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Mergers and Acquisitions — A Brief Look Back and a View Forward

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M&A activity in 2016 had a slow start and a strong finish, reaching \$3.7 trillion globally, behind 2015, but the third-busiest year on record. Deals involving U.S. targets were strong at just under \$1.7 trillion, and represented a share of total global deal value comparable to 2015. Overall, 2016 had its share of large deals, albeit trailing 2015 levels, with 45 deals over \$10 billion (compared to 69 in 2015) and 4 deals over \$50 billion (compared to 10 in 2015). The year also set a record in announced friendly deals that were withdrawn or terminated, many due to regulatory issues, with \$567 billion of U.S. M&A deals falling into this category.

A variety of macroeconomic factors drove the level of M&A activity in 2016. As in 2015, increasingly scarce opportunities for organic growth, coupled with relatively inexpensive debt financing, fueled strategic acquisitions. Equity markets started off the year sluggish but later rebounded, enhancing the ability of strategic acquirors to use their stock as acquisition currency. In step with the increasing value of equity markets, U.S. M&A volume peaked in October, breaking the record for the highest monthly U.S. M&A volume. Commodities likewise started out slowly, but gained momentum as the year progressed. The unexpected Brexit vote in June 2016 appeared to have had some impact on European M&A, and the process of extricating the United Kingdom from the European Union is only just beginning, with the possibility of significant events in 2017. Technology, real estate

and utility & energy were among the most active industries in M&A.

Markets have rallied following the U.S. elections in November, as investors appear to be anticipating a mix of deregulation, tax reform and infrastructure spending that will boost economic activity, without significant concern about trade conflicts and further geopolitical shocks. Although interest rates have recently increased modestly, in light of both the U.S. elections and the increase in rates by the Federal Reserve in December 2016 and its signal of further increases in 2017, borrowing costs remain at low levels. Prognostication is a dangerous sport even in times of relative predictability, and 2016 was anything but predictable. However, to the extent these trends continue, M&A activity can be expected to remain at relatively high levels in 2017.

Below, we review some trends from 2016 and whether we expect them to continue in 2017.

Cross-Border M&A

Cross-border activity represented a significant component of global M&A transactions in 2016, with cross-border volume amounting to approximately 40% of total volume, as compared to one-third in 2015. One reason for this increase was the rise of China-outbound M&A, with such deal activity reaching \$230 billion in 2016, as compared to \$86 billion in 2015.

Chinese state-owned enterprises and other firms aggressively pursued targets in a variety of industries in 2016, including transactions such as ChemChina's pending \$47 billion acquisition of Syngenta AG (the largest outbound Chinese transaction on record), Haier Group's \$5.6 billion acquisition of GE's appliances business, HNA Group's \$6.1 billion acquisition of Ingram Micro and Chongqing Casin Enterprise Group's pending acquisition of the Chicago Stock Exchange. Among other drivers, China's growing middle class, appetite for commodities, supportive political environment and growing experience in M&A all contributed to the continued high volumes. As the year progressed, however, the volume of Chinese acquisitions slowed compared to the record-breaking first quarter of 2016, amid reports that the Chinese government was seeking to impose limits on outbound M&A in order to limit the flight of capital out of the country.

Cross-border transactions involve multiple layers of complexity not present in purely domestic transactions. Transactions involving foreign buyers may involve review by the Committee on Foreign Investment in the United States (CFIUS), a multi-agency committee that reviews acquisitions involving non-U.S. acquirors for potential national security implications. CFIUS scrutiny is not limited to the defense sector; for example, in January

2016, CFIUS blocked a majority investment in Phillips' Lumileds lighting-components business by a group of Asian buyers.

In addition to CFIUS and other national security, foreign investment and competition law regimes, parties need to have a thorough understanding of other relevant legal considerations, both foreign and domestic. These include securities laws (including potential exemptions for transactions with a foreign component), stock exchange listing rules, corporate law rules and judicial doctrines and labor laws. In addition, parties need familiarity with the bodies charged with administering and enforcing these various rules, and how all these myriad legal regimes are best navigated in practice. Certain contractual terms in acquisition agreements can take on increased prominence when dealing with a foreign buyer, such as governing law provisions, choice-of-forum provisions, reverse-termination-fee provisions, escrows and other potential recourses for breach. Parties also must be aware of cultural norms as to negotiation and business practices.

Looking forward, President-elect Trump appears to be taking an aggressive posture toward China, but it is unclear whether CFIUS review would be more assertive under a Trump administration in deals involving Chinese or other foreign buyers. U.S. relations with China and other trading partners more broadly could also have an impact on the level of cross-border investment and M&A activity.

Antitrust Enforcement

Several large deals fell apart in 2016 after announcement due to aggressive antitrust efforts by regulators. Casualties of heightened regulatory enforcement include Halliburton's \$35 billion acquisition of Baker Hughes and Staples' \$6 billion acquisition of Office Depot. As of this writing, the U.S. Department of Justice continues to seek to block Aetna's \$35 billion acquisition of Humana and Anthem's \$49 billion acquisition of Cigna. It has generally been the case that Democratic administrations are tougher on antitrust enforcement than Republican administrations, and antitrust enforcement has been particularly active toward the end of President Obama's term. As a result, dealmakers may become more bullish in 2017 in seeking to get potentially difficult deals approved. But here, as in other areas, it is unclear whether President-elect Trump's administration will follow traditional Republican policies. For example, during the campaign, he called out the then-rumored (and later agreed and still pending) AT&T acquisition of Time Warner as a deal that his administration would not approve. In deals involving potentially significant antitrust risk, transaction participants will need to pay close attention to changes at the U.S. antitrust enforcement authorities in 2017, in terms of key personnel appointments (which may not be fully implemented for several months), policy pronouncements and enforcement trends.

Potential Tax Reform

With the incoming Trump administration and both houses of Congress controlled by Republicans, tax reform is expected to be high on the agenda in 2017. President-elect Trump has spoken often of lowering corporate tax rates. To the extent tax law changes leave more cash in the hands of U.S. companies, this could bolster acquisition activity. There also has been much discussion of how to bring the trillions of dollars held overseas by U.S. companies back to the United States, with some predicting a possible tax holiday allowing foreign earnings to be repatriated at a lower tax rate, which likewise could lead to U.S. companies having more financial resources for acquisitions (or could lead companies to use cash on their balance sheets instead of new financing for acquisitions). There also have been other proposals that would involve a more radical restructuring of the tax system. The ultimate shape of any tax reform is difficult to predict, but it could have a significant impact on the financial calculus of M&A.

Financial Regulation

The impact of the Trump administration on the financial services regulatory environment and bank merger activity could be highly significant. Although a great deal of attention has been paid to rolling back the Dodd-Frank Act, the real potential for change is Trump's ability to appoint the senior-most bank regulators. Taken together, the senior policymakers at the Federal Reserve, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Consumer Financial Protection Bureau have had a greater impact on the regulatory environment than has the Dodd-Frank Act. A change in the tone at the top at these agencies would have profound industry implications. Three primary reasons for the relative inactivity in bank mergers and acquisitions have been: (1) a large number of would-be buyers that are in the regulatory penalty box for years at a time for relatively minor infractions; (2) the regulatory onslaught that has had the banking industry on its heels and caused the industry to think more defensively than offensively; and (3) a weak market for bank stocks and, consequently, weak acquisition currency. All of these factors could change significantly in the near future.

Acquisition Financing

After nearly a decade categorized first by tumult and then by recovery driven by unprecedented monetary loosening, 2016 was a turning point for U.S. acquisition financing markets. Interest rates, after years of historic lows, began to rise modestly, and the election set the stage for significant regulatory and legislative changes that could have profound effects on the financing markets in the coming years.

As described above, changes to the corporate tax code could significantly affect acqui-

sition financing activity in 2017—in particular, loosening restrictions on U.S. companies’ ability to repatriate cash from overseas could provide companies with a large stockpile of funds to use for acquisitions in lieu of new debt financing. In addition, potential regulatory changes, such as adjustments to the Dodd-Frank Act, could infuse the debt markets with new sources of leveraged financing, although it is difficult to predict the net effect of all of these changes at this time because of the uncertainty around what legislative and regulatory changes might be made. Finally, rising interest rates are likely to drive increased demand for floating-rate paper, potentially reducing interest rate spreads as a result, and may make stock more attractive as an acquisition consideration (as compared to debt).

Spin-offs and Reverse Morris Trusts

Spin-offs continued to be a popular means of seeking to unlock value in 2016, in some cases initiated by pressure from shareholder activists and other shareholders. A spin-off involves the separation of a company’s businesses through the creation of one or more separate, publicly traded companies. Spin-offs have been popular because many investors, boards and managers believe that certain businesses may command higher valuations if owned and managed separately, rather than as part of the same enterprise. An added benefit is that a spin-off can usually be accomplished in a manner that is tax free to both the parent company and its shareholders. Moreover, in recent years, companies have been able to tap the debt markets to lock in low borrowing costs for the business being separated and monetize a portion of its value, often resulting in a dividend to the parent concurrent with the separation.

A spin-off can also be used in combination with a concurrent M&A transaction. For example, “Morris Trust” and “Reverse Morris Trust” transactions effectively allow the parent to transfer a business to a third party in a transaction involving stock consideration in a manner that is tax free to the parent if certain requirements are met. In a traditional Morris Trust transaction, all of the parent’s assets other than those that will be combined with the third party are spun off or split off into a new public company and then the parent merges with the third party. In a Reverse Morris Trust transaction, all assets to be combined with the third party are spun off or split off into a new public company and then the new company merges with the third party. In order to be tax free, the Morris Trust and Reverse Morris Trust structures generally require, among other things, that the merger partner be smaller than the business to be combined with the merger partner (i.e., that the shareholders of the spinning or spun-off company own a majority of the stock of the combined entity after the subsequent merger). Examples of Reverse Morris Trust transactions in 2016 include Citrix Systems’ separation and merger of its GoTo business with LogMeIn, Hewlett Packard Enterprise’s separation and merger of its software business with Micro Focus International,

Proctor & Gamble's separation and merger of its specialty-beauty business with Coty and Lockheed Martin's separation and merger of its information systems and global solutions business with Leidos Holdings.

One advantage of a Reverse Morris Trust structure over a Morris Trust structure is that a Reverse Morris Trust transaction generally does not require approval by the parent shareholders for the spin-off or merger. In a Reverse Morris Trust transaction, the spin-off company is combining with the merger partner, and the parent entity approves this combination at the time when the parent entity is the sole shareholder of the spin-off company. By contrast, a Morris Trust transaction often requires approval by the parent's shareholders because the merging party (i.e., the parent) is already a public company at the time that the merger is submitted for approval by the parent's shareholders.

We expect companies to continue to pursue spin-offs, Reverse Morris Trusts and other tax-efficient divestiture transactions in 2017.

Private Equity

As in 2015, there were few acquisitions of large public companies by private equity firms in 2016, but the private equity space was hardly inactive. Many sponsors were active participants in buyouts of public companies. Supported by a generally healthy financing market, private equity firms were strong competitors in many auctions, although it is also clear that many financial sponsors are showing reluctance to participate in auction processes.

Funds under management by private equity firms remained at very high levels, with \$852 billion of "dry powder" available to private equity buyers as of mid-December. Although fundraising in the first half of 2016 was stronger than in the first half of 2015, fundraising activity began to slow in the second half and the total for 2016 through mid-December was approximately 13% below the comparable period in 2015. Both IPOs and M&A exits by private equity sponsors slowed in 2016 relative to 2015. Sponsors continued to use portfolio companies as a platform for bolt-on acquisitions, allowing them to create value through synergies.

Another notable recent trend is the blurring of the line between private equity and shareholder activism, and the use of private-equity backed buyouts either in response to, or as part of, an activist approach. Some private equity firms have acquired toehold stakes in public companies with a view to suggesting changes to the business, such as Oaktree Capital's investment in SunOpta and appointment of two directors to its board. In addition, some activists are seeking buyouts, including Icahn Enterprises' buyout of Pep Boys for \$1 billion. Private equity funds also are being more open about how hedge fund activism

increases private equity deal flow by encouraging take-private / sell-the-company / sell-the-division activism. Moreover, some public company CEOs also are viewing a buyout by a private equity firm as a means of potentially avoiding the distraction and disruption of activists and the public markets. With competition for attractive investment opportunities becoming increasingly intense, and many hedge funds under pressure to realize returns on investments, we would expect that activism in 2017 will likely lead to more financial-sponsor buyouts.

Deal Activism

In today's robust M&A environment, parties to a potential merger or acquisition must anticipate and manage "deal activism." Just as all companies and boards should prepare for shareholder activism generally, deal participants should plan for the possibility that, after a deal is announced, activists may seek a higher price, encourage a topping bid for all or part of the company, dissent and seek appraisal, try to influence the combined company and its integration or even try to scuttle a deal entirely, leveraging traditional disruptive activist campaign tactics in their efforts.

For example, in December 2016, the drugstore chain Fred's announced an agreement to purchase 865 Rite Aid stores for almost \$1 billion. Just a few days later, activist investor Alden Global Capital revealed that it had acquired 25% of Fred's and that it wished to discuss the Rite Aid deal, leading Fred's to adopt a poison pill. Similarly, Starboard Value is pressuring aircraft-parts maker Rockwell Collins to terminate its proposed \$6.4 billion deal with B/E Aerospace and instead put itself up for sale.

Deal activism is but one part of the broader intersection of M&A and activism. M&A is itself a frequent activist demand, such as when activists (i) try to force a company to seek a buyer; (ii) seek to encourage or pressure two companies to merge (and build stakes in both companies as part of the campaign); (iii) urge a company to engage in buy-side M&A; (iv) propose that a company sell divisions or assets to finance stock buybacks; or (v) push a spin-off with the idea that either the spin-off company or the remaining company will become a takeover target.

While shareholder activism is a part of modern corporate life, it should not deter boards from approving a significant acquisition or other material transaction or rejecting a merger proposal or a hostile takeover bid, all of which are squarely within the board's business judgment.

M&A Litigation Trends

The Delaware courts ruled on a variety of important issues in 2016, including decisions

related to stockholder ratification of mergers, disclosure-only settlements and appraisal proceedings. With respect to stockholder ratification, there were a number of decisions that followed the rule of *Corwin v. KKR Financial Holdings LLC*, which held that when a merger is approved by an informed body of disinterested stockholders and then closes, courts should apply the business judgment rule to claims challenging director conduct in approving the merger. *Singh v. Attenborough* extended the *KKR Financial* ruling to aiding-and-abetting claims against corporate advisors, such as investment bankers. In addition, the Delaware Chancery Court's *In re Volcano Corp. Stockholder Litigation* decision further applied this principle to claims against directors and their financial advisors in third-party cash-out mergers under section 251(h) of the Delaware General Corporation Law following a tender offer, although the Delaware Supreme Court is set to review this decision on appeal. These decisions confirm that, if the disinterested stockholders approve a third-party acquisition, the court will grant substantial deference to this decision in any post-closing merger litigation as long as the stockholders were fully informed. Attention to complete disclosure is therefore important in any transaction subject to stockholder approval.

The Delaware courts also continued the trend of rejecting "disclosure-only" settlements of claims challenging a merger. In a "disclosure-only" settlement, the defendants receive a release of claims in exchange for making supplemental disclosures to stockholders and plaintiff's counsel receive a fee award. Largely as a result of the trend of rejecting "disclosure-only" settlements, litigation challenging mergers (which had previously become nearly ubiquitous) has dropped precipitously.

Although the litigation trends noted above should increase predictability in M&A transactions, the Delaware Court of Chancery's ruling in the *In re Appraisal of Dell, Inc.* proceeding could create additional risk for certain deals. In the *Dell* decision, the court ruled that the fair value for Dell shares in its 2013 go-private transaction was \$17.62, almost 30% more than the price paid in the merger. This decision was particularly noteworthy in that it suggests that courts may find a company's "fair value" to be much higher than any bidder was prepared to pay. This decision is set to be reviewed on appeal by the Delaware Supreme Court in 2017, and it remains to be seen whether the court will uphold this decision (which, if upheld, would increase the risk of "appraisal arbitrage," in which investors acquire shares with a view to getting an appraisal award in excess of the deal price) or follow other decisions of the Delaware Court of Chancery that have found that the merger price is often the best indicator of fair value.

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After a record 2015, and an unpredictable but active 2016, signs are pointing toward continued robust levels of M&A activity in 2017. Dealmakers will need to pay close atten-

tion to economic trends, legal developments and what comes out of the new U.S. administration and Congress, as well as how the business community, both domestic and global, reacts to these events.

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