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Mergers and Acquisitions — 2019

As a whole, 2018 proved to be another strong year for M&A. Total deal volume reached almost $4.2 trillion globally, higher than the $3.7 trillion volume of 2017, but still less than the record of over $5 trillion set in 2015. Deals involving U.S. targets totaled over $1.7 trillion, compared to approximately $1.5 trillion in 2017. The number of large deals significantly increased in 2018, with 60 deals over $10 billion announced globally (compared to 46 deals in 2017). The technology sector saw the largest deal volume, followed by healthcare, oil and gas, and real estate. Private equity firms also had a banner year. As of late December, private equity buyout volume had reached almost $384 billion, the highest since the PE boom before the financial crisis. Although hostile and unsolicited M&A remained prevalent, the volume of these deals fell globally both in absolute terms, from $575 billion in 2017 to $522 billion in 2018, and in terms of share of overall deal volume, from 15% in 2017 to less than 13% in 2018.

But these aggregate statistics tell only part of the story of 2018. The beginning of 2018 was active for global M&A because of a variety of factors, including generally positive economic indicators, the effects of U.S. tax reform enacted at the end of 2017, new highs in global equity markets, and inexpensive debt financing. By the third quarter, however, deal activity began to decline, with global volume falling from approximately $1.2 trillion in each of the first two quarters of 2018 to just $850 million by the fourth quarter. The decline was driven by a number of factors, including escalating trade tensions, particularly between the United States and China; fears that the long-running U.S. economic expansion may be slowing; equity markets flirting with bear market territory; expectations for continued interest rate increases by the Federal Reserve; the continued drama surrounding how (and perhaps whether) Brexit will be implemented, as well as political conditions in the United States, France, Germany and elsewhere; oil price volatility; and disruption in the debt markets.

Below, we review some of the key themes driving M&A activity in 2018 and expectations for 2019.

Delaware at the Forefront

The Delaware courts issued a number of decisions in 2018 that will be relevant to future dealmaking. In *Akorn, Inc.* v. *Fresenius Kabi AG*, C.A. No. 2018-0300-JTL (Del. Ch. Oct. 1, 2018), the Delaware Court of Chancery for the

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first time held that a merger target had suffered a material adverse change that allowed the acquiror to walk away from the transaction. The 246-page post-trial opinion was later affirmed by the Delaware Supreme Court, *Akorn, Inc.* v. *Fresenius Kabi AG*, No. 535, 2018 (Del. Dec. 7, 2018), and the case confirmed that Delaware courts will enforce all contract provisions — including MAE provisions — in accordance with their terms upon an appropriate evidentiary record.

The Delaware Supreme Court also clarified important open questions relating to the landmark *MFW* decision, which held that go-private mergers and other controlling stockholder transactions can avoid onerous "entire fairness" judicial scrutiny if they are conditioned "upfront" on approval by a fully disinterested special committee and the fully informed vote of a disinterested stockholder majority. In *Flood* v. *Synutra Int'l, Inc.*, No. 101, 2018 (Del. Oct. 9, 2018), the Delaware Supreme Court rejected a "bright-line" requirement that the controlling stockholder commit to the protective conditions in the very first written expression of interest, and instead held that *MFW* will be satisfied so long as the controlling stockholder has agreed to condition the transaction on special committee approval and a disinterested stockholder vote "at the germination stage of the Special Committee process, when it is selecting its advisors, establishing its method of proceeding, beginning its due diligence, and has not commenced substantive economic negotiations with the controller." The Court went to hold that a stockholder plaintiff could not sustain a claim against a controller transaction just by complaining about the price. *Synutra* makes clear that what matters in determining the standard of review in a controlling stockholder deal is whether independent directors and disinterested stockholders have been fairly and promptly empowered to decide for themselves. The test is practical, not formalistic, and when it is satisfied, courts will defer to independent fiduciaries and disinterested investors with skin in the game.

In addition, Delaware courts built on the Delaware Supreme Court decisions in *Dell* v. *Magnetar* and *DFC* v. *Muirfield*, the 2017 rulings that stressed deference to the market's view of value in appraisal proceedings. Delaware courts have repeatedly found in appraisal proceedings that fair value was equal to the arms' length negotiated deal price, and they have even found it to be *below* the deal price in a number of cases, including in *Merlin Partners, LP* v. *SWS Group, Inc.*, No. 295, 2017 (Del. Feb. 23, 2018) (affirming the Delaware Court of Chancery's finding of the appraisal value at 8% below the merger price) and *Verition Partners Master Fund Ltd.* v. *Aruba Networks, Inc.*, C.A. No. 11448-VCL (Del. Ch. Feb. 15, 2018) (finding the appraisal value at more than 30% below the merger price).

Finally, while the number of disclosure-only merger challenges in Delaware courts has remained low following the Delaware Court of Chancery's rejection of a proposed disclosure-only settlement in *In re Trulia, Inc. Stockholder Litigation*, there has been a marked increase in the number of such cases in federal court. Thus, unless and until the federal courts adopt the Delaware courts' view of such claims — which often are filed by plaintiffs seeking a quick settlement from transaction parties eager to close a merger — parties will need to be prepared to handle these federal claims. Federal judges have recently begun to scrutinize disclosure-only settlements as well. How federal courts navigate this uptick in cases will be a key focus of deal litigation in 2019, and we may see different approaches being adopted by a number of courts (at the district and appellate court levels).

Activism and Governance

Activists continue to hold large amounts of assets under management, and declining stock prices may lead them to view certain companies as vulnerable. In addition, activists have increasingly been targeting companies in Europe and Asia. Although many large and high-profile activist funds had poor performance in 2018, they can be expected to remain aggressive in 2019, in some cases leading to M&A activity at targeted companies.

Deal-related shareholder activism remains prevalent, with activists instigating deal activity, challenging announced transactions (*e.g.*, the "bumpitrage" strategy of pressing for a price increase, as in Carl Icahn's challenge to the Dell/DVMT transaction) and/or pressuring the target into a merger or a private equity deal with the activist itself. Outside of deal activism, a notable recent development is for shareholder activists to incorporate more ESG initiatives into their campaigns to try to appeal to certain institutional investors. For example, Jana Partners partnered with CalSTRS to urge Apple to take steps to allow parents to limit their children's phone use, and Trillium Asset Management filed a first-of-its-kind proposal at Nike, Inc. urging the board to improve oversight of workplace sexual harassment and to improve gender diversity and pay disparity.

We have also recently seen a rise in "debt default activism," where investors purchase debt on the theory that a borrower is *already* in default, and then actively seek to enforce that default in a manner by which they stand to profit. Companies with debt trading below par should stay particularly alert to the threat of default activism, just as companies that have endured short-term stock slumps should be wary of shareholder activism.

Especially in the current environment of depressed equity prices, companies should remain focused on executing their long-term strategies and maintaining relations with key shareholders, and should continually evaluate their exposure to, and prepare for, potential activist attacks.

A significant governance trend is the increasing focus on board diversity by large institutional investors. For example, BlackRock, State Street Global Advisors, CalSTRS and CalPERS now include board diversity in their voting policies. Notably, California enacted the first U.S. law that requires a minimum number of female directors, although there is some doubt as to whether the law may constitutionally be applied to corporations that have a principal executive office in California, but are not incorporated in California.

More broadly, corporate leaders, institutional investors and policymakers increasingly recognize the importance of long-term investment horizons and sustainable corporate strategies that take into account the interdependencies between a corporation and its employees, customers, communities, the environment and other stakeholders, consistent with *The New Paradigm*. In 2019, concerns about short-termism will continue and will influence tactics by activists and behavior by institutional investors and companies.

SEC Developments

2018 also saw developments in federal securities regulation that could affect corporate governance, activism and M&A. With over 80% of the market value of the Russell 3000 and the S&P 500 held by institutional investors, the role of proxy advisors has come under increased scrutiny. The Corporate Governance Reform and Transparency Act, which passed the House of Representatives in late 2017 and was the subject of a hearing held by the Senate banking committee in June 2018, would require proxy advisors to register with the SEC, file an annual report and make publicly available their methodology for the formulation of voting recommendations. The Corporate Governance Fairness Act, which was introduced in the Senate in November, would require proxy advisors to register with the SEC under the Investment Advisers Act of 1940. The SEC has also signaled a review of proxy advisor regulation, hosting a roundtable on the proxy process in November 2018. The essential role of proxy advisors in the voting process likely ensures that the regulation of proxy advisors will continue to be an area of focus for regulators and lawmakers in 2019.

In addition, following comments by President Trump in support of semi-annual rather than quarterly reports, the SEC launched a formal process in

December 2018 seeking comments on a wide range of issues related to the periodic reporting system for U.S. companies. The SEC's review focuses on variety of topics with governance implications, including whether reforms could and should be made to discourage quarterly forward-looking earnings guidance, the degree to which the frequency of reporting and guidance may lead managers to focus on short-term results to the detriment of long-term performance and the identification of other factors that may promote short-termism. It remains to be seen whether the SEC review will result in changes to the U.S. periodic reporting system in 2019.

Another area to watch is the universal proxy card. Although the 2016 SEC proposal to require the use of universal proxy cards in contested elections remains in regulatory limbo, SandRidge Energy included its five nominees along with seven nominees selected by Carl Icahn in its June 2018 proxy card, marking the first time that a U.S. corporation used a universal proxy card. Although Carl Icahn ultimately won control of the SandRidge board, the use of a universal proxy card by SandRidge indicates that there may be circumstances in which issuers believe that its use is advantageous.

In the M&A realm, the SEC recently has declined to review and provide comments on all-cash merger proxy statements with increasing frequency. In 2018, the SEC provided comments on less than 10% of proxy statements for all-cash transactions, a decline from approximately 23% in 2016. The increased likelihood that the SEC will not review an all-cash merger proxy statement may change the calculus of whether to structure an all-cash deal as a merger or a tender offer, by decreasing the delay between signing and closing of all-cash mergers.

<u>Private Equity Trends</u>

In 2018, private equity dealmakers showed remarkable ingenuity in finding ways to deploy the vast sums of capital they have accumulated. Many of the larger transactions depended upon strategic partnerships. Blackstone, for example, partnered with Thomson Reuters to carve out its financial and risk business into a $20 billion strategic venture owned 55% by Blackstone and its co-investors and 45% by Thomson Reuters. One high-profile activist's willingness to take more long-term risk supported major PE deals — Veritas' and Elliott Management's pending acquisition of athenahealth and Siris Capital Group's and Elliott Management's pending acquisition of Travelport. Whereas activist hedge funds have often advocated for target companies to sell, including to PE firms, it remains to be seen whether other activist hedge funds will also be willing to partner as co-buyers with PE firms.

Sponsors also built transactions based on their relationships with owners of private firms and public company CEOs. In these bespoke public target situations, to retain the "first-mover" track, PE firms often accepted, or even proposed, "go-shop" provisions to address concerns about the absence of a more full pre-signing market check (about 20% of private equity deals in 2018 had a go-shop provision).

We enter 2019 in a period of significant uncertainty across a variety of macroeconomic, geopolitical and financial factors, with accompanying substantial volatility in equity and debt markets. Such an environment tends to chill strategic deals, and makes other deals more difficult. However, we expect that nimble and innovative financial sponsors will find opportunities even in these challenging conditions, or in fact because of them.

Acquisition Financing

In the first three quarters of 2018, the financing markets were strong, and numerous corporate acquirors locked in committed financing on favorable terms to support their deals. But momentum stalled in the fourth quarter. The high-yield bond market ground to a halt, with zero dollars of new issuance in December, the first such month since 2008. Investment grade bond issuance levels in December 2018 were the lowest of any December since 1995. And leveraged loan prices fell to their lowest levels in over two years.

While routine debt financing transactions can often wait until a sunny day, transformative M&A transactions often cannot. For acquirors seeking committed financing in the midst of the current volatility, it is critical to start thinking early in the M&A process about financing plans. When markets are volatile, different lenders may deliver drastically different terms, depending on their other credit exposures, market and industry outlooks, and other considerations. To achieve the best outcome, borrowers should engage with multiple potential financing sources, balancing healthy competition among lenders against relationship, speed and confidentiality considerations.

Volatility creates opportunity, and well-prepared acquirors, working closely with their advisors, need not shy away from challenging financing markets. But they must play smart.

Financial Institutions M&A

Financial institutions M&A remained active with landmark deals occurring in the insurance sector — Cigna's $67 billion acquisition of Express

Scripts, which was announced in March and closed in December, and CVS' $69 billion acquisition of Aetna, which was announced in 2017 and closed in November 2018. Private equity funds drove a significant amount of deal activity — notably Blackstone's $20 billion acquisition of a majority stake in Thomson Reuters' financial and risk business, Silver Lake's and P2 Capital's $3.5 billion acquisition of Blackhawk Network Holding and The Carlyle Group's $6.7 billion acquisition of a majority stake in Sedgwick Claims Management.

Bank M&A proceeded at a brisk pace for the first three quarters of the year with six mergers with a deal value of $1 billion or more, including Fifth Third's acquisition of MB, Synovus' acquisition of FCB and Cadence Bancorporation's acquisition of State Bank. A steep sell-off of bank stocks in the fourth quarter sparked by overblown concerns over softer loan growth, weakening credit and a flattening yield curve dramatically slowed the pace of bank M&A, except at the community bank level. However, powerful secular trends, such as the growing value of strong deposit franchises in a rising interest rate environment as well as the increasing dominance of the "Big Three" banks in retail banking, should continue to drive bank consolidation.

Several important regulatory developments during 2018 will likely provide an additional tailwind. The raising of the "SIFI" (systemically important financial institution) threshold — at which a bank holding company becomes subject to significantly more burdensome regulation — from $50 billion to $250 billion in assets eliminated a powerful deterrent to bank M&A and should facilitate transactions by regional banks. In addition, regulators are approving bank mergers more quickly with substantially less deference to community group protests.

Fintech has also been an active sector. While regulatory barriers to entry have proven difficult for fintech companies aspiring to own banks, pending applications with the FDIC by Varo to form a national bank and Square to form an industrial bank should call the question. An expected relaxation by the Federal Reserve of its "control" rules should expand the possibilities for bank/fintech partnerships — further enabling banks to invest in fintech companies without being deemed to control them and thereby subjecting them to Federal Reserve regulation.

Spotlight on Technology M&A

As in 2017, the technology sector saw the largest deal volume in 2018. Technology deals exhibited strength in a variety of areas, reflecting some of the broader trends in the M&A market, including large public transactions (for example, Salesforce's $6.5 billion acquisition of MuleSoft and Broadcom's $18.9

billion acquisition of CA Technologies); large private investments (for example, Altria's $12.8 billion minority investment in JUUL Labs); transactions involving significant foreign investment or regulatory review (for example, Qualcomm's blocked $44 billion acquisition of NXP); and private equity investments (for example, Searchlight Capital's $2.0 billion acquisition of Mitel Networks and Thoma Bravo's $950 million acquisition of Veracode from Broadcom).

Despite equity values reaching record highs in 2018, strategic acquirors were still willing to pay large premiums to gain access to new or disruptive technologies. Looking forward, changes to foreign direct investment regimes could have an outsized impact on future technology deals as countries attempt to prevent geopolitical rivals from gaining access to sensitive technologies. Growing delays between signing and closing due to regulatory scrutiny could put a damper on future deals. However, we expect technology to continue to be one of the busiest deal sectors.

Foreign Investment Review

Heightened scrutiny of foreign direct investment by countries around the world has led to an increase in the number of deals blocked on national security grounds. In the United States, the President blocked a $117 billion bid by Broadcom, then a Singapore-domiciled company in the process of redomiciling to the United States, to acquire Qualcomm, citing national security concerns (after completing its redomiciliation, Broadcom successfully acquired CA Technologies). In 2018, Germany and France invoked their foreign investment regimes to block transactions by Chinese investors. This heightened scrutiny, as well as the Chinese government's continued clampdown on outbound investment, also contributed to limiting outbound Chinese M&A volume to approximately $117 billion in 2018, far below the 2016 peak of over $210 billion, but similar to 2017 levels.

Significant legislation on foreign investment was also enacted around the world in 2018. In the United States, the Foreign Investment Risk Review Modernization Act of 2018 ("FIRRMA") ushered in significant reforms to the Committee on Foreign Investments in the United States ("CFIUS") regime. FIRRMA codified the jurisdiction of CFIUS over foreign acquisitions of real estate and transactions involving sensitive personal data of U.S. citizens, in addition to expanding CFIUS review to cover minority investments involving critical technologies, critical infrastructure or sensitive personal data of U.S. citizens. The U.S. Department of the Treasury issued interim regulations introducing a pilot program that implemented certain of FIRRMA's procedural reforms, including a requirement that certain transactions file brief declarations to allow CFIUS to

determine within 30 days of filing whether a full review is required. Outside the United States, the European Union Parliament's Committee on International Trade approved a proposed regulation that would establish, for the first time, an EU-wide framework for review of foreign direct investment. The German Federal Government and the United Kingdom also expanded review of acquisitions by foreign investors, and the United Kingdom continues to explore more significant reforms that would create a system similar to the CFIUS regime.

Parties pursuing cross-border transactions should be focused on the foreign investment regulatory landscape and be prepared from the outset to deal with potential scrutiny by the relevant regulators.

Antitrust

Although some had forecast more lax antitrust enforcement, the Trump Administration's antitrust leadership at the Antitrust Division of the U.S. Department of Justice and the Federal Trade Commission proved their intent to scrutinize and bring enforcement actions at levels comparable to the Obama administration. As with prior administrations, the agencies have used consent orders to resolve agency concerns in most matters, and the agencies continued to bring court challenges and had success in most cases at the trial court level. The agencies have conducted more extensive scrutiny of vertical transactions, as illustrated by the DOJ's challenge of the AT&T/Time Warner transaction. The DOJ's investigation of the CVS/Aetna transaction also included vertical considerations. In addition, the DOJ has expressed concern over using behavioral remedies to resolve competitive concerns, even for vertical mergers.

Both agencies — but the FTC in particular — have focused on innovation and nascent competition in their investigations and challenges. Healthcare/pharma and high technology/Internet remain among the sectors ripe for agency focus. Narrow market definitions and unilateral effects theories are pervasive in the enforcement actions.

Some key members of the Democratic congressional leadership have been active in advocating for major changes in antitrust procedures and standards, all under the rubric of a "Better Deal." The Democratic leadership in the Senate introduced legislation in September 2017 that would radically change the procedures and standards applied during merger reviews. These bills were intended to provide for tougher merger enforcement, including granting the federal agencies enhanced tools to challenge transactions. Even assuming, however (as is likely to be the case), that the consumer welfare standard remains the operative test

of competitive harm, the antitrust agencies are reevaluating whether they are striking the right balance regarding the effects of concentration, including the extent to which labor concerns, such as stagnating wages and rising income inequality, may be affected. The 2018 election results, if anything, kept alive the debate and focus on increased — rather than decreased — antitrust enforcement.

Parties also need to be prepared to deal with regulators of foreign jurisdictions in cross-border transactions. One significant trend is the increasing assertiveness of China, which consolidated its existing three antitrust bodies into the State Administration for Market Regulation (SAMR) and blocked or delayed large transactions in 2018, including Qualcomm's proposed acquisition of NXP.

Transaction parties should be cognizant of the current antitrust environment when planning for the review of their transaction. The parties should identify not only current overlapping operations that may raise issues under traditional horizontal merger theories, but also other possible areas of inquiry, including vertical merger issues and the elimination of potential competition as a result of the transaction. Transaction parties should also have a clear understanding of what remedies they will be prepared to offer if, at the end of the investigation, the agency remains concerned about the transaction, and whether they are prepared to litigate if these concerns cannot be resolved.

The Impact of Tax Reform

One year following the enactment of the Tax Cuts and Jobs Act (the "TCJA"), taxpayers continue to adapt and grapple with the complexity of the new landscape. Treasury and the IRS released an unprecedented amount of TCJA-related guidance in 2018, with much guidance still to come. Given the extensive changes and complexities introduced by the TCJA, taxpayers will have to continue to adapt in 2019. Although the jury is still out on the ultimate effect of the TCJA on M&A activity and deal structuring, some trends have begun to emerge.

While the TCJA generally has made asset sales more palatable to sellers (due to the decrease in the corporate tax rate) and buyers (due to "full expensing" of acquired tangible property), it does not appear that there has been a dramatic shift to asset deals in domestic M&A overall, and modeling is still necessary to determine if the benefits outweigh the costs.

Some of the TCJA's most drastic changes were in the international tax arena, but whether these rules will have a meaningful impact on off-shore cash levels going forward remains to be seen. Although repatriations reportedly surged

early in 2018, recent data suggests that the volume has since dropped to levels comparable to those prior to the TCJA's enactment.

The TCJA does not appear to have had a meaningful impact on the decision to effect tax-free spin-offs or split-offs, which continued at an energetic pace in 2018. Many taxpayers took advantage of a "pilot program" (initiated in 2017) pursuant to which the IRS recommenced issuing "transactional" rulings on the overall qualification of such transactions for tax-free treatment. In addition, in October 2018 the IRS issued new procedures for private letter rulings involving spin-offs where the parent corporation uses stock or debt securities of the spun-off corporation to repay existing or newly issued debt of the parent corporation.

Inversions, already stymied by prior Treasury regulations, were made even less attractive by the TCJA, though they may still be viable where the former shareholders of the U.S. merger partner are deemed to own less than 60% of the combined company. In addition, the TCJA does not appear to have incentivized non-U.S. corporations that previously inverted to re-domicile in the United States. While there are a number of reasons for this, a few key reasons are the international provisions of the TCJA and concerns that the reduced U.S. corporate tax rate may not be permanent.

The new limitations on the deductibility of net interest expense do not appear to have had a significant impact on deal financing (yet), with leverage in large LBOs in 2018 exceeding historic levels. It remains to be seen if this will change in 2022 when the deduction limits become more restrictive. Foreign-parented groups making U.S. acquisitions will also need to consider the impact of the base erosion limitations of the TCJA on their deal financing. In many cases, it will be preferable for the U.S. subsidiary acquiror to borrow directly from third parties rather than push down borrowing incurred at the foreign parent level.

Ever-Evolving Risks

Dealmakers need to be sensitive to how changes in the legal, social and economic landscape can affect the risks posed by a particular transaction. For example, significant developments in cybersecurity and privacy legislation, in Europe (GDPR), California and elsewhere, as well as increasingly sophisticated and high-profile attacks by criminals (and state actors), have elevated the importance of thorough due diligence of such matters. The #MeToo movement likewise has brought increased attention to harassment and discrimination policies and procedures and historical incidents as part of the vetting of an acquisition target, and transaction agreements are beginning to include specific representations

and warranties on these topics. Failure to identify relevant risks can lead to financial and reputational harm and embarrassment when issues are identified after closing.

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As always, it is difficult to predict how economic, financial and political factors will affect M&A over the course of the coming year. As of this writing, uncertainty and volatility are elevated, but it is not clear whether boards and executives are losing confidence in the ability of M&A to create (or protect) value or are in wait-and-see mode before pursuing transformative transactions. And some conditions may prove conducive to M&A, such as lower equity prices enticing private equity firms to deploy their considerable dry powder. Flexibility and creativity will serve transaction parties well in navigating the uncertain landscape.

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