Recent Trends and Legal Developments You Should Consider in 2015: Part I – Mergers & Acquisitions

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Agenda

• M&A 2014 Deal Overview
• Corporate Inversion Transactions
• Third Point v. Ruprecht - Two-Tiered Poison Pills
• Financial Advisor Conflicts
• Cigna v. Audax - Post-Closing Obligations of Target Stockholders in Mergers
• Two-Step Merger and Section 251(h) of the Delaware Corporate Law
• What’s Market?
• Other Recent Developments
M&A 2014 Deal Overview
Overview of Deal Activity in 2014

• Third-strongest year ever recorded for global M&A volume, behind only 2006 and 2007\(^1\)
• Global deal value hit $3.5 trillion, up 47% from 2013\(^2\)
  • Increase in number of mega-deals
    - 95 deals valued at $5B or more
• Abundance of cross-border M&A activity
  - Cross-border M&A activity totaled $1.3 trillion during full year 2014, accounting for 37% of overall M&A volume and a 78% increase over full year 2013 levels\(^2\)
    - 5,501 announced deals (highest on record), up 630 from 2013\(^3\)
• Increase in the size of cross-border transactions
  - Average deal size for cross-border deals hit $453.9M, up from $291.4M in 2013\(^3\)
• Increase in deals involving European companies targeting the U.S.
  - 421 announced deals (highest on record) for an aggregate of $259.7B\(^3\)

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\(^1\) Citi, A Perspective on the M&A Market, January 29, 2015
\(^3\) MergerMarket, Global and Regional M&A: 2014, January 2015
Overview of Deal Activity in 2014* (Continued)

• M&A activity in the U.S. returned to levels not seen since the recession
• U.S. targeted M&A accrued a total of $1.5 trillion in 2014, driven by 9,814 deals
• Top industries in 2014 for U.S. M&A included:
  • Energy and Power ($338.4B)
    - 22.1% market share
  • Healthcare ($237.4B)
    - 15.5% market share
  • Media and Entertainment ($207.8B)
    - 13.6% market share
  • High Technology ($167.6B)
    - 11.0% market share

*Thomson Reuters, Mergers & Acquisitions Review Full Year 2014, January 2015
Overview of Deal Activity in 2014* (Continued)

• Surge in Technology activity
  • 787 deals (highest on record)
  • Value up 29.3% from 2013
• Energy, Mining & Utilities M&A deal value more than doubled from 2013
  • Deal announcements up 107 from 2013
• Pharmaceutical, Medical & Biotech sector saw increase in deal values
  • Value up 16.5% from 2013
• Foreign investors flocked towards U.S. targets
  • 820 deals (highest on record)
  • $373.5B (highest value on record, surpassing even pre-recession levels)

Overview of Deal Activity in 2014 (Continued)

- Year characterized by announcement of large numbers of mega-deals
  - U.S. involved in 10 of the 15 largest global deals in 2014\(^1\)
  - U.S. average deal value increased 30.15% from 2013\(^2\)
- Three largest announced deals (U.S. and worldwide), each of which is still pending:\(^1\)
  1. Comcast Corp. and Time Warner Cable ($70.6B)
  2. AT&T and DirecTV ($67B)
  3. Actavis and Allergan ($66B)
- Return of mega-deals driven by increase in corporate profits and corresponding valuations, increase in confidence and ideal marketplace conditions
  - Large number of pharmaceutical mega-deals driven by corporate tax inversion strategies (discussed later in this presentation)

\(^1\) *Thomson Reuters, Mergers & Acquisitions Review Full Year 2014, January 2015.*
\(^2\) *MergerMarket, Global and Regional M&A: 2014, January 2015*
Overview of Deal Activity in 2014 (Continued)

Trends in U.S. Market in 2014

• Increase in large cap acquisitions
• Increase in stock deals
• More strategic buyers, fewer financial buyers
• Rise of debt-financed deals
• Increase and decrease of corporate tax inversion strategies
• Steady hostile deal activity
• Increase in spin-off transactions
Deals are driven by:

- Rising confidence and renewed boldness
- Relatively stable macroeconomic environment
- Strong equity market
- Low interest rates
- Deep corporate cash reserves
- Return of the strategic acquirer
- Relatively low organic growth opportunities
- Activist investors

**Significant Challenges Cannot Be Ignored**
Winston & Strawn in the Marketplace

• **U.S. News-Best Lawyers® 2015** ranks Winston in Tier 1 for Mergers & Acquisitions, Securities/Capital Markets, and Corporate Law

• **Chambers USA 2014** ranks Winston in Band 2 for Corporate/ M&A & Private Equity (Illinois)

• **Legal 500 2014** ranks Winston in Tier 1 for M&A: Middle-market

• Ranked in the top 20 among law firms for U.S. buyouts by **MergerMarket**

• Ranked 16th by **The Deal** M&A League Tables H1 2014 (deal over $100 million)

• Ranked 19th by **Bloomberg** H1 2014 for mid-market deals in the U.S.

• 6th Annual International **M&A Advisor** Awards Winners for two “Corporate/ Strategic Acquisitions of the Year”
  • the acquisition of UK-based Orthoplastics Ltd. by MedPlast, Inc. ($75 Million - $100 Million); and
  • the $1.2 Billion acquisition of Harland Financial Solutions by Davis + Henderson Corp. ($1 Billion - $5 Billion)

• Partner Oscar David included on **Global M&A Network's** Top 50 North America M&A Lawyers list

• Partner Steve Gavin selected as **Best Lawyers'** 2014-15 Chicago M&A "Lawyer of the Year"

• Partner Bob Wall selected as **Best Lawyers'** 2014-15 Chicago Corporate Law "Lawyer of the Year"

• Partner Geoff Rahie selected as an **M&A Advisor** “40 Under 40 Legal Advisor”
Corporate Inversion Transactions
Background

• U.S. Company undertakes a strategic transaction with a foreign company in which the top holding company of the combined group is domiciled in a foreign country.

• Strategy used by U.S. companies with substantial non-U.S. business operations, as a response to current U.S. tax rules that subject the income from such non-U.S. operations to U.S. tax when the associated cash is repatriated or redeployed elsewhere in the group.

• “Self-inversions” largely eliminated by 2004 enactment of Internal Revenue Code section 7874; current transactions are generally combinations with a substantial foreign company.

• Benefits: allow future expansion of non-U.S. business to take place outside U.S. tax net; enable U.S. group to reduce U.S. taxable income through internal leverage; subject to additional restrictions announced by IRS in 2014, allow existing assets and activities to be moved out from under former U.S. parent.
Conventional Merger Structures

Forward Triangular Merger

Pre-Transaction
- Parent
- Subsidiary
- Target

Post-Transaction
- Parent
- Subsidiary

Reverse Triangular Merger

Pre-Transaction
- Parent
- Subsidiary

Post-Transaction
- Parent
- Target
Step 1: Under US law, US Co merges with the newly incorporated US Merger Sub, a wholly owned subsidiary of Irish HoldCo.

Step 2: Irish HoldCo acquires Foreign Target in the Foreign Target’s home jurisdiction. Shares held in Foreign Target by Foreign Target Shareholders are cancelled and replaced with shares in Irish HoldCo in a cancellation scheme of arrangement. Foreign Target is now under ownership of Irish HoldCo.
Steps 1 and 2 would occur effectively simultaneously. The final structure would look as follows:

- Former US Co Stockholders
- Former Foreign Target Stockholders
- Irish HoldCo
- US Co
- US Subsidiaries
- Foreign Target
- Foreign Subsidiaries
2014 saw an increase in inversions by pharmaceutical companies that generate sizable revenues overseas that would be taxed at high U.S. rates if brought into the country.

Deal Data: Corporate Inversions

In the last decade, over 47 corporations have been involved in Corporate Inversions

TIMELINE*

- McDermott International
- Helen of Troy
- Global Santa Fe Corp.
- Foster Wheeler
- Accenture
- Global Marine
- Noble Corp.
- Cooper Industries
- Weatherford Int’l
- Ingersoll-Rand
- PWC Consulting Ltd.

- Star Maritime Acquisition Group
- Fluid Media Network
- Western Goldfields
- Lincoln Gold
- Hungarian Telephone & Cable Corp.
- 2020 ChinaCap Acquisition
- InterAmerica Acquisition
- Ideation Acquisition Corp.
- Vantage Energy Services
- Alist Acquisition Grp.
- Alpha Security
- ENSCO Int’l
- Pentair
- Rowan Companies
- AON
- Tronox Inc.
- Argonaut
- Jazz Pharmaceuticals
- Azur Pharma
- D.E. Master Blenders
- Eaton/Cooper
- Cadence Pharmaceuticals
- Actavis/Warner
- Chilcott
- Endo Health Solutions
- Liberty Global PLC
- AOE Corporations
- Alkermes
- Dutch Co
- Stratasys
- TE Connectivity
- Mallinckrodt Pharmaceuticals

*Congressional Research Service. Data current up to May 2014.
IRC Section 7874

• Limitations of section 7874 apply if:
  • Foreign corporation acquires substantially all assets of a U.S. corporation or partnership;
  • After the acquisition, the former owners of the U.S. entity own at least 60% of the foreign corporation by reason of owning the U.S. entity; and
  • The foreign corporation’s group does not have “substantial business activities,” defined as at least 25% of employees, tangible property and sales, in its country of incorporation.

• If these tests are met, gain recognized by the U.S. entity in connection with the inversion (including gain realized on transactions to move foreign operations “out from under” the U.S. entity) cannot be offset by losses or credits.

• If these tests would still be met if “60%” were replaced by “80%,” then instead of the inversion gain rule the foreign corporation is treated as a U.S. corporation for all federal tax purposes.
New Anti-Inversion Rules: Notice 2014-52

• The enactment of section 7874 did not stop inversion deals:
  • Deals in which the U.S. company’s shareholders obtain less than 60% of the stock of the combined group are not subject to section 7874.
  • Deals in which the U.S. shareholders obtained 60% or more, but less than 80%, of such stock went forward because the benefits of the inversion were considered to outweigh the cost of the “inversion gain” rule.
• On September 22, 2014, the Treasury Department and IRS released Notice 2014-52 (the Notice) announcing new rules that would:
  • Tweak the calculation of the post-acquisition ownership percentage to make it more difficult to avoid crossing the 60% and 80% thresholds; and
  • Counteract some of the tax benefits that had been available through inversions.
New Anti-Inversion Rules: Notice 2014-52 (Continued)

• The new regulations strengthen the test for determining whether the former owners of the U.S. company own less than 60% or 80% of the new foreign parent. The new rules:

  1. Exclude a portion of the foreign acquirer's stock from the determination of the post-acquisition ownership percentage if more than 50% of the gross value of the “foreign group property” constitutes “foreign group nonqualified property.”

• This limits the ability to reduce the post-acquisition ownership percentage of a US company’s former shareholders by issuing additional stock to the foreign company’s former shareholders in exchange for cash or other passive assets that are not part of the group’s foreign business activities (commonly referred to as using a "cash box"). Banks and other financial services companies are exempted.
New Anti-Inversion Rules: Notice 2014-52 (Continued)

2. Disregard “non-ordinary course” distributions or “extraordinary dividends” paid by U.S. companies to reduce their size before an inversion.
   
   • Non-ordinary course distributions mean the excess of all distributions made during a taxable year by the domestic entity with respect to its stock or partnership interests, as applicable, over 110 percent of the average of such distributions during the thirty-six month period immediately preceding such taxable year.

   • A distribution means any distribution, regardless of whether it is treated as a dividend, any distribution made by the domestic entity in redemption of its stock, and any transfer of money or other property to the owners of the domestic entity that is made in connection with the acquisition.

3. Restrict the use of “spinversions” by changing the treatment of certain transfers of stock of a foreign acquiring corporation, such that it will not qualify for the section 7874 ‘expanded affiliated group’ exception.
The new regulations will also thwart techniques used by inverted companies to access overseas earnings of their controlled foreign corporations (CFCs) without paying U.S. tax.

The new regulations will prohibit companies from:

- Using “hopscotch loans” (a loan from a CFC to the new foreign parent, instead of the U.S. parent) to access a CFC's earnings while deferring U.S. tax.

- Restructuring a CFC in a "de-controlling" transaction so that it is no longer a CFC so that foreign members of the group can access the earnings of the former CFC without the imposition of U.S. tax. Typically, this was done by having the new foreign parent (i) purchase a controlling stake in the CFC from the former US parent or (ii) contribute cash or assets to the CFC in exchange for a newly issued controlling stake in the CFC.

- Utilizing related party stock sales in order to repatriate a CFC's earnings tax-free. Previously, new foreign parents sold their stock in the former U.S. parent to a CFC with deferred earnings in exchange for cash or property of the CFC to conduct a tax-free repatriation of the CFCs earnings.
New Anti-Inversion Rules: Notice 2014-52 (Continued)

• The Notice does not contain rules affecting the ability of inverted companies to use internal leverage to reduce U.S. tax liability (“earnings stripping”).

• However, the IRS is continuing to consider such rules, and the Notice states that any such new rules directed specifically at inversions will have a September 2014 effective date.
Deal Data after New Anti-Inversion Rules

Major Deals that Collapsed Soon After September 22, 2014 Rules

- Oct 2014: $2.7B deal between Salix Pharmaceuticals Ltd. and Irish company Cosmo Technologies Ltd.
- Oct 2014: $345M deal between Auxilium Pharmaceuticals and Canadian company QLT Inc.
- Oct 2014: $54B deal between AbbVie Inc. and U.K.-based company Shire PLC. AbbVie blamed the new restrictive rules imposed by the U.S. Department of the Treasury.
- Oct 2014: $1.3B deal between Chiquita Brands International Inc. and Irish company Fyffes PLC.

Major Deals Announced After September 22, 2014

- Sept 2014: Civeo Corp. first company to announce inversion plans after September 22, 2014. Civeo Corp. said it will move its tax address to Canada (self-inversion).
- Oct 2014: $2B deal between Steris Corp. and U.K. company Synergy Health PLC.
- Oct 2014: $3.3B deal between Wright Medical Group Inc. and Dutch Company Tornier N.V.
Deal Data after New Anti-Inversion Rules (Continued)

Pending Deals/Deals Moving Forward

• Dec 2014: $12B deal between Burger King and Canadian company Tim Horton’s completed.

• Dec 2014: $2B deal between C&J Energy Services and a unit of Nabors Industries Inc. Combined company to be headquartered in Bermuda. Deal pending.

• Dec 2014: $5.27B deal between Walgreen Co. and Alliance Boots GmbH completed. Walgreens dropped earlier plans to transfer its tax domicile abroad. Walgreens confirmed that after the new regulations were implemented, it had to undertake an “extensive analysis to explore the feasibility of a restructured inversion transaction that would provide the company with the customary level of confidence needed to withstand IRS review and scrutiny.”


• Jan 2015: $5.3B deal between Mylan and Abbott Laboratories for Abbott’s branded generics business in developed markets is still pending. Combined company to be domiciled in the Netherlands.

• Jan 26, 2015: $48B deal between Medtronic Inc. and Irish company Covidien PLC closed. This deal is among the first and biggest inversion transactions to close after September 22, 2014.

Data current as of January 2015.
New Tax Rules Slow, not Halt, Inversion Deals

• Rules have slowed, but not halted, inversion deals. New deals have been announced since the September 22, 2014 rules by companies like Civeo Corp., Steris Corp. and U.K. company Synergy Health PLC, Wright Medical Group Inc. and Dutch Company Tornier N.V.
• Benefits of moving to a territorial tax system with a lower rate remain. Inverted companies can still benefit from removing future foreign growth from the U.S. tax system.
• The new rules negatively affect the financing of deals however, since companies previously expected to use “hopscotch loans” to help finance inversions (no longer favorable).
• Ancillary considerations include public perception, since inverted companies have been branded as “corporate deserters” and “unpatriotic.”
• One of the biggest incentives for continuing inversions is that the new rules do not address the controversial practice of “earnings stripping,” the ability of U.S. companies to deduct interest payments on loans from their new foreign affiliates, thus reducing their taxable income.
Outlook for 2015

• On May 20, 2014, Democratic lawmakers in the House and Senate proposed legislation that would further block corporate inversion transactions. This legislation, which was re-introduced on January 20, 2015, would generally be effective for deals taking place after May 8, 2014.

• Under the proposed legislation, the 80% threshold for treating the foreign parent in an inversion as a domestic corporation would be reduced to a greater-than-50% threshold.

• In addition, the foreign parent in an inversion would be treated as a domestic corporation if (i) the combined group is managed and controlled in the U.S., (ii) the group has “significant domestic business activities,” and (iii) the combined group does not conduct substantial business activities in the country in which the foreign acquiring corporation is organized.
Outlook for 2015 (Continued)

• Similar legislation was included in the Administration’s revenue proposals in the FY 2016 Budget released February 2, 2015.

• The Administration’s proposal would broaden the definition of an inversion transaction by reducing the 80% test to a greater-than-50% test, and eliminating the 60% test.

• Under the Administration’s proposal, regardless of the level of shareholder continuity, a foreign parent would be treated as a domestic corporation if (i) immediately prior to the acquisition, the fair market value of the stock of the domestic entity is greater than the fair market value of the stock of the foreign acquiring corporation, (ii) the combined group is primarily managed and controlled in the United States, and (iii) the combined group does not conduct substantial business activities in the country in which the foreign acquiring corporation is organized.

• Finally, the IRS may issue new guidance limiting “earnings stripping” in the context of inversions. As noted previously, such guidance could have a September 22, 2014 effective date.

• While some deals are still moving forward, the prospect of new IRS guidance and/or legislation could have a chilling effect on future inversion deals.
Third Point v. Ruprecht - Two-Tiered Poison Pills
Background

• Case arises from shareholder activism involving Sotheby’s.

• In May 2013, Sotheby’s became aware that Third Point, led by Daniel Loeb, and other activist hedge funds, including Trian Fund Management and Marcato Capital Management, had acquired significant ownership positions in Sotheby’s stock.
  • The activist funds had accumulated 19% of Sotheby’s stock, with just under 10% held by Third Point.
  • Third Point sent a letter to the Company making known its intentions to seek fundamental changes at Sotheby’s.

• By July 2013, the board realized that it was to become the subject of an imminent activist effort to shift its management agenda.
Sotheby’s Poison Pill – “Two-Tiered Rights Plan”

• In response to perceived threat of increasing hedge fund activity, including potential creeping control, the board adopted a poison pill in October 2013:

  • Stockholders required to file a Schedule 13D with the SEC were limited to acquiring no more than a 10% interest before triggering the poison pill.
  
  • Stockholders who filed a Schedule 13G with the SEC could acquire up to a 20% interest before triggering the poison pill.
  
  • Poison pill was to expire after one year and would not apply to “qualifying offers”, which were defined as offers for “any-and-all” shares that would give Sotheby’s stockholders at least 100 days to consider such offer and that would cash out all such stockholders.
  
• Two-tiered rights plans are not uncommon. This structure has grown significantly in recent years in response to the rise of shareholder activism and as boards perceive that a two-tiered structure best addresses the threats posed by activist investors.
Third Point Challenges Poison Pill

• On February 27, 2014, Third Point filed an amended Schedule 13D announcing its intention to commence a proxy contest to elect three directors to the Sotheby’s board.

• Third Point also requested that Sotheby’s grant it a waiver from the 10% trigger of the poison pill to allow it to purchase up to 20%.

• Sotheby’s rejected the request, citing as a reason, “the risk that Third Point could obtain ‘negative control’ or effectively a controlling influence without paying a premium with respect to certain matters if it achieved a 20% stake.”

• On March 25, 2014, Third Point and other shareholders filed a complaint in the Delaware Court of Chancery contending that the board of Sotheby’s had breached its fiduciary duties by (1) adopting a discriminatory rights plan and (2) refusing to waive the 10% trigger.

• Third Point also sought a preliminary injunction to delay Sotheby’s annual stockholder meeting.
Decision: Standard of Review

• The Delaware Court of Chancery declined to apply the standard of review from Blasius Industries, Inc. v. Atlas Corp., under which a board must show a compelling justification for actions it takes with the “primary purpose” of interfering with the effectiveness of a stockholder vote.

• The Court instead found that the board’s primary intent was takeover defense, not interfering with shareholder voting rights.

• As a result, the Court applied the standard of review from Unocal Corp. v. Mesa Petroleum Co., finding that both the Court of Chancery and Delaware Supreme Court have applied Unocal exclusively in determining whether a board has complied with its fiduciary duties in adopting and refusing to amend or redeem a rights plan.
Decision: Standard of Review

• The **Unocal** two-prong standard consists of:

  1. **The Reasonableness Test**: board must demonstrate reasonable grounds for believing that a danger to corporate policy and effectiveness existed.

  2. **The Proportionality Test**: board must show that its defensive response was proportional or reasonable in relation to the threat posed.

• The Court declined to enjoin Sotheby's annual meeting because the rationale behind Sotheby's stockholders rights plan and the rejection of the waiver were both reasonable and proportionate to the threat posed by activist investors.
Reasonableness and Proportionality in Adopting the Pill

• **Reasonableness Prong Met through Threat of Creeping Control**
  
  • The Court focused on the concept of “creeping control.”
  
  • The Court accepted the notion that a ‘wolfpack’ of activist investors who form together to jointly acquire large allotments of a target's stock could pose a legally cognizable and objectively reasonable threat to stockholders.
  
  • The Court also noted that the board was comprised of a majority of independent directors and retained outside advisors in connection with the investigation into the activists’ activity, which reflected a good faith and reasonable investigation that supported the board’s findings of threat.

• **Proportionality Prong**

  • The Court held that a two-tiered approach was arguably a better response to the threat than a "garden variety" plan that imposes one standard on every stockholder. The differing treatment of passive and active investors could better address Sotheby’s need to prevent activists from achieving effective control without paying a premium.
Refusal to Provide a Waiver for 10% Cap

- Reasonableness Prong Met through Threat of Negative Control
  - The Court focused on the concept of “negative control.”
  - The Court found that Sotheby’s board had legitimate concerns that allowing an activist investor like Third Point to obtain 20% ownership would give it disproportionate control and influence that should be acquired through payment of a premium of a target's stock.
  - The Court noted in particular, the "aggressive and domineering manner" in which Daniel Loeb of Third Point had conducted himself. For example, in emails revealed in discovery, Loeb described his efforts as part of a “holy jihad” to make “Sotheby’s infidels” aware there is “only one true God” and part of a “Special Operation on Sotheby’s” intended to “shock and awe” the company. He also apparently represented himself to Sotheby’s employees as the one who would be appointing management soon.
  - Such behavior, combined with 20% ownership (which would make Third Point the largest stockholder of Sotheby's by far), led to the Court’s finding that negative control was a legally cognizable threat.

- Proportionality Prong
  - The Court found that refusing to allow Third Point to acquire up to 20% of Sotheby's stock fell within the range of reasonableness. Although some level of ownership between 10% and 20% could have been more optimal, the Court only required "a reasonable decision, not a perfect decision."
Settlement

• On May 5, 2014 Sotheby's announced an agreement to:
  • appoint Third Point's three designees to the board
  • terminate the rights plan upon completion of the stockholder meeting
  • allow Third Point to increase its equity stake in Sotheby's to 15%
  • Third Point agreed to withdraw the lawsuit with respect to the rights plan.
2015 Takeaways

• Significant that Sotheby's board implemented a two-tiered rights plan aimed at shareholder activists even though Third Point had not actually threatened to take over the company at the time the pill was adopted. Third Point had only called for management and governance changes. The decision affirmed the broad discretion of corporate boards in adopting poison pills to ward off the prospect of takeover by activist shareholders.

• Effective negative control, creeping control and rapid stock accumulations by activists can be threats against which a board may use a rights plan.

• Although Vice Chancellor Parsons cautions that, “I do not mean to endorse the Rights Plan’s two-tiered feature,” the holding makes clear that a two-tiered rights plan may be a reasonable response by a board.

• Boards should conduct a good faith and reasonable investigation into threats posed by activist shareholders. Board discussions should be led by independent directors and the board should seek and rely on the advice of outside financial, legal and other appropriate expert advisors.

• To satisfy the reasonableness standard, the record of a board’s deliberations should demonstrate that defensive measures were not designed to improperly interfere with the shareholder voting process or otherwise be “coercive” or “preclusive,” but designed to be responsive to a specific threat.
2015 Takeaways (Continued)

• Decision implicitly advises against shareholder activist tactics of behaving in a domineering or aggressive manner. The court clearly appeared to be more comfortable extending the concept of negative control in part because of Loeb's conduct.

• Though Sotheby’s won a favorable decision, the settlement agreement suggests the poison pill ultimately didn’t work. Sotheby’s gave Third Point most of what it wanted in the proxy contest and pill litigation, including three new board seats, termination of the poison pill and an extension of ownership to 15%.

• Boards of public companies should consider whether it makes sense to spend time and money to adopt and defend anti-activist poison pills. Vice Chancellor Parsons noted in the opinion, “there is a substantial possibility that Third Point will win the proxy contest, which would make any preliminary intervention by this court unnecessary.”
Financial Advisor Conflicts
Financial Advisors and Conflicts of Interest – Recent Cases

- Delaware courts are carefully scrutinizing the actions of boards of directors and financial advisors when conflicts of interest impact the sale process.

- Whether the conflict is known or unknown, the courts may find the Board responsible if a conflict of interest is viewed as tainting the sale.

- Financial advisors may be held liable for aiding and abetting a Board’s breaches of fiduciary duties.

- Three Recent Cases:
  - In re Del Monte Foods Company (February 2011)
  - In re El Paso Corporation (February 2012)
  - In re Rural Metro Corporation
    - March 2014—Original Decision
    - October 2014--Damages
Del Monte and El Paso

• *Del Monte* – addressed unknown conflicts of interest:

  • Financial advisor, without informing the corporation, (i) allowed two buyers to team up to make a joint bid in violation of no-teaming provisions in the confidentiality agreement and (ii) sought to obtain staple financing from potential buyers.

  • When the conflicts were finally disclosed, the Del Monte Board allowed them, without extracting any concessions.

  • Stockholder vote on the buyout was temporarily enjoined by the Court but later went through.

  • Del Monte and the financial advisor ultimately agreed to an $84.3M settlement with stockholders ($23M paid by the financial advisor and the rest by Del Monte).
Del Monte and El Paso

• *El Paso* – addressed known and unknown conflicts of interest:

  • Financial advisor disclosed its significant minority ownership in potential buyer of El Paso.

  • El Paso had publicly announced plan to spin-off one of its two businesses.

  • Primary financial advisor continued in its role on the spin-off. Secondary financial advisor was brought in to “cure the conflict” but would only get fee if sale of whole company occurred. Court viewed this as a distorted financial incentive for the secondary financial advisor.

  • Case also involved undisclosed conflicts, including lead banker for primary financial advisor personally owning $340K in stock of acquirer. Court was highly critical of sale process but declined to enjoin the vote.
Rural/Metro - Background

- Financial advisor to Rural/Metro pitched a special committee of the Board on potential sale:
  - Disclosed to Rural/Metro that it hoped to provide staple financing to bidders of Rural/Metro.
  - Did not disclose that it also sought to provide buy-side financing to bidders of EMS, a primary competitor of Rural/Metro undergoing a sale process at the same time.
- The special committee agreed to hire the financial advisor, despite not having full Board approval to hire a sell side advisor or start a sale process.
- The financial advisor promoted a process that focused on EMS bidders, in order to obtain potential buy-side financing engagements from EMS bidders. Financial advisor only focused on financial buyers (more likely to require financing) and no interest was elicited from strategic buyers.
- The financial advisor’s potential fees in connection with a financing would greatly exceed fees in connection with its advice on the sale process.
Rural/Metro - Background

• Financial advisor focused on a near-term sale:
  
  • Many potential Rural/Metro bidders could not fully participate in process due to their involvement in the EMS process – some bidders (including the winner of the EMS auction) requested an extension of the bid deadline, which the Board rejected.
  
  • Reversed its previous advice that Rural/Metro further build value through acquisitions before putting itself up for sale.

• Ultimately, only one PE fund made a bid for Rural/Metro, which was accepted by the Board.

• Financial advisor made a significant push to obtain a role in PE fund’s financing:
  
  • Offered a $65 million revolver for another portfolio company of the PE fund.
  
  • Court noted the financial advisor “re-doubled its efforts on the financing front and played nice on the deal front.”
Rural/Metro - Background

• The financial advisor’s questionable fairness opinion:

  • Opinion delivered by financial advisor’s “ad hoc” fairness committee (as opposed to a standing committee staffed by senior bankers).

  • One member of the ad hoc committee had never previously served on a fairness committee.

• The financial advisor’s questionable valuation advice:

  • The Board received the financial advisor’s valuation analysis only hours before the merger agreement was approved.

  • The day prior to the merger, the financial advisor (as well as the secondary advisor) made several decisions which had the effect of reducing the valuation significantly, making the merger price appear more attractive.

  • The Court found that the financial advisor’s valuation analysis contained outright falsehoods – did not add back to EBITDA $6.3M charge for one-time expenses, claiming that Wall Street analysts’ consensus does not make such adjustments, which was false.
Rural/Metro – Holding—March 2014

• The financial advisor was found to have aided and abetted breaches of the Board’s fiduciary duty. (Both the Board and a secondary financial advisor settled before trial.)

• Rural/Metro had adopted an exculpatory 102(b)(7) provision, which eliminates monetary damages for breach of a director’s duty of care, but this does not protect non-directors.

• Because of the conflicts of interest, the Court’s standard of review is “enhanced scrutiny” – an intermediate test between the business judgment rule and the entire fairness standard.
  • Conflicts of interest “do not comfortably permit expansive judicial deference.”
  • Board’s action must lie within a range of reasonableness.
• Court held that the Board breached its fiduciary duties in the sale process:
  
  • Sale process in parallel with the EMS process was not reasonable: not authorized by the full Board, improperly influenced by the financial advisor and made by decision makers who suffered due to these conflicts of interest.
  
  • Board failed to provide active and direct oversight of the financial advisor.
Rural/Metro – Damages—October 2014

• Financial advisor ordered to pay damages of $75.79 million to shareholder class.

  • Amount represented 83% of total damages class suffered. The Court found, under a relative fault analysis, that the financial advisor was entitled to claim 17% of damages in settlement credits from two of the Rural/Metro directors under the Delaware Uniform Contribution Among Tortfeasors Act (DUCATA).

  • Under equitable doctrine of Unclean Hands, the financial advisor was only entitled to claim settlement credits for the breaches in which it was not instrumental. Thus, it could not claim credits for Disclosure Claim or Sale Process Claim.

  • Damages determined using quasi-appraisal method. Court determined “intrinsic” value of stock at time of merger, less the price per share shareholders were actually paid. Found underpayment amount of $4.17 per share.
Financial Advisor Conflicts - Lessons and Takeaways

• Conflicts of interest cause the Court to be skeptical about the entire process.

• Hiring a second financial advisor is not, by itself, sufficient – especially when it does not cure other conflicts (Rural/Metro) or when such second financial advisor is subject to distorted incentives (El Paso).

• Boards must issue clear mandates to committees which must be followed – In Rural/Metro, the Court took significant issue with the special committee’s lack of authority to pursue the sale.

• Staple financing is not necessarily inappropriate, but can be risky from a conflict of interest perspective, especially if other sources of financing in the debt markets are available.

• Financial advisors and Boards should pay attention to fairness opinion procedures – Court deeply skeptical of “ad hoc” fairness opinion committee used by Rural/Metro’s financial advisor.
Financial Advisor Conflicts - Lessons and Takeaways

• Boards can protect themselves with a well-run (and well-documented) process. In particular, the Delaware courts in Rural/Metro took note of Board meeting minutes prepared long after the meeting and minutes with a “feel of a document drafted in anticipation of litigation.”

• Acknowledging a conflict is not enough - the Court will expect the Board to obtain something of value for allowing a financial advisor to have a conflict of interest.

• General disclosures in an engagement letter are not sufficient:
  
  • Rural/Metro’s financial advisor’s engagement letter contained language that it provides other financial products and services to companies that may be involved in the potential sale.

  • Informing the Board of potential conflicts before engagement does not relieve a financial advisor of its obligation to inform the Board of actual conflicts as they arise.
Cigna v. Audax - Post-Closing Obligations of Target Stockholders in Mergers
Cigna v. Audax - Background

- In February 2014, Optum Services, Inc., a subsidiary of United Health Group, Inc., acquired privately held Audax Health Solutions, Inc. by a merger.
- Cigna was a preferred stockholder of Audax. Cigna did not vote in favor of the merger.
- Merger was approved by a majority of the Audax board and written consent of 66.9% of the Audax stockholders. Merger closed pursuant to §251 of the DGCL.
- Merger Agreement conditioned payment of the merger consideration on stockholders’ surrender of shares and execution of a Letter of Transmittal.
  - The Letter of Transmittal was defined as a “letter of transmittal in form and substance reasonably acceptable to Buyer, pursuant to which, among other things, the Effective Time Holders shall make standard representations and warranties [and] agree with the provisions hereof (including the indemnification provisions set forth in Article VII).”
- Cigna refused to execute the Letter of Transmittal.
- Audax refused to pay Cigna its merger consideration.
Letter of Transmittal

The Letter of Transmittal required that Cigna agree to:

1. The Release Obligation
   - a release of any claims against United Health, its affiliates, employees and agents
   - Unlike the other obligations, the release obligation did not appear in the merger agreement itself and was only contained in the letter of transmittal

2. The Indemnification Obligation
   - an agreement to be bound by the terms of the Merger Agreement, specifically including the provisions indemnifying United Health for any breaches of representations and warranties
     - provisions made former Audax stockholders liable to United Health, up to the pro rata amount of the merger consideration they received
     - representations and warranties survived closing of the merger; most terminated eighteen months afterwards, some IP representations and warranties survived for thirty-six months. Most importantly, the “Seller Fundamental Representations and Warranties,” along with the indemnification obligation, survived indefinitely after closing.

3. The Stockholder Representative Obligation
   - an appointment of Shareholder Representative Services, LLC as the Stockholder Representative
Issues

Cigna sued for the merger consideration, arguing that:

1. **Release unenforceable for lack of consideration for the Letter of Transmittal**
   - Stockholders entitled to payment of merger consideration under §251 of the DGCL immediately upon cancellation of target company's shares in merger.
   - Release unenforceable because contained within a contract (the Letter of Transmittal), not in the Merger Agreement, that does not provide any extra consideration for the release. Merger consideration cannot be for the Letter of Transmittal because that consideration is already owed under §251 of the DGCL.

2. **Indemnification Obligations violated §251 of the DGCL**
   - §251 of the DGCL requires merger agreements to set forth cash, property, rights or securities that stockholders are to receive as merger consideration. Stockholders need to be able to ascertain the value, at or about the time of the merger, of what they will receive as merger consideration.
   - Indemnification obligation rendered the amount of merger consideration indeterminable.
Decision

The Delaware Court of Chancery held that:

1. Release Obligation in the Letter of Transmittal unenforceable because it lacked consideration.

2. The Indemnification Obligation making former Audax stockholders liable to United Health, up to the pro rata amount of the merger consideration received, violated §251 of the DGCL because the value of the merger consideration was unascertainable.

3. Validity of Stockholder Representative Obligation not sufficiently pled to warrant a judgment on the pleadings.
Release Obligation

- Release Obligation was a new obligation imposed on Cigna post-closing. Nothing new was provided to Cigna beyond the merger consideration.
- Cigna became entitled to merger consideration when the merger was consummated and shares were canceled. (§251 DGCL).
Indemnification Obligation

• Indemnification Obligation made former Audax stockholders liable to United Health, up to the pro rata amount of merger consideration they received for breach of certain of the Company’s representations and warranties. Some of these representations and warranties survived a limited number of years post-closing, while others survived indefinitely.

• Under DGCL §251(b), merger consideration may be subject to adjustment post-closing based on “facts ascertainable” outside the merger agreement (i.e., target company breaches representations and warranties and causes buyer a determined amount of damages) if manner in which such facts will affect the amount of merger consideration is “clearly and expressly set forth in the agreement of merger.”

• Despite literal compliance with “facts ascertainable” provision, the Court found that the value of the merger consideration itself was deemed not in fact ascertainable. Potentially all of the merger consideration was at risk for an unlimited period of time.
Indemnification Obligation (Continued)

- Given that: (1) the potential adjustments depend on any damages that United Health might suffer, (2) the obligations place potentially all of the merger consideration at risk, and (3) the indemnification provisions continued indefinitely, the Court found that the merger consideration itself was technically unascertainable - either precisely, or within a reasonable range of values, even accounting for laches or statute of limitation defenses - for an indefinite period of time.

- The Court noted that this is important because target holders need to be in a position to evaluate whether to accept the merger consideration or exercise appraisal rights. The merger consideration should be subject to sufficient parameters that would permit stockholders to undertake a reasonable assessment.
2015 Takeaways

Ambiguous holding:

• Does not address whether a release would be enforceable if explicitly included in the merger agreement and not simply in a separate letter of transmittal.

  • One of the Court’s concerns with the release in the letter of transmittal was the fact that any range of provisions/releases could be imposed on stockholders as conditions precedent to payment of the merger consideration even though stockholders would have no way of anticipating such provisions/releases from the mere reference in the merger agreement to a letter of transmittal.

• Does not address whether a release not included in the merger agreement, but included in a letter of transmittal could be supported by separate consideration.
2015 Takeaways (Continued)

Ambiguous holding:

• The Court did not rule broadly that imposing indemnification obligations on non-signatories to a merger agreement is unenforceable under the DGCL. The Court focused specifically on the merger consideration and the lack of a time limit/monetary cap on it.

• The opinion does not give clear guidelines as to what would make the merger consideration sufficiently ascertainable.
  
  • What if a price adjustment covers all of the merger consideration but is time-limited?
  • Is an indefinite adjustment time period permissible with a monetary cap?
  • What about a limit in scope as to the damages and the nature of the subject matters covered by the indemnification?

• Overall, the Court provides insufficient clarity on the enforceability of indemnities fashioned as claw backs of the merger consideration. The Court states, “…the absence of a definitive precedent on whether Section 251(b) allows a clawback from the stockholders simply means the question is unsettled.”
Court’s Explanation of Holding

Vice Chancellor Parsons attempts to limit the opinion:

“This Opinion does not concern escrow agreements, nor does it rule on the general validity of post-closing price adjustments requiring direct repayment from the stockholders. This Opinion does not address whether such a price adjustment that covers all of the merger consideration may be permissible if time-limited, or whether an indefinite adjustment period as to some portion of the merger consideration would be valid. I hold only that the combination of these factors present in this case—indefinite length and the contingent nature of the entirety of the consideration—renders the value of the merger consideration unknowable and, therefore, violates Section 251.”
Practical Implications

• Stockholders’ right to receive merger consideration under the DGCL vests upon cancellation of shares. Stockholders cannot be required to release claims post-closing absent additional consideration.

• Consider structuring transaction as a stock purchase where each stockholder signs and agrees to the obligations directly.

• When stock purchase is not feasible:
  • require as many stockholders as possible (especially key stockholders) to sign the merger agreement or a support agreement
  • condition the closing of the merger on the acceptance by any particular stockholder of certain obligations, if that stockholder's acceptance is particularly important
Practical Implications (Continued)

- offer stockholders a choice to receive a higher per share price or additional payment if they agree to a post-closing indemnity, or offer a lower per share price with limited or no post-closing obligations
- if including a condition or obligation in a separate contract or letter, ensure that there is additional consideration
- rather than paying the entire consideration up front and hoping to claw some back later, withhold a portion of the purchase price in escrow
- restructure the indemnity clawback as a contingent right to receive further payment absent breaches or other claims
- in order to ensure likelihood of enforceability, include a monetary cap or temporal limitation, or both, to stockholder indemnification obligations that apply to merger consideration
- consider representation and warranty insurance
Two-Step Merger and Section 251(h) of the Delaware Corporate Law
Two-Step Merger and Section 251(h) of the DGCL

• **Background**

  • Public company acquisitions are typically structured as either (1) a one-step long-form merger or (2) a two-step merger that begins with a tender offer and is followed by a back-end squeeze out merger.

  • The delay and costs associated with acquiring stockholder approval under a one-step long-form merger makes the two-step tender offer/short form merger transaction far more preferable, so long as the buyer owned 90% of the target’s voting securities upon consummation of the tender offer.

  • If the buyer failed to own 90% of a target company’s voting securities after the tender offer, the buyer could not consummate a “short-form” merger and would need to obtain stockholder approval, absent availability of a top-up option.
Two-Step Merger and Section 251(h) of the DGCL

• In tender offer transactions, to the extent there were sufficient authorized shares available, Buyers would often include a “top-up” option in the merger agreement, which granted the buyer the right (and in some cases, the obligation) to acquire an amount of shares of the target necessary to reach the 90% threshold.

• “Top-Up” options are limited to the extent that the target company has insufficient authorized but unissued shares. Amending the target company’s charter to increase the authorized shares requires stockholder approval and would typically not be an optimal path to pursue relative to a one-step merger.

• For deals without significant time-consuming regulatory approvals, one-step mergers and two-step mergers (with “top-up”) brought buyers, sellers and stockholders to the same end result, but the one-step merger process (due to shareholder approval requirements) took months longer.
Two-Step Merger and Section 251(h) of the DGCL

• On August 1, 2013, the Delaware General Corporation Law was amended to add Section 251(h) which, subject to certain conditions, permit a back-end merger to be consummated following a tender offer that results in the buyer acquiring at least enough of the target’s shares to approve the merger (but less than 90%).

• 17.5% of deals in the first half of 2013 were structured as tender offers

• 37.9% of deals signed after August 1, 2013 were structured as tender offers

• Since August 1, 2013, only one Delaware-governed tender offer did not opt-in to Section 251(h)*


*2014 ABA Deal Points Study
Two-Step Merger and Section 251(h) of the DGCL

In order to qualify for Section 251(h), the following conditions must be satisfied:

- The target’s shares must be listed on a national securities exchange or have more than 2,000 stockholders of record immediately prior to the execution of the merger agreement.

- The buyer must be a corporation.

- The target’s certificate of incorporation must not contain a requirement for a stockholder vote to consummate a merger.

- The merger agreement must expressly permit or require that it will be governed by Section 251(h) and be approved by the target’s board.

- The merger agreement must provide that the second-step merger be effected as soon as practicable following the consummation of the tender offer.

- The tender offer must be for any and all outstanding stock of the target that, absent Section 251(h), would be entitled to vote to adopt the merger agreement.

- Following consummation of the tender offer, the buyer must own at least the required percentage of the outstanding shares of each class or series of stock of the target that would have been required to approve the merger agreement (typically a majority).

- The consideration paid for shares in the second-step merger must be the same amount and kind of consideration paid to stockholders in the tender offer.
# Comparison of One-Step and Two-Step Mergers

## One-Step Merger

<table>
<thead>
<tr>
<th>Pros</th>
<th>Two-Step Merger</th>
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<tbody>
<tr>
<td>• Often utilized for mergers where the buyer is financing the transaction with loans and the lenders do not wish to provide bridge financing for the purchase of shares in a first-step tender offer.</td>
<td>• If the buyer is paying all cash, the two-step merger can be completed quickly, without prior SEC review.</td>
</tr>
<tr>
<td>• In a transaction where the merger consideration consists of shares of the buyer, the timing advantages of a two-step merger are less pronounced.</td>
<td>• Can opt-in to Section 251(h) and do not need to obtain 90% in order to effect the back-end merger. Eliminates the need for the top-up and dual-track structure work-arounds.</td>
</tr>
<tr>
<td>• Beneficial structure if the transaction requires a significant amount of time between signing and closing to obtain 3rd-party approvals.</td>
<td>• No stockholder vote; front-end speed; deal certainty</td>
</tr>
<tr>
<td>Cons</td>
<td>Cons</td>
</tr>
<tr>
<td>• SEC review</td>
<td>• If the target has debt or other obligations that will become due upon the change of control, the buyer must be prepared to refinance or pay the obligations in full, which could be more difficult because the buyer does not own 100 percent of the target.</td>
</tr>
<tr>
<td>• Stockholder vote</td>
<td>• A financing closing condition requires an additional 5 business day notice period.</td>
</tr>
</tbody>
</table>
Recent Amendments to Section 251(h)

• Took effect on August 1, 2014 for merger agreements entered into on or after such date.

• Eliminate the prohibition against the statute's use in circumstances where a party to the merger agreement is an “interested stockholder.” Eliminates any questions as to whether buyer’s entry into voting agreements make the buyer an “interested stockholder.”

• Clarify that the merger agreement may either permit or require the merger to be effected under Section 251(h), enabling the parties to agree that the proposed merger under Section 251(h) may be abandoned in favor of a merger accomplished under a different statutory framework.

• Clarify certain timing and other requirements in respect of the back-end merger.

• Clarify that the tender offer may exclude stock owned by the target corporation.

• Do not change the fiduciary duties of directors.
Practical Implications Section 251(h)

• Increase in tender offer transactions v. one-step long form merger transactions

• Private equity considerations
What’s Market?
What’s Market?

• Earn-Outs—Note Winston & Strawn Real Deal Presentation January 22, 2014

• Material Adverse Change Provisions

• Deal Protection Terms
  • No-Shop/No-Talk Provisions
  • Go Shop
  • Break-Up Fees
  • Reverse Break-Up Fees

• Indemnification Terms
Earn-Outs: What is Market?*

- Comprise about 10-15% of aggregate purchase price

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*From American Bar Association, Private Target Mergers & Acquisitions Deal Points Study (Including Transactions Completed in 2012.) (Study of publicly available acquisition agreements for transactions completed through 2012 that involved private targets being acquired by public companies. Hereinafter referred to as the “2012 ABA Deal Points Study.”)
Earn-Outs: What is Market?*

• Frequency of Earn-Outs by close year
  • 2011- 39%
  • 2012- 29%
  • 2013- 33%
  • 2014- 27%

*Based off 580 J.P. Morgan escrow transactions with publicly available acquisition information that closed between 2011 and the first half of 2014.

*J.P. Morgan 2014 M&A Escrow Study
Earn-Outs: What is Market?*

**Earn-Out Length**

- 1 year or less
  - 2012- 20%
  - 2013- 7%
- >1 to 2 years
  - 2012- 33%
  - 2013- 43%
- >2 to 3 years
  - 2012- 13%
  - 2013- 36%
- >3 to 4 years
  - 2012- 20%
  - 2013- 7%
- >4 to 5 years
  - 2012- 13%
  - 2013- 7%
- >5 years
  - 2012- 0%
  - 2013- 0%

**Measured by the date the latest Earn-Out period ends.**

*2014 SRS/Acquiom M&A Deal Terms Study*
Earn-Outs: What is Market?*

2012 ABA Deal Points Study

Earnings/EBIDTA: 30%
Revenue: 32%
Combo: 3%
Other: 30%
Not Determinable: 5%
Material Adverse Change Provisions*

- Use of “Prospects” in Primary Definition—Less than 2% of transactions include “Prospects”

- MAC/MAE Carve-Outs
  - **General Economy**: 97% inclusion, of which 90% have “Disproportionate” Standard
  - **Industry**: 94% inclusion, of which 90% have “Disproportionate” Standard
  - **Announcement/Pendency**: 90%+ inclusion
  - **Failure to Meet Projections**: 85%+ inclusion
  - **Change in Law**: 95%+ inclusion
  - **Change in Accounting Principles**: 90%+ inclusion
  - **Terrorism/War**: 90%+ inclusion

*ABA 2014 Strategic Buyer/ Public M&A Deal Points Study*
Deal Protection Terms—No Talk Provisions*

• Fiduciary Exception to No-Talk
  • “Acquisition Proposal Expected to Result in Superior Offer” – 87% inclusion
  • Mere “Acquisition Proposal” – 9% inclusion
    • Generally defined as an offer, proposal, inquiry or indication of interest concerning 15% or more of the Target’s stock or assets
  • Actual “Superior Offer” – 4% inclusion
    • Generally defined as a bona fide, unsolicited, written Acquisition Proposal which would result in the Offeror owning a substantial amount of the Target’s outstanding shares or all or substantially all of its consolidated assets

*ABA 2014 Strategic Buyer/ Public M&A Deal Points Study
Deal Protection Terms—Go Shop Provisions

• Allow a Target’s Board of Directors to solicit Acquisition Proposals, generally for a period of 1-2 months, in order to satisfy their fiduciary duties to shareholders (their *Revlon* duties)

• 11% inclusion*

* ABA 2014 Strategic Buyer/ Public M&A Deal Points Study
Deal Protection Terms--Break-Up Fees; Reverse Break-Up Fees

- Value of Break-Up Fee v. Reverse Break-Up fee—No longer symmetrical
  - Break-Up fees—3% to 5%
  - See later charts for Reverse Break-Up fees
Target Break-Up Fee Triggers

- Naked No-Vote Fee
- Fee for No-Vote + Acquisition Proposal
- Drop-Dead Date + Acquisition Proposal
- Change in Board Recommendation
- Breach of No-Shop or Meeting Covenants
Break-Up Fee Triggers*

- Naked No-Vote
  - 75% in 2012
  - 71% in 2011
- No-Vote + Acquisition Proposal
  - 87% in 2012
  - 84% in 2011
- Drop Dead Date + Acquisition Proposal
  - 77% in 2012
  - 80% in 2011

*ABA 2014 Strategic Buyer/ Public M&A Deal Points Study
Break-Up Fee Triggers*

- Change of Board Recommendation
  - 95% in 2012
  - 92% in 2011
- Breach of Acquisition Agreement
  - General Breach
    - 5% in 2012
    - 8% in 2011
- Breach No-Shop
  - 51% in 2012 and 2011
- Breach Stockholder Meeting Covenants
  - 23% in 2012 and 2011

*ABA 2014 Strategic Buyer/ Public M&A Deal Points Study
Target Break-Up Fees: Liquidated Damages*

- Break-up fee characterized as liquidated damages
  - 38% in 2012
  - 23% in 2011

- Break-up fee NOT characterized as liquidated damages
  - 62% in 2012
  - 77% in 2011

*ABA 2014 Strategic Buyer/Public M&A Deal Points Study
Deal Protection Terms: Reverse Break-Up Fees/Financing Failure Risk

• Financing Failure Risk--68% of leveraged deals in 2013 included, payable if:
  • Buyer materially breaches, or
  • Transaction fails to close*

• Fell to 33.8% in 2014, due largely to the slowdown in M&A activity among financial buyers**

• Size of fee as % of deal value in debt-financed deals*
  • >8% (3 deals)
  • 5-7% (42 deals)
  • 2-4% (12 deals)

• In 2014, 12 of 71 (16.9%) debt-financed deals had reverse break-up fees priced at 6% or more of the total deal value**

*PLC Deal Protections and Remedies: 2013 Analysis of Public Merger Agreements
**PLC 2014 Year-end Public M&A Wrap-up
Reverse Break-Up Fees/Antitrust Risk*

• 19 deals in 2014 included reverse break-up fees for failure to secure antitrust approval (up slightly from 14 in 2013)

• Antitrust break-up fee as % of deal value*
  
  • 2-4% (7 deals)
  
  • 4-6% (9 deals)
  
  • 6-8% (1 deals)
  
  • >10% (2 deals)

*2014 PLC What’s Market: Reverse Break-up Fees for Antitrust Failure
Reverse Break-Up Fees and Specific Performance*

• Three general models for remedies for buyer breach:
  ➢ Strategic Model
  ➢ Private Equity Model
  ➢ Financing Failure Model

• Agreements in study analyzed for two types of remedies:
  ➢ Pre-termination equitable remedy
    • Full Specific Performance.
    • Conditional Specific Performance.
    • Limited Specific Performance.
    • No Specific Performance.
  ➢ Post-termination fee or damages

Reverse Break-Up Fees and Specific Performance*

Equitable Remedies Across All Transactions

- Full Specific Performance
- Conditional Specific Performance
- Limited Specific Performance
- No Specific Performance

**2013**
- 21 Deals (35%)
- 37 Deals (63%)
- 0 Deals (0%) 1 Deal (2%)

**2012**
- 34 Deals (50%)
- 32 Deals (47%)
- 1 Deal (1.5%) 1 Deal (1.5%)

**2011**
- 49 Deals (57%)
- 31 Deals (36%)
- 3 Deals (3.5%) 3 Deals (3.5%)

Reverse Break-Up Fees and Specific Performance*

Equity Remedies by Buyer Type

• Financial Buyers
  • 85% of transactions contain Conditional Specific Performance Terms
  • Less than 10% contain Full Specific Performance terms

• Strategic Buyers
  • 70% of transactions contain Full Specific Performance Terms
  • 25% of transactions contain Conditional Specific Performance Terms

Reverse Break-Up Fees and Specific Performance*

• Post-termination Monetary Remedies
  • No Reverse Break-up Fee (RBF), Full Damages.
  • No RBF, Damages for Willful Breach.
  • RBF, Uncapped Damages for Willful Breach.
  • RBF, Cap on Damages.
  • Two-tier Reverse Break-up Fee.

Reverse Break-Up Fees and Specific Performance*

Damages Remedies Across All Transactions

- **No RBF, Damages for Willful Breach**
- **RBF, Cap on Damages**
- **Two-tier Reverse Break-up Fee**
- **RBF, Uncapped Damagers for Willful Breach**
- **No RBF, Full Damages**

### 2013
- 7 Deals (12%)
- 3 Deals (5%)
- 30 Deals (51%)
- 15 Deals (25%)

### 2012
- 10 Deals (7%)
- 4 Deals (6%)
- 27 Deals (40%)
- 27 Deals (40%)

### 2011
- 12 Deals (14%)
- 5 Deals (7%)
- 28 Deals (33%)
- 30 Deals (35%)

Damage Remedies by Buyer Type

• Financial Buyers
  • 80% of transactions contain Reverse Break-up fee with cap on damages
  • Two-tier Reverse-Break Up Fee and next largest percentage (approximately 10%)

• Strategic Buyers
  • 30% of transactions contain Reverse Break-Up Fee
  • Majority of transactions contain no Reverse-Break-up Fee combined with damages for willful breach

Indemnification: Key issues in Private Transactions

• Critical M&A concept
• Along with price, the most important issue
• Key issues include caps, deductibles, escrows/holdbacks, survival
Indemnification: Caps

• Most deals include "caps" on losses relating to breaches of reps and warranties
• Different representations have different caps
  • So called “fundamental reps” related to title, authority, etc., are generally capped at purchase price received by seller
• Caps for reps relating to the Company’s condition (“Company representations”) have fallen from 40% range to much lower
  • According to one study, 89% of caps are 15% or less of purchase price*
    • Varies with market
    • UK deals feature higher caps (e.g., 40-50%)
• Many sellers are demanding "no rep" or "as is where is" deals
  • Essentially sets cap at zero for all reps (other than "fundamental" reps)
  • Aggressive/risky position for buyers, but gives sellers perfect peace of mind
  • How good is the price?
  • How comfortable is buyer with due diligence?
  • How comfortable is buyer with industry?
  • Seller’s bargaining power
  • Ultimately a business issue;
    • Indemnities are like "extended warranties" on cars and appliances; are they worth paying for?
    • Rep & warranty insurance may be used to reduce risk
• Caps generally don’t apply to breaches of covenants

*2013 ABA Deal Points Study
Indemnification: Deductibles v. Tipping Baskets

• Purchase agreements typically require losses to exceed "basket" level before indemnification applies
  • Typically 0.5% to 1.0% of purchase price
  • Essentially an increase of purchase price
  • "Tipping baskets" revert to "dollar 1"

• “Mini baskets” provides that losses under a de minimis amount do not apply to the basket
  • Included in 30% of 2012 deals.* Becoming more prevalent.
  • Usually a de minimis amount, such as $10,000 to $50,000 (depending on size of deal)
  • Again, a seller-friendly development

• Baskets and mini baskets serve as global materiality qualifier for indemnification
  • Watch effect of materiality qualifier in reps
  • May create additional barrier to recovery
  • "Scrape" qualifiers
  • Quantify "material"

*2013 ABA Deal Points Study
Indemnification: Escrows / Holdbacks

• Buyers often negotiate escrows or holdbacks to provide security for breaches of representations
  • Avoids problems of chasing individual sellers
  • May not be as important when seller is a large established company
• Escrows and holdbacks have declined as a percentage of transaction value
• Increasingly, the escrow or holdback is the exclusive source of recovery for Company representations (32% of deals in 2012)*

*2013 ABA Deal Points Study
**Indemnification Terms: What is Market?**

Distribution of % of Purchase Price Placed in Indemnity Escrow 2011-2014**

- **Private Equity Seller**
  - 2011 - 7.5%
  - 2012 - 5.8%
  - 2013 - 10%
  - 2014 - 10.8%

- **Non-Private Equity Seller**
  - 2011 - 9.8%
  - 2012 - 10.1%
  - 2013 - 10.1%
  - 2014 - 9%

**Based off 580 J.P. Morgan escrow transactions with publicly available acquisition information that closed between 2011 and the first half of 2014.

*J.P. Morgan 2014 M&A Escrow Study*
Indemnification: Survival Periods

• Eighteen months is a common survival period for general reps and warranties

• Survival periods are generally shortening, in favor of sellers

• Instead of a definite time period, survival periods can be linked to financial audits

• Fundamental reps (e.g., title to shares) survive indefinitely

• Special reps (e.g., environmental) may survive for longer period

• Tax reps often limited to statute of limitations
To Recap:

Public Transactions

Private Transactions

- Sellers are demanding lower caps, shorter survival, higher baskets and mini-baskets

- “Rep free” or “as is, where is” deals are not the norm but are happening

- For buyers, underlines importance of thorough due diligence and cold-eyed focus on price paid

- Rep and warranty insurance may help
Other Recent Developments
Other Recent Developments

- Shareholder Activism
- Contested/Hostile Transactions and/or Situations
- Representation and Warranty Insurance
- Take Private Transactions
- Spin-Off Transactions
Questions?

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Thank You