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Mergers and Acquisitions—2016

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2015 was a record year for M&A. Global M&A volume hit an all-time high of over $5 trillion, surpassing the previous record of $4.6 trillion set in 2007. U.S. M&A made up nearly 50% of the total. The "mega-deal" made a big comeback, with a record 69 deals over $10 billion, and 10 deals over $50 billion, including two of the largest on record: Pfizer's $160 billion agreement to acquire Allergan and Anheuser-Busch InBev's $117 billion bid for SABMiller. Cross-border M&A reached $1.56 trillion in 2015, the second highest volume ever.

A number of factors provided directors and officers with confidence to pursue large, and frequently transformative, merger transactions in 2015. The economic outlook had become more stable, particularly in the United States. Many companies had trimmed costs in the years following the financial crisis, but still faced challenges generating organic revenue growth. M&A offered a powerful lever for value creation through synergies. In a number of cases, the price of a buyer's stock rose on announcement of an acquisition, as investors rewarded transactions with strong commercial logic, bucking historical trends. Equity prices in 2015 were strong, if flat, providing companies with valuable acquisition currency. For at least the first half of the year, strong appetite from debt investors (particularly for quality credits) and low interest rates enabled acquirors to obtain financing on attractive terms.

Industry trends also played a significant role in M&A activity in 2015. There was consolidation in pharmaceuticals (including the pending Pfizer-Allergan transaction and AbbVie's $21 billion acquisition of Pharmacyclics), technology (including Dell's pending $67 billion acquisition of EMC and Avago's $37 billion acquisition of Broadcom), insurance (including Anthem's pending $54 billion acquisition of Cigna, Aetna's pending $37 billion acquisition of Humana and ACE's $28 billion acquisition of Chubb), and oil and gas (including Energy Transfer Equity's pending $38 billion combination with Williams Companies and Royal Dutch Shell's pending $70 billion acquisition of BG Group).

Looking ahead, as energy and commodity markets plumb lows, equity markets have become volatile, China and Brazil slump, Europe splinters, and debt markets look increasingly shaky, one may well wonder if M&A activity in 2016 will be less robust than in 2015. Although many of the factors that drove activity in 2015 continue to be present, volatility impairs the confidence essential to large, strategic M&A transactions, even though it may also create opportunities. It is difficult to imagine M&A activity in 2016 surpassing 2015 levels, but there are signs of continuing M&A dealmaking, even amidst the current turmoil.

Below, we review some trends that we expect to continue in 2016.

Hostile and Unsolicited M&A

Hostile and unsolicited M&A have increased dramatically in recent years, from $145 billion of bids, representing 5% of total M&A volume, in 2013 to $563 billion of bids, representing 11% of total volume, in 2015. Notable recent bids include 21st Century Fox's $80 billion offer for Time Warner, which was ultimately withdrawn; Cigna's bid for Anthem, resulting in an agreed $54 billion merger; Mylan's $35 billion bid for Perrigo, which was defeated, and Teva's $40 billion bid for Mylan, which was ultimately withdrawn; DISH Network's $26 billion bid for Sprint Nextel, which was ultimately withdrawn; and Energy Transfer Equity's bid for Williams Companies, resulting in an agreed $38 billion combination.

A number of recent hostile and unsolicited transactions have involved non-U.S. targets. Foreign takeover laws present a multifaceted overlay in any cross-border transaction, and the legal and tactical considerations can be particularly complex in the case of a hostile bid for a non-U.S. company. Careful planning and coordination with foreign counsel are critical in hostile and unsolicited transactions, on both the bidder and target sides.

The three-way Mylan/Perrigo/Teva battle illustrates how the takeover regimes in different jurisdictions can have a significant impact. Perrigo (which had inverted from Michigan to Ireland) was subject to the "no frustrating action" rule and other Irish Takeover Rules, which made it more difficult to defend against Mylan's hostile bid—although Perrigo ultimately succeeded in convincing shareholders not to accept the bid. By contrast, Mylan (which had inverted from Pennsylvania to the Netherlands) used a potent combination of takeover defenses facilitated by Dutch law and its own governance documents to take a resist-at-all-costs approach to Teva's bid.

The Perrigo situation demonstrates that it is possible for a target board to successfully resist a hostile takeover attempt, even without the ability to use a poison pill. And where a poison pill is permissible, it can be a powerful means of protecting shareholder value, as illustrated by the Airgas situation: in December 2015, in vindication of the Airgas board's judgment and confirmation of the wisdom of the Delaware case law (particularly the Delaware Chancery Court's 2011 Airgas opinion validating the use of the poison pill), Airgas agreed to be sold to Air Liquide at a price of $143 per share, in cash, nearly 2.4 times Air Products' original $60 offer and more than double its final $70 offer, in each case before considering the more than $9 per share of dividends received by Airgas shareholders in the intervening years.

Inversions

Over the last several years, a number of U.S. companies have "inverted" through mergers with foreign companies, affording the combined company greater flexibility in future tax planning. Many predicted that the Treasury/IRS notices issued in September 2014 and November 2015 might impede inversion transactions by making it more difficult to invert and by reducing the advantages of becoming an inverted company. Some deals fell apart after the September 2014 notice, and each of the notices led to the restructuring of some deals. However, companies have continued to pursue inversion transactions.

Activism and M&A

Shareholder activism has reached unprecedented levels, and we expect that trend to continue. Despite recent poor performance by big-name activists such as Carl Icahn and Pershing Square and by activist-targeted companies, we expect shareholder activism to continue, including at the largest companies. In the M&A realm, Pershing Square currently is working with Canadian Pacific Railway in its bid for Norfolk Southern. ValueAct publicly advocated for Willis Group's merger with Towers Watson after the deal faced criticism for offering too low a price for Towers Watson shareholders (the deal was approved after it was amended to increase the consideration to the Towers Watson shareholders). Following earlier pressure from Trian on DuPont and Third Point on Dow Chemical to break up, DuPont and Dow agreed to a $69 billion merger, with an anticipated three-way separation in the future. Icahn is continuing to agitate for a break-up of insurance giant AIG, even after the company recently presented its own alternative plan. Icahn also made a successful overbid for Pep Boys after it had agreed to sell itself to Bridgestone. Other activist tactics included encouraging or pressuring two companies to merge (and building stakes in both companies as part of the campaign, as Elliott did in the Polycom/Mitel Networks situation and Starboard Value did at Staples/Office Depot and at Yahoo! / AOL), or seeking to interfere with pending transactions (as in the Media General/Meredith Corp/Starboard Value/Nexstar Broadcasting situation).

Activists often urge or are attracted to M&A situations because they create opportunities for short-term profits and can be exploited by savvy investors who understand the workings of transactions and public markets. As with all activism, it is critical to be well-prepared; to honestly evaluate both strengths and weaknesses of the situation; to carefully consider how, when and whether to respond to the activist; and to engage with shareholders, analysts and other relevant market participants.

Spin-offs

Many companies do spin-offs to create value by, among other things, allowing for enhanced business focus, business-appropriate capital structure and distinct investment identity for both the spun-off business and the remaining business. Significant recent spin-offs include Energizer Holdings' spin-off of its household products business, Gannett's spin-off of its publishing business, DuPont's spin-off of its performance chemicals business, eBay's spin-off of PayPal, Baxter's spin-off of its biopharmaceuticals business, HP's separation of its PC and printer business and its enterprise business, and W.R. Grace's separation of its construction products and packaging technologies businesses and its catalyst technologies and engineered materials businesses. Pressure from activists in recent years has led to greatly increased spin-off volumes, as companies respond to direct pressure and in other cases act preemptively to avoid activism where a "conglomerate discount" can be a source for agitation.

2015 brought important changes to the tax landscape for spin-offs. The IRS will no longer issue rulings as to the tax-free treatment of certain "cash-rich" spin-offs, where a very large percentage of the asset value of the parent or the spun-off corporation consists of cash or a noncontrolling stake in another publicly traded entity. The IRS also will no longer rule on whether the "active trade or business" requirement for a tax-free spin-off is satisfied if the fair market value of the gross assets of the active trade or business on which either company is relying is less than 5% of the total fair market value of the gross assets of the company. This appeared to lead Yahoo! to

abandon its planned tax-free spin-off of a company that would hold its stake in Alibaba. In addition, Congress amended Section 355 of the Internal Revenue Code to provide that a spin-off in which only the spun-off company (or the remaining company) is a REIT cannot qualify for tax-free treatment. (REIT to REIT and REIT/Taxable REIT Subsidiary spin-offs can still qualify as tax-free, however.) As a result, the popular activist tactic of pushing for "OpCo / PropCo" separations—in which an operating company with significant real estate holdings spins its properties off into a separate publicly traded REIT and leases them back—has become less attractive.

Governance advisors and activists have increased their focus on newly public companies. ISS issued voting guidelines under which it generally will make adverse recommendations for directors at the first shareholder meeting of a newly public company if that company has bylaw or charter provisions that are "adverse to shareholder rights." The Council of Institutional Investors issued a draft statement laying out investor expectations as to various governance features of newly public companies. And Carl Icahn threatened campaigns at eBay, Manitowoc and Gannett, resulting in settlements in which the companies undertook various commitments relating to the governance structure of the businesses they were spinning off.

Newly public companies often are at their most vulnerable to takeover approaches, as they seek to establish themselves and build a knowledgeable investor base. Companies considering a spin-off or IPO should, as always, focus on how to structure the governance of the new company in a manner that maximizes long-term value creation. But they also should understand the governance landscape and the implications of their choices as they chart a course for the enterprises they are creating.

Strategic Deals and Regulatory Scrutiny

Bigger is not always better in the eyes of regulators, and muscular enforcement of antitrust and other regulatory regimes, both domestic and foreign, repeatedly manifested itself in 2015. We expect this trend to continue at least through the upcoming presidential election. Comcast's $45 billion acquisition of Time Warner Cable, Sysco's $3.5 billion acquisition of U.S. Foods, Tokyo Electron's $9.3 billion acquisition of Applied Materials, and Electrolux's $3.3 billion acquisition of General Electric's appliances business were all blocked or scuttled after facing stiff resistance from regulators. A number of significant deals also remain in the regulatory pipeline, including Halliburton's $35 billion acquisition of Baker Hughes, FedEx's $5 billion acquisition of TNT Express, and Staples' $6 billion acquisition of Office Depot.

Even difficult deals, however, can get done. General Electric's $14 billion acquisition of Alstom's energy business, Holcim's $47 billion merger with Lafarge, Expedia's $1.6 billion acquisition of Orbitz, and Dollar Tree's $9 billion acquisition of Family Dollar Stores all withstood significant regulatory scrutiny. The key to getting a tough deal through is a thorough analysis of the substantive issues, and the potential objections and theories that may be advanced by regulators; development of a comprehensive and well-thought out approach for proceeding through global regulatory processes, including consideration of possible remedy packages; and, if necessary, preparing a litigation strategy.

Parties also need to carefully consider the appropriate contractual allocation of risk in light of the competition and other regulatory issues presented. The "outside date" of the agreement

(including extension provisions), extent of “efforts” obligations, cooperation and control provisions and closing conditions all merit detailed attention. Reverse termination fees tied to failure to obtain regulatory approval, while not necessarily appropriate in all cases, can also be an effective mechanism for aligning incentives.

Continued Creativity by Private Equity

Private equity firms have played a less visible role in the current M&A boom than they did 10 years ago, when PE firms would routinely agree to $10 billion+ leveraged buyouts, sometimes in “club deals” along with other firms. This has been driven by a variety of factors, including relatively high public market valuations, which provided strategic bidders competing with PE buyers with a valuable acquisition currency and led sponsors to conclude that targets were overvalued in many cases; strategic bidders’ ability to extract synergies, which allowed them to dig deeper when bidding against PE firms; and the leveraged lending guidelines issued by the FDIC, the Federal Reserve and the OCC, which constrained banks’ ability to lend into more heavily leveraged transactions.

Despite these factors, PE firms hardly stayed on the sidelines. In some cases, sponsors teamed with strategics to bid on an asset, bringing together expertise in financial structuring and operational management, as well as the ability to create synergies. Notable examples of such transactions include the acquisition of Kraft Foods by H.J. Heinz, 3G Capital and Berkshire Hathaway, and the $9 billion acquisition of Suddenlink by Altice, BC Partners and CPP Investment Board. In other cases, PE firms used portfolio companies as a platform for M&A, again combining the strengths of private equity and strategic firms. PE firms also used creative deal structures, such as a rollover by a PE seller of part of its stake in a portfolio company for the stock of the acquiror, which can help bridge a valuation gap and preserve a portion of the upside for the PE seller. Similarly, a company may sell a business to a PE firm and retain a stake in the divested business, which could ease the sales process, facilitate ongoing relationships and reduce the need for debt financing.

With substantial capital at their disposal, and the continued availability of financing on relatively attractive terms—as well as sponsors’ desire for exits—private equity firms can be expected to continue to seek opportunities, both traditional and non-traditional. Flexibility and creativity will continue to be key in getting transactions done.

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With a record year behind us, and market conditions that have become decidedly turbulent, dealmaking volume in 2016 remains an open question. Regardless of how robust it continues to be compared to 2015’s record volume, it is important for any company undertaking M&A to understand the context of the particular situation, including the risks and benefits of a particular transaction, and the forces that may encourage or derail an agreement and its consummation.