Meyer-Sparenberg / Jäckle

Beck'sches M&A-Handbuch

Planung, Gestaltung, Sonderformen, regulatorische Rahmenbedingungen und Streitbeilegung bei Mergers & Acquisitions

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I. Overview of Recent Public M&A Activity in the United States[1]

1 After a record-setting 2007, the collapse of the housing market and vanishing liquidity severely constrained both U.S. and global M&A activity, particularly private equity deals, which in 2007 accounted for approximately 25% of total M&A volume. M&A volume continued its downward march in 2008 and in 2009 reached the lowest level since 2004. Deal volume began to increase in late 2009, however, as economic conditions improved, with momentum continuing to build in 2010. A surging stock market, availability of near-record amounts of private equity capital, and increased optimism that the worst of the economic downturn and financial crisis had passed drove double-digit gains both in the number of transactions and dollar volume in 2010.

2 After a strong start to the year, deal activity slowed during the second half of 2011, constrained by concerns about the strength of the global economic recovery, the European sovereign debt crisis and other global events. Nonetheless, the dollar value of announced transactions involving U.S. targets rose by approximately 12% compared with 2010. This sluggishness in U.S. deal activity extended into 2012, as investor confidence continued to be affected by concerns about the macroeconomic climate. M&A activity turned sharply upward in the fourth quarter, however, as announced deal volume for the fourth quarter reached its highest level in four years. Nevertheless, both dollar deal volume and number of transactions finished below 2011 levels. 2013 extended the strong finish of 2012, with the announcement of a number of highly significant deals, including the $130 billion acquisition of Vodafone's 45% interest in Verizon Wireless by Verizon Communications; the $28 billion acquisition of H.J. Heinz by Berkshire Hathaway and 3G Capital, and the $25 billion leveraged buyout of Dell. 2014 reached several noteworthy post-crisis high-water marks, with robust global M&A volume of over $3.5 trillion for the year—the largest volume since 2007, with "megadeals" making a comeback (90 deals announced over $5 billion). Particularly significant 2014 transactions included Actavis's $67 billion acquisition of Allergan, AT&T's $48 billion acquisition of DIRECTV, Actavis's $24 billion acquisition of Forest Laboratories and Burger King's $11 billion acquisition of Tim Hortons. Global M&A volume in 2015 exceeded $5 trillion, an all-time high. Although booms inevitably raise questions about their sustainability, and it remains to be seen how long this one will last, as of this writing M&A shows no signs of slowing. 2015 transaction volume exceeded 2014's by $1.4 trillion, as well as the prior 2007 record. One-third of the 2015 volume represented **cross-border deals**, approx-

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imately 40% of which ($637 billion) involved U.S. companies. Incoming deals to the United States were valued at $433 billion, also an all-time high. Acquirers from Germany, France, Canada, Japan and the United Kingdom accounted for approximately half of the volume of acquisitions into the United States, and acquirers from China, India and other emerging economies accounted for approximately 5%. Cross-border deals involving U.S. companies included a number of record-breaking transactions, including Pfizer's announced $160 billion combination with Allergan, ACE's $28.5 billion acquisition of Chubb, Visa's $24 billion acquisition of Visa Europe and Air Liquide's $13.4 billion acquisition of Airgas.

II. Laws and Regulations Governing the Conduct of Public M&A in the United States

In the United States, mergers and acquisitions implicate a host of laws at both the **federal and state levels.** Federal and state spheres of regulation sometimes overlap in the United States, with the laws of more than one jurisdiction sometimes applying. Federal law, on the one hand, generally provides for, among other things, securities regulation, disclosure requirements and rules in respect of the acquisitions of securities through "tender offers," all of which are overseen primarily by the **U.S. Securities and Exchange Commission** (the "**SEC**"). The laws of the U.S. state in which the company is incorporated, on the other hand, dictate more substantive aspects of transactions, such as the conduct of the board of directors and the company itself. Each of the 50 U.S. states has its own set of laws that govern corporations and mergers and acquisitions in that jurisdiction. That said, the vast majority of publicly traded companies in the United States are incorporated in **Delaware.** Thus, that state's court and legislature have taken a leading role in developing legal doctrines in respect of the duties of boards in the context of M&A, and the statutory framework in which transactions can be effected. The **U.S. securities exchanges** provide a third source of regulation: The New York Stock Exchange (NYSE), the Nasdaq Stock Market (NASDAQ) and the NYSE MKT (formerly known as the American Stock Exchange, or AMEX) all have listing rules that may be applicable in a merger transaction. U.S. competition laws also regulate mergers and acquisitions by prohibiting transactions that substantially lessen competition or create a monopoly, and by subjecting virtually all significant transactions to regulatory scrutiny in that regard. The **Committee on Foreign Investment in the United States** ("**CFIUS**"), an interagency committee that is authorized to review transactions that could lead to control of a U.S. business by a foreign person or entity, provides another layer of regulation over cross-border M&A transactions involving a U.S. target. CFIUS has the authority, through the President, to block any transaction with a U.S. target if it determines that such transaction would have a negative effect on the national security of the United States. Finally, certain industries are subject to specific regulatory schemes, such as the media and communications industry, which is regulated by the Federal Communications Commission, and the nuclear energy industry, which is regulated by the Nuclear Regulatory Commission and state agencies. 3

Before delving into U.S. federal and state default rules in the M&A context, it is helpful to note that in the United States, absent fraud and subject to compliance with the federal and state securities laws, any person or entity can freely acquire shares of a publicly traded company (in the open market or through privately negotiated transactions). When combined with the ability to effect a merger after acquiring 50% or 66.7% (depending on the circumstances and/or state), the acquirer can thereby gain complete control of a publicly traded company (see Section III.1, → paras. 26 *et seq.*). An offer to buy a large number of shares of a corporation in the secondary market, usually at a premium to the current market price and conditioned upon the occurrence (or non-occurrence) of certain 4

events, is called a tender offer (to be further discussed in Section III). U.S. law does not prohibit a buyer from acquiring a controlling position in a company if the majority of stockholders agree to tender or sell their stock and U.S. federal and state laws do not have mandatory offer requirements, which are common in other jurisdictions. Tender offers, however, must comply with federal and state laws, which generally include disclosure obligations and mandate fair dealing. At the federal level, for example, the Exchange Act requires disclosure and filing of important information by anyone seeking to acquire more than 5% of a company's securities by direct purchase or tender offer.

1. Federal Securities Laws

5 The federal securities laws, in particular the **Securities Act of 1933**, as amended (the "Securities Act"),[2] and the **Securities Exchange Act of 1934**, as amended (the "Exchange Act"),[3] and related rules and regulations govern the conduct of participants in U.S. securities markets. These rules generally address, among other topics:

(1) disclosure obligations of persons or entities engaging in transactions, including the accumulation of shares in publicly traded companies;
(2) disclosure obligations of targets of M&A transactions, including required financial and other information when seeking approval by stockholders of a transaction (where state law or stock exchange rules require such approval);
(3) procedures for commencing and consummating an offer (commonly referred to in the U.S. as a tender offer) for the shares of a public company,[4] including disclosure obligations,[5] minimum time periods during which an offer may be open,[6] and the "best price" rule,[7] which requires that the consideration paid to any security holder in a tender offer be the highest consideration paid to any other security holder in the offer;
(4) disclosure obligations for issuers of securities in the U.S. or to U.S. persons; and
(5) prohibitions on buying or selling securities in various circumstances, including when in possession of material nonpublic information.[8]

6 These laws, rules and regulations are enforced primarily by the SEC, an agency of the federal government that oversees the key participants in the U.S. securities markets, including securities exchanges, brokers and dealers, investment advisors and mutual funds. The SEC is primarily concerned with protecting against fraud, promoting the disclosure of important market-related information and maintaining fair dealing. The SEC consists of five commissioners who serve staggered five-year terms. Each commissioner must be nominated by the President and confirmed by the U.S. Senate; no more than three of the commissioners may belong to the same political party; and one is designated by the President as Chairman of the Commission, the SEC's chief executive. The commissioners have the authority to interpret and enforce federal securities laws; establish and amend rules and regulations under the relevant securities laws; grant waivers in certain circumstances; oversee the inspection of securities firms, brokers, investment advisers, and ratings agencies; oversee private regulatory organizations in the securities, accounting, and auditing fields; and coordinate U.S. securities regulation with federal, state, and foreign authorities.

7 Decisions of the SEC may be reviewed by U.S. federal courts, although such review is rare in the context of an M&A transaction and is generally reserved for broader challenges to the SEC's rulemaking authority. The role of the commissioners is to establish policy

[2] 15 U.S.C. § 77a *et seq.*
[3] 15 U.S.C. § 78a *et seq.*
[4] Exchange Act Regulations 14D and 14E.
[5] Exchange Act Rule 14d-3.
[6] Exchange Act Rule 14e-1.
[7] Exchange Act Rule 14d-10.
[8] Exchange Act Rule 10b-5.

and approve rules to be adopted by the SEC; however, they are rarely involved in the day-to-day administration and affairs of the SEC, which are left to the purview of the SEC staff.

8 The **SEC** is organized into five divisions and 23 offices, each of which is headquartered in Washington, D.C. and spread across 11 regional offices throughout the United States. The five divisions are: Corporation Finance, Trading and Markets, Investment Management, Enforcement, and Economic and Risk Analysis. In the M&A context, the staff of the **Division of Corporation Finance** generally plays the largest role. The responsibilities of the Division of Corporation Finance involve reviewing documents that publicly held companies are required to file with the Commission, such as registration statements for newly offered securities; annual and quarterly filings; proxy materials sent to stockholders before an annual meeting, annual reports to stockholders; documents concerning tender offers (to be further discussed in the next Section on State Law); and filings related to mergers, acquisitions and offers. The main purpose of the Division's review is to ensure that public companies are satisfying their disclosure requirements to make available all information, whether positive or negative, that might be relevant to an investor's decision to buy, sell or hold the security, and to improve the quality of the disclosures made. The Division's staff provides guidance to registrants and prospective registrants to help them comply with the law. As a result, issuers will engage with the staff of the SEC, in particular legal and accounting staff members of the Division of Corporation Finance, who have authority to interpret SEC rules and to provide guidance to issuers. Required transaction-related filings, such as registration statements for the issuance of securities, proxy statements to call a stockholder meeting, tender offer documents to launch a cash or stock offer for shares, and Rule 13e-3 filings (required in connection with going-private transactions) are reviewed by the staff, who typically provide written comments that must be addressed before the parties may publicly launch the tender offer, securities offering or the merger vote process.

2. State Law

9 State law generally governs the ability of a potential acquirer to purchase, or acquire by merger or other business combination, a U.S.-domiciled company; the responsibilities of boards in these circumstances; and the rights of stockholders of the target in such a transaction. More than 50% of publicly traded companies in the United States and 63% of Fortune 500 companies are incorporated in Delaware. Therefore, the **Delaware General Corporation Law** (the "**DGCL**"), and the interpretation of those statutes and related common law by the Delaware Supreme Court and the Delaware Court of Chancery, has a dominant influence on the market for U.S. public companies. For purposes of this report, Delaware is treated as the controlling jurisdiction and, unless expressly stated otherwise, any discussion of state laws assumes the application of the DGCL.

10 The DGCL governs all aspects of the legal organization of Delaware corporations, including formation and corporate existence, the required contents of the articles of incorporation and bylaws, meetings of and actions by stockholders, the election of directors, meetings of directors and statutory transaction mechanisms. **Statutory mergers** are a common transaction structure provided for by state law. The DGCL provides that two corporations may merge following the adoption of a plan of merger by the target company and the approval of its stockholders, generally by a majority vote of its outstanding capital stock.[9] In addition to establishing the statutory mechanism for effecting the transaction, the DGCL also places **limitations** on the availability of mergers and the requirement**s** for their **approval.** For example, the DGCL provides that in certain circumstances where a merger is proposed with an interested stockholder (defined as a stockholder who

[9] DGCL § 251.

previously acquired at least 15% of the common stock without prior board or stockholder approval), the required vote to approve a merger is two-thirds of the voting stock not held by the interested party.[10] The DGCL also provides for the ability to **squeeze out** public stockholders in a short-form merger in certain circumstances, typically where a controlling party already owns at least 90% of the common stock of the target corporation.[11] A 2013 amendment to the DGCL also obviates the need for a stockholder vote to consummate a merger where the buyer acquires sufficient shares in a tender offer to approve the merger.[12] The DGCL also provides for **appraisal, or dissenters' rights**, in mergers in which the consideration to stockholders does not consist solely of common stock of the surviving corporation or of a corporation either listed in the United States or held by more than 2,000 persons, or in mergers where the minority is squeezed out in a short-form merger.[13]

11 The DGCL, like most U.S. state corporate laws, is **permissive in nature**; in addition to a relatively narrow set of mandatory provisions, companies incorporated in the state are free to adopt additional rights or restrictions on corporate and stockholder power in the certificate of incorporation. For example, a company incorporated in Delaware is required to have at least one class of capital stock; however, it may have as many classes of capital stock as desirable, each of which may have different voting rights, including the right to vote as a separate class, or no voting rights at all. Corporations may also change threshold approval requirements with respect to quorum, approval of actions by the corporation's stockholders, the ability of stockholders to act by written consent, procedures for nominating and electing directors (e.g., plurality, cumulative or majority voting), the ability of stockholders to remove directors with or without cause, the indemnification rights of directors and corporate management and many other aspects of the corporate form. These rights and restrictions are set forth in the company's certificate of incorporation and bylaws, which may contain any provisions not prohibited by law.[14]

12 **Case law** developed by the Delaware courts interprets the DGCL and outlines the **duties of boards of directors**, including the duties of the board of a target company when considering an offer (as discussed in more detail in Section III.7, → paras. 53 *et seq.*), including the ability of the company to "just say no,"[15] to choose to conduct a broad or limited "auction" to sell the company, or to approve the sale of the company without an auction.[16] Likewise, the cases address the role of the board of the target where management or a controlling stockholder seeks to acquire the company by taking out minority stockholders.[17] Important Delaware cases also speak to the permissibility of takeover defenses in the face of a hostile or unsolicited offer, or stakebuilding, including the ability to implement a stockholder rights plan,[18] and to the inclusion of deal protection measures, such as breakup fees[19] (in a recommended transaction).

13 The DGCL and Delaware case law are interpreted primarily by the **Delaware Court of Chancery**, which is the court of first instance for corporate law matters in Delaware.

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[10] DGCL § 203.
[11] DGCL § 253.
[12] DGCL § 251(h).
[13] DGCL § 262.
[14] Amendments to a company's certificate of incorporation require stockholder approval under DGCL § 242.
[15] *See Air Products & Chemicals, Inc.* v. *Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011) (*Airgas*).
[16] *See, e.g., Revlon, Inc.* v. *MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) (holding that once the board decides to sell the company (i.e., a sale of control), it must seek to achieve the highest value reasonably available for stockholders); *In re The Topps Co. 12 S'holders Litig.*, 926 A.2d 58 (Del. Ch. 2007) (permitting a board to undertake a post-signing "go shop" period rather than a full auction process).
[17] *See, e.g., Kahn* v. *Lynch Communications Sys. Inc.*, 638 A.2d 1110 (Del. 1994); *In re Cox Communications, Inc. S'holders Litig.*, 879 A.2d 604 (Del. Ch. 2005); *In re CNX Gas Corp. S'holders Litig.*, 4 A.3d 397 (Del. Ch. 2010).
[18] *See Airgas*, 16 A.3d at 122.
[19] *See Brazen* v. *Bell Atl. Corp.*, 695 A.2d 43 (Del. 1997).

This court provides important decisions on directors' fiduciary duties when considering and recommending business combinations, as well as interpretations of the DGCL. Those decisions may be reviewed on appeal by the Delaware Supreme Court. The Delaware legislature retains the power to amend or revise the DGCL, although this has tended to be an evolutionary process, not one of periodic radical change.[20]

3. U.S. Securities Exchange Regulations

14 The U.S. securities exchanges provide a third source of regulation. The NYSE and NASDAQ have **listing rules** that may be applicable in a merger transaction. For example, these rules generally provide that for a U.S.-listed company to issue 20% or more of its voting or equity interests, stockholder approval of the issuance is required.[21] Likewise, the exchange rules provide time-period requirements relating to the calling and holding of stockholder meetings.[22] More generally, these rules provide certain disclosure requirements and set corporate governance standards that are not specifically implicated by an M&A transaction.[23] Each exchange has a staff which will provide interpretations of the listing rules and clear applications.

4. U.S. Competition Law

15 Section 7 of the **Clayton Act**, as amended,[24] prohibits mergers and acquisitions "the effect of [which] may be substantially to lessen competition, or tend to create a monopoly." Enforcement of Section 7 of the Clayton Act is enhanced by the **Hart-Scott-Rodino Antitrust Improvements Act**[25] (the "**HSR Act**"), which requires pre-merger notification of transactions that exceed certain size thresholds, which thresholds are updated by the U.S. **Federal Trade Commission** (the "**FTC**") on an annual basis. Under the HSR Act, the FTC and the **U.S. Department of Justice's Antitrust Division** (the "**DOJ**") receive concurrent notification of the potential transaction and decide which agency will investigate. The HSR Act provides two tests for determining whether a **premerger filing** is required. Subject to certain exemptions, for 2015 a potential transaction was reportable if the acquirer would hold an aggregate total amount of voting securities and assets of the target in excess of $305.1 million following the transaction. Post-acquisition holdings of between $76.3 million and $305.1 million must be reported only if the acquirer or the target has total assets or annual net sales of at least $152.5 million and the other party has total assets or annual net sales of at least $15.2 million. Failure to file when required to do so can result in civil penalties of $16,000 for each day of noncompliance.

16 The FTC or the DOJ may review and **challenge** a transaction under Section 7 of the Clayton Act whether or not it is reportable. Furthermore, a transaction may be reviewed by one or more states' attorneys general, typically in conjunction with the federal enforcement agency investigating the transaction.

17 An acquisition that is reportable under the HSR Act **may not be consummated** until the required forms have been filed with the FTC and the DOJ and the applicable waiting period has expired or been terminated early. In a merger transaction, both acquirer and target must file and the waiting period will not commence until both have done so. In the case of a tender offer, the waiting period commences when the acquirer files. The initial waiting period is 30 days (or 15 days for a cash tender offer or bank-

[20] Notable exceptions include the additions of DGCL § 251(h), discussed above, and DCGL §§ 204 and 205, that came into effect on August 1, 2013.
[21] NYSE Rule 312; Amex Rule 712; NASDAQ Rule 5635.
[22] NYSE Rules 401–402; Amex Rules Part 7; NASDAQ Rule 5620.
[23] NYSE Rule 303 A; Amex Rules 801–809; NASDAQ Rule 5600.
[24] 15 U.S.C. § 18.
[25] 15 U.S.C. § 18a.

ruptcy filing), but may be terminated early at the parties' request. Although formally the waiting period may only be extended if the reviewing agency issues a "second request" for additional information, the parties to the transaction may also agree to give the agency more time to review by withdrawing and refiling or by delaying completion of the transaction.

18 The FTC and DOJ both receive HSR notifications, and a process exists for determining which agency is "cleared" to investigate the transaction. Once cleared, the reviewing agency can contact the parties (and third parties) for information regarding the deal. If the agency decides to issue a second request, a second 30-day waiting period (10 days in the case of a cash tender offer or bankruptcy filing) commences after the parties have substantially complied with the second request.

19 Almost all notified transactions are cleared during the initial waiting period. In contrast, many of the transactions in which an agency issues a second request result in some form of enforcement action, in the form of a lawsuit or consent decree, typically with an upfront buyer specified for the assets to be divested or a short divestiture period. If a consent decree is sought, the reviewing agency will permit the transaction to close once it provisionally accepts the consent decree and publishes it for comment. Final acceptance of the consent decree, however, comes only after a period of public comment and approval by the FTC commissioners or by a federal district court judge, as applicable. If agreement with the parties cannot be reached, the reviewing agency can seek a preliminary injunction from federal district court to block completion of the transaction.

20 Finally, the agencies can challenge a transaction at any time **after completion**, in federal district court, in the case of the DOJ, or in administrative court, in the case of the FTC. Challenges can also be brought by state attorneys general, by private parties, or jointly these parties and agencies. Most challenges to consummated deals involve transactions that were **exempt** from premerger notification requirements under the HSR Act because the value of the transaction in question fell below the HSR Act reporting thresholds. These challenges can result in financial penalties, consent decrees requiring divestiture of certain assets, disgorgement of profits or conduct restrictions such as limitations on future dealings with other entities. Post-consummation review highlights the importance of seeking the advice of antitrust counsel, of thorough analysis of substantive antitrust issues that may be raised by transactions—even where HSR Act reporting thresholds are not met— and of the contractual allocation of antitrust-related risk in transaction documentation.

5. Regulation of Non-U.S. Acquirers

21 The **Committee on Foreign Investment in the United States** ("**CFIUS**") is a multi-agency committee that reviews transactions under the Exon-Florio Amendment[26] for potential **national security implications** where non-U.S. acquirers could obtain "control" of a U.S. business or assets or where transactions involve investments by non-U.S. governments or investments in U.S. critical infrastructure, technology or energy assets. CFIUS by no means imposes an insurmountable hurdle, notwithstanding some highly publicized examples to the contrary, such as Sany-Group-controlled Ralls Corporation's acquisition of four Oregon wind farm projects and Dubai Ports World's attempt to buy the U.S. port assets of the Peninsular and Oriental Steam Navigation Company. Foreign acquirers from China and other locales have successfully cleared the CFIUS process. For example, CFIUS approved the $4.7 billion purchase of pork producer Smithfield Foods Inc. by Shuanghui International Holdings, the biggest purchase of a U.S. company ever by a Chinese firm, in September 2013; and BGI-Shenzen, a Chinese operator of genome

[26] 50 U.S.C. app § 2170.

sequencing centers, obtained CFIUS approval for its acquisition of Complete Genomics, Inc., a publicly traded U.S. life sciences company, in December 2012.

22 The vast majority of cross-border transactions that are reviewed are cleared within the **initial review period** of 30 days, and only a small percentage of transactions requires further review and possibly some form of remedial action. If an initial determination of risk is found by CFIUS, a further 45-day review period may ensue. Having received the recommendation of CFIUS, the President of the United States then has 15 days to determine whether to prohibit or suspend the transaction, on the basis that: (a) foreign control may impair national security, and (b) no other applicable law permits the President to protect national security in this regard.

23 Although filings with CFIUS are voluntary, CFIUS also has the ability to investigate transactions at its discretion, including after the transaction has closed. CFIUS initiated such a post-consummation investigation in the Ralls Corporation matter in 2012, and ultimately the President ordered that the transaction be retroactively unwound. The President's order is not subject to judicial review.

24 As a CFIUS review is only applicable when the foreign person is acquiring "**control**" over a U.S. business, such review can be avoided by structuring a transaction so that the investor is not acquiring "control." CFIUS regulations issued by the U.S. Department of the Treasury provide an exemption for non-U.S. investments of 10% or less of the voting securities of a U.S. business if made "solely for the purpose of passive investment." If the intent changes, CFIUS may review the investment even though the investment was initially made with a passive intent. Control status is a fact-specific inquiry that turns on whether a foreign person may "determine, direct, or decide important matters affecting an entity," and also considers a number of statutory guidelines, including with respect to implications of possession of a board seat, and the exercise of pro rata voting rights. Certain minority stockholder protections and negative rights may be held by non-U.S. investors without rendering such investors in control of an entity. As a practical matter, CFIUS typically considers sufficient control to be present when a minority foreign investor obtains the type of protective supermajority rights often seen in M&A and investment transactions.

6. Other Applicable Laws and Regulations

25 Finally, specific regulatory regimes apply to certain industries, such as utilities (subject to both state and federal regulations relating to production and fees), media and communications (regulated primarily by the Federal Communications Commission (the "FCC")) and banking (regulated by numerous agencies, including the Office of the Comptroller of the Currency, the Federal Reserve System and the Federal Deposit Insurance Corporation). Depending on the transaction, and generally regardless of whether the acquirer is U.S. or foreign, substantial approvals for the transfer of ownership may be required, some of which can be time-consuming and may affect the closing of a deal.

III. The Mechanics of an Acquisition of a Public Company

1. Acquisition Structure

26 In the United States, the usual means of acquiring a public company is by a statutory merger pursuant to state corporate law, generally between a newly formed subsidiary of the acquirer and the target company. Although various permutations of this structure are possible, the most common structure involves the merger of the acquirer's newly formed merger subsidiary with and into the target corporation, with the target surviving the

merger as a wholly owned subsidiary of the acquirer. This structure is commonly referred to as a "reverse triangular merger."

27 The merger described above is also sometimes referred to as a **"one-step" merger**, to differentiate it from a transaction in which the acquirer first accumulates significant share ownership prior to consummating a merger in a second-step transaction that consolidates the remaining unowned shares. A **"two-step" merger**, therefore, is simply a **tender offer** followed by a one-step merger. In the first step, the buyer acquires a majority of the target company's outstanding stock in a tender offer and, in the second step, the buyer acquires the balance of the company's stock by completing a "back-end" merger. The stockholders' consent representing a majority of the untendered shares is usually necessary to effect the second step back-end merger *unless* at least 90% of the target company's stock is acquired in the tender-offer first step, in which case the buyer can effect a "short-form merger" without a stockholder vote. Although one-step mergers are more common than two-step transactions, tender offers are not unusual in the U.S. market.

28 The **legal effect of a merger** (whether in a one-step transaction or as a second-step following a tender offer) is that, at the effective time of the merger: (a) the combined entity automatically becomes responsible for the debts and obligations of, and will have the rights previously held by, the merged company (although contractual limitations with respect to change in control and transfer restrictions may nonetheless give a counterparty special contractual rights); and (b) the rights of the former stockholders of the merged company are converted into the right to receive the merger consideration and in some cases, as noted above, appraisal rights. A merger allows the acquirer to fully incorporate the target, to extract synergies, pay dividends and otherwise control the capital structure without regard to minority holders. Unlike in many European jurisdictions that permit schemes of arrangement or amalgamations, no court proceedings are required to implement a merger in the U.S. and creditors do not have the right to object unless such a right is specifically provided in the relevant debt agreements.

29 In the case of a one-step merger transaction that is recommended by the target board, the typical **timeline to completion** is approximately three to five months, depending on the required regulatory approvals. One-step mergers typically require the approval of the target stockholders under state law and, where the acquisition consideration includes newly issued shares of acquirer stock, may also require the approval of the acquirer stockholders under applicable listing rules, as noted in →para. 14. In order to solicit necessary stockholder approvals, a statement must be filed with the SEC disclosing all relevant information in advance of the stockholders' meeting at which the vote on the merger will take place. This statement is called a "**proxy statement.**" Preparation and initial filing of the proxy statement with the SEC generally requires approximately two to three weeks, with the SEC staff typically providing comments on the preliminary proxy statement 30 calendar days later. Where the acquisition consideration includes acquirer stock, the acquirer is also required to register the issuance of that stock with the SEC and may only offer that stock pursuant to a **prospectus.** The prospectus is generally included together with the proxy statement (referred to as a "joint proxy statement/prospectus") and included in the registration statement filed with the SEC. SEC comments on the proxy statement or joint proxy statement/prospectus must be resolved prior to mailing the proxy statement to stockholders. It is not uncommon for companies to receive two or three rounds of comments on documents filed with the SEC, each round of comments requiring two to three weeks. Thereafter, the company can mail the proxy statement and prospectus (if necessary) and hold the stockholder meeting, which usually requires at least 20 business days' notice. Unless the parties receive a HSR second request or an equivalent review in Europe, or are caught in another extended regulatory review (e.g., by CFIUS or the FCC), a three- to five-month timetable is realistic.

30 A key advantage of the tender offer is that, absent other regulatory approval requirements, it typically can be completed more quickly than a merger: in theory, as quickly as

20 business days (or about 30 calendar days) from launch. Although in practice such a rapid timeline is rare in U.S. transactions because of regulatory, financing and other closing conditions, the tender offer route remains attractive for well-funded buyers without regulatory issues. Although unlikely, the buyer in a tender offer may risk not acquiring sufficient shares to complete a short-form merger in the second step, in which case the process of eliminating minority investors may require the lengthier long-form merger process, including the solicitation of stockholder approval, as the second step of the transaction. This reality can raise complications for two-step transaction bids, such as where the financing of the transactions requires security over the target's assets or otherwise requires support from the balance sheet of the target. Two-step transactions are also the preferred structure for hostile transactions, because they can be initiated without the approval of the target board (although the target board is permitted to adopt structural defenses to seek to delay or prevent the proposed transaction, as further described in Sections IV.5 (→ paras. 109 et seq) and IV.6 (→ paras. 115 et seq.).

2. Disclosure Obligations

31 Under U.S. laws and regulations, the obligation to disclose a transaction typically does not arise until the execution of definitive transaction documentation. Due diligence and negotiations are typically conducted pursuant to a **non-disclosure agreement** that requires the parties to retain the confidentiality of their discussions and parties are not generally required to comment on rumors. In the event of a **market rumor**, companies may simply maintain a "**no comment**" position, and this is the usual course in U.S. M&A processes. U.S. stock exchanges do not typically require announcements in these circumstances, unless it can be shown that the company itself is the source of the rumor. In some cases, a target will desire to confirm to the market that discussions are underway, while clarifying that no deal may be reached. Federal securities laws do not impose a general duty upon a corporation to respond to market rumors or to disclose merger or other similar transaction negotiations until there is a material definitive agreement—unless the market rumors result from leaks attributable to the issuer. In *Basic* v. *Levinson*, the U.S. Supreme Court confirmed that in response to an inquiry regarding M&A activities, a target could quite respond with a "no comment" statement despite the fact that material developments were already under way.[27] Once a company chooses to speak on corporate developments, however, it is under a duty not to make statements that are materially misleading or omit to state any material fact. Further, where a target has previously commented on a possible transaction, the target may have a duty to update the market on material changes in the situation. In order for a "no comment" policy to be an effective tool, a company must apply the policy consistently.

32 The other circumstances in which public announcement of pending discussions may be required occur where the buyer already owns more than **5% of the target's common stock**, and has filed a **Report on Schedule 13D**, a required SEC filing upon an acquisition of shares that results in a person beneficially owning more than 5% of a listed company's stock. In this case, it may be necessary to update the buyer's Schedule 13D to reflect a change in its plans or intentions regarding the target. As such announcements tend to result in sudden increases in the target's stock price, buyers and targets alike tend to work to avoid this requirement.

3. Deal Announcement and Restrictions on Offers

33 An offer must be announced when there is a **definitive agreement** with the target company either to seek to complete a merger or to commence a tender offer. In the case of

[27] *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988).

hostile offers, announcement occurs at the time that the buyer chooses to make the proposal public, which may be by means of launching a tender offer, or through a press release indicating that a transaction has been proposed to the company. Offers by the acquirer to the target's stockholders (whether in the context of a negotiated transaction or a hostile approach) are regulated by the SEC, which requires that the appropriate registrations and disclosures be made.

34 Section 2(a)(3) of the Securities Act defines an "**offer**" expansively to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value," and the term has been interpreted broadly by both the SEC and the courts.[28] Generally, ordinary factual business information and information that a company is required to disclose under the Exchange Act does not constitute an offer, provided that such information does condition the market and investors for a sale of securities. But the distinction between an offer that must be preceded by a registration statement, on the one hand, and permissible preliminary negotiations, on the other hand, is difficult to delineate precisely as it hinges to a large extent on the facts and circumstances.

35 **Publicity** prior to a proposed offering of securities may be deemed an effort to "condition" the market and generate interest in the issuer or its securities, raising questions about whether such publicity is part of a selling effort.[29] Such publicity may constitute a "gun-jumping" violation (conditioning the market prior to an official announcement) even absent an express offer. Courts have made it clear that a communication may constitute an "offer" in the context of Section 5 of the Securities Act even if it is unenforceable and has conditions precedent to purchase.[30] The SEC has provided little additional guidance, although it has asserted that "whether an item of information or publicity could be deemed to constitute an offer—a step in the selling effort—in violation of Section 5 must be made by the issuer in the light of all the facts and circumstances surrounding each case."[31]

36 Given that an offer is determined principally by the context in which it is made, an **offer** can be made **to the board of the target company** without triggering disclosure or announcement obligations. For example, if a bid were made via a confidential, written merger proposal and were only made available to the directors of the target company, such bid would generally not qualify as an "offer" under the Securities Act because it was not made available to those in a position to accept the potential bid—the target stockholders. Under such or like circumstances, there would be no disclosure or announcement obligations.

37 At the time a **definitive transaction agreement** is signed, the target company will announce, prior to the opening of trading on the next business day, the material terms of the agreement—essentially, the identity of the buyer, deal price, any material conditions (stockholder vote, regulatory approvals, minimum tender condition in the case of a tender offer) and, perhaps, the nature of any break-up fee. Transaction announcements typically also note whether an investment bank provided a fairness opinion, and whether there is a "go shop" period, or preliminary period in which the company is permitted to seek other bids on superior terms to the agreed deal. While not required, announcements also typically indicate expected timing for completion.

38 Within four business days, the company will be required to publicly file with the SEC a current report on **Form 8-K**, describing and attaching the transaction agreement itself. These filings are readily available online through the SEC's EDGAR filing system and are also typically made available via the parties' websites.

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[28] *See, e.g., Chris-Craft Indus., Inc.* v. *Bangor Punta Corp.*, 426 F.2d 569 (2d Cir. 1970); Securities Act Release No. 33–5180, 1971 WL 120474 (Aug. 16, 1971).

[29] *See id.*

[30] *S.E.C.* v. *Cavanagh*, 155 F.3d 129, 135 (2d Cir. 1998) ("[Securities Act's definition of offer] extends beyond the common law contract concept of an offer …").

[31] *Id.* at *3 (emphasis added).

4. Diligence

Other than compliance with third-party confidentiality obligations and the limitations of antitrust law, there are **no limitations** on the scope of due diligence that may be provided to a buyer. Prudence and federal securities laws dictate that such information should be shared only pursuant to a non-disclosure agreement. Subject to the board complying with its fiduciary duties to the corporation, there is no strict legal obligation requiring either that the same information be shared with each potential buyer or that each such potential buyer be treated equally. 39

U.S. **antitrust laws** prohibit the sharing of information with respect to product pricing and certain other competitive information between direct competitors. Information about product-specific pricing and margins should not generally be shared with employees at competitors within the same industry. Such information, however, as well as other sensitive competitive information, may be separated for review by a "clean team" limited to certain employees and outside advisors who report only key findings with respect to their diligence, within the scope permitted by antitrust regulation. 40

5. Timetable

As mentioned in→ para. 29, in the case of a **recommended merger transaction**, the typical timeline to completion generally ranges from approximately three to five months. It will usually take the parties two weeks to prepare and file the proxy statement with the SEC, whose staff then typically provides comments 30 calendar days later. Those comments must be resolved prior to mailing the proxy statement to the target's stockholders, and one to four weeks of engagement with the SEC staff is the typical range. Thereafter, the company can mail the proxy statement and hold the stockholder meeting, which usually requires at least 20 business days' notice. Unless the parties receive a second request under the US antitrust filing reviews, enter a Phase II or equivalent review in Europe, or are caught in another extended regulatory review (e.g., CFIUS, FCC), such a timeline is achievable. 41

Tender offers can be launched promptly (within a few days) of reaching an agreement with the target. Unless competition approvals delay closing of the offer, these offers may be open for as few as 20 business days (or approximately 30 calendar days from agreement). Such a rapid timeline is rare in U.S. transactions, due to other regulatory, financing and closing conditions that may exist, but this route remains attractive for well-funded buyers without regulatory issues. 42

As a strictly technical matter, **hostile bids** do not necessarily require a longer timetable. If the buyer launches a tender offer, the same timeline is still possible. But it is likely that the target will put, or already have, in place takeover defenses, such as a stockholder rights plan, that will preclude the buyer from acquiring the company absent an agreement with the board. Litigation also is likely to ensue. 43

In the case of **competing buyers**, once a definitive agreement is signed with one of the buyers, the usual timeline should apply. However, if higher offers from other buyers emerge post-announcement, the target may require time to assess the bids, which may delay calling the stockholder meeting and would certainly delay an early closing to a tender offer. 44

6. Obligations of Target Directors

When considering a potential acquisition or otherwise, directors owe two fundamental duties to stockholders: the **duty of care** and the **duty of loyalty.** Simply put, a director satisfies his duty of care if he determines he has sufficient knowledge and data to make a well-informed decision, and a director satisfies his duty of loyalty if he acts in good faith 45

and only in the interests of the stockholders and the corporation (rather than in his personal interests). Sometimes there is a reference to a third duty—the duty of "good faith"—but the Delaware courts have recently adopted the view that this is a subset of the duty of loyalty.

a) Duty of Care

46 To demonstrate that a board has not met its duty of care, a plaintiff must prove that directorial conduct has risen to the level of "**gross negligence**," measured under the standard announced in 1985 by the Delaware Supreme Court in *Smith* v. *Van Gorkom* (the *Trans Union* case).[32] The core of the duty of care may be characterized as the directors' obligation to act **on an informed basis** after due consideration of the relevant materials and appropriate deliberation. Directors should act to assure themselves that they have the information required to take (or refrain from taking) action, that they devote sufficient time to the consideration of such information and that they obtain, where useful, **advice from counsel** and other experts. While Delaware law recognizes that directors may use outside experts to advise the board on significant legal and financial matters affecting their analysis,[33] a board is not permitted to delegate its duty of care to other decision makers.

47 With respect to a director's decision to approve a corporation's entry into a business combination transaction, directors who act without adequate information or without active involvement in the decision will have difficulty defending the transaction in court, regardless of the level of scrutiny applied by a court. Failure to assume an active role in the decision-making process and remain fully informed throughout that process may enable a plaintiff to rebut the presumption inherent in the traditional business judgment rule, discussed below, and potentially win a duty of care claim against the directors. Similarly, such failure may prevent directors from sustaining their burden of proof in cases where an enhanced scrutiny standard is applicable.

48 Because a central inquiry in a duty of care case is whether the board acted on an informed basis, a board should carefully **document** the basis for its decisions. For example, the Delaware Supreme Court in *Paramount Communications, Inc.* v. *Time, Inc. (Time-Warner)*[34] placed great weight on the extensive participation of Time's board in the decision whether to seek a merger partner, its identification of important factors to be considered in evaluating any potential merger and its initial decision to seek a merger with Warner Communications, as well as the board's active involvement after Paramount first appeared with a competing bid. Although the Court ultimately deferred to the board's decisions, it did so only after extended analysis of the board's level of engagement throughout the process. In contrast, the Court in the *Trans Union* case, which found the board of directors liable for breaches of the duty of care, was specifically disturbed by the fact that the directors of the selling company failed to read the merger agreement before approving it and failed to obtain the advice of investment bankers. Accordingly, the importance of informed, independent board decision making cannot be overstated.

49 In the wake of the *Trans Union* case and the subsequent increase in the cost of director and officer liability insurance, Delaware amended the DGCL to permit corporations to include in their certificates of incorporation provisions that exculpate directors from monetary liability for breaches of the duty of care.[35] Such provisions cannot, however, exculpate breaches of the duty of loyalty, and they do not prevent a court from ordering equitable relief against violations of any fiduciary duty.

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[32] *Smith* v. *Van Gorkom (Trans Union)*, 488 A.2d 858, 874 (Del. 1985).
[33] DGCL § 141(e).
[34] *Paramount Commc'ns, Inc.* v. *Time, Inc.*, 571 A.2d 1140, 1153 54 (Del. 1990).
[35] *See* DGCL § 102(b)(7).

b) Duty of Loyalty

Every director has a duty to act in what he or she believes to be in the best interests of the corporation and its stockholders. This includes a duty not to act in a manner adverse to those interests by putting a personal interest or the interests of someone to whom the director is beholden ahead of the corporation's or stockholders' interest. The classic manner of showing that a director has not met his or her duty of loyalty involves proof that the director engaged in a "**self-dealing**" transaction. However, any time a majority of directors are either (a) personally interested in the decision before the board or (b) not independent from or otherwise dominated by someone who is interested, courts will be concerned about a potential violation of the duty of loyalty and will review the corporate action under the "entire fairness" level of scrutiny, described more fully below. 50

The duty of loyalty also encompasses the **concept of good faith.** A director violates his or her good faith obligations where he or she "intentionally acts with a purpose other than that of advancing the best interests of the corporation … with the intent to violate applicable positive law, or where [he or she] intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his [or her] duties."[36] 51

Understanding what rises to a duty of loyalty violation is especially important in light of Section 102(b)(7) of the DGCL, because, as previously noted, corporations may not exculpate their directors for breaches of the duty of loyalty. Take, for example, the Delaware Supreme Court's opinion in *Lyondell Chemical Co.* v. *Ryan*, which rejected stockholder claims that directors had breached their duty of loyalty and were liable for failing to act in good faith in selling the company.[37] There, under the procedural posture of summary judgment review, the Delaware Supreme Court assumed that the directors did nothing to prepare for an impending offer and did not even consider conducting a market check before entering into a merger agreement (at a substantial premium to market) containing a no-shop provision and a 3.2% break-up fee. But even this conduct, the Delaware Supreme Court held, did not rise to the level of "bad faith," because the Lyondell board had not "utterly failed" to try to meet its obligations. Because the board had engaged in some level of negotiation and pushed back (albeit unsuccessfully) on the acquirer, the Delaware Supreme Court reversed the Court of Chancery, noting that the directors needed only to make decisions that were "reasonable, not perfect." *Lyondell* is a powerful statement that courts appreciate the complex decisions directors must make in selling the company, and will not equate post hoc process attacks with a duty of good faith violation. 52

7. The Standards of Review of a Transaction

The level of scrutiny with which courts will review directors' compliance with their duties varies with situation and context. The default rule is the traditional business judgment rule, which holds that directors' business decision making will generally not (absent a personal conflict of interest) give rise to personal liability. Certain contexts, including when directors defend against a threatened change-of-control or engage in a sale of control of a company, invite a heightened level of scrutiny. In those cases, the so-called *Unocal* standard or the *Revlon* test may be applied. Finally, in transactions involving a conflict of interest, an "entire fairness" standard will typically apply. 53

a) Business Judgment Rule

The traditional business judgment rule is the default standard of review applicable to directors' decisions. Under the business judgment rule, directors' decisions are presumed to 54

[36] *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 67 (Del. 2006).
[37] *Lyondell Chem. Co.* v. *Ryan*, 970 A.2d 235, 235 (Del. 2009).

have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.[38] In other words, the business judgment rule is a **presumption** that directors are complying with their fiduciary duties. In the case of a Delaware corporation, the statutory basis for the business judgment rule is Section 141(a) of the DGCL, which provides that "[t]he business and affairs of every corporation … shall be managed by or under the direction of a board of directors." In cases where the traditional business judgment rule applies, directors' decisions are protected unless a plaintiff is able to carry its burden of proof in showing that a board has in fact acted disloyally, in bad faith, or with gross negligence. This rule prevents courts and stockholders from interfering with managerial decisions made by a loyal and informed board unless the decisions cannot be "attributed to any rational business purpose."[39] If a plaintiff is able to rebut the presumptive protections of the business judgment rule, the court will review the action or decision for entire fairness.

55 The Delaware Supreme Court held in *Time-Warner* that for stock-for-stock mergers with no sale of control, the ordinary business judgment rule applies to the decision of a board to enter into a merger agreement.[40] Under *Time-Warner*, a stock-for-stock merger between two [truly] public companies will not constitute a change-of-control under Delaware law, and thus will not trigger the requirement under *Revlon* that the seller's board seek, through auction or otherwise, the highest value reasonably available to stockholders. Directors approving such a transaction will not be subject to enhanced judicial scrutiny.

b) The Unocal/Unitrin Standard

56 Instead of benefiting from the presumption attending the traditional business judgment rule, directors who adopt **defensive measures** in reaction to an **unsolicited offer** carry the burden of proving that their process and conduct satisfy the enhanced standard established in 1985 by *Unocal Corp.* v. *Mesa Petroleum Co.*[41] and its progeny. This standard requires that the board meet a two-pronged test:

- the board must show that it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed," which may be shown by the directors' reasonable investigation and good faith belief that there is a threat; and
- the board must show that the defensive measure chosen was "reasonable in relation to the threat posed," which the Delaware Supreme Court in *Unitrin, Inc.* v. *American General Corp.* defined as being action that is not "coercive or preclusive" and otherwise falls within "the range of reasonableness."[42]

57 The 2011 landmark decision in *Air Products & Chemicals, Inc.* v. *Airgas, Inc.*,[43] upholding the Airgas board's refusal to accept a premium cash bid from Air Products, is the most important recent decision reviewing the law applicable to board responses to unsolicited tender offers. The Delaware Court of Chancery upheld under *Unocal* the Airgas directors' decision to block a hostile tender offer, ruling that the "power to defeat an inadequate hostile tender offer ultimately lies with the board of directors." In ruling for the Airgas board, the Chancery Court found that the directors had acted in good faith in determining that Air Products' "best and final" tender offer was inadequate. In making this finding, the Chancery Court relied on the fact that the board was composed of a majority of outside directors, that the board had relied on the advice of outside legal counsel and three separate financial advisors, and that the three Airgas directors nominated to the Airgas board by Air Products had sided with the incumbents in concluding that Air Prod-

[38] *See, e.g.*, *Aronson* v. *Lewis*, 473 A.2d 805, 811–812 (Del. 1984).
[39] *Unitrin, Inc.* v. *Am. Gen. Corp.*, 651 A.2d 1361, 1373 (Del. 1995).
[40] 571 A.2d at 1140.
[41] 493 A.2d 946 (Del. 1985).
[42] 651 A.2d 1361, 1361.
[43] *Air Prods. & Chems., Inc.* v. *Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011).

ucts' offer should be rejected. The Chancery Court's opinion held that "in order to have any effectiveness, pills do not—and cannot—have a set expiration date."[44] The Chancery Court continued that while "this case does not endorse 'just say never,'" "it does endorse [] Delaware's long understood respect for reasonably exercised managerial discretion, so long as boards are found to be acting in good faith and in accordance with their fiduciary duties (after rigorous judicial fact-finding and enhanced scrutiny of their defensive actions). The Airgas board serves as a quintessential example."[45]

58 Notably, even in the absence of a known hostile threat, deal protection devices such as termination fees, force-the-vote provisions, expense reimbursements and no-shop provisions are generally reviewed under the *Unocal* standard, unless the factors triggering *Revlon* review are present.

c) Revlon

59 Transactions involving a "sale of control" or "**change of control**" of a corporation (i. e., a cash merger, or a merger in which a preponderant percentage of the consideration is cash, or in which there will be a controlling stockholder post-merger) are also subject to enhanced judicial review. In *Revlon Inc.* v. *MacAndrews & Forbes Holdings, Inc.*, the Delaware Supreme Court explained that fiduciary duties in a sale of control context require directors to take efforts to achieve the highest value reasonably available for stockholders.[46]

60 The Delaware Supreme Court has written that when *Revlon* is triggered, "[t]he directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company."[47] Under this conception of *Revlon*, provided a board is choosing between two or more capable buyers presenting transactions that are comparable in terms of timing and likelihood of consummation, it must look solely to price. Specifically, a board comparing two or more cash offers cannot choose the lower one because, for example, it has advantages for "constituencies" other than common stockholders, such as employees, customers, management and preferred stockholders.

61 All that said, the Delaware Supreme Court has also been very clear that "there is no single blueprint that a board must follow to fulfill its duties" in the *Revlon* context,[48] and "[i]f a board selected one of several reasonable alternatives, a court should not second-guess that choice even through it might have decided otherwise or subsequent events may have cast doubt on the board's determination."[49] The court has recently stressed that "[w]hen a board exercises its judgment in good faith, tests the transaction through a viable passive market check, and gives its stockholders a fully informed, uncoerced opportunity to vote to accept the deal," the board's *Revlon* obligations are well met.[50]

62 The Delaware Supreme Court generally subscribes to the notion that the *Revlon* "duty to seek the best available price applies only when a company embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control."[51] The prototypical example of this is where the board of a non-controlled company decides to sell the company in an all-cash deal. But, where the board does not embark on a change of control transaction, *Revlon* review will not apply. Accordingly, enhanced scrutiny is not triggered by a board's mere refusal to engage in negotiations where

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[44] *Id.* at 129.
[45] *Id.*
[46] 506 A.2d. 173, 182 (Del. 1986).
[47] *Paramount Commc'ns Inc.* v. *QVC Network Inc.*, 637 A.2d 34, 46 (Del. 1994) (citation omitted).
[48] *Barkan* v. *Amsted Industries, Inc.*, 567 A. 2d 1279, 1286 (Del. 1989).
[49] *QVC*, 637 A.2d at 45.
[50] *C&J Energy Servs., Inc.* v. *City of Miami Gen. Emps.' & Sanitation Emps.' Ret. Trust*, 107 A.3d 1049, 1053 (Del. 2014).
[51] *Lyondell Chem.*, 970 A.2d at 242.

an offeror invites discussion of a friendly deal. Nor will enhanced scrutiny apply to a merger transaction in which there is no change of control, such as in a purely stock-for-stock merger between two non-controlled companies. A stock-for-stock merger will be deemed a sale of control, however, when there would exist a post-merger controlling stockholder. Under such circumstances, *Revlon* applies.

63 Pure stock-for-stock mergers between non-controlled entities do not result in a *Revlon*-inducing "change of control," because such combinations simply shift "control" of the seller from one dispersed generality of public stockholders to a differently constituted group that still has no controlling stockholder. Accordingly, the future prospect of a potential sale of control at a premium is preserved for the selling company's stockholders. This principle applies even if the acquired company in an all-stock merger is very small in relation to the buyer. Nor is there a "change of control" in the cash (or stock) sale of a company with a controlling stockholder to a third party. Where a company already has a controlling stockholder, "control" is not an asset owned by the minority stockholders and thus they are not entitled to a control premium.

64 The law is less clear, however, in transactions involving the sale of non-controlled companies for consideration involving a blend of cash and stock. Though, as discussed, it is clear that all-cash deals invoke *Revlon* review and all-stock deals do not, the courts have not drawn a bright line in mixed-consideration cases. In *In re Santa Fe Pacific Corp.*, the Delaware Supreme Court held that a transaction in which cash represented $33\frac{1}{3}\%$ of the consideration would not be subjected to *Revlon* review.[52] However, in one recent case, the Delaware Court of Chancery ruled that the *Revlon* standard would likely apply to half-cash, half-stock mergers, reasoning that enhanced judicial scrutiny was in order because a significant portion "of the stockholders' investment […] will be converted to cash and thereby be deprived of its long-run potential."[53] This issue, however, remains unresolved by the Delaware Supreme Court.

65 *Revlon* does not require boards to blindly accept the highest nominal offer for a company. For example, factors may lead a board to conclude that a particular offer, although "higher" in terms of price, is substantially less likely to be consummated; the risk of non-consummation is directly related to value. Directors "should analyze the entire situation and evaluate in a disciplined manner the consideration being offered. Where stock or other non-cash consideration is involved, the board should try to quantify its value, if feasible, to achieve an objective comparison of the alternatives."[54] The Delaware Supreme Court has stated that a board may assess a variety of additional practical considerations, including an offer's "fairness and feasibility; the proposed or actual financing for the offer, and the consequences of that financing; questions of illegality; … the risk of non-consummation; … the buyer's identity, prior background and other business venture experiences; and the buyer's business plans for the corporation and their effects on stockholder interests."[55] In the context of two all-cash bids, under certain circumstances a board may choose to take a bid that is "fully financed, fully investigated and able to close" promptly over a nominally higher yet more uncertain competing offer.[56] Such concerns, however, must be fairly and evenly applied when evaluating competing bids.

66 Even under *Revlon*, a board has substantial latitude to decide what tactics will result in the best price. Directors are not required "to conduct an auction according to some standard formula" nor does *Revlon* "demand that every change of control of a Delaware cor-

[52] *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59 (Del. 1995).
[53] *Smurfit-Stone*, 2011 WL 2028076, at *15.
[54] *QVC*, 637 A.2d at 44.
[55] *Mills Acquisition Co.* v. *Macmillan, Inc.*, 559 A.2d 1261, 1282 n.29 (Del. 1989).
[56] *Golden Cycle, LLC* v. *Allan*, C.A. No. 16301, 1998 WL 892631, at *16 (Del. Ch. Dec. 10, 1998); *accord*, *In re MONY Grp. Inc. S'holder Litig.*, 852 A.2d 9, 15 (Del. Ch. 2004).

poration be preceded by a heated bidding contest."[57] Courts have recognized that in general, disinterested board decisions as to how to manage a sale process are protected by the business judgment rule. In *Mills Acquisition Co.* v. *Macmillan, Inc.*, the Delaware Supreme Court stated that "[i]n the absence of self-interest, and upon meeting the enhanced duty mandated by *Unocal*, the actions of an independent board of directors in designing and conducting a corporate auction are protected by the business judgment rule."[58] The Court continued that "like any other business decision, the board has a duty in the design and conduct of an auction to act in 'the best interests of the corporation and its shareholders.'"[59] The decision as to which process will produce the best value reasonably available to stockholders is, therefore, within the business judgment rubric, provided that a board or special committee evaluating the proposed transaction is not affected by self-interest and is well informed as to the process. A board approving any sale of control must be fully informed concerning the development of the transaction, alternatives, valuation issues and all material terms of the merger agreement. A valid fairness opinion issued by an investment bank in connection with the decision may help support a court finding that the board is fully informed. Thus, even in the change-of-control context, a board retains a good deal of authority to determine the best value reasonably available to stockholders.

d) Entire Fairness

67 The "entire fairness" standard is "Delaware's **most onerous standard**, and it requires the Director Defendants to demonstrate their utmost good faith and the most scrupulous inherent fairness of the" transaction or decision under review.[60] A court will review a board's decision or action under the entire fairness standard when the presumptive protections of the business judgment rule have been rebutted. This may occur when a plaintiff pleads facts showing:

- that a majority of the board has an interest in the decision or transaction that differs from the stockholders in general;
- that a majority of the board lacks independence from or is dominated by an interested party; or
- that the transaction at issue is one where the directors or a controlling stockholder "stand on both sides" of a transaction; or
- that a majority of the board has breached the duty of care by acting with "gross negligence".

68 Although there is no bright-line test to determine what level of director self-interest will result in entire fairness review of the whole board's action, conflicts of interest triggering this enhanced level of review may arise in situations where the directors appear on both sides of a transaction or derive a personal financial benefit that does not devolve generally upon all the stockholders. Potential conflicts can take many shapes, including when a director receives certain payments from, or has certain family relationships or prior business relationships with, a party to the transaction, and other instances where a director will benefit or suffer a detriment in a manner that is not aligned with the interests of the corporation to which he or she owes fiduciary duties.

69 The Delaware Court of Chancery has stated that it applies the following test to determine when entire fairness review is appropriate even though a majority of directors are disinterested:

[57] *Macmillan, Inc.*, 559 A.2d at 1286; *Barkan* v. *Amsted Indus., Inc.*, C.A. No. 9212 (Del. Ch. Sept. 21, 1990), slip op. at 13.
[58] *Macmillan*, 559 A.2d at 1287.
[59] *Id.* (citations omitted).
[60] *Encite LLC* v. *Soni*, C.A. No. 2476-VCG, 2011 WL 5920896, at *20 (Del. Ch. Nov. 28, 2011) (internal quotation marks omitted).

In my opinion a financial interest in a transaction that is material to one or more directors less than a majority of those voting is "significant" for burden shifting purposes … when the interested director *controls or dominates* the board as a whole or when the interested director *fails to disclose his interest* in the transaction to the board and a reasonable board member would have regarded the existence of the material interest as a significant fact in the evaluation of the proposed transaction.[61]

70 The entire fairness standard may also be applied in a "squeeze-out" merger in which a controlling stockholder buys out the public minority stockholders. The entire fairness standard of review may even apply in the context of a transaction ostensibly with an unaffiliated third party. The cases where this occurs typically involve situations where different groups of stockholders arguably are not treated equally in connection with the transaction. In these controlling stockholder situations, certain procedural protections (e. g. the use of a special committee of disinterested, independent directors and a nonwaivable majority-of-the-minority approval condition) may help avoid entire fairness review or at least shift the burden of disproving entire fairness to the plaintiffs.

71 When analyzing a transaction to determine whether it satisfies the entire fairness standard, a Delaware court will consider both **process** ("fair dealing") and **price** ("fair price"), although the inquiry is not a bifurcated one; rather, all aspects of the process and price are considered holistically in evaluating the fairness of the transaction.[62] As the Delaware Court of Chancery has stated in *In re John Q. Hammons Hotels Inc. Shareholder Litigation:*

The concept of entire fairness has two components: fair dealing and fair price. These prongs are not independent, and the Court does not focus on each of them individually. Rather, the Court determines entire fairness based on all aspects of the entire transaction. Fair dealing involves questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. Fair price involves questions of the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.[63]

72 Because entire fairness review focuses holistically on both process and price, the Delaware courts have in practice, at least at the trial court level, been unlikely to award equitable relief or damages where the price is fair, even if there may have been process flaws. Nevertheless, the Delaware courts have stressed their belief that "[a] fair process usually results in a fair price," and, in defending suits governed by the entire fairness standard, it is advantageous to be able to build a record reflecting a robust and meaningful process.

73 With respect to such process, the Delaware Supreme Court has long encouraged boards to utilize a "**special committee**" when a conflict transaction is proposed. A special committee attempts to reproduce the dynamics of arm's-length bargaining. To be effective, a special committee generally should: (1) be properly constituted (i. e., consist of genuinely independent directors); (2) have an appropriately broad mandate from the full board (i. e., it should not be limited to simply reviewing an about-to-be-agreed-to transaction); and (3) have legal and financial advisors. As noted above, the use of a well-functioning special committee can shift the burden of proof to the plaintiff. Approval of a cash-out merger with a controlling stockholder by a majority of the minority stockholders also could shift the burden. The quantum of proof needed under entire fairness is a "preponderance of the evidence," which has led the Delaware Supreme Court to note that

[61] *Cinerama, Inc.* v. *Technicolor, Inc. (Technicolor II),* 663 A.2d 1134, 1153 (Del. Ch. 1994) (emphasis in original), *aff'd, Cinerama, Inc.* v. *Technicolor, Inc. (Technicolor III)*, 663 A.2d 1156 (Del. 1995).

[62] *Weinberger*, 457 A.2d at 711; *accord Kahn* v. *Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994) (quoting *Weinberger*, 457 A.2d at 711).

[63] *John Q. Hammons Hotels*, 2009 WL 3165613, at *13 (internal quotations and citations omitted).

the effect of a burden shift is "modest," as it will only prove dispositive in the rare instance where the evidence is entirely in equipoise.[64] Nevertheless, the Supreme Court has also stressed that it views the use of special committees as part of the "best practices that are used to establish a fair dealing process," and, thus in spite of the only "modest" benefit from a burden standpoint, special committees remain important in conflict transactions.[65]

74 As for avoiding entire fairness review entirely in the context of a controller squeeze-out merger, the Delaware Supreme Court has recently reaffirmed the principle that entire fairness review is unavoidable where a controller stands on both sides of a transaction.[66] Although there is earlier Court of Chancery authority for the proposition that structuring a squeeze out as a tender offer made directly by the controller to the minority stockholders means the controller is not technically "on both sides"—and thus makes entire fairness inapplicable[67]—this doctrine has been called into question in more recent Chancery decisions. Those same decisions have proposed a "unified" standard in which a squeeze-out transaction could receive business judgment review if it employed both a special committee and a majority-of-the-minority stockholder vote requirement.[68] The Delaware Supreme Court, however, has not yet expressed an opinion on this view.

IV. Other Issues

1. Protecting the Deal

75 It is customary for parties to U.S.-style M&A transactions to include deal protection devices, designed to prevent other parties from encroaching on a previously negotiated transaction. Common deal protection devices include break-up fees, "no-shop" clauses, force-the-vote provisions and stockholder voting agreements, all of which allow buyers "to protect themselves against being used as a stalking horse and [provide] consideration for making target-specific investments of time and resources in particular acquisitions."[69] Sellers are generally willing to agree to provisions of this variety as a means of inducing value-maximizing bids. Delaware courts have recognized that deal protection devices are permissible means of protecting a merger from third-party interference, where such provisions (viewed holistically) are reasonable under the circumstances.

76 The **legal standards of review** under which deal protections are scrutinized were discussed in detail in Section III.7 (→ paras. 53 *et seq.*). Generally, deal protection devices in transactions not involving a sale of control have been reviewed under the intermediate standard of scrutiny formulated in *Unocal*.[70] Thus, a board of directors that adopts a protective measure should be prepared to demonstrate that it had reasonable grounds to believe that a third-party bid would be a **danger to corporate policy**[71] and that the deal protection measure was **reasonable** in response to the **perceived threat.** In contrast, review of deal protection devices in change-of-control transactions (i.e., a merger in which a sufficient percentage of the consideration is for cash or in which there will be a controlling stockholder post-merger) involves the more exacting *Revlon* test, where the board's duty is to secure the best value reasonably available for stockholders.[72]

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[64] *Americas Mining Corp. v. Theriault*, 51 A.3d 1213, 1240 (Del. 2012) at 1243.
[65] *Id.* at 1244.
[66] *Id.* at 1240.
[67] *See In re Siliconix Inc. S'holders Litig.*, C.A. No. 18700, 2001 WL 716787, at *8 n.26 (Del. Ch. June 19, 2001).
[68] *In re CNX Gas Corp. S'holders Litig.*, 4 A.3d 397 (Del. Ch. 2010).
[69] *NACCO Indus., Inc.* v. *Applica Inc.*, 997 A.2d 1, 19 (Del. Ch. 2009).
[70] *Unocal Corp.* v. *Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).
[71] *Id.*
[72] *Revlon, Inc.* v. *MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

77 In addition to the inclusion of deal protections in definitive transaction documentation, it is also possible for a public company to grant limited forms of **exclusivity** to a potential acquirer *before* the execution of a definitive agreement. For example, a company might agree not to seek other bids for a brief period while diligence or negotiations are completed, or it may agree to reimburse certain expenses of the buyer upon termination of negotiations.

78 The most common forms of deal protection are discussed below.

a) Break-up Fees

79 The transaction agreements for most U.S. M&A transactions include a reasonable break-up fee payable by the target in the event that the target terminates the merger agreement to accept a superior proposal, as well as other specified circumstances generally involving the failure of the merger to occur as a result of a third-party bid. In some cases, break-up fees are offered by sellers to compensate an unsuccessful buyer for the risk and costs incurred in advancing the competitive bidding process and incentivize potential buyers to undertake the cost of evaluating the target. Of course, termination fees, even more than other deal protection devices, impose an easily calculable cost on overbids, and accordingly may deter the making of overbids in the first instance. An "excessive" break-up fee therefore will be viewed critically by the courts. There is, however, no fixed metric for determining the reasonableness of a termination fee. Even the question of whether the fee should be measured against equity value or enterprise value (i.e., equity value plus net debt) will depend on the circumstances[73]—for example, enterprise value may be more appropriate where the company's capital structure is highly leveraged, although in a recent case, a Delaware judge noted that Delaware law "has evolved by relating the break-up fee to equity value," absent a "compelling reason" to deviate from that approach.[74] Unlike many foreign jurisdictions, Delaware courts have not articulated a specified percentage for permitted break fees. The usual rule is that the fee must be reasonable and not so high as to unduly tax the stockholder vote. Parties typically agree that fees should not exceed 3 to 4% of transaction value, although fees above 4% are not unheard of, and context is all-important.

b) "No-Shops," "No Talks" and "Don't Ask, Don't Waive" Standstills

80 A "**no-shop**" provision in a merger agreement provides that a selling company will not encourage, seek, solicit, provide information to or negotiate with third-party buyers, but generally allows the seller to respond to unsolicited offers by supplying confidential information and to consider and negotiate with respect to certain competing bids. In 2009, in *NACCO Industries, Inc.* v. *Applica Inc.*, the Delaware Court of Chancery stated that it is "critical to [Delaware] law" that no-shop provisions be enforced.[75] NACCO also recognized that a successful interloper could be liable for tortious interference with the no-shop provision. Once a merger agreement is signed, directors and corporate representatives inside and outside the company should be instructed to adhere to its terms. "**Go-shop**" provisions, which allow the target company to actively solicit competing offers and are sometimes used in deals where there has not been any extensive pre-signing market canvass, are a variation on the typical no-shop clause. In addition to the general no-shop restrictions, go-shops provide a period after the merger agreement signing—usually 30 to 60 days—in which the target is permitted to affirmatively solicit competing bids. Overly

[73] *See, e.g.*, *In re Cogent, Inc. S'holder Litig.*, 7 A.3d 487, 503–04 (Del. Ch. 2010) (citing *Lear*, 926 A.2d at 94) (observing that the decision whether to view a termination fee's preclusive effect in terms of equity value or enterprise value will depend on the factual circumstances existing in a given case).

[74] *In re Answers Corp. S'holders Litig.*, C.A. No 6170-VCN, 2011 Del. Ch. LEXIS 57, at *19 n.52 (Del. Ch. Apr. 11, 2011).

[75] 997 A.2d 1 (Del. Ch. 2009).

restrictive no-shop clauses may be rejected by Delaware courts as breaches by the board of its fiduciary duties. In *QVC*, the Delaware Supreme Court expressed concern that the highly restrictive no-shop clause of the Viacom/Paramount merger agreement was interpreted by the board of Paramount to prevent directors from even learning of the terms and conditions of QVC's offer, which was initially higher than Viacom's offer by roughly $1.2 billion.[76] The Court concluded that the board invoked the clause to give directors an excuse to refuse to inform themselves about the facts concerning an apparently bona fide third-party topping bid, and therefore the directors' process was not reasonable. Therefore, the usual rule is that boards should take care that a "no-shop" does not also function as a "**no-talk**"—i. e., a clause that interferes with the board's ongoing duty to familiarize itself with potentially superior bids made by third parties.

81 Similarly, in 1999, in *Phelps Dodge Corp.* v. *Cyprus Amax Minerals Co.*, the Delaware Court of Chancery stated that "no talk" clauses that prohibit a board from familiarizing itself with potentially superior third-party bids were "troubling precisely because they prevent a board from meeting its duty to make an informed judgment with respect to even considering whether to negotiate with a third party."[77] The Court acknowledged that under *Time-Warner*, where the business judgment standard rather than *Revlon* applies, parties to a stock-for-stock merger have no duty to negotiate with third parties, but noted that "even the decision not to negotiate, in my opinion, must be an informed one." Boards should therefore take care that a "no-shop" does not also function as a "no-talk."

82 Targets in an auction will often require that bidders agree to a "**standstill**" that precludes bidders from making a topping bid in the event that they are not selected as the acquirer, prohibiting losing bidders from seeking to disrupt the negotiated outcome of the auction process. A properly drafted standstill will also include an anti-evasion clause that prohibits the potential buyer from requesting a waiver or taking actions that may make the buyer's interest in the target public. Even private requests for a waiver have generally been prohibited by standstill agreements because under certain circumstances, they can lead to disclosure on the part of the target, or simply leak, thus putting the target "in play."

83 In *In re Complete Genomics, Inc. Shareholder Litigation*,[78] Vice Chancellor Travis Laster of the Delaware Court of Chancery enjoined a target company subject to *Revlon* duties (discussed in greater depth in → paras. 59 *et seq.*) from enforcing such a clause, which he referred to as a "Don't Ask, Don't Waive" provision. In the November 2012 bench ruling, the Court did not object to the buyer being prohibited from publicly requesting a waiver of the standstill (which the Court understood would eviscerate the standstill the buyers had agreed to by putting the target "into play"), but held that directors have a continuing duty to be informed of all material facts, including whether a rejected buyer is willing to offer a higher price. The Court suggested that a "Don't Ask, Don't Waive" provision is analogous to the "no-talk" provision held invalid in *Phelps Dodge* and is therefore "impermissible because it has the same disabling effect as a no-talk clause, although on a buyer-specific basis."[79]

84 Less than a month later, however, then-Chancellor Strine's bench ruling in *In re Ancestry.com Inc. Shareholder Litigation*[80] held that there is no *per se* rule against "Don't Ask, Don't Waive" standstill provisions, although he did express the view that they are "potent" provisions that must be used with caution. *Ancestry.com* recognized the valuable function that "Don't Ask, Don't Waive" standstill agreements can play in the process of selling a company as an "auction gavel" encouraging buyers to put their best offers on the

[76] *Paramount Commc'ns Inc.* v. *QVC Network, Inc. (QVC),* 637 A.2d 34, 45 (Del. 1994) at 47–48.
[77] *Phelps Dodge Corp.* v. *Cyprus Amax Minerals Co.*, C.A. No. 17398, 1999 WL 1054255 (Del. Ch. Sept. 27, 1999) at *1.
[78] *In re Complete Genomics, Inc. S'holder Litig.*, C.A. No. 7888-VCL (Del. Ch. Nov. 27, 2012).
[79] *Id.*
[80] *In re Ancestry.com Inc. S'holder Litig.*, C.A. No. 7988-CS (Del. Ch. Dec. 17, 2012).

table. But the Court also emphasized that "Don't Ask, Don't Waive" standstills will be subject to careful judicial review in the *Revlon* context. Then-Chancellor Strine's ruling expressed the view that the directors of the selling company should be fully informed of the use and implications of the "Don't Ask, Don't Waive" standstill provision, and stockholders whose votes are sought for the transaction should be informed if buyers that participated in the auction are contractually prohibited from offering a topping bid. A board that is considering the use of these standstill provisions should ensure that its decision-making process is clearly documented.

85 More recently, in the *NetSpend* case,[81] the Court of Chancery again addressed the use of "Don't Ask, Don't Waive" standstill provisions. The seller had previously entered into "Don't Ask, Don't Waive" standstill agreements with two private equity firms, while the company was "not for sale." The Court criticized the board's decision to keep the provisions in place noting that the board had not "considered whether the standstill agreements should remain in place" and "blinded itself to any potential interest" from the private firms.[82] The Court of Chancery has noted that "directors cannot willfully blind themselves to opportunities that are presented to them."[83] In considering the totality of the deal protection, the board should consider the effect of any "standstill provisions" included in confidentiality agreements signed with potential buyers, including the ability (or inability) of potential buyers to seek to have these restrictions waived.

c) Board Recommendations, Fiduciary Outs and "Force-the-Vote" Provisions

86 Most public company merger agreements include provisions requiring the board of directors of the target (and, if the acquirer's stockholders also will be voting on the transaction, the board of directors of the acquirer) to recommend that stockholders **vote in favor of the merger agreement** except in specified circumstances. One issue that sometimes is negotiated is whether the board may **change its recommendation** whenever the directors determine that their fiduciary duties so require, or only in certain circumstances, such as in the context of a "superior proposal." In light of Delaware case *dicta*, many Delaware practitioners believe that a merger agreement provision precluding a change in recommendation except where a superior proposal has been made may be invalid, on the theory that a "duty of candor" (or a duty of disclosure) requires directors to be able to change the recommendation for any reason.[84] In Vice Chancellor Laster's recent bench ruling in *In re Complete Genomics Shareholder Litigation*, he made clear his view that Delaware boards should retain the right to change their recommendation in compliance with their fiduciary duties, explaining that "[u]nlike in the no-shop and termination outs, fiduciary duty law in this context can't be overridden by contract" because "it implicates duties to target stockholders to communicate truthfully."[85] In some cases, practitioners have sought a middle course, writing provisions that bar a change in recommendation unless there has been an "intervening event" in an attempt to preserve some measure of protection against an unwarranted change in recommendation while minimizing an attack on duty of candor grounds. In any case, merger agreements often include termination rights for the buyer triggered upon a change in recommendation by the target board and fees payable upon such termination. That is, an adverse change in board recommendation typically gives the

[81] *Koehler* v. *NetSpend Holdings Inc.*, C.A. No. 8373-VCG, 2013 WL 2181518 (Del. Ch. May 21, 2013).
[82] *Id.* at *19.
[83] *Cirrus Holding Co. Ltd.* v. Cirrus Indus., 794 A.2d 1191, 1207 (Del. Ch. 2001).
[84] *See Frontier Oil Corp.* v. *Holly Corp.*, C.A. No. 20502, 2005 WL 1039027, at *27 (Del. Ch. Apr. 29, 2005) ("The Merger Agreement, of course, was not an ordinary contract. Before the Merger could occur, the shareholders of Holly had to approve it. The directors of Holly were under continuing fiduciary duties to the shareholders to evaluate the proposed transaction. The Merger Agreement accommodated those duties by allowing, under certain circumstances, the board of directors to withdraw or change its recommendation to the shareholders that they vote for the Merger.").
[85] *In re Complete Genomics S'holder Litig.*, C.A. No. 7888-VCL (Del. Ch. Nov. 9, 2012).

buyer the right to terminate the agreement and receive a break-up fee. In addition, most agreements provide for various consultation and 'matching' rights for buyers, so that, prior to changing its recommendation, the board must consult with the buyer and permit the buyer to propose alternative terms that would result in the board maintaining its recommendation based on the revised price.

87 Merger agreements also often include a provision that permits a party to terminate the agreement to accept a superior proposal, subject to payment of a termination fee and other conditions—commonly known as a "**fiduciary out**". The non-terminating party may be given the right to match competing bids, and may contractually specify a period of time that must pass before the fiduciary out may be exercised. In some cases, however, the merger agreement provides that a party may change its recommendation in response to a superior proposal, but cannot terminate the agreement unless its stockholders vote the deal down (in these cases the board's right to change its recommendation is still referred to as a "fiduciary out").

88 Transaction agreements typically also include provisions that forbid the target from seeking, or entertaining, other offers, unless their fiduciary duties require them to do so. Further, at least in Delaware, a buyer may obtain a "**force the vote**" provision that requires the target to submit the deal to stockholders even if the target's board of directors changes its recommendation; this can result in a significant timing advantage for the first buyer to make an offer. The precise mix of customary deal protections, of which the foregoing are just the most common, depends on the nature of the sale process, whether the transaction is a cash or stock deal, and the relative bargaining power of the parties.

89 In addition to other deal protections, an acquirer may also seek **commitments from significant stockholders** of the seller, whether members of management or otherwise, to support the transaction. Such commitments may be in the form of voting agreements or separate options for the acquirer on such stockholders' stock. The visible, up-front support of major stockholders for a transaction can be a significant deterrent to third-party bids and may be critical in consummating the transaction. As a result, it is common practice for buyers seeking targets that have large stockholders to require and obtain voting and support agreements, which essentially provide that the stockholder will vote in favor of the transaction (or tender its shares in the case of a tender offer), until such time as the company terminates the agreement (which it typically is entitled to do if a superior offer is received). Buyers need to be careful not to run afoul of the proxy solicitation rules, which essentially means that they may only speak to a few stockholders and not to a large number (Exchange Act Rule 14a-2 provides a safe harbour for buyers to solicit not more than 10 target stockholders), prior to deal announcement and to comply with the SEC filing requirements relating to preliminary proxy materials.

2. Funding and Consideration

90 Funding must be in place at the time the merger is effective, or the time of acceptance of tenders pursuant to a tender offer, when payment is actually due to target stockholders. The U.S. M&A market does **not** have a "**certain funds**" or similar requirement relating to bids and offers or to agreed transactions, and the nature and extent of funding commitments and contingencies (which are permitted in both unsolicited bids and agreed transactions) are the subject of much discussion, negotiation and variation.

91 In the relevant disclosure document to the stockholders of the target, the buyer will need to generally describe what financing, if any, is required to complete the transaction, and may need to publicly file related documents, such as commitment letters, so that stockholders can assess the certainty of the financing for the transaction. While it is relatively unusual in the current M&A market to have financing conditions in transactions, or a full walkaway right for the buyer, it is not unusual, in the case of financial sponsor acquirers, for the transaction agreement to have an express limitation on damages that can

be claimed if the buyer fails to obtain financing, other than due to a breach by buyer. These so-called **reverse break fees** appear frequently in public company deals.

92 As noted above, the U.S. M&A market is open to all forms of consideration and forms other than cash are not uncommon. In 2015, deals with some or all stock consideration represented 48% of total U.S. M&A transactions. The percentage of stock consideration from year to year tends to vary with the relative performance of the equity markets (i.e., whether the buyer's stock currency is cheap or dear, in the buyer's view), as well as the availability and cost of cash borrowing.

93 In the case of **non-cash consideration**, it will likely be necessary for the buyer to register such offering of equity or debt securities with the SEC, and to list such instrument on a national securities exchange, such as the NYSE or NASDAQ.[86] This may have timing and disclosure implications for buyers not currently SEC registrants, who may be required either to become a domestic registrant or to register as a foreign private issuer.

94 Although not as limiting, the U.S. doctrine of **fraudulent conveyance** can play a similar role to the financial assistance rules of Germany and other European jurisdictions, especially in the context of distressed company M&A. If the target becomes liable for acquisition debt in a way that prejudices the target's pre-existing creditors, the fraudulent conveyance doctrine may allow a prejudiced creditor to require certain assets to be returned to the bankrupt company for the creditor's benefit. However, defenses such as demonstrating a lack of "badges of constructive fraud" (i.e., if the target remains solvent after the acquisition) have prevented fraudulent conveyance laws from becoming a major transactional risk.

3. Closing Conditions

95 Transactions in the U.S. market may be conditioned on any terms agreed between the buyer and the target. In the case of a hostile tender offer, the buyer likewise can attach any conditions it deems appropriate. Conditions can be based on the discretion or judgment of the buyer, or can be "objective" and factual in nature.

96 The extent and nature of conditions are, of course, key terms of any bid to acquire a public company, and these conditions need to be fully and clearly disclosed to the target's stockholders so that they may assess the likelihood of completion.

97 Typical conditions in an agreed merger or recommended tender offer include: receipt of the necessary stockholder vote, or in the case of a tender offer, minimum tender; competition approvals; no material adverse change in the business or financial condition of the target (and of the buyer where a material amount of equity is being issued); no legal impediment or prohibition on closing; material accuracy of representations and warranties contained in the acquisition agreement, and a "bring-down" of those representations to closing; material compliance with interim undertakings; and, in the case of tax-free transactions, receipt of the appropriate tax opinion from counsel.

98 Where material third-party consents are required for the buyer to realize the value it anticipates from the transaction, receipt of such consents, from a joint venture partner or key supplier or customer, may also be included. Parties may also agree that, in the event more than a specified percentage of stockholders elect appraisal rights, the buyer is not required to close.

99 Of these, the only required condition relates to stockholder approval in the case of a merger. It is possible to complete a tender offer for less than a majority of the company's

[86] Although there are no restrictions on the amount of its own stock that a corporation is permitted to hold in treasury under Delaware law (in contrast to German law), a company will typically issue new stock to the target's stockholders, as permitted under its certificate of incorporation, rather than use treasury stock in a stock-for-stock merger.

shares, but it is not possible to complete a merger unless the requisite stockholder vote is obtained.

While the "no material adverse change" closing condition is nearly universal in U.S. public company M&A, it should also be noted that courts have refused to recognize such claims by buyers, even in circumstances where the business at issue has in fact materially declined. Delaware courts have typically described the existence of a "material adverse change" in this context as requiring proof of an unanticipated, long-term and material decline in a key element of the target's business or financial condition. *See Hexion Specialty Chems., Inc.* v. *Huntsman Corp.*, 965 A.2d 715, 738 (Del. Ch. 2008). On occasion, courts have suggested that where a buyer genuinely has a concern with a material adverse change, it would be best to specify such measures in quantitative rather than qualitative terms. 100

As tender offers and mergers are subjects of contract, a buyer may rely on any basis agreed between the parties, including the failure to satisfy a closing condition, to refuse to close. 101

4. Stakebuilding

Under the U.S. securities laws, a party in possession of material non-public information (MNPI) relating to an issuer may generally not transact in securities of that issuer until such time as either the information is no longer material, or it is publicly disclosed. While this rule is somewhat simple on its face, the interpretation of it by the courts can be complex, as prosecutors must generally show that the MNPI was obtained in violation of fiduciary duties to a company's stockholders or by fraud.[87] 102

Once the buyer has signed a non-disclosure agreement with the target, it is likely inappropriate for the buyer to engage in transactions in the target's stock. Most non-disclosure agreements would specifically prohibit this, and contain an appropriate **standstill provision.** Further, the negotiations between the buyer and target are confidential, and likely material, and the buyer is likely to receive MNPI from the target in the course of due diligence. 103

Once the transaction is announced, it is likely that the definitive agreement (or the continuing effect of the initial confidentiality agreement until closing) will prohibit the buyer from transacting in the target's shares. This is important to the target so that the stockholder vote is not tilted by the buyer's ownership of target shares. MNPI concerns for the buyer also likely exist at least until the proxy statement or tender offer documents are disseminated to stockholders. 104

Therefore, in general, the only time that a buyer may engage in stakebuilding is in the period leading up to negotiations with the target. However, under U.S. disclosure rules, ownership of more than 5% of a listed security requires that the holder file a Report on Schedule 13D with the SEC, and one required disclosure in this report is specification of the **purchaser's plans or intentions**, if any, with respect to the target, including extraordinary business combinations (→ para. 32).[88] Thus, practically speaking, a potential acquirer will not wish to cross this threshold. 105

A further limitation exists in the U.S. antitrust rules. As discussed in Section II.4 (→ paras. 15 *et seq.*), under the HSR Act and the relevant rules, the acquisition of more than $76.3 million in value of equity securities usually requires prior approval. Such approval, in turn, would require notice to the target of the intention to exceed this amount, and effectively preview to the target the buyer's intention. While such filings may be con- 106

[87] *See, e.g.*, *Dirks* v. *SEC*, 463 U.S. 646 (1983) (securities analyst not liable for insider trading since MNPI was obtained from corporate insiders who were attempting to expose a corporate scandal, not violate their fiduciary duties); *SEC* v. *Dorozhko*, 574 F.3d 42 (2d Cir. 2009) (computer hacker unaffiliated with an issuer could be guilty of insider trading because he obtained the material MNPI by "deception").

[88] Exchange Act Rule 13d-1; Item 4 of Schedule 13D.

fidential, it is possible that the buyer's interest would leak at least to competitors, who may be contacted as part of the review by the Federal Trade Commission or DOJ.

107 In summary, a buyer might consider acquiring up to the lesser of 5% of the target's equity, or $76.3 million.

108 Such a level of ownership does not cause material consequences for the transaction, and likewise may have limited benefits. Some buyers prefer to be a stockholder of the target especially in the case of a hostile bid, so that they can bring legal action in their capacity as a stockholder of the target in the event the target declines to approve their bid.

5. Hostile Bids

109 Under Delaware law, a target of a hostile bid has a wide range of tools to protect itself from a hostile offer. First, the company may already have, or can usually quickly adopt, a stockholder rights plan, which effectively makes the acquisition by a buyer of more than 15% or 20% of the target's equity prohibitively dilutive and expensive to the buyer. The rights plan can be subsequently waived or withdrawn by the board for a friendly deal. The legality of rights plans is well-settled in Delaware and other states as well.[89]

110 Second, the target may seek to sell a large amount of stock to a friendly holder. Under NYSE and other stock exchange rules, this amount may be limited to 19.9% of the target's equity or voting power, but can be a substantial protection against a hostile buyer.

111 Third, the target may seek to engage in a recapitalisation or extraordinary dividend, to provide some immediate benefit to stockholders and potentially derail any momentum the hostile buyer has.

112 Fourth, the company may consider an alternative corporate transaction, such as a stock-for-stock merger that does not involve a sale of control, or the sale of a division for cash or assets of a third party, or a spin-off or other corporate transaction. Each of these may be of material benefit to the company's stockholders and reduce the appeal of the company as a target.

113 There are other measures that may be taken as well, some of which would require stockholder approval and therefore substantial time to complete, as well as inherent risk in attempting to do so.

114 Under Delaware law, responses by a target of an unsolicited bid are measured under the *Unocal* standard, which requires that the target show it had "reasonable grounds for believing that a danger to corporate policy and effectiveness existed" and that its defensive measures were "reasonable in relation to the threat posed."[90] Before taking any of these defensive actions, it is critical for the board to consider and identify the threats to the company and its stockholders from the hostile bid, and the potential risks and benefits of the defensive measure.

6. Poison Pills

115 Although strategies implemented once an unsolicited offer has emerged can provide a board valuable time during which it can evaluate a bid and determine the correct response, advance takeover preparedness is important. A corporation that carefully employs advance takeover measures can improve its ability to deter coercive or inadequate bids or to secure a high premium in the event of a sale of control of the corporation. If gaps in a company's takeover defenses are found, the board must carefully consider whether to address them in the short term in the absence of any particular threat (and thus risk raising

[89] *See*, *e.g.*, *Airgas*, 16 A.3d 48; Business Corporation Law § 505 (New York); Virginia Stock Corporation Act § 13.1–646.

[90] 493 A.2d at 955.

the company's profile with stockholder and governance activists), or whether to be prepared as part of a contingency plan to understand any potential vulnerabilities and move to mitigate them in the face of a specific threat.

Advance preparation for defending against a takeover may also be critical to the success of a preferred transaction that the board has selected as part of the company's long-term plan. As discussed in Section III.7 (→ paras. 53 *et seq.*), a decision to enter into a business combination transaction does not necessarily obligate a board to serve merely as auctioneer. In the case of a merger or acquisition not involving a change of control, the board may retain the protection of the business judgment rule in pursuing its corporate strategy. 116

The Delaware Supreme Court's landmark *Time Warner* decision illustrates the importance for a company that desires to maximize its ability to reject a hostile takeover bid to consider periodically its long-term business and acquisition strategies. In *Time Warner*, both the Delaware Court of Chancery and the Delaware Supreme Court were influenced heavily by the documented history of Time's long-term business and acquisition strategies and Time's prior consideration and rejection of Paramount as a merger partner. The lesson here is that courts will respect and defer to a company's long-term plans and will not force a company to accept a hostile takeover bid if its board decides to reject the bid and pursue the long-term plans. 117

Rights plans, popularly known as "poison pills," are the most effective device yet developed to deter abusive takeover tactics and inadequate bids, and remain a central feature of major corporations' takeover preparedness. Rights plans do not interfere with negotiated transactions, nor do they preclude unsolicited takeovers. The evidence is clear, however, that rights plans do have the desired effect of forcing a would-be acquirer to deal with a target's board and ultimately may enable the board to extract from such acquirer a higher acquisition premium or deter offers that the board determines to be inadequate. Economic studies have concluded that, as a general matter, takeover premiums are higher for companies where rights plans are in effect than where they are not and that a rights plan or similar protection increases a target's bargaining power.[91] In addition, numerous studies have concluded that any negative impact of adoption of a rights plan on a company's stock price is not statistically significant. 118

Rights plans can take various forms, but they typically grant stockholders the **right to buy additional shares at a discount** if a single stockholder buys a specified percentage (known as the "trigger") of the company's shares. The plan is typically structured as an option or warrant attached to existing shares, and is revocable only at the discretion of the board of directors. The effect is that the purchases by other stockholders dilute the potential takeover suitor's interest, increasing the cost of the bid substantially. 119

The issuance of share purchase rights has no effect on the capital structure of the issuing company. If an acquirer takes action to trigger the rights, however, dramatic changes in the capital structure of the target company and/or the acquirer can result. 120

Rights plans have long been the subject of active discussion and debate, and they continue to contribute significantly to the structure and outcome of most major contests for 121

[91] A study jointly released in February 2004 by ISS and Georgia State University found that companies with rights plans and other takeover defenses outperformed companies without such defenses. Strong takeover defenses were found to be correlated with: (1) higher stockholder returns over three-, five- and ten-year periods, (2) stronger profitability measures (return on equity, return on assets, return on investment and net profit margin), (3) higher dividend payouts and dividend yields and (4) higher interest coverage and operating cash flow to liability ratios. Moreover, a 2009 study released by Citigroup Global Markets showed that since 2001, initial takeover premiums offered in hostile transactions average 28.5% when the target company has a rights plan, as compared with 22.8% for a target lacking a rights plan or staggered board. The Citigroup study also showed that since 2001, the average revision in offer price for companies with rights plans equaled 9.8%, whereas on average there was no net upward revision in offer prices for companies lacking a rights plan or staggered board. Accordingly, companies with a rights plan received an average final premium of 38.3%, almost twice the average final premium of 21.5% for companies without a rights plan or staggered board.

corporate control. This debate has only increased, as many companies have allowed their rights plans to expire, have affirmatively terminated their rights plans, have modified their rights plans with watered-down protections, or have agreed not to implement rights plans absent stockholder approval or ratification within some period of time, generally one year. In addition, Institutional Shareholder Services ("**ISS**") has **policy guidelines** providing that it would recommend an "against" or "withhold" vote for directors who adopt a rights plan with a "dead-hand" or "modified dead-hand" feature or a term of more than 12 months, or renew any existing rights plan (regardless of term), without stockholder approval, although a commitment to put a newly adopted rights plan to a binding stockholder vote within 12 months "may potentially offset an adverse vote recommendation." ISS also stated that it would review companies with classified boards every year and annually elected boards at least once every three years, and recommend an "against" or "withhold" vote from all nominees if the company still maintains a non-stockholder-approved rights plan. Directors who adopt a rights plan with a term of 12 months or less will be evaluated on a case-by-case basis, taking into account, among other things, how close the plan's adoption was to the date of the next stockholders meeting and the company's rationale. ISS also has a general policy of recommending votes in favor of stockholder proposals calling for companies to redeem their rights plans, submit them to stockholder votes or adopt a principle that any future rights plan would be put to a stockholder vote, with certain limited exceptions for companies with existing stockholder-approved rights plans and for companies with policies permitting only short-lived rights plans that must be put to a stockholder vote within one year.

122 According to SharkRepellent, over 3,000 companies at one point had adopted rights plans, including over 60% of the S&P 500 companies. However, recent trends in stockholder activism, as well as the ability of a board to adopt a rights plan on short notice in response to a specific threat, have led to a marked decrease in the prevalence of these plans. Today, approximately 369 U.S.-incorporated companies, including 4.0% of the S&P 500, have rights plans in effect. However, rights plans continue to be adopted by small-cap companies that feel vulnerable to opportunistic hostile bids, companies responding to unsolicited approaches, including by stockholder activists, and, as noted below, companies putting in place so-called "Section 382" rights plans. In addition, many companies have an up-to-date rights plan "on the shelf," which is ready to be quickly adopted if and when warranted.

123 Despite the decreased prevalence of long-term rights plans, rights plans—or at least a board's ability to adopt them rapidly when the need arises—remain a crucial component to an effective takeover defense and serve the best interests of stockholders. Accordingly, boards should generally endeavor to avoid situations that would lead to this ability being lost or significantly curtailed.

124 Rights plans may also be used to protect a corporation's **tax assets.** Opportunistic investors who see attractive buying opportunities may present special risks to corporations with net operating losses ("NOLs"), "built-in" losses and other valuable tax assets. Accumulations of significant positions in such a corporation's stock could result in an inadvertent "ownership change" (generally, a change in ownership by five-percent stockholders aggregating more than 50 percentage points in any three-year period) under Section 382 of the Internal Revenue Code ("IRC"). If a company experiences an ownership change, Section 382 will substantially limit the extent to which pre-change NOLs and "built-in" losses stemming from pre-change declines in value can be used to offset future taxable income. As with operating assets, boards of directors should evaluate the potential risks to these valuable tax assets and consider possible actions to protect them. In the last five years, over 100 companies with significant tax assets have adopted rights plans designed to deter a Section 382 ownership change in the last five years, according to SharkRepellent. Such rights plans typically incorporate a 4.9% threshold, deterring new stockholders from accumulating a stake of 5% or more, as well as deterring existing five-per-

cent stockholders from increasing their stake in a way that could lead to a Section 382 ownership change. ISS recognizes the unique features of such a rights plan and will consider, on a case-by-case basis (despite the low threshold of such plans), management proposals to adopt them based on certain factors—including, among others, the threshold trigger, the value of the tax assets, the term of the plan, other stockholder protection mechanisms and the company's governance structure and responsiveness to stockholders. ISS updated this policy in November 2010 to provide that it will oppose any management proposal relating to a Section 382 pill if it has a term of more than three years or the earlier exhaustion of the NOLs.

125 A rights plan has also been used as a **deal protection device** following the signing of a friendly merger agreement. Rights plans in such cases may help protect a deal against hostile overbids in the form of a tender offer and could deter activist stockholder efforts to accumulate large numbers of shares and vote down a proposed merger. In Apollo's 2014 acquisition of Chuck E. Cheese, Chuck E. Cheese adopted a poison pill that had a 10 percent trigger. If the board of Chuck E. Cheese waived, amended, or redeemed the rights plan, Apollo could terminate the deal and receive the termination fee.

126 Hedge funds and other stockholder activists have used **equity swaps** and other **derivatives** to acquire substantial economic interests in a company's shares but without the voting and investment power that may be required to have "beneficial ownership" of such shares for disclosure purposes under the federal securities laws. Rights plans can be drafted to cover equity swaps and other derivatives so as to limit the ability of hedge funds to use these devices to facilitate change-of-control efforts, although careful consideration should be given as to whether and how to draft a rights plan in this manner. One such rights plan was challenged in a Delaware court, although the case was settled with the company making clarifications to certain terms of the rights plan.[92]

7. Hedge Fund Activism

127 Recent years have seen a **resurgence** of raider-like activity by activist hedge funds, both in the U.S. and abroad, often aimed at forcing the adoption of policies with the aim of increasing short-term stock prices, such as increases in dividends or share buybacks, the sale or spin-off of one or more businesses of a company, or the sale of the entire company. Matters of business strategy, capital allocation and structure, CEO succession and other economic decisions have also become the subject of stockholder referenda and pressure. Hedge fund activists have also pushed governance changes as they court proxy advisory services and governance-oriented investors and have run (or threatened) proxy contests, usually for a short slate of directors, though increasingly for control of the board. Activists have also worked to block proposed M&A transactions, mostly on the target side but also sometimes on the acquirer side.

128 In terms of deal catalysts, stockholder activists, such as short-term hedge fund investors, and well-known corporate raiders such as Carl Icahn, have pressed many companies to seek a sale or change their corporate strategy, often with no results. One such example is Lions Gate Entertainment: Mr. Icahn agreed in 2011 to sell most of his shares after owning a significant stake of Lions Gate for almost three years and waging a series of unsuccessful tender offers, an unsuccessful proxy fight, and an unsuccessful effort to merge Lions Gate with Metro-Goldwyn-Mayer. Another is Clorox, for which an activist proposal to nominate a slate of directors was withdrawn after it was evident that activist plan to sell the company was not supported by Clorox stockholders.

129 In recent years, it has become clear that even household-name companies with best-in-class corporate governance and rising share prices are liable to find themselves targeted by shareholder activists, represented by well-regarded advisors. Shareholder acti-

[92] *La. Mun. Police Emps.' Ret. Sys.* v. *Laub*, C.A. No. 4161-CC (Del. Ch. filed Nov. 14, 2008).

vism, in its latest incarnation, is no longer a series of isolated approaches and attacks; instead, it is creating an environment of constant scrutiny and appraisal requiring ongoing monitoring, awareness and engagement by public companies. The trend of targeting (and sometimes achieving settlements at) large, multi-billion dollar, high-profile companies in diverse industries continued in 2014 and 2015, as illustrated by Carl Icahn and Greenlight Capital's "return the cash" campaigns at $700 billion Apple; Trian Partners campaign at $140 billion Pepsico regarding separating its global snacks and beverage businesses into two independent public companies (settled for one nominee); Third Point's multi-pronged platform at $118 billion Amgen; Carl Icahn's successive rounds at $70 billion eBay, even after eBay announced a spin-off of PayPal; JANA Partners at $70 billion Walgreen (settled for one JANA insider); Trian Partners at $66 billion DuPont; Elliott Management at $60 billion EMC Corporation (settled for two industry nominees); Appaloosa, Hayman, Taconic, HG Vora and Harry Wilson at $60 billion General Motors (withdrawn following GM's announcement of a robust capital allocation plan, including buybacks); and Third Point at $50 billion Dow Chemical (settled for multiple nominees).

130 In addition to becoming more ambitious, activists have become more sophisticated, hiring investment bankers and other seasoned advisers to draft sophisticated "white papers," aggressively using social media and other public relations techniques, consulting behind-the-scenes with traditional long-only investment managers and institutional stockholders, nominating director candidates with executive experience and industry expertise, invoking statutory rights to obtain a company's non-public "books and records" for use in a proxy fight, deploying precatory shareholder proposals, and being willing to exploit vulnerabilities by using special meeting rights and acting by written consent. Special economic arrangements among hedge funds have also become more common, such as Pershing Square and Sachem Head's profit-sharing arrangements involving Zoetis and the arrangements the four hedge funds targeting General Motors entered into with their consultant and director nominee Harry Wilson.

131 Activist hedge funds have had to cope with recent **changes to the legal environment** that pose new challenges to their agendas, with a significant federal court decision taking a broad view of funds' Schedule 13D disclosure obligations (→ para. 32),[93] a Delaware court decision reaffirming the principle that voting power and economic interests should be aligned and not decoupled, and proposed legislative and regulatory reforms. Many companies have also adopted changes to their governing documents, including amendments to their advance notice bylaws (and, in some cases, stockholder rights plans) that capture equity swaps and other derivatives as well as director qualification bylaws that, among other things, may require a nominee to disclose background information, including about activist stockholders supporting such nominee, and affirm that he or she has no agreement or understanding to vote a certain way and that he or she will abide by confidentiality and applicable governance policies. Nonetheless, these developments have not always dissuaded activists, who remain a significant part of the corporate landscape and can be expected to seize on what they regard as catalyst opportunities. Stockholder activism remains, and is expected to continue to be, a significant deal pressure in the U.S. market.

132 In this environment of hedge fund activism, including activism against some of the largest and most well-known U.S. companies, **advance takeover preparedness** is critical to improve a company's ability to deter coercive or inadequate bids, secure a high premium in the event of a sale of control of the corporation and otherwise ensure that the company is adequately protected against novel takeover tactics. Advanced preparation for defending against a takeover also may be critical to the success of a preferred transaction that a company has determined to be part of its long-term plan. Companies that

[93] *See CSX Corp.* v. *Children's Inv. Fund Mgmt. (UK) LLP*, 562 F. Supp. 2d 511 (S.D.N.Y.), *aff'd*, 292 F. App'x 133 (2d Cir. 2008).

can build and maintain constructive engagement with stockholders, including stockholder activists, are better able to diffuse potentially confrontational situations before they become public, bloom into a full-fledged fight or result in the company being put "in play."

8. Auctions and Market Checks

Although, as discussed above in Section III.7 (→ paras. 53 *et seq.*), there is no single blueprint that directors must follow when selling a public company (even if the *Revlon* standard of review applies), auctions and market checks are commonly used methods for directors to fulfill their duties with respect to a merger transaction. 133

a) Formal Auction

In a "formal" auction (sometimes referred to as a "closed auction"), prospective acquirers are asked to make a bid for a company by a fixed deadline, in one or several "rounds" of bidding. A company, usually with the assistance of an investment banker, may prepare a **descriptive memorandum**, known sometimes as a "confidential information memorandum" or an "offering memorandum," that is circulated to prospective bidders. Prior to the bidding, a company will typically send a **draft contract** and related documentation to multiple parties. Interested bidders are allowed to engage in **due diligence** and then submit their bids, together with any comments on the draft contract. A formal auction often has more than one round and may involve simultaneous negotiations with more than one bidder. 134

A significant advantage of a formal auction is that it can be effective even if there is only one bidder. Absent leaks, a bidder has no way to know whether there are other bidders, and can be expected to put forward its best bid. In addition, the seller in a formal auction can negotiate with bidders to try to elicit higher bids. It is difficult to conduct a formal auction without rumors of a sale leaking into the marketplace. As a result, many public companies conduct a formal auction only after they have announced an intention to seek a sale of the company. Other companies engage in a "mini-auction" where, only the most likely bidders are invited to participate. One difficulty in any auction process is that the true "value" of a bid, which must take into account not only the price to be paid but also the likelihood and timing of consummation and the related financing and regulatory approval risks, may be difficult to discern with certainty. Of course, the sale process to be employed depends on the dynamics of the particular situation, and should be developed in close consultation with financial and legal advisors. 135

b) Market Check

A second technique for selling a public company is a "market check." There are essentially two types of market checks. The first is a **pre-signing market check** where, prior to signing an agreement, a company, usually through its financial advisors, attempts to identify interested acquirers and the best price without initiating a formal auction. A pre-signing market check may occur even if not initiated by the company, for example when publicity has indicated that the company is seeking an acquirer or is the subject of an acquisition proposal (i.e., is "in play"). The second type of market check is a **post-signing market check.** Here, a transaction is privately agreed to, with provisions in the agreement providing a fair opportunity for other bidders to make competing offers. Post-signing market checks may either be passive—the so-called "window shop" where new bidders must take the first step of declaring their interests—or active, *i.e.*, where the seller actively seeks out new bidders (a "go-shop" provision). 136

An advantage of a post-signing market check is that it ensures that the seller may secure the offer put forth by the first bidder while leaving the seller open to consider higher 137

offers. Acquirers, of course, will typically seek to limit the market check and will negotiate for so-called "**no-shop**" covenants restricting the seller's ability to solicit or discuss alternative transactions (→ para. 80), and termination or "break-up" fees in the event that the initial transaction is not consummated due to the emergence of another bidder (→ para. 79). For a post-signing market check to be effective, bidders must be aware of the opportunity to bid, have sufficient information and time to make a bid, and not be deterred by unreasonable break-up fees or deal protections given to the first bidder. Management buyouts have frequently made use of a "**go-shop**" provision to encourage a robust post-signing market check, and the use of go-shops has increased in recent years in financial sponsor transactions. These provisions allow the target to actively solicit competing offers for a limited time period (typically 30 to 60 days) after signing an acquisition agreement—permitting the target to, in the words of then-Vice Chancellor Strine, "shop like Paris Hilton" during the go-shop period—and may provide for a lower break-up fee if the agreement is terminated to accept a superior proposal received during the go-shop period. For example, the agreed-upon break-up fee in the February 2013 announced management buyout of Dell Inc. dropped 60% during the 45-day go-shop period. The proposed acquisition of Maytag by Ripplewood Holdings included such a provision. Maytag approached some 36 potential buyers during the go-shop period and obtained a higher bid (from a consortium led by Haier Ltd.), which itself was ultimately topped by an unsolicited bid from Whirlpool Corporation. Other management buyouts, including HCA, Outback Steakhouse, West Corporation, Aleris International, Kerzner International, Duff & Phelps Corporation and the Dell management buyout have made use of go-shop provisions. Go-shops have been passed upon by the Delaware courts, which have generally found them reasonable, but not required, approaches to satisfying *Revlon* duties. To date, however, go-shops rarely have been used in strategic deals, although some strategic deals have coupled a no-shop with a lower break fee for a specified period of time.

9. Private Auctions

138 Although the board of a privately held company owes fiduciary duties to its stockholders to the same extent as the board of a public company, the federal rules and requirements governing public M&A deals often do not apply to private M&A deals, and buyers and sellers have **greater freedom in negotiating transactions.** This is due to the fact that the rules governing public M&A deals are designed to protect stockholders who are generally far removed from the management of the companies in which they own stock. In contrast, private companies generally have few stockholders who can look after their own interests without the same protection afforded to stockholders of public companies.

139 For example, public companies are required by the SEC disclosure rules to provide information to stockholders about the proposed transaction through either a proxy statement on Schedule 14 A or an information statement on Schedule 14C. In private deals and auctions, on the other hand, buyers and sellers are generally shielded from these disclosure obligations. Furthermore, buyers and sellers in private deals and auctions are not obligated to announce the terms of their deals or the deals altogether, nor are they subject to a timeline imposed by federal securities laws.

140 Because an auction involves the sale of a company through which the seller solicits bids from potential buyers, the auction process produces a **competitive environment** in which potential buyers must submit bids. As a result, the seller controls the process and the timing of the transaction. The seller can thus maximize its bargaining leverage by developing a bid submission schedule, controlling the timing and scope of access to due diligence materials and providing an initial draft of the acquisition agreement for each bidder to review and revise.

The **auction process** usually commences with the seller identifying potential bidders, 141
and each bidder receives a summary describing the target company or the assets to be sold. This summary is most likely accompanied by a non-disclosure or confidentiality agreement, which may prohibit bidders from engaging in discussions with each other and/or with the seller's customers and suppliers. After a confidentiality agreement is executed, a bidder will likely receive three documents: 1) a confidential information memorandum, providing detailed information about the seller and/or the seller's assets to be sold, 2) a bid process letter, outlining details of the auction process and 3) an auction draft of the acquisition agreement. In response to a bidder's diligence questions, the seller typically will post initial disclosure documents and documents responding to such diligence requests in an electronic data room.

The **acquisition agreement** distributed by the seller is drafted by the seller and con- 142
sequently, reflects the seller's positions on key deal terms. Each bidder must mark-up the acquisition agreement or provide an issues list, depending on the instructions laid out in the bid process letter. The degrees to which the bidder marks up the acquisition agreement or is aggressive during negotiations are tactical decisions. Once the acquisition agreement reflects the bidder's markup (or an issues list is compiled) and initial due diligence has been conducted, the bidder will submit a bid package, including a bid letter and mark-up of the acquisition agreement, along with its bid according to the guidelines set out in the bid process letter. The bid letter is not binding but is akin to a letter of intent and usually summarizes the bidder's proposed purchase price and consideration, financing and closing conditions.

The auction process can include multiple rounds of bidding. Once the seller selects a 143
bidder and signs a definitive acquisition agreement, the auction proceeds similar to a typical single buyer acquisition transaction.

Because private companies do not have the same obligations to its stockholders, as re- 144
quired by law, largely through case law, the rules summarized in Sections III.6 and III.7 of this report (→ paras. 45 and 53 *et seq.*) generally do not apply. In this regard, U.S. private companies have greater freedom in conducting deals with one another and in selling themselves through private auctions.

10. Tax Issues

The tax considerations involved in M&A deals vary significantly depending on the form 145
of transaction and the types of entities involved.

In an **asset purchase**, the consideration (as determined for U.S. federal income tax 146
purposes) is generally allocated among the seller's assets in accordance with their fair market values at the time of sale. The seller recognizes gain based on the difference between the adjusted basis of the transferred property and the amount realized, while the buyer will receive a stepped-up basis (equal to fair market value) in the acquired assets, and can thus take advantage of additional depreciation deductions, thereby reducing taxes going forward. However, where the seller is a corporation, an asset purchase usually results in double taxation, as the seller is taxed on the gain recognized on the sale of assets and the stockholders of the seller are taxed on after-tax proceeds distributed by the seller.

For this reason, acquisition of a freestanding corporation will frequently be structured 147
as a **stock purchase.** The selling stockholders will recognize gain equal to the difference between their basis in the stock and the sale price, and the gain is taxed as a long-term or short-term capital gain depending on individual stockholders' holding periods. The acquired corporation will retain its tax attributes and tax history (including the historic tax basis in its assets, which will not be stepped up as a result of the acquisition). The acquired corporation will also retain any net operating losses, however, the use of such losses to offset taxable income in future periods may be limited as a result of the acquisition.

148 In certain circumstances, acquisition transactions can be structured on a **tax-deferred basis** with respect to any stock of the acquirer received by the sellers as consideration. Generally, such treatment requires that the aggregate consideration consist of a minimum proportion of stock of the acquirer and that other requirements are satisfied. Moreover, whether such treatment is available will often depend on the form of the transaction.

11. Environmental Issues

149 In an acquisition, the buyer by default assumes the environmental legacy costs of the seller, including potential liability for contamination of land or facilities, non-compliance with laws and regulations, and future environmental compliance costs. The Comprehensive Environmental Response, Compensation and Liability Act of 1980 (**CERCLA**) gives rise to the greatest environmental concern, because it imposes liability for cleanup costs and other response actions on a wider range of actors than other environmental regulations. Under certain circumstances, courts have also imputed violations of CERCLA to an entity's parent company.

150 In an asset purchase, CERCLA may provide certain **liability protections** (known as Landowner Liability Protections, or LLPs) if the acquiring company qualifies as a bona fide prospective purchaser, contiguous property owner, or "innocent" landowner. In stock transactions, less protection is available, though the Environmental Protection Agency (EPA) has some policies that limit the acquirer's liability for pre-transaction non-compliance if specific steps are taken within a short period following the transaction.

151 Although it is customary to ask for **environmental warranties and indemnities** from the seller, the value of those warranties and indemnities is, of course, only as strong as the financial position of the seller. Moreover, these warranties and indemnities may contain restrictive qualifications (i.e., only cover those matters that the seller knew about). Generally, courts will examine whether the specific negotiated language of warranties or indemnities encompasses the specific environmental costs, including cleanup costs under CERCLA.