The M&A LAWYER

January 2015 ■ Volume 19 ■ Issue 1

The Allergan Aftermath: Lessons Learned and New Ideas For Bidders, Activists and Targets

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Valeant's failed acquisition bid for Allergan has underscored longstanding M&A principles—even as the involvement of shareholder activists in the M&A arena has introduced new technologies, opportunities, and challenges. In the aftermath of the Allergan saga, it is clear that Pershing Square was richly rewarded for having crafted a novel bidder-activist collaboration model. The outcome for Valeant, however, notwithstanding the creative collaboration, is that its bid ultimately failed, and in the most conventional of ways (losing to a superior offer from an alternative bidder).

The Allergan outcome highlights the benefits of the Valeant-Pershing Square collaboration model to the activist partner, while underscoring the disadvantages of the model for bidders. We expect that the Valeant-Pershing Square model will be followed only under limited circumstances, but that bidder-activist collaborations will continue and evolve, and that other new technologies for bidders, activists, and target companies will emerge.

In this article, we discuss: (i) the broad lessons learned from the Allergan situation; (ii) the circumstances under which we expect that the Valeant-Pershing Square model may be followed by others; (iii) restructuring of the model that may be considered by future bidders and activists; (iv) specific

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THOMSON REUTERS

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The M&A Lawyer
West LegalEdcenter
610 Opperman Drive
Eagan, MN 55123

One Year Subscription ■ 10 Issues ■ $831.00
(ISSN#: 1093-3255)

From the EDITOR

Recovering From a Heavy Holiday Season

As expected, 2014 was the best year for M&A since the financial crisis of 2007, with $3.34 trillion in total global volume posted. Mega-deals were naturally a huge part of that picture, as 96 deals of more than $5 billion were completed, representing about 37% of overall volume. Top titans included Comcast/Time Warner ($45 billion), DirecTV/AT&T ($67.2 billion) and Actavis/Allergan ($66.4 billion).

Given this onslaught of deals, it's not surprising that the amount of withdrawn transactions also spiked. About $662 billion in deals were pulled, a leap from the $285 billion recorded in 2013. This was a hard hit for investors betting on the likelihood of deals succeeding. According to research firm HFR, the average event-driven hedge fund gained only 1.5% in 2014 compared to a 14% return for those investing in the S&P 500 index. Among the disappointments for merger-arbitrage funds were AbbVie's scrapped $54 billion bid to buy Shire (a casualty of the U.S. government's crackdown on "inversion" deals late in 2014), Pfizer's unsuccessful attempt to acquire AstraZeneca, 21st Century Fox's scrapped $80 billion bid for Time Warner and the end of the proposed Sprint/T-Mobile deal.

For some market players, the AbbVie situation was a portent of more government interference in M&A in the new year. Natalie Blyth, HSBC's co-head of Global Banking, UK, told the *Financial Times* that "government and regulatory hurdles are increasingly critical factors...from the policies of the US when it comes to tax inversions and the European Union on approvals for big deals."

Still there are many portents for another strong year in 2015. Global private equity-backed deals are still in an early stage of recovery, their percentage of new issuance still well below early 2000s levels. And there looks to be a lot of spin-off and divestiture activity in the works, with Hewlett-Packard, eBay and Eon planning to split up businesses and BHP Billiton and Vale announcing asset spin-offs.

Our New Year's issue is chock full of recent court decisions from Delaware and New York. The implications of *In Re Zhongpin Inc. Stockholders Litigation*, *Ambac Assurance Corp. v. Countrywide Home Loans, Inc.* and *Cigna Health and Life Insurance Company v. Audax Health Solutions*, to name three late 2014 decisions of great interest to M&A lawyers, are examined in full by our authors. And Fried Frank's Philip Richter, John Sorkin, David Shine, Steven Epstein and Gail Weinstein dig extensively into Valeant's failed acquisition bid for Allergan. As the authors write, "we expect that the Valeant-Pershing Square model will be followed only under limited circumstances, but that bidder-activist collaborations will continue and evolve, and that other new technologies for bidders, activists, and target companies will emerge."

The M&A Lawyer looks forward to going through 2015 with you: we hope all readers had a great New Year.

CHRIS O'LEARY
MANAGING EDITOR

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lessons learned for bidders and target companies (the activist appears to need no lesson!); and (v) some new ideas to be considered by bidders, activists, and target companies in their respective quests to deliver shareholder value.

In our view, the broad lessons learned from the Allergan situation are:

- Activists, bidders, and target companies will continue to develop creative M&A technologies as part of their respective efforts to deliver value to shareholders.

- Bidder-activist collaborations, as they continue to evolve, are likely to create profit opportunities for activists and bidders and also to lead to shareholder value.

- Target companies, focused on shareholder value and not on entrenchment, are likely to develop ways to establish a timeframe needed to create shareholder value and mechanisms to ensure that all shareholders participate in the value creation.

- The best result for shareholders—and optimal functioning of our capital market system—requires both that activists have avenues to advance ideas that will deliver value for all stockholders (while protecting shareholders against those that deliver value for the activist at the expense of the other shareholders) and that companies have a reasonable period of time to respond to unsolicited bids (while protecting shareholders against entrenchment of boards and management teams).

Circumstances Under Which the Valeant-Pershing Square Collaboration Model May Be Followed

Pershing Square's inspired crafting of the collaboration model resulted in a gain to Pershing Square of well over $2 billion on its toehold stake in Allergan. While some saw a meaningful risk in the substantial investment Pershing Square made in Allergan without knowing whether Valeant's (or any other) bid for Allergan would succeed, our view from the outset has been that there was almost a certainty that either the Valeant bid would succeed or that Allergan would deliver equivalent or greater value to the shareholders in some other way. There is every reason to believe that activists would want to follow what appears to be a high reward-low risk model.

There are significant disadvantages of the model to bidders, however. These include: the high economic cost to the bidder (most importantly, the bidder's forgoing the opportunity to capture all or most of the gain on the toehold stake for itself); the inherent distraction to the deal from the activist's involvement (reducing the critical focus on and "selling" of the deal and the bidder's equity); and the conflicts of interest between the activist and the bidder (primarily that the activist is advantaged by an alternative superior transaction that thwarts its bidder-partner)—all of which occurred in the Allergan situation and played a part in Valeant's ultimate failure. To these issues, serious legal uncertainty for the model was added when a California federal district court judge recently found that the model raised "serious questions" about whether the activist's buying of the toehold stake constituted insider trading, as it was based on the activist's knowledge of the bidder's nonpublic intention to make a bid for the company and the activist, in the court's view, probably was not a "true" co-bidder.

While the insider trading issues may be resolved by future judicial or SEC action, and while we believe in any event that they are not insurmountable (as discussed below), in our view, it is unlikely that the model will be followed by a bidder who has the financial ability and overall credibility to proceed on its own—unless the model is restructured and the bidder is more economically advantaged. The model may, however, on balance be beneficial to a bidder that has cash constraints and weak credit, or who has other reasons to seek assistance with the funding of the pre-announcement toehold stake in a target company (and/or an upfront commitment for assistance with funding the acquisition of the company). Thus, we expect that the model, as currently structured, may be followed in the following circumstances:

The bidder requires assistance with funding the toehold stake (and/or the acquisition of the company). While the primary benefit of a toehold stake in a target company is the economic benefit of the gain on the investment once the announcement of the bid is made—and while that benefit is largely transferred from the bidder to the activist in the Valeant-Pershing Square model—acquisition of the toehold stake should increase the bidder's leverage with the target board and shareholders. Thus, the advantages of the model to a bidder may outweigh the disadvantages if the bidder cannot fund the acquisition of the toehold stake (and/or the acquisition of the target company) on better economic terms. For most bidders, we would expect that the significant costs of the model would make more conventional financing a preferred choice.

The market for the target's stock and/or options is highly liquid. The significant and aggressive pre-announcement purchase of stock and/or options by the activist (which is the linchpin of the model) is practical only if the market for the target's stock and/or options is highly liquid, so that the buying does not dramatically move the market price and give notice of a bidder/activist's interest.

There is reasonable certainty that a target shareholders meeting, at which the toehold shares can be voted in support of the bid, will be held without significant delay. Assuming that neither the activist nor any of its portfolio companies is a competitor of the target company, the activist generally can obtain Hart-Scott-Rodino clearance (which is needed before the shares can be voted) in a shorter timeframe than the bidder can, assuming the bidder is a competitor of the target. Thus, the purchase of the toehold stake by the activist instead of the bidder can provide the bidder with a significant advantage by making the toehold shares available quickly to be voted in support of the bid. The advantage of early Hart-Scott-Rodino clearance for the voting of the shares would not be meaningful, however, if it is not reasonably certain that a shareholder meeting at which the bidder could obtain control of a majority of the board would be held promptly. Thus, the timing advantage of the model is largely eliminated if either a) the target has a classified board, or b) the bid cannot be made shortly before the target's annual meeting (although the target will have some ability to delay that meeting) and the target's charter and bylaws do not provide reasonable certainty that the bidder can call a special meeting that would have to be held promptly.

The potential for insider trading liability for the activist partner is eliminated or significantly reduced. Neither activists nor bidders are likely to follow the model unless greater clarity on the insider trading issues is provided by the courts or the SEC, or the model is restructured (as discussed below) to eliminate or significantly reduce the potential liability (and distraction for the bid).

How the Bidder-Activist Collaboration Model Could Be Restructured

No tender or exchange offer. Absent further clarity on the insider trading issues by judicial or SEC action, the risk of insider trading liability could be substantially reduced by restructuring the bid as an acquisition offer and proxy contest only—with the record supporting that no tender or exchange offer was commenced or contemplated in the early stages. Rule 14e-3 provides for insider trading liability for a person who purchases shares of a target company at a time he knows that another person has plans to seek to acquire the company and has taken "a substantial step toward" commencing a tender or exchange offer. While a tender or exchange offer can create added momentum for a bid and pressure on a target, a "fully" priced offer and proxy contest by a credible buyer—without a tender or exchange offer initially—can be almost as compelling, since a bidder generally cannot buy shares in a tender or exchange offer in any event until it wins a proxy contest, replaces the board, and redeems the target's shareholder rights plan.

Making the activist a "true" co-bidder. A person making a bid (alone or as a co-bidder) does not have liability for trading on its own information that it intends to make a bid. While Pershing Square and Valeant labeled Pershing Square as a "co-bidder," the California court indicated that the underlying collaboration arrangements had no indicia of Pershing Square's being a true co-bidder. We expect that it would be possible for a viable co-bidder model to be developed.

More beneficial economic terms for the bidder. Pershing Square appears to have benefitted from a strong "first-mover" advantage. As with any new technology, the cost to the user (and gain to the provider) can be expected to decrease once the technology is known and begins to be used more widely. We expect that the model will develop to reduce the outsized-return-with-limited-risk of the activist partner. The most critical change would be a different split of the profits from the toehold stake. In the Allergan situation, the Pershing Square-Valeant split was 85%-15%, costing Valeant $7-$8 per share that could have been used to increase the price of its bid, and, in the context of its bid not having succeeded, resulting in a $300 million profit for Valeant as compared to well over $2 billion for Pershing Square. A possible alternative would be a tiered profit split where, for example, the bidder shares a lower percentage of the gains up to a certain amount, and then a higher percentage of gains above that amount. A bidder might also try to negotiate for more financing, a greater commitment with respect to the stock portion of the consideration to be received by the activist in the offer if the bidder succeeds, a longer commitment with respect to retention of stock received in the offer, a post-acquisition standstill agreement, and so on, depending on the bidder's greatest areas of need or concern. Of course, each situation will require a review by the bidder and the activist of their respective options, risks, and potential rewards—including whether the collaboration terms could both meet the risk-reward ratio required by the activist and induce the bidder to enter into the arrangement.

"Minimum" and/or "preferred" return for the activist. Other alternatives would be a "minimum" or "preferred" return to the activist partner. For a minimum return, the activist would receive all the profits up to a specified amount, with the remaining profits being split with the bidder. For a preferred return, the activist would receive a stated percentage return, with the remaining profits allocated to the bidder.

Lessons Learned For Bidders

Need for a singular and continuous focus on "selling" the deal. To the extent possible, the focus on the activist and the collaboration should be limited, as it distracts from the fundamentals of the transaction, the bidder, and the value of the bidder's equity.

Consider a contingent value right. A critical aspect of success for a bid that includes the bidder's equity as part of the deal consideration is the ability to convince the target board and shareholders of the value of that equity. Under appropriate circumstances, a bidder should evaluate the utility and risks of a contingent value right or other value assurance mechanism to backstop the equity portion of the offer price.

Benefits of the process being concluded as quickly as possible. A bidder is advantaged when the target has less time to develop strategic alternatives to a bid.

- ***Commence and effect the proxy contest as early as possible in the process.*** In the Allergan situation, the activist's early effort at an "informal" shareholder meeting to pressure the target board was unproductive, wasted time, and created a distracting focus on the collaboration. Moreover, it is unclear why Valeant waited for months after that to commence the proxy contest.

- ***Consider whether to offer the best and final offer price early in the process.*** Offering the best price early in the process may a) deter white knights from emerging and b) may induce the target company to agree to the transaction before white knight possibilities have emerged.

Negotiate a better deal with the activist. As discussed above, it is possible that bidders may now be able to negotiate better terms with activists.

Consider collaboration after the bid is made, rather than before.

- ***Benefits to the bidder.*** A well-financed and credible bidder who does not need an activist to fund or execute the pre-announcement toehold stake but believes that collaboration with an activist would still be beneficial, would probably be advantaged by entering into a collaboration arrangement after making a bid rather than before. At that time, the bidder will have gained the full post-announcement profit on the toehold stake for its own account, and will have more information about the Hart-Scott-Rodino timing, the target's reaction, the market reaction, the emergence (or not) of competing bidders, and so on, before deciding what arrangement, if any, would be most appropriate. In addition, the bidder will have avoided at the critical early stage the inherent distraction from the financial merits of the bid that the collaboration causes when in place at the outset, including, as in the Allergan situation, the attention the arrangement generated relating to the perception of unfairness in dealing with shareholders by selectively providing the activist partner with an opportunity to trade based on non-public information.

- ***Benefits to the activist.*** Similarly, under some circumstances, an activist may be advantaged by collaborating only after it has bought shares in a potential target company. While adding some degree of risk for the activist (that a bid partner may not be found or that the partner that emerges will not be the optimal bidder), a credible and well-financed activist can on its own put a company into play by buying shares and filing a 13D, sending a public letter, or making a proposal. With this approach, the activist could obtain the full profit on the initial equity stake and would eliminate the insider trading risk.

Lessons Learned For Target Companies

Need to monitor trading in the company's stock and options in order to have as much notice as possible of a possible threat.

Need to define a compelling "message" and to deliver it consistently. Allergan was advantaged in the process by a) quickly developing a coherent and compelling message that cast serious doubt on Valeant's business and growth plans and b) delivering the message consistently and effectively throughout the process.

Target shareholder patience, providing the company with reasonable time to respond to a bid, can lead to the best result for the shareholders. In the face of an unsolicited bid, target companies must have the objective (and must persuade shareholders that it is their objective) to deliver value for shareholders and not to entrench the board or management. In the Allergan situation, eight months after the unsolicited bid was received, Allergan announced a white knight transaction that nominally provided shareholders with $66 billion rather than Valeant's $54 billion final offer price.

Dismantling of defensive protections increases a company's vulnerability to unsolicited bids. In response to shareholder pressure for "good governance," many companies have voluntarily declassified boards, shortened or simplified advance notice provisions, and otherwise dismantled defensive protections. In the Allergan situation, the earlier declassification of the board made the company significantly more vulnerable to a third party unsolicited bid. Allergan's bylaw provisions—which gave the board broad authority with respect to calling a shareholder meeting and imposed requirements with respect to advance notice of director nominations—provided the company with time to consider and respond to the bid, including finding and considering alternatives. Notably, if Allergan had not had its unusual bylaws that ultimately led to a shareholder meeting date that was nine months after the bid was launched, Allergan could have had as little as 30 days (the period of the advance notice bylaw) to respond to the bid. The longer timeframe did not lead to entrenchment but to a much better result for the shareholders. A shorter timeframe likely would have made it less likely that the company could have found and negotiated a superior offer at a significantly higher price or even have caused Valeant to significantly raise its offer price, thus enriching the bidder at the expense of the shareholders.

New Ideas For Activists and Bidders To Consider

Acquiring more than a 10% toehold, in appropriate circumstances. If there is sufficient liquidity in the market for a target's stock and/or options to avoid a dramatic rise in the price or notice of the buying (and if there is no required regulatory approval, or a target company shareholder rights plan, that would be triggered), an activist or bidder might want to consider buying through the Section 16(b) 10% limit—thereby further increasing the pressure on the target, having additional capacity to increase the bid price and, if not successful, increasing the profit from the toehold stake. In most cases there should be no issue of 16(b) recapture, given that the process generally will continue for more than six months and/or the shares will be converted in a merger.

Marketing collaboration plans to bidders. To the extent activists believe that collaboration will generate better returns or less risk for them than go-it-alone investments that may put a company in play, and to the extent that they wish to profit as Pershing Square has but are willing to realize lower profit, activists may market their availability for similar collaborations on terms less favorable to the activist. Activists may actively approach potential bidders having the appropriate characteristics on a general basis or with a particular target in mind. Even under these circumstances, potential bidders may prefer to go it alone with a bid or to wait for an activist to put a company into play and then be available as a white knight (where the likelihood of successfully acquiring a company is heightened).

Joining with other activists to spread risk. Smaller or less established activist investors may become more involved in bidder activist collaborations by joining together in order to diversify their bidder-collaboration activities and otherwise spread their risk in this area. These arrangements would be complicated, raising legal and business issues about how decisions will be made; whether the activists will be a group for purposes of Section 13(d) or Hart-Scott-Rodino; and the potential for the triggering of shareholder rights plans (especially those that contemplate protection against "wolf packs").

New Ideas For Target Companies to Consider

In the context of increasing involvement of activists in the M&A arena, a convergence of the focus of activists and companies on delivering shareholder value, a general dismantling of traditional corporate defenses (such as classified boards), and new M&A technologies being developed by activists and bidders, target companies also may seek to develop new ways of responding to unsolicited bids.

Shareholder-friendly, tailored rights plans. Currently, when a company receives, or perceives that there is an actual threat of, an unsolicited bid, the typical response is a) to adopt a shareholder rights plan to prevent bidders from acquiring more than a threshold ownership interest and b) unless there is a classified board, to seek ways to obtain time to consider and respond to the threat. Once adopted, a shareholder rights plan in effect prevents further purchases of target stock by a bidder (through the threat of severe economic dilution of the bidder's shares once the rights are triggered), but can be redeemed by the bidder if the bidder obtains control of a majority of the board. Target companies may wish to consider alternative shareholder rights plans that would be more shareholder-friendly than current rights plans, while being more specifically tailored to address target company concerns.

"Reasonable time response plan". For a company that does not have a classified board, this plan would facilitate both a) stockholder decision-making, by putting acquisition bids and change-of-control proxy contests on a more predictable timetable, and b) value creation, by providing a company with a reasonable period of time for its response to an unsolicited bid. The plan would require that a target company that has received an unsolicited "Qualified Proposal" would have to take action to schedule and hold a meeting of shareholders to vote on the proposal within [12] months. (A "Qualified Proposal" would be any bona fide acquisition proposal for all shares that the bidder's bankers confirm is financeable or any bona fide proxy contest seeking a change in [25]% or more of the board.) The plan would be redeemable at the typical nominal redemption price, except that it could be redeemed by "Non-Plan Directors" only at a redemption price of [200]% of the unaffected market price. ("Non-Plan Directors" would be directors proposed by a person making an unsolicited acquisition proposal or conducting a proxy contest for more than [25]% of the board unless elected at the meeting contemplated by the rights plan.) Possible modifications to these terms that could be considered would include: reducing the 12-month time period; limiting a proxy contest Qualified Proposal to only those proxy contests that are made in connection with an acquisition bid; and/or making the plan non-redeemable by Non-Plan Directors.

It should be noted that the legal validity of a rights plan of this type has not been tested. In addition, institutional shareholders and proxy advisory firms have not generally been supportive of shareholder rights plans and other actions that may deter activism and acquisitions. However, in the context of the current environment of an overall decrease in defensive protections, shareholders should favor this type of plan, which is more shareholder-friendly and tailored—particularly if experience proves that it does not deter bids or permit entrenchment and that it creates additional value for shareholders.

"13D disclosure plan". This plan would be designed to recapture for target company shareholders the profits made by a purchaser of target shares after crossing the 5% ownership threshold without public disclosure of the ownership. Currently, the SEC's Schedule 13D rules permit a person who has acquired 5% of a company's shares to wait for up to 10 days before filing a 13D that discloses the ownership, during which time additional shares can be purchased. Pershing Square, for example, disclosed in its first 13D filing on Allergan that it had purchased a 5% stake over several months and then had almost doubled that, to a 9.7% stake, during the 10-day 13D filing window period. Thus, the Allergan shareholders and option holders who sold to Pershing Square during that 10-day period did not know that they were selling to someone who had already bought 5% and who was buying their equity to assist Valeant in acquiring the company. A window-closing rights plan—which would cause severe dilution of the shares of a bidder who did not file a 13D immediately after crossing the 5% ownership threshold—has been proposed in the past but has never been adopted. A target company may wish to consider the 13D disclosure rights plan—which would only seek to recapture for the target shareholders the purchaser's profit on the shares purchased after the 5% threshold is crossed and before a 13D is filed (or, alternatively, could seek to recapture the purchaser's profit on all of the shares purchased prior to the 13D filing). (One issue that would have to be addressed is how and when the profit would be measured, and whether, for timing and implementation purposes, the recapture would have to be of a "presumed profit.") Importantly, since this type of rights plan would have to be in place before an activist started buying shares, a company should, before adopting this type of plan, consider the reaction of stockholders and proxy firms.

Other possible actions to protect shareholders. Depending on the circumstances, target companies may wish to consider other novel approaches, each of which generally would be reviewable based on whether the action taken represented a proportionate response to the threat faced by the target company. Each of the possible approaches noted below would present practical and legal issues, and the advantages and risks would have to be evaluated by a target company to determine in any given case whether any of them might be in the company's best interests under the applicable circumstances.

Possible actions could include the following: (i) if the target is of roughly equal size or bigger than the bidder and the bid is highly leveraged, the target company could acquire the bidder's shares in order to vote against the bidder's issuance of equity and/or make financing of the bid more difficult; (ii) if there are concerns about the value of the bidder's equity, the target could create a value assurance plan that would protect against underperformance of the bidder's equity (which would focus attention on concerns regarding the bidder's equity—even if the plan were redeemable, or the bidder responded by lowering its price or by conditioning its offer to purchase shares on the value assurance rights being attached); and (iii) if appraisal rights are not statutorily available (and particularly if the bid significantly undervalues the company), the target could provide a kind of "quasi-appraisal right" for an impartial arbitration to determine an appraised value (based on state law), with a claim against the company for the appraised value by any stockholder who did not vote in favor of the bidder's transaction and agreed to forgo the merger consideration it would receive in the deal in exchange for the appraisal amount.

Conclusion

In our view, the Valeant-Pershing Square saga highlighted the value that can be delivered through activist involvement in M&A, while at the same time underscoring the risks to shareholders of companies not having protections that provide a reasonable amount of time for them to respond to unsolicited bids. As we have discussed in previous memoranda, we expect that the Valeant-Pershing Square model of bidder-activist collaboration will be followed only in limited circumstances (even if there is a final judicial determination or SEC action that removes the insider trading liability issues). Nonetheless, we expect that bidder-activist collaborations, and other new M&A technologies, will continue to evolve, with the arrangements in each case depending on the circumstances of the particular bidder, activist, and target company.

New York Appeals Court Provides Guidance For Merger Parties Sharing Privileged Communications

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Merger counterparties frequently must balance their desire to share privileged materials against the risk of waiving privilege and potentially having to disclose the privileged materials to other parties. This concern can arise in contexts including the sharing of tax or intellectual property opinion letters, or regulatory or litigation risks, and can be significant in due diligence or consummation of the transaction. Advising transaction parties on these issues has been further complicated by rulings from courts in New York and Delaware providing differing standards on when counterparties can assert a common-interest privilege. Some of this uncertainty potentially has been alleviated by a recent New York appeals court ruling. On December 4, 2014, the Appellate Division of the Supreme Court of New York, First Judicial Department ("First Department"), issued *Ambac Assurance Corp. v. Countrywide Home Loans, Inc.*,[1] holding that parties to mergers or other transactions may, in some circumstances, assert privilege over communications shared among the merger counterparties, even if no litigation is pending or anticipated concerning the issue. In doing so, the First Department joined Delaware and federal courts and departed from prior decisions by some other New York courts that had limited the common-interest privilege for transactions to communications involving pending or anticipated litigation. The First Department based its ruling on the needs of parties to transactions to share common legal advice "in order to accurately navigate the complex legal and regulatory process involved in completing the transaction."

Ambac will assist transactional parties in confidentially sharing privileged communications in furtherance of a common legal interest. However, even among New York appellate courts there are divergent rulings as to whether invocation of the common-interest privilege requires litigation. In addition, although *Ambac* leaves unanswered a number of questions as to the scope of the common-interest privilege under New York law, there are several steps that transacting parties can take that might increase the likelihood that their shared privileged communications will remain protected. Because privilege determinations are often highly context-specific, we encourage transacting parties to consult with their counsel as to the applicability of the common-interest or other privilege to their circumstances.

Background

The First Department's decision arises from a lawsuit in the Commercial Division of the Supreme Court of New York, New York County, by Ambac Assurance Corporation ("Ambac"), a financial-guaranty insurer, against Countrywide Home Loans, Inc. and certain affiliates (collectively, "Countrywide") and Bank of America Corp. ("Bank of America"). In that suit, Ambac alleged that Countrywide fraudulently induced it to insure payments on residential mortgage-backed securities from 2004 through 2006. Ambac claimed that Bank of America (which merged with Countrywide in 2008) was liable for Countrywide's conduct as its successor-in-interest.

In connection with its successor liability claims, Ambac sought disclosure of several hundred documents reflecting communications between Bank of America and Countrywide and their counsel in the period from their entry into a merger agreement in January 2008 until the close of the merger in July 2008. Bank of America resisted disclosure, arguing that the documents were protected by the common-interest privilege and were shared by the parties "to ensure their accurate compliance with the law and to advance their common legal interests in resolving the many legal issues necessary for successful completion of the merger."[2] A special master subsequently ordered production of the documents and the Commercial Division Justice denied Bank of America's motion to vacate the order, reasoning that there must be "a reasonable anticipation of litigation for the common-interest doctrine to apply" and none was present here.[3] Bank of America appealed.

The First Department's Decision

The First Department unanimously reversed, holding for the first time that "pending or reasonably anticipated litigation is not a necessary element of the common-interest privilege."[4] Although recognizing that other New York courts had applied a pending or prospective litigation requirement (but New York's highest court, the Court of Appeals, had not addressed the issue), the First Department found the requirement inconsistent with the purposes of the privilege and with the weight of authority.

The Court observed that the purpose of the attorney-client privilege is "to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice," a purpose that applies equally in both litigation and non-litigation contexts.[5] "[A]dvice is often sought, and rendered, precisely to avoid litigation, or facilitate compliance with the law, or simply to guide a client's course of conduct."[6] The Court noted that the common-interest privilege derives from the attorney-client privilege and its purposes are essentially the same: to "encourage[] parties with a shared legal interest to seek legal assistance in order to meet legal requirements and to plan their conduct accordingly."[7] The Court thus concluded that it made no sense to impose a litigation requirement for the common-interest privilege when none exists for the attorney-client privilege.

In declining to impose a pending or prospective litigation requirement, the Court chose to follow the prevailing approach taken by federal courts and to depart from a line of New York decisions holding to the contrary.[8] The Court held that the New York courts that previously had addressed the issue had erroneously adopted a litigation requirement by relying on cases applying the common-interest privilege in a criminal context, where it applies to communications between co-defendants and their counsel "in furtherance of a common defense."[9] Although applicable in criminal cases, this limitation is not pertinent to situations like *Ambac*, where legal advice was sought in a transactional setting for the purpose of complying with the legal and regulatory requirements inherent in closing the merger.

Applying these principles to the discovery dispute at issue in *Ambac*, the Court held that the common-interest privilege could apply to pre-closing communications between Bank of America and Countrywide and their counsel because the parties (a) signed a merger agreement, (b) signed a confidentiality agreement governing pre-closing exchanges of information, and (c) needed shared advice of counsel "in order to accurately navigate the complex legal and regulatory process involved in completing the transaction."[10]

Implications

The First Department's decision potentially brings New York law in line with the prevailing treatment of the common-interest privilege in federal courts and in Delaware by protecting from disclosure legal advice shared among multiple parties to further a "common legal interest" unrelated to pending or anticipated litigation. The decision, however, is not of New York's highest court and is subject to appeal (although the Court of Appeals has discretion as to whether to hear an appeal). In addition, although *Ambac* is controlling in the First Department (which includes cases filed in Manhattan), it might not be controlling elsewhere, especially as the Second Department (which covers ten counties, including Kings (Brooklyn) and Queens) has held as recently as last year that the common-interest privilege requires "reasonable anticipation of litigation."[11]

The decision also leaves open a number of questions:

- *Ambac* does not directly address whether the common-interest privilege can apply to communications shared with parties other than the transaction parties and their counsel—for example, the investment bankers of the merging entities. The court does, however, state that it was "guided by Delaware's approach to the common-interest privilege."[12] Although courts in some jurisdictions have held that the presence of investment bankers breaks the privilege because they are not "'necessary' for the 'effective consultation' between client and attorney," Delaware law "sanctions the privilege's application to attorney-client communications including an investment banker, especially within the context of a pending transaction."[13]

- *Ambac* addresses the application of the common-interest privilege to the sharing of communications after execution of a merger agreement, but does not address whether the common-interest privilege could also apply prior to the execution of a merger agreement (for example, to privileged communications shared during a due diligence process). Some courts have declined to apply the common-interest privilege to communications shared in due diligence prior to entry into a merger agreement, finding that the parties' interests at that point are not sufficiently aligned.[14] Nevertheless, other courts have been willing to extend the privilege to cover communications shared with prospective buyers, particularly with respect to communications about potential post-acquisition litigation.[15]

- The decision does not address who retains control over pre-merger communications protected by the common-interest privilege after the close of the merger. The general rule is that rights to privileged communications pass to the purchaser upon the close of a merger.[16] The seller thus risks losing any control over communications subject to the common-interest privilege after the close of the merger. Delaware courts have held that parties to a merger agreement can agree to limit the purchaser's post-merger rights to certain privileged communications, and selling parties might wish to carefully delineate those rights even in the absence of specific guidance from New York courts.[17]

The First Department in *Ambac* remanded to the Commercial Division to apply its decision to the documents at issue. Questions of whether the common-interest privilege can apply, or if it applies to particular documents, are necessarily context-specific, and transaction parties should consult counsel for specific advice. Based on *Ambac* and other authorities, however, taking certain steps might be helpful in preserving the ability to assert the common-interest privilege, including:

- ***Contemporaneous documentation***. The *Ambac* Court took particular note of the fact that the parties had signed both a merger agreement and a confidentiality agreement. Contemporaneous documentation of the basis for the common-interest privilege and the parties' intent to preserve it can often be more persuasive to courts than explanations provided after the privileged communications have been shared.

- ***Confidentiality***. Communications are generally not privileged unless kept confidential between the attorney and client, and *Ambac* referenced the parties' confidentiality agreement in reaching its decision. Transaction parties might bolster their ability to invoke the common-interest privilege by such measures as executing confidentiality agreements, limiting the individuals receiving the communications to those strictly necessary, placing time limits on the ability to access the communications, and placing constraints on distribution (*e.g.*, prohibiting copying or forwarding of the communications, or requiring that the privileged communications be reviewed in a facility with limited access).[18]

- ***Limitation to common legal interests***. Courts addressing the common-interest doctrine frequently assess whether the interest being furthered was a "legal" or "business" interest, and have held that merely furthering common business interests does not invoke the protections of the doctrine. *Ambac* noted that the doctrine would not apply to "advice of a predominately business nature,"[19] but found a common legal interest in advice on how "to accurately navigate the complex legal and regulatory process involved in completing the transaction."[20] Transaction parties might strengthen their common-interest privilege claims by contemporaneously documenting the legal interest that is to be furthered, by advising transaction participants to segregate their privileged communications from more general business communications, and by limiting those privy to the privileged communications to counsel and others necessary to furthering the common legal interest.

NOTES

1. Index No. 651612/10 (1st Dep't Dec. 4, 2014).
2. *Id.*, slip op. at 4.
3. *Ambac Assurance Corp. v. Countrywide Home Loans, Inc.*, 2013 WL 5629595, at *1-2 (Sup. Ct., N.Y. Cnty. Oct. 16, 2013).
4. *Ambac Assurance Corp.*, Index No. 651612/10, slip op. at 2.
5. *Id.* at 7 (quoting *Upjohn Co. v. United States*, 449 U.S. 383, 389 (1981)).
6. *Id.* at 7-8 (quoting *Spectrum Sys. Int'l Corp. v. Chem. Bank*, 78 N.Y.2d 371, 380 (1991)).
7. *Id.* at 8 (quoting *United States v. BDO Seidman, LLP*, 492 F.3d 806, 816 (7th Cir. 2007)).
8. *Id.* at 11 (citing *Hyatt v. State of Cal. Franchise Tax Bd.*, 105 A.D.3d 186, 205 (2d Dep't 2013); *Hudson Valley Marine, Inc. v. Town of Cortlandt*, 30 A.D.3d 377, 378 (2d Dep't 2006); *Aetna Cas. & Sur. Co. v. Certain Underwriters at Lloyd's, London*, 176 Misc. 2d 605, 612-13 (Sup. Ct., N.Y. Cnty. 1998); *Allied Irish Banks, P.L.C. v. Bank of Am. N.A.*, 252 F.R.D. 163, 171-72 (S.D.N.Y. 2008)).
9. *Id.* at 12-13 (quoting *Parisi v. Leppard*, 172 Misc. 2d 951, 955 (Sup. Ct., Nassau Cnty. 1997)).
10. *Id.* at 14.
11. *Hyatt*, 105 A.D.3d at 205; *see also Hudson Valley Marine*, 30 A.D.3d at 378.
12. *Ambac Assurance Corp.*, Index No. 651612/10, slip op. at 14.

13. *3Com Corp. v. Diamond II Holdings, Inc.*, 2010 WL 2280734, at *4-5 & n.18 (Del. Ch. May 31, 2010) (quoting *Comm'r of Revenue v. Comcast*, 901 N.E.2d 1185, 1197 (Mass. 2009)); *cf. Blanchard v. EdgeMark Fin. Corp.*, 192 F.R.D. 233, 237 (N.D. Ill. 2000) (common-interest privilege does not apply to document sent to investment banker whose "legal interests were [not] threatened in a meaningful way").
14. *See, e.g., In re JP Morgan Chase & Co. Sec. Litig.*, 2007 WL 2363311, at *5 (N.D. Ill. Aug. 13, 2007) (declining to apply common-interest privilege because the court "does not understand how [the parties] can be said to share a common legal interest prior to their signing the merger").
15. *See, e.g., Nidec Corp. v. Victor Co. of Japan*, 249 F.R.D. 575, 579 (N.D. Cal. 2007) (citing cases).
16. *See CFTC v. Weintraub*, 471 U.S. 343, 349 (1985).
17. *See Great Hill Equity Partners IV, LP* v. *SIG Growth Equity Fund I, LLLP*, 80 A.3d 155, 161 (Del. Ch. 2013) (advising parties "to use their contractual freedom … to exclude from the transferred assets the attorney-client communications they wish to retain as their own").
18. *See, e.g., Tenneco Packaging Specialty & Consumer Prods., Inc. v. S.C. Johnson & Son, Inc.*, 1999 WL 754748, at *2 (N.D. Ill. Sept. 14, 1999) (upholding assertion of common-interest privilege where disclosing party "took substantial steps to ensure that the opinion would remain confidential," including disclosing the privileged communication only to a limited number of individuals, each of whom agreed to abide by the confidentiality agreement).
19. *Ambac Assurance Corp.*, Index No. 651612/10, slip op. at 11.
20. *Id.* at 14.

Cigna Health: Delaware Court Addresses the Binding (or Not) Nature of Indemnification and Other Stockholder Obligations in Merger Transactions

BY DAVID A. LIPKIN, MICHAEL G. O'BRYAN, ROBERT S. TOWNSEND AND CHARLES C. COMEY

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The Delaware Chancery Court (in a decision by Vice Chancellor Parsons in late November) has held unenforceable against a stockholder, that had not agreed in advance to the terms of a merger agreement effecting the sale of the company, two commonly-used provisions in private M&A transactions: (a) a post-closing indemnity obligation, to the extent that it involved a risk of repayment of up to 100% of the stockholder's share of the merger consideration for an "indefinite" period of time; and (b) a broadly-worded stockholder release that was contained in a letter of transmittal sent to stockholders after the merger was consummated. The court accordingly ordered that the stockholder be paid its proceeds without having to agree to the indemnity or the release.[1]

Although *Cigna Health* leaves open as many questions as it answers, its invalidation of a portion of a frequently-used indemnity structure and the stockholder release means that private M&A practice will evolve as a result of this case. Prior to this decision, it was not uncommon to see these types of obligations implemented through the means of a post-closing letter of transmittal. We suggest below a number of practical techniques that may help to mitigate the impact of the *Cigna Health* decision.

Background

Acquisitions of private companies by way of merger are typically conditioned on the target company stockholders agreeing to a number of important provisions, beyond the per share merger consideration, that directly impact the stockholders following the closing of the transaction. Since their operative effect is to allocate post-closing risk in the transaction, the enforceability of such provisions against the selling stockholders is critical for acquirors. At the same time, target company boards expect these provisions to be enforceable in a consistent manner across all (rather than just against certain) stockholders, and they want a deal structure that will help make the company attractive as a target to potential acquirors.

For example, the merger agreement for a private acquisition typically gives the acquiror a post-closing indemnification remedy for damages arising from the target's breach of its representations, warranties and covenants. The indemnity is commonly supported by an escrow or holdback of a portion of the merger consideration for an agreed period following closing. In addition, in the case of the target's fraud, breach of certain "fundamental" representations and warranties or breach of covenants, the acquiror may also be entitled (beyond the more limited escrow or holdback) to sue former stockholders directly for recovery of an agreed portion of the consideration paid to them at closing.

Similarly, merger agreements in private M&A transactions often require, as a condition to closing, that all or a specified portion of the target's stockholders execute a general release in favor of the acquiror and the target.

The *Cigna Health* Decision

Facts

Optum Services, Inc. agreed to acquire Audax Health Solutions, Inc. via a merger. Several Audax stockholders executed support agreements shortly after the merger agreement was signed, which served as written consents providing stockholder approval of the merger. The support agreement provisions included:

- an agreement to be bound by the provisions of the merger agreement, including those requiring indemnification of Optum and related parties (the indemnification obligation);
- the appointment of a third party as a stockholders' representative to administer the indemnification provisions (the stockholders' rep obligation); and
- a release of any claims against Optum and Audax (the release obligation).

The indemnification obligation required stockholders to repay to Optum up to 100% of the merger consideration received by them if Optum were damaged by breaches of certain representations and warranties of Audax or the selling stockholders in the merger agreement. While most of these representations and warranties survived for a limited post-closing period (18 or 36 months), a number of them, by their terms, survived indefinitely. Somewhat unusually, the agreement did not provide for an escrow or holdback of any portion of the merger consideration.

The merger agreement required each Audax stockholder to execute a letter of transmittal reasonably acceptable to Optum as a condition to receiving the per share consideration. The form of letter of transmittal in turn required that stockholders agree to the indemnification and stockholders' rep obligations (which were contemplated by the merger agreement) as well as the release obligation (which was not mentioned in the merger agreement).

Cigna, a significant preferred stockholder of Audax (with its shares valued at over $46 million in the merger) with a representative on the board of directors of Audax (and a significant competitor of the acquiror), did not sign a support agreement and did not vote in favor of the merger. Following the closing, Cigna refused to sign the letter of transmittal and demanded its share of the merger consideration, alleging in its lawsuit (a) that the indemnification obligation violated Section 251 of the Delaware General Corporation Law (DGCL), (b) that the stockholders' rep obligation was invalid since it was "inextricably entwined" with the indemnification obligation and (c) that the release obligation was unenforceable since it lacked consideration.

The Court's Ruling

The court held that both the indemnification obligation and the release obligation were unenforceable, for the reasons set forth below.

Indemnification Obligation. The court held that the indemnification obligation, to the extent it was "indefinite" in duration and put at risk the stockholder's entire purchase price, violated Section 251 of the DGCL, which requires merger consideration to be determinable from the merger agreement. Under Section 251, merger consideration can be determinable from "facts ascertainable" outside of the merger agreement, but only if "the manner in which such facts shall operate … is clearly and expressly set forth in the agreement." Here, the court noted, a stockholder might never know the value of its merger consideration, since the indemnification obligation (a) placed potentially all of the stockholder's merger consideration at risk, and (b) continued indefinitely. The court rejected the acquiror's argument that the indemnification obligation was economically equivalent to an escrow structure (which the court said was "widely understood to be permissible" under Delaware law).[2]

The court did "not address whether such a price adjustment that covers all of the merger consideration may be permissible if time-limited, or whether an indefinite adjustment period as to some portion of the merger consideration would be valid." Rather, the court held only that the combination of these factors present in this case violated Section 251.

Release Obligation. Cigna argued that the release was unenforceable, since the merger consideration vested as a matter of law under the DGCL when the merger was consummated, and there was no other stated consideration for the release. The court agreed, and held the release unenforceable, noting also that the merger agreement "provided no indication to stockholders that they might have to agree to a release, let alone the sweeping release called for in the Letter of Transmittal" and rejecting the acquiror's argument that the release was "part and parcel of the overall consideration."

Effect on Private Company M&A Practice

The *Cigna Health* decision carries implications for both acquirors and targets in private company acquisitions. For practitioners who had previously assumed that indemnity, release and similar post-closing stockholder obligations could be effectively implemented through a post-closing letter of transmittal, the effect on existing practice will be most significant. Following *Cigna Health*, we expect that more companies engaged in private M&A, particularly on the buy-side, will want to consider techniques including the following to mitigate the impact of the decision:

- Securing joinders expressly agreeing to the merger terms from as many stockholders as possible prior to closing, as a condition to closing, or by using a stock purchase structure in lieu of a merger.
- Increasing the size and duration of indemnification escrows and holdbacks, to mitigate against the possibility that indemnification recovery beyond these sources will not be fully available.
- Similarly, in deals that have earnouts and other forms of contingent consideration, providing expressly for offset rights against post-closing payouts (on the basis that offsets are more akin to an escrow/holdback

than a right to recover consideration previously paid).

- Considering requiring stockholders that do approve the deal to pay for more than their *pro rata* share of indemnity obligations, to make up for those not signing.

- Providing in the acquisition agreement that fewer (if any) representations and warranties survive "indefinitely" and more survive for a fixed time period, and limiting the total indemnity exposure to an agreed percentage of the total merger consideration that is less than 100% of the merger consideration.

- Ensuring that all required stockholder releases and other post-closing stockholder obligations are specified with particularity in the merger agreement, and stating in the merger agreement that the purchase price is in consideration for and based on the acquiror's expectation of the enforceability of these obligations.

- Relying on other risk mitigation measures, such as purchasing representation and warranty insurance, or conducting additional due diligence.

- On the sell-side, increasing use of "drag-along" provisions in corporate charters and stockholder agreements, in order to minimize the percentage of the stockholder base whose separate approval is required for terms of a future acquisition.

- Limiting the authority of the stockholders' representative to the administration of the escrow or holdback provisions (as distinguished from the indemnity provisions that contemplate a recovery of merger consideration previously paid).

NOTES

1. *Cigna Health and Life Insurance Company v. Audax Health Solutions, et al*, Del. Ch. Nov. 26, 2014.
2. The court's ruling that the indemnification obligation was unenforceable effectively mooted Cigna's claim with respect to the stockholders' rep obligation (the court also stated that the stockholders' rep obligation had been inadequately briefed to enable it to uphold Cigna's challenge).

Delaware Court Determines That 17.5% Stockholder Seeking To Take Company Private Could Be Deemed a Controller and Therefore Exacting Entire Fairness Review Applied

BY JASON M. HALPER, PETER J. ROONEY AND NATALIE NAHABET

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On November 26, 2014, the Delaware Court of Chancery denied a motion to dismiss a complaint challenging a going-private transaction where the company's CEO, Chairman and 17.5% stockholder was leading the buyout group. In his decision in the case, *In Re Zhongpin Inc. Stockholders Litigation*, Vice Chancellor Noble concluded that the complaint pled sufficient facts to raise an inference that the CEO, Xianfu Zhu, was a controlling stockholder, and as a result, the deferential business judgment rule standard of review did not apply. Instead, the far more exacting entire fairness standard governed, which in turn led the Court to deny the motion.

This is the fourth recent decision to address when a less-than 50% stockholder can be considered a controller, an issue that determines whether the alleged controller owes fiduciary duties to other stockholders and the standard of review the Court will apply in evaluating the challenged transaction. The decision therefore provides important guidance for directors and their advisors in structuring transactions involving large stockholders.

Background

The company, Zhongpin Inc., a Delaware corporation headquartered in China, announced in March 2012 that Zhu proposed to purchase all the outstanding shares he did not own for $13.50 per share in cash. The CEO informed the board at that time that he did not intend to sell his stake to a third party. The board formed a special committee to address the proposal, which was comprised of the three non-employee members of the five-person Zhongpin board. The special committee retained independent financial and legal advisors and ultimately determined to enter into a merger agreement with the CEO-led group and recommended that stockholders approve the transaction. The merger agreement included a non-waiveable requirement that a majority of the minority stockholders approve the transaction; a 60-day go-shop that permitted the company in that period to solicit superior proposals; and the right on the part of the company to terminate the agreement for any reason during the go-shop period with no termination fee.

Takeaways

Meaningful stock ownership, even if far less than 50%, coupled with unusually significant managerial and operational authority, may be sufficient to plead control.

In finding that the complaint pled control, the Court recognized that there is no "absolute percentage of voting power" required. Rather, the test is whether the stockholder's combined voting, managerial or other power permit control of the corporation. Here, while acknowledging that most 17% stockholders are not controllers, and that a less-than 50% owner is "presumptively not a controlling stockholder," the Court found that the complaint pled both "latent" and "active" control.

The complaint alleged latent control, or control via stock ownership, because (according to the company's Report on Form 10-K) Zhu's stockholdings allowed him to "exercise significant influence over" the company, including "shareholder approvals for the election of directors… the selection of senior management, the amount of dividend payments, if any…mergers and acquisitions, and amendments to [the company's] By-laws." Again citing the 10-K, the complaint also alleged that Zhu's stock ownership could be a "possible impediment" to a third party acquisition—an allegation buttressed by the fact that the company received no bids during the go-shop period. The Court also found that the complaint alleged "active" control over the company's daily operations. Relying yet again on the 10-K, the Court cited the company's statements that it "rel[ies] substantially" on Zhu to manage operations and that his departure could have a "material adverse effect" on the company. The Court concluded that Zhu's level of control was "significantly more than would be expected" of a CEO and 17.5% stockholder.

This is the fourth recent decision to address when a less-than 50% stockholder nonetheless may be a controller. In *In Re: Crimson Exploration Inc. Stockholder Litigation*,[1] the court expressed skepticism about (but did not decide) whether a 33.7% stockholder "actually exercised control over" the company's board. In so holding, however, the court affirmed that mere allegations of a close working relationship between management and a large stockholder do not plead control, particularly given that a large stockholder "would suffer the most from a low merger price." In *In re Sanchez Energy Derivative Litigation*[2] and *In re KKR Financial Holdings LLC Shareholder Litigation*,[3] the Chancery Court likewise rejected allegations of minority stockholder control over the board with respect to the challenged transaction based on supposed control over management and operations of the company. Given that some level of stockholder influence on or control of management existed in all the cases, it is somewhat difficult to reconcile the outcome in these decisions with *Zhongpin*. One possible explanation is that Zhu's control over the corporation was so substantial, and relatively greater than the power exercised by the alleged controllers in the other recent cases noted above, that, at the pleading stage, it sufficed to survive a motion to dismiss.

A controlling stockholder transaction will not receive deferential business judgment review under M&F Worldwide unless there is approval by a majority-of-the-minority stockholders and an independent board committee from the outset of the transaction.

In *Kahn v. M&F Worldwide Corp*.,[4] which was decided after the Zhongpin transaction closed, the Delaware Supreme Court held that in going-private mergers where there is a controlling stockholder, the use of both a truly independent special committee and a majority-of-the-minority stockholder vote may allow for judicial review under the deferential business judgment standard. Here, both of these structural devices were in place, but the transaction was not conditioned on both sets of approvals from the outset. Rather, the majority-of-the-minority provision was included "at the tail end" of the process after the $13.50/share price had been agreed upon. As a result, entire fairness applied. The decision reinforces the importance of structuring controlling stockholder transactions from the outset to include minority protection devices in order to maximize the chances of obtaining deferential business judgment rule review in controlling stockholder transactions, assuming the committee and the controller are willing to agree to such provisions.

The risk of "inherent coercion" in a controlling stockholder transaction warrants entire fairness review even if there is no allegation that the controller actually attempted to coerce the company's board or committee to approve the transaction.

The Court also found that the absence of any allegations in the complaint that Zhu attempted to use his voting or other power to force the committee to accept his proposal did not affect whether the entire fairness standard applied. The premise of the entire fairness standard is that controlling stockholders "possess such potent retributive capacity" that entire fairness review is appropriate regardless of whether an effective special committee approved the transaction. At most, the presence of an effective committee or an informed majority-of-the-minority vote affects the burden of proof but not the applicable standard that applies.

Interestingly, the Court does not appear expressly to find that the complaint pled control over the committee with respect to the challenged going-private transaction—the inquiry deemed to be the relevant one in *Crimson* and *Sanchez*. However, such a conclusion may be inferred from the Court's discussion of Zhu's voting and operational power coupled with facts suggesting that the committee was ineffective (as discussed below).

The sales process, including the effectiveness of the committee in negotiating with the alleged controller and the sufficiency of a pre- or post-merger agreement market check or go-shop, will affect the Court's assessment of entire fairness.

The Court concluded that the complaint adequately pled unfair dealing and unfair price. As for price, the Court cited allegations referring to Bloomberg data suggesting that the transaction did not compare favorably to comparable transactions and that the $13.50/share price represented a 42% discount to the three-year high for the stock. As for unfair dealing, the Court observed that the company's 10-K stated that Zhu's cooperation may be necessary to attract third party acquisition proposals and that Zhu expressed an unwillingness to sell to a third party. As a result, the Court appeared to find plausible the allegation that the committee had no real power to generate superior proposals, rendering the market check conducted prior to signing the merger agreement and the solicitation efforts in the go-shop period ineffective. The Court also cited the fact that while the committee authorized its financial advisor to negotiate with Zhu on price, the committee did not provide firm counteroffers and it approved the merger agreement without a fairness opinion.

Although not stated explicitly in the portion of the Court's opinion addressing unfair dealing, elsewhere in the decision the Court cites additional facts that suggest it viewed critically the sales process conducted by the committee. These include the facts that: (i) a few weeks after providing the committee's financial advisor with financial forecasts for 2012 through 2016 prepared by management and reviewed by Zhu, the committee received revised forecasts (also reviewed by Zhu) reflecting decreases in projected revenues, profits and gross margins; (ii) Zhu never increased his initial acquisition price; (iii) during the pre-signing market check, when another bidder expressed interest in an acquisition at $15/share conditioned on Zhu's participation, Zhu refused and threatened to withdraw his acquisition proposal if a deal was not signed promptly; and (iv) soon thereafter the committee's financial advisor resigned.

The Court's discussion of these allegations, and the picture they paint of a potentially ineffective committee, suggests that these considerations factored into its determination that the complaint pled unfair dealing. Particularly noteworthy is the fact that management provided downward revised projections to the committee within a few weeks of having provided an earlier set of data. As was the case in *In re Rural/Metro Corp. Shareholders Litigation*,[5] *Chen v. Howard-Anderson*[6] and *In re Orchard Enterprises, Inc. Stockholder Litigation*,[7] Delaware courts will look quite skeptically at conduct suggesting that a participant in a merger transaction, whether management, a board or board committee, or an advisor, is manipulating financial projections or data in order to achieve a personally beneficial outcome to the detriment of stockholders.

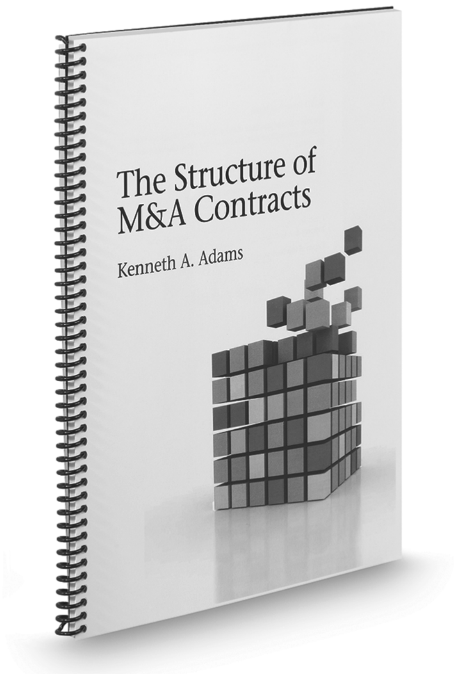
A Section 102(b)(7) exculpation provision will not be a basis for dismissing claims against directors where entire fairness applies.

The Court rejected the directors' argument that the claims should be dismissed against them based on the company's charter exculpation provision, which precludes claims for monetary damages arising from due care breaches against the directors. Although not stated explicitly, the Court appeared to conclude that the duty of loyalty potentially always is implicated whenever a complaint sufficiently pleads that directors "negotiated or facilitated" a transaction with a controlling stockholder that allegedly was unfair to the minority and the controlling stockholder used its power "over the corporate machinery" to bring about that transaction. That is the result, according to the Court, even in the absence of allegations of "specific wrongdoing by disinterested directors."

Given this holding, it is difficult to understate the significance of the determination of whether a large stockholder is a controller. A finding of control makes it far more likely, if not certain (in the absence of satisfying the *M&F Worldwide* criteria) that stringent entire fairness review applies and that the directors will not prevail on a motion to dismiss based on a Section 102(b)(7) charter provision.

NOTES

1. Del. Ch. Oct. 24, 2014.
2. Del. Ch. Nov. 25, 2014.
3. Del. Ch. Oct. 14, 2014.
4. Del. Mar. 14, 2014.
5. Del. Ch. Mar. 7, 2014.
6. Del. Ch. Apr. 8, 2014.
7. Del. Ch. Feb. 28, 2014.



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