $24.50 per share in cash.

While much work remains to be done to combat the self-dealing and conflicts of interest present in many corporate management structures, by pursuing actions derivatively on behalf of corporations, and directly on behalf of shareholders, institutional investors are holding boards and senior management responsible for systemic governance failures and improving corporate governance practices in many important ways. Little by little, institutional shareholders are returning some power to public shareholders and balancing the allocation of power in corporations.

Amy Miller is an associate in BLB&G's New York office. She can be reached at amy@blbglaw.com.