

Notes From the Maelstrom

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Things are moving fast.

I only realized how fast on Wednesday, when Jack Welch vociferously decried excessive executive compensation on CNBC. Neutron Jack, as you may remember, was severely criticized for what some considered to be excessive pay while he himself was chief executive at **General Electric**.

Anyway, there's so much going on that I thought I would just give a quick update on a number of things that are occurring in the markets.

## **Short-selling ban**

The short ban is the new Borg, expanding every day. It now covers shares of more than 900 companies, including **I.B.M.**, **Ford Motor Company** and Mr. Welch's former employer, G.E. You get the idea.

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Unfortunately, though, this overbroad ban is adversely affecting the market in real ways. Many traders are shut down, since their models no longer work without a shorting component. Meanwhile, any work-around is difficult and expensive, since it involves buying much more expensive puts and calls. The result is to lock out program traders from the market, with a resulting decline in liquidity — share trading volume is down significantly. The credit worries have no doubt contributed to wider spreads in merger and acquisition transactions, but so has this phenomenon.

## **American International Group**

There seem to be some last-standers who think that since A.I.G. has announced there will be a shareholder vote on the authorization of common shares, there is still a way out for the insurance giant. They are misguided.

A.I.G. has already agreed to sell the government a preferred stock interest that gives it a 79.9 percent vote and an equivalent interest in any dividends. There will be no vote on this, only a vote to authorize the common

shares that the preferred is convertible into. I suspect that the government will be able to vote the preferred on the common stock issuance, thereby ensuring the passage of this proposal.

In any event, the government has most likely negotiated that it will be an event of default on the government loan if there is indeed a no vote. So the A.I.G. shareholders will have equally unpalatable choices, at best. A.I.G. will probably survive, but it will need to sell a significant amount of its assets to service this loan.

There is now going to be a feast as buyers rush to pick up A.I.G.'s assets at fire-sale prices. This is a shame, really, since the company was a good competitor abroad for America, particularly in China. Now that Chinese business will probably just be sold to the Chinese at a bargain price.

### **Merrill Lynch**

Similarly, there is speculation in the market that 1) if a bailout plan is passed, Merrill will try to get out of its deal to be acquired, or 2) **Bank of America** is going to try itself to break the deal.

While both companies can terminate the agreement if their shareholders vote no, the chief executives of both companies appear bent on completing this deal, and BofA is getting a good price.

Unless the Apocalypse hits (a likelier possibility these days), this deal is going through.

For deal lawyers, I just reread the Merrill agreement and noticed that it contains a unique recommendation provision. Merrill can change its recommendation only if there is a superior third-party proposal that it determines it is required to recommend under its fiduciary duties. This is much different from what you usually see, which is a provision which permits the board to change its recommendation whenever its fiduciary duties require.

The provision Merrill has would prevent a change of recommendation in the case of any other changed circumstance (i.e., a bailout bill that makes Merrill suddenly worth far more), and to the extent it trumps fiduciary duties, it is probably invalid under Delaware law. Though the issue is really how much it does so trump.

### **Morgan Stanley**

Morgan has agreed to negotiate a 10 to 20 percent investment by **Mitsubishi UFJ Financial Group**. However, it is important to remember that this is not a done deal; right now, they have a letter of intent that is nonbinding. Either party can walk at any time.

In addition, for those who are watching as companies sharpen their by-law notification provisions in anticipation of next year's proxy season and a new rash of shareholder activism, Morgan joined the club last week. Morgan amended its by-laws to require, among other things, that any shareholder making a shareholder proposal or director nomination include in the proposal a list of any cash-settled derivatives that it owns.

## **Goldman Sachs**

I haven't calculated the discount that Warren Buffett received for the warrants he got for purchasing \$5 billion of Goldman preferred stock. The warrants have an exercise price of \$115 a share. If you add in the value Mr. Buffett received for getting them as a bonus, he is most likely paying far less than \$115 a share when he actually does exercise the warrants. (The value of the warrants, by the way, is simply the option price he would have to pay to purchase similar long-dated options in the market.)

This means that Mr. Buffett is paying about one times book for Goldman under these warrants, a real shock considering that investment banks have historically traded at two to three times book.

Remember, though, that before the big wave of public investment banks in the 1980s, this is where they traded. There is no longer much franchise value in these institutions.

## **CKX**

Last week, the chief executive of CKX, Robert F. Sillerman, notified the company's board that he believed that the management buyout he was sponsoring would no longer be completed at the current price of \$12 a share. As you may remember, Mr. Sillerman and CKX announced this deal all the way back on June 1, 2007. It has since been amended four times and the price has been cut, while Mr. Sillerman has tried to line up financing.

Now, he has failed. Unfortunately for CKX's shareholders, the company also stated that "Mr. Sillerman further informed the company that despite the difficult economic climate, he intends to continue to pursue a transaction and intends to approach the board with an alternate acquisition proposal." I would guess that this is some mechanism for Mr. Sillerman either to lower the price or avoid paying breakup fees. In either case, I believe the deal highlights the potential problems of management buyouts and a company's trapped position. It is hard for a board to turn down your controlling shareholder and C.E.O.

## **CSX**

Buried in the turmoil last week was the news that the Second Circuit Court of Appeals had upheld the decision of the lower court to refuse to enjoin the voting of the shares held by the **Children's Investment Fund** and **3G**. As you may remember, CSX had alleged that the two hedge funds had violated Section 13D by failing to report cash-settled derivatives and filing as a group. The lower court had held that there was a violation but refused to enjoin the conduct.

The Second Circuit has affirmed the latter part of the holding, but it will be interesting to see if the Second Circuit holds that there are circumstances where cash-settled derivatives do need to be reported on a Schedule 13D. The narrow statement of the court would seem to be a no, but we await the full opinion. The hedge funds now have four seats on CSX's board.

## **Hunstman/Hexion**

The [post-trial briefs](#) were filed. I'll be posting an update on them for Monday.

According to reports, there will be an opinion in this case by Oct. 1. Right now, Huntsman's stock price is trading at less than \$10 a share; the market is clearly betting that this deal will not be completed.

### **Securities and Exchange Commission**

Criticizing the S.E.C. has been a favorite activity for many people this past week. But I think it is important to put things in perspective: The S.E.C. is not responsible for systemic risk issues nor bank regulation nor regulation of much of the derivatives and securitization markets. Moreover, the administration has no doubt constrained the S.E.C. from acting.

Still, I fear that the S.E.C. will not fare well in the coming regulatory reform. It may indeed absorb the Commodity Futures Trading Commission, but the real, substantive regulation will go under the aegis of the Treasury Department or the Federal Reserve. The S.E.C. is probably about to become a pure consumer protection agency, like the Food and Drug Administration.