"Out Clauses" in M&A: Maximizing Deal Protection

A Live 90-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:
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Wednesday, December 16, 2009
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“Out Clauses” in M&A Transactions: Maximizing Deal Protection

Buy-Side “Outs”

Charles Baker
December 16, 2009
Recent Trends

- To no surprise, over the last several months, M&A activity has been down.

- Deal flow continues to move toward the pharmaceutical and technology sectors and away from private equity.

- Low rate of foreign acquisitions.

- Deals are lacking homogeneity.
Recent Trends (cont’d)

- Tender offers are routinely used largely due to the speed in which they can be completed.

- Go-shop provisions are rare.

- Average termination fee has been around 3.35% of the transaction value.
Buy-Side Deal Protection

- Purpose of buy-side deal protection?

- Some key buy-side deal protection measures which will be discussed over the next several slides
  - Financing and Credit outs
  - Consideration Make-up and Technical Outs
    - Pricing Mechanisms to manage risk in stock deals (e.g. fixed exchange ratio versus fixed value with floating exchange ratio and use of collars)
  - Contingent Value Rights
Financing and Credit Outs

- Typically in the form of a closing condition that would read:

  “The Buyer shall have obtained the financing described in the Commitment Letters on the terms set forth in the Commitment Letters and on such other terms as are reasonably satisfactory to the Buyer.”

- Financing outs are less common in strategic acquisitions as compared to private equity acquisitions.

- We are seeing fewer and fewer traditional financing and credit outs and more innovative solutions mostly in connection with stock deals.
Cash is still king from the seller’s perspective. Yet, use of stock is on the rise over the last two years, largely due to the lack of financing (see next slide).

Inherent risks and tensions in stock-for-stock transactions
- Tension – Seller’s desire to achieve certainty of value versus buyer’s concern over the dilutive effect of significant stock issuance
- Risk – Agreed value may change between signing and closing due to movements in buyer’s stock

Pricing mechanisms can be used to manage this risk
- Fixed Exchange Ratio
- Fixed Value with Floating Exchange Ratio
  - Use of collars in both mechanisms
Consideration Make-up (cont’d)

Source: Mergerstat (U.S. targets only)
Under a fixed exchange ratio, the parties agree at signing on a specified exchange ratio.
Fixed Exchange Ratio (cont’d)

- Benefits / risks to buyer

- Risks to seller

- When used
  - Frequently in large deals and merger of equal transactions
  - Actively traded, similarly sized companies in the same industry
Fixed Exchange Ratio

with Collar

- Use of collars to protect both parties

- Seller stockholders receive a fixed number of shares of buyer stock unless the price rises or falls beyond collar range, in which case there is an adjustment in the number of shares to be delivered (see next slide)

- Not common in mixed consideration transactions, where cash portion mitigates value impact of fluctuating stock prices
Fixed Exchange Ratio with Collar (cont’d)

Relationship between exchange ratio and per share value of stock portion of deal as buyer’s stock price rises or falls.

![Graph showing the relationship between exchange ratio and per share value of stock portion of deal as buyer’s stock price rises or falls.](graph.png)
Fixed Value/Floating Exchange Ratio Transactions

- Fixed value structure is used to deliver a fixed dollar amount of buyer’s stock to target’s stockholders

- How the exchange ratio is used and calculated (see next slide)
Fixed Value/Floating Exchange Ratio Transactions (cont’d)

Relationship between exchange ratio and buyer’s stock price at various spot prices

Exchange Ratio

Per Share Value

$50

Value Line

Ratio Line

Buyer's Stock Price

$46 $47 $48 $49 $50 $51 $52 $53 $54
Fixed Value/Floating Exchange Ratio Transactions (cont’d)

- Benefits/risks to buyer
- Benefits/risks to seller
- Use of collars to manage dilution (see next slide)
Floating Exchange Ratio with Collar

If market prices go outside the collar, no further adjustments are made to the exchange ratios. As a result, the range of the collar determines the protection provided to, and risk borne by the buyer’s and target’s shareholders.
Contingent Value Rights ("CVRs")

- What are CVRs?
- Why are they beneficial to buyers in today’s market?
- CVRs may be preferable to collars, particularly in a volatile market

Examples of frequently used CVRS
- Hedging CVRs
- Purchase price adjustments/earn-outs
- Event driven CVRs
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Fiduciary Duties in the Context of an M&A Transaction

December 16, 2009

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Agenda

- Basic Overview of Fiduciary Duties and Standards of Review Under Delaware Law
- Revlon Duties
- Overview of Deal Protections
- Fiduciary Outs
- Go-Shops
Basic Overview of Fiduciary Duties and Standards of Review Under Delaware Law

- **Basic Duties**
  - Due Care
  - Loyalty

- **Standards of Review**
  - Business Judgment Rule
  - Enhanced Scrutiny
    - *Revlon*
    - *Unocal*
  - Entire Fairness
**Revlon Duties**

- What are the so-called *Revlon* duties?
- When are they triggered?
- No “one-size-fits-all” approach
- What it takes to satisfy *Revlon* duties is context-specific
  - Public vs. private company profile
  - Industry
  - Size/visibility
  - History of going to market and market knowledge
- Alternatives
  - Full auction
  - Pre-signing market check/canvas of the market
  - Post-signing market check/go-shop
Deal Protections

- **Broadly Defined**
  - Terms that protect the buyer from, or allow a buyer to meaningfully respond to, a competing bid

- **Types of Deal Protections**
  - Voting agreement
  - Board recommendation to stockholders
  - Force-the-vote provision
  - No-talk, no-shop and window shop vs. go-shop
  - Break-up fees
  - Matching/topping rights
Fiduciary Outs

- **Omnicare (2003)**
  - Deal protections:
    - Voting agreement binding sufficient shares to carry the vote
    - Force-the-vote provision
    - No fiduciary out termination right
  - Holding: Target’s board breached its fiduciary duties to its minority stockholders by agreeing to a fully-locked deal—without a fiduciary out—that rendered the closing a *fait accompli*, as an alternative deal was "mathematically impossible"
  - Rationale: Deal protections were “preclusive and coercive” and, therefore, violated *Unocal*
  - Significance: Case marked the end of “no-talk” provisions
Fiduciary Outs

- **Orman v. Cullman (General Cigar) (2004)**
  - Deal protections:
    - Voting agreement by majority stockholders agreeing to (1) vote their shares *pro rata* in accordance with the public stockholders--"mirrored-voting" provision essentially creating a "majority of the minority" approval requirement, and (2) withhold vote in favor of, and vote against, any competing transaction for 18 months
    - Board was permitted to withdraw its recommendation if it concluded it was required to do so to fulfill its fiduciary duties
    - Did *not* include a "force-the-vote" provision
  - Holding: Deal protections upheld; no fiduciary duty violation
  - Rationale: Not a *fait accompli*; deal protections not coercive because (1) stockholders retained ability to reject the transaction, and (2) board retained right to alter its recommendation
  - Significance: Delaware Chancery Court's reasoning is similar to the dissent in *Omnicare*; case limits and narrowly construes *Omnicare*
Stockholder Approval Post-Omnicare

**Problem**
- Post-Omnicare, voting agreements with sufficient percentage of shares to carry vote are subject to attack

**Solutions**
- Voting agreements and proxies with significant percentage of shares (e.g., 35%), but not enough to carry the vote
- Voting agreement with larger percentage of shares (e.g., 51%) with a percentage (e.g., 16%) subject to release from voting agreement if the holder chooses to favor a subsequent competing proposal or if the board recommends a superior proposal

**Orman Approach**
- Private company setting: stockholder consents promptly post-signing (private company context) coupled with termination fee if consent not delivered in specified time period
Stockholder Approval Post-Omnicare

- **Optima Int’l of Miami v. WCI Steel (2008)**
  - Facts: Board of WCI, a private, closely-held company, approves merger agreement that includes a termination right (and termination fee) if the stockholders fail to approve the merger by written consent within 24 hours of signing
  - Holding: Merger agreement upheld; Optima's motion to enjoin denied
  - Rationale: A stockholder vote is not like the lock-up in Omnicare; rather, "the stockholder vote, although quickly taken, was simply the next step in the transaction as contemplated by the [Delaware] statute"
  - Significance: Vice Chancellor Lamb, who issued a strong dissent in Omnicare, notes that Omnicare is of "questionable continued vitality"
Go-Shops

- Typical go-shop:
  - Target is permitted to solicit proposals and enter discussions/negotiations with competing bidders
  - Go-shop period of 30 – 50 days post-signing
  - Even playing field regarding exchange of confidential information
  - Bifurcated termination fee: (1) lower fee (e.g., 1%) payable if the target terminates for a competing bidder identified during the go-shop period; and (2) traditional termination fee (e.g., 3%) for a competing bidder identified after the go-shop period has ended

- Variations
  - "Open" Go-Shop: Requires only that (1) the target board determines, prior to expiry of the go-shop period, that the topping bidder has submitted a bid that is or is likely to lead to a superior proposal, and (2) the target board terminates the initial proposal (before OR after the go-shop period)
  - "Closed" Go-Shop: Requires, prior to expiry of the go-shop, that (1) the new bidder must sign a confidentiality agreement, complete its diligence, and submit a toping bid and full merger agreement, and (2) the target board must conclude that the toping bid is a superior proposal, adhere to the initial bidder's matching right period, accept the toping bid, approve the merger agreement and terminate the initial merger agreement
Go-Shops

- Go-shops rose to popularity in 2003 – 2007, largely in reaction to pressure from private equity buyers looking to circumvent a full, pre-signing auction in favor of a post-closing market check with certain counter-bid rights.

- Recent trend portended a series of Delaware cases establishing parameters of a meaningful go-shop vs. an illusory go-shop.

- Issue, in general across recent cases, is whether the go-shop at issue is sufficiently meaningful to enable to the target's board to satisfy its *Revlon* duties.

- Study by a prominent Delaware law firm: only 4 of 62 reviewed transactions with go-shops between 2004 and 2007 were "successfully jumped" during the go-shop period.

- Go-shops have been relatively rare during the last couple of years, but are likely to return as the M&A market rebounds.
Go-Shops

Overview of Recent Delaware Cases

- Topps (2007)
- Lear I (2007) and Lear II (2008)
- Netsmart (2007)
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Remedies

Kevin Logue, Partner New York

December 16, 2009
Termination Fees - Generally

“Though a ‘3% rule’ for termination fees might be convenient for transaction planners, it is simply too blunt an instrument, too subject to abuse, for this Court to bless as a blanket rule.” 
*Louisiana Mun. Police v. Crawford* (rejecting “argument by custom”)

- Court must consider a number of factors, including:
  - “overall size of the termination fee, as well as its percentage value; the benefit to shareholders, including a premium (if any) that directors seek to protect; the absolute size of the transaction, as well as the relative size of the partners to the merger; the degree to which a counter-party found such protections to be crucial to the deal, bearing in mind differences in bargaining power; and the preclusive or coercive power of all deal protections included in a transaction, taken as a whole.” (*Id.*)
Deal Protection - Generally

- “. . . the reasonableness of a particular mix of deal protections is context specific and does not lend itself to an algebraic formulation such that "x" amount of market check, knowledge, or raw premium to market entitles the board to agree to "y" level of deal protections as a matter of course" (Ryan v. Lyondell (Chancery Court decision))

- "The fact that a term is customary is not proof that it is . . . either permissible or justifiable under the specific circumstances faced by the board." (San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals)
Historically, viewed with concern due to *Blasius* issues about interfering with exercise of shareholder franchise and *Unocal/Unitrin* coercion issues.

In *Lear*, a damages action, Vice Chancellor Strine found that plaintiffs failed to state a non-exculpated claim regarding a naked-no-vote termination fee of 0.9% of equity value.

- Aside from small size of fee, stockholders voted down deal, so fee could not be coercive and could not have interfered meaningfully with the shareholder franchise.
  - Company fully shopped in frothy m&a market and no topping bid emerged
  - Fee granted for $1.25 increase on prior $36 bid
  - Independent board used adequate process, employed reputable advisors and had substantial basis to conclude deal fair
Termination Fees - Other
Common Issues

- Bifurcation/escalation?
- Relationship with reverse termination fee level?
- Fee trigger - - Superior Proposal v. Change in Board Recommendation?
- Impact of match right?
Reverse Termination Fees

- Different governing standard – liquidated damages?
- Levels trending higher?
- Two-tiered fees?
- Who pays fee?
Damages Caps/Hybrid Alternatives

- Hexion model?
- Uncapped damages based on knowing and intentional breach?
- Not subject to liquidated damages analysis?
- Consolidated Edison provisions?
- Damages – proof and causation issues
- Limits on liability to fraud/selected breaches?
- Consistent choice of law and venue provisions in transaction documents?
"I'm just a simple guy who believes that when there is a specific performance remedy in the contract, it has to have some meaning". (Vice Chancellor Strine, quoted in DealBook March 9, 2009).

"To the extent that contracts invoke equitable remedy, . . . the Court of Chancery always must, in the end, weigh not only a party's legal entitlement to a remedy, but . . . other circumstances that may bear upon whether it is prudent and appropriate to deploy a particular equitable remedy." (Chancellor Chandler, *Rohm and Haas v. Dow*, Jan.26, 2009 (Tr. 25))

Would money damages be sufficient? All cash deal?
Specific Performance of What?

- In *Hexion v. Huntsman*, the Court rejected buyer's MAE claim and found buyer "knowingly and intentionally" breached merger agreement, construed as "taking of a deliberate act, which act constitutes in and of itself a breach . . . , even if breaching was not the conscious object of the act".

- However, the agreement provided for (and the Court ordered) specific performance of all obligations short of (i.e. not including) the obligation to close.
Specific Performance – Other Common Issues

- Solvency of combined entity?
- Interplay with reverse termination fee/damages caps (*United Rentals*)
  - Conflicting remedies
- Bifurcated specific performance/fee or cap remedies
- Upstream entities/shell buyers?
Enforcement Against Lenders

- Standing to enforce?
- Availability of specific performance of lending commitments?
- Solvency provisions?
- Interplay with reverse termination fees/buyer’s damage caps
- Trends/issues in lender litigation
  - the Lone Star Option - - tortious interference?