M&A Update

Highlights from 2015 and Implications for 2016

January 19, 2016

A record-setting year for M&A deal activity, 2015 also yielded several important legal decisions and highlighted significant trends that are likely to influence M&A market participants in 2016 and beyond.

Increased Activism

Stockholder activists launched over 360 campaigns in the U.S. in 2015, which is more campaigns than were launched in any other year on record. Moreover, target companies have shown an increased willingness to engage with activist investors. Indeed, in 2015, approximately 117 target companies agreed to appoint activist investor nominees to their board of directors through either settlement of a proxy fight or mutual agreement without the need for commencement of a proxy fight. In addition, funds managed by activists increased to more than $120 billion as of the end of 2015, which is almost twice the amount under management in 2012. Campaigns involving DuPont Co., Apple Inc., General Electric Company and Qualcomm Incorporated signal that activists remain undeterred by the size and stature of their targets. Moreover, the pending merger between DuPont and Dow, and the planned split up of the combined company into three separate companies following completion of the merger, emphasizes the increased influence of activist investors who advocated for these transactions. In addition to full company sales and acquisitions, activist investors have played a key role in the increase in other extraordinary transactions, such as spin-offs, dispositions of business units and share buybacks.

Stockholder Engagement

Companies have increased their level of engagement with both activists and institutional investors. Over the past several years, stockholder engagement policies, such as the SDX Protocol, have increasingly gained traction in the marketplace. In February, Vanguard's CEO sent letters to the independent chair or lead director of approximately 500 of Vanguard's largest holdings regarding the importance of effective stockholder engagement, and over the course of a twelve-month period, Vanguard engaged with the management or directors of nearly 700 companies. Similarly, BlackRock's CEO sent a letter to hundreds of companies urging them to focus on long-term value

creation, demonstrating that institutional investors have become more assertive in advocating for their interests. As further evidence of the increasing focus on stockholder engagement, in 2015, 56% of S&P 500 companies disclosed information regarding their engagement activities in their SEC filings, which is an increase from only 6% in 2010.

Inversions Continue

The U.S. Treasury in 2014 and 2015 issued new guidance limiting the tax benefits of inversions and making it more difficult for some U.S. companies to invert. The U.S. Treasury's guidance presented additional challenges for U.S. companies seeking to invert and resulted in abandoned inversions and a decreased level of inversion activity in 2015. However, companies have, and should be able to continue to navigate these challenges successfully and invert with proper planning. In fact, inversion strategies are continuing as notably evidenced by the 2015 announcements of the planned inversions of Pfizer to Ireland through its merger agreement with Allergan, CF Industries Holdings to the Netherlands through its merger agreement with OCI NV and Coca-Cola Enterprises to the U.K. through its merger agreement with two of its international bottling counterparts. These transactions are scheduled to close in 2016 and it remains to be seen whether the U.S. Treasury will take any additional action to discourage or block these or other transactions.

Antitrust Scrutiny

Enforcement continues to be a top priority for regulatory agencies and 2015 saw a number of significant deals challenged on antitrust grounds. In December, the FTC blocked the Staples Inc./Office Depot Inc. merger. Further, deals between Comcast and Time Warner Cable, General Electric Co. and AB Electrolux and Chicken of the Sea International and Bumble Bee Foods LLC were abandoned following FCC and DOJ objection. In total, U.S. antitrust regulators filed suits to block seven deals this past year and required remedies in twenty-three more. This activity demonstrates that antitrust agencies are willing to take an aggressive approach with respect to market definition, industry concentration and competitive effects. A vigorous enforcement environment is likely to continue in 2016, requiring merger partners to undertake careful planning and analysis.

Financial Advisors

Several financial advisors have been criticized by the Delaware courts over the past few years for conflicts of interest and "outcome-driven analyses" in connection with challenged mergers and acquisitions. Financial advisors can take some comfort, however, as court rulings in 2015 rejected the role of financial advisors as "gatekeepers" of the M&A process and reinforced the challenges that plaintiffs face in bringing this type of claim.

In *In re Dole Food Co., Inc. Stockholder Litigation*, the Delaware Chancery Court made clear that a financial advisor's liability for aiding and abetting requires both knowledge and a duty to the selling stockholders or the board committee representing them. The decision provides an important limitation on potential liability where an advisor does not represent the selling company, its stockholders or the board committee charged with negotiating on their behalf.

In *In re Rural/Metro Corp. S'holders Litig.*, the Delaware Supreme Court upheld the Chancery Court's $76 million damages award against RBC Capital. The *Rural/Metro* decision makes clear that in order for a financial advisor to be held liable for aiding and abetting a breach of fiduciary duty, the financial advisor must act with *scienter*; that is act "knowingly, intentionally or with reckless indifference" and with an "illicit state of mind." The Court emphasized that its holding should be viewed as a narrow one and the requirement that the financial advisor must be found to have acted with *scienter* makes an aiding and abetting claim among the most difficult claims to prove. Notably, the Court rejected the Chancery Court's statement that financial advisors have a duty to act as "gatekeepers" of an M&A process including a duty to "determine a corporation's value" and "design and carry out a [corporation's] sale process." The duties of a financial advisor are determined by its engagement agreement with its particular client.

Post-Closing Damages Claims

The Delaware Supreme Court's 2015 decision in *Corwin, et al. v. KKR Financing Holdings LLC., et al.*, should narrow the scope of post-closing damages claims. In this case, the Court clarified that once a merger closes, as long as it has been approved by a fully informed vote of the disinterested stockholders, the standard for reviewing the board's conduct in connection with a post-closing damages claim will be the business judgment rule unless the transaction is subject to the entire fairness standard (as can be the case in a transaction with a controlling stockholder or other conflicts of interest). The Court explained that *Revlon* enhanced scrutiny will not apply to post-closing transactions, even if *Revlon* enhanced scrutiny applied prior to the closing of the merger. The Court reasoned that approval by the fully informed, uncoerced majority of stockholders was "outcome determinative" and as a result, should be reviewed under the business judgment rule. This holding should also be welcomed by financial advisors, as it should make it more difficult to find a breach of fiduciary duty by directors post-closing, which is a predicate to a financial advisor's aiding and abetting liability.

Director Liability and the Power of "Exculpatory" Charter Provisions

The Delaware courts decided several cases in 2015 that provide important lessons for directors regarding when certain procedural actions (such as a special committee and majority of the minority vote) may or may not protect them from personal liability. While controlling stockholder transactions that employ adequate procedural protections should be subject to the more lenient

review of the business judgment rule, the *Dole Food* decision made clear that the use of procedural protections will not avoid application of the heightened entire fairness review in the presence of fraud or inadequate disclosures. Controlling stockholders and executives who create an informational deficit for the reviewing special committee and minority stockholders (by withholding accurate and up-to-date financial performance information, for example) or who otherwise interfere with the proper functioning of a special committee risk personal liability. Even if the price is determined be fair, wrong-doers will not be able to profit from their misconduct.

In 2015, the Delaware Supreme Court also ruled that claims against independent directors must be dismissed when a company charter provision shields directors from monetary liability for breach of the duty of care and the plaintiffs are unable to plead facts establishing that the directors breached the duty of loyalty, acted in bad faith or gained an improper personal benefit. The decision, *In re Cornerstone Therapeutics Inc. Stockholder Litigation*, illustrates the power of so-called "exculpatory" charter provisions and emphasizes that plaintiffs bear the burden of pleading facts to support a "non-exculpated" claim against independent directors. However, the *In re Cornerstone* decision is not likely to benefit directors in pre-closing litigation and independent directors whose cases are dismissed may remain involved as important witnesses in related cases. Also, if a breach of the duty of loyalty *is* adequately pled, then an exculpatory provision's impact will not be determined until after trial.

Lessons in Indemnification and Advancement Agreements

Dov Charney v. American Apparel, Inc. highlights the limits on the ability of officers and directors to receive indemnification or advancement for actions taken beyond the scope or span of their positions. The indemnification agreement in *American Apparel* provided advancement for claims "related to the fact" that Mr. Charney is or was a director or officer of American Apparel. The Court found that the actions by Mr. Charney at issue, including privately discussing a potential takeover with a private equity firm or seeking to replace or solicit directors, did not implicate his use or abuse of corporate power as a fiduciary of American Apparel. Instead, Mr. Charney took those actions solely in his personal capacity. Thus, the Court found that the lawsuit brought by American Apparel was not based on the fact that Charney was an American Apparel director or officer or his conduct in that capacity. The Court, therefore, denied advancement of expenses under an indemnification agreement. In another 2015 decision, *Lieberman v. Electrolytic Ozone, Inc.*, the Chancery Court denied advancement to company officers and directors for similar reasons, finding that the breach of contract claims did not arise "by reason of the fact" that they held these positions because the underlying claims rested on alleged misconduct that is identical to tort claims. It was known to be rare for the Chancery Court to deny advancement, but these two cases, provide a strong warning that the tide may be turning.

Appraisal Actions

In *Merion Capital LP and Merion Capital II LP v. BMC Software, Inc.*, the Delaware Chancery Court provided valuable lessons for acquirors and targets in how to minimize post-closing exposure under Delaware's appraisal statute. The Court held that the merger price was the best indicator of the fair value of the target and elected against awarding stockholders any additional consideration in an appraisal rights action. In reaching its conclusion, the Court focused on the effectiveness of the sales process, emphasizing that the target received multiple offers, negotiated with the buying consortium and succeeded in having the consortium raise its bid multiple times. The Court also noted that the merger agreement included a 30-day go-shop period with a robust marketing effort, a two-tiered termination fee and a reverse termination fee.

The Court nevertheless did conduct its own discounted cash flow analysis in considering alternative valuations. Thus, in the absence of an effective and robust sales process, the Delaware courts will still determine fair value by closely analyzing the relevant valuation methodologies and substituting their own reasonable inputs, while taking into account the respective positions of the parties' experts. In addition, the case highlights the fact that in determining fair value in an appraisal case, a company will be valued as an independent going concern, excluding synergies that were included in the deal price. Companies looking to defend against appraisal claims should not only demonstrate to the Court that the transaction will result in synergies, but should also take care to quantify the synergies and prove to the Court that the synergies were included in the final deal price.

Fee-Shifting and Forum Selection

In 2015, the Delaware legislature approved amendments to the DGCL that bar companies from including in their charters and bylaws provisions that require a stockholder to pay a company's legal fees if the stockholder brings an action against the company that is not successful. The amendments, however, do not invalidate fee-shifting provisions in stockholders' agreements or other instruments signed by stockholders.

Under recent amendments to the DGCL, the Delaware legislature validated forum selection provisions and clarified that Delaware corporations are permitted to include in their organizational documents an exclusive forum provision in which the company selects only Delaware or both Delaware and a non-Delaware forums as exclusive forums for resolving corporation-stockholder disputes. A Delaware corporation cannot exclude Delaware as an available forum. However, similar to fee-shifting provisions, the amendment does permit the inclusion of non-Delaware forum selection provisions in stockholder agreements or other instruments signed by stockholders. Exclusive forum provisions, to the extent they are enforced by non-Delaware courts, will offer Delaware corporations the ability to exclusively defend against M&A-related litigation in the more

predictable and sophisticated Delaware courts and avoid forum shopping and the need to defend against the same claim in multiple jurisdictions.

Disclosure Only Settlements

The Delaware Chancery Court's patience for settlements of merger lawsuits that fail to create meaningful value for stockholders appears to be wearing thin. Delaware judges have become increasingly critical of cases and resulting settlements that do little for stockholders. In October, Vice Chancellor J. Travis Laster rejected a settlement related to Hewlett-Packard Co.'s purchase of Aruba Networks Inc. Vice Chancellor Laster characterized the case as "pseudo-litigation" where lawyers follow "the path to getting paid." Other Chancery Court judges have begun to follow the Vice Chancellor's approach and litigators appear to have taken notice, as evidenced by several transactions where plaintiffs have elected not to seek to enjoin a pending merger and the abandonment of a number of existing cases. The Chancery Court's distaste for disclosure only settlements makes inclusion of a Delaware forum selection clause in a company's organizational documents even more effective in deterring litigation, although a byproduct of this trend may be that such suits, once filed, can be more difficult to settle.

Director Removal Without Cause

A December 2015 transcript ruling by the Delaware Chancery Court invalidated charter and bylaw provisions limiting the removal of directors only "for cause" for companies that do not have classified boards. The Court ruled that the provisions of VAALCO's constituent documents conflicted with the plain reading of Section 141(k) of the DGCL. Companies with similar provisions should consider their defensive profiles and be aware that their directors may be subject to removal without cause in the event of a campaign by stockholders to replace some or all of their directors.

Proxy Access

2015 saw an increase in the number of stockholder proposals to amend corporate organizational documents to incorporate proxy access. Over 100 proposals were submitted and approximately 58% of those proposals were approved by stockholders. The large number of stockholder proposals was in part attributed to the Comptroller of New York City who filed 75 proxy access proposals on behalf of various city pension funds. In October, the SEC Staff issued a legal bulletin clarifying when a company may exclude a stockholder proposal on the basis that the proposal "directly conflicts" with a management proposal. Based on that bulletin, the Staff will not conclude that a stockholder proposal directly conflicts with a management proposal if a reasonable stockholder could logically vote for both proposals. As a result, it will be difficult for companies to successfully exclude a stockholder proxy access proposal by offering alternative proxy access

parameters. See more highlights from the 2015 proxy season and a guide to this upcoming season here.

Foreign Takeover Defenses

2015 saw two hostile takeover attempts of large international companies: Mylan's attempted takeover of Perrigo and Teva's attempted takeover of Mylan. Each was unsuccessful, highlighting potential pitfalls companies may face in pursuing these types of transactions. Companies undertaking an inversion strategy would be wise to consider the takeover defenses in their jurisdiction of reincorporation and potential acquirors of these companies would be wise to understand these defenses in advance of any hostile approach. For example, Mylan's previous inversion and reincorporation to the Netherlands allowed it to take advantage of an arcane Dutch takeover defense known as a "stichting". A stichting trust is an independent foundation that can play the role of a company's protector, allowing trustees to take control of a company if faced with a perceived ill, including a hostile takeover approach. While certain aspects of the stichting may be subject to challenge in court, the stichting defense presented a clear obstacle to a potential hostile acquiror. The Mylan-Teva example highlights the importance of a potential acquiror's understanding of applicable foreign takeover defense structures when considering an international deal on a hostile basis.

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Questions regarding this M&A Update can be directed to your Cadwalader contact or to any of the following attorneys.

William P. Mills	+1 212 504 6436	william.mills@cwt.com
Martin L. Seidel	+1 212 504 5643	martin.seidel@cwt.com
Gregory A. Markel	+1 212 504 6112	greg.markel@cwt.com
Joshua A. Apfelroth	+1 212 504 6391	joshua.apfelroth@cwt.com
Braden K. McCurrach	+1 212 504 6788	braden.mccurrach@cwt.com
Lindsey Kister	+1 212 504 6225	lindsey.kister@cwt.com