Recent M&A Trends & Developments—December 2009

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M&A Trends & Developments Overview

- Trends: Down Market Issues
- Tougher Antitrust Environment
- Increased M&A Litigation
- Fiduciary Duty Issues
  - Business Judgment Rule Affirmed, MAC Out Clause Developments, “Just Say No” OK, Troubled Company Issues
- Acquisition Method of M&A Accounting
- Anticipating Earnout Disputes

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Trends: Down Market Issues

- M&A Timing/Currency issues
  - Credit crisis impact: made borrowing to do deals less viable, except for extremely credit-worthy buyers, and made using up balance sheet cash seem less appropriate
  - Stock market volatility impact: made using stock as consideration seem unwise until stock prices fully rebound and become less volatile
  - Stock deals disfavored: stock deals still unattractive to targets, especially if buyer shareholder vote required
    - Report: only 34% of deals offered stock consideration either alone or with cash and 9.2% of those had a collar
  - Time to buy? Market indices are rising, targets may not be any cheaper, so perhaps time to buy is now, or perhaps the recent run up means it's too late

Trends: Down Market Issues (cont.)

- Cash Tender Timing Advantages
  - Given that currencies are depressed, contested deals are more likely, and HSR scrutiny is greater, timing advantages of cash tender offers are even more critical
- Hedge Fund Activism
  - As market values tumbled, activist hedge funds became more aggressive about pushing for a sale
  - Hard to resist if market cap is below cash
- Reduced Private Equity Activity
  - PE funds mostly sidelined due to lack of credit
    - recent Silver Lake/eBay/Skype exception

Trends: Down Market Issues (cont.)

- Increase in Hostile/Topping Bids for Public Companies
  - Data Domain/EMC (NetApp)
  - Yahoo/Microsoft
  - Samsung/SanDisk
  - Microchip/Atmel
- Increase in Low Valuation Deals
  - Desperate sellers? Closed IPO window and VC portfolio pruning has led to many low value private target sales that gave only a partial return of investment to VCs and little, if anything, to founders; some sales of public targets at only a modest premium to their cash

Trends: Down Market Issues (cont.)

- Reverse Termination Fees
  - More frequent? Financing difficulties resulting in increased use of reverse termination fees, even absent a financing condition
  - Ability to opt out? Does capped termination liability really give the buyer an option to buy?
    - Brocade example: Brocade had right to pay $85M (2.8%) to terminate upon a “financing failure” that did not result from a willful breach of any of Brocade’s financing covenants. Result: $400M negotiated price cut.
  - Size/Scope Trends: some trend towards bigger (6% of deal value) reverse than forward termination fees, some provisions give buyer a narrow basis for opting out, some give seller a right to seek specific enforcement against lenders. Cf., Pfizer/Wyeth deal.

Trends: Down Market Issues (cont.)

- Effect of Declining Market Caps
  - Hostile bids more likely
  - Increased hedge fund activism
  - Need to sell if can't pay off or restructure debt?
  - Less time to implement a rights plan
    - Since HSR threshold is now $65.2M, a bidder could quietly acquire up to 16% of a $400M company, for example, without the need for HSR pre-clearance, within the 10 days leading up to a 13D filing obligation, leaving little opportunity to adopt a plan

Trends: Down Market Issues (cont.)

- Greater Need to Update Strategic Defenses
  - Check charter provisions as to notice of director nominations and shareholder proposals, rights to call special meetings or remove directors, rights plan adoption
  - Sign indemnity agreements in light of cases denying advancement of defense expenses to former directors due to bylaw change (Schoon v. Troy Corp.)
    - But: recent DGCL 145(f) amendment prohibits changes to charter/bylaws after event giving rise to need to indemnify
  - Update valuation metrics reflective of strategic plans rather than running such valuations after receiving a hostile bid, making them more subject to challenge
  - Adopt rights plan, or discuss in advance and have "on the shelf", ready for quick adoption if hostile threat emerges

Tougher Antitrust Environment?

- U.S.: Obama administration promising more activity
  - Announcements re more active antitrust enforcement and retraction of Bush policies
  - New leadership applying expanded theories of potential competitive harm from mergers of close competitors
  - Expect greater HSR scrutiny and more uncertain timing and outcome
- EU: increased aggressiveness (Oracle/Sun delay)
- China: new Anti Monopoly Law showing teeth (Coca-Cola deal stopped)

M&A Litigation Update

- "Plaintiffs' Bar" is:
  - Chasing ever smaller M&A deals
  - Seeking ever larger settlements
    - Typically settled with enhanced disclosure and payment of attorney's fees
    - Negotiation often starts with request for price increase and changes to allegedly preclusive deal terms ("high" break up fee, right to match)
  - Increasingly sophisticated as to arguments relating to "Revlon" breach (i.e., inadequate shopping) and the need for additional disclosure

M&A Litigation Update (cont.)

- Plaintiff threatens injunction to slow deal, claiming:
  - Breach of duty of care by target directors based on insufficient shopping, failure to obtain adequate deal value, or improper agreement to preclusive deal terms
  - Breach of duty of loyalty by target directors by favoring their own interests rather than doing what is right for all shareholders
    - Allegation is often that there is a "hidden agenda" to improperly favor a particular buyer
  - Lack of adequate disclosure, for example, as to:
    - fairness opinion valuation methodology
    - background summary
    - banker's fee (implying that the "independent" fairness opinion was compromised by the large fee paid)

M&A Litigation Update (cont.)

- Reduce risk by:
  - Adequate shopping where appropriate, due board consideration of all alternatives and consultation with legal and financial advisors
  - Avoiding deal terms that preclude unsolicited bids or unduly favor one bidder (it is in neither party's interests to have the deal enjoined)
  - Having full proxy disclosure and minutes that demonstrate full and fair process and render inadequate disclosure arguments moot
  - Excluding strike suit and its unilateral settlement from MAE so buyer does not have an "opt out"

Fiduciary Duty Issues Overview

- Business Judgment Rule Affirmed
- MAC Out Clause Developments
- “Just Say No” OK
- Troubled Company Issues

Business Judgment Rule Affirmed

- In a "change of control" transaction the board's duty is to seek highest value reasonably available
- "No single blueprint" for obtaining highest value
- Possible alternative strategies used by target boards:
  - Avoid or limit no shop
  - Conduct pre-signing market check
    - contact other potential bidders prior to signing a deal
  - Conduct an auction
  - Obtain a fiduciary out
    - permits an unsolicited superior bid to prevail post signing
  - Post-signing market check
- Reasonable process is key: board need not make a perfect decision when establishing the process, just a reasonable one

Business Judgment Rule Affirmed (cont.)

- Lyondell Chemical Co. v. Ryan reversal
  - Lower court ruling raised question of whether directors could be held liable for a (non-indemnifiable) breach of the duty of loyalty for not conducting a pre-signing market check, taking a "wait and see" approach to a 13D filing made when the company was not for sale, and otherwise setting a record that made them seem "indolent"
  - Surprising case given the 45% deal premium and deal approval by 99%+ of voted shares

Business Judgment Rule Affirmed (cont.)

- Delaware Supreme Court Reversed:
  - Court emphasized the disinterested and independent nature of the directors, their awareness of the company's value and prospects, and their consideration of the offer with the assistance of bankers and counsel
  - Court characterized situation as, at most, a due care issue, noting that there was no evidence that directors knowingly ignored responsibilities and thereby breached their fiduciary duty of loyalty
  - "[In M&A context] an extreme set of facts is required to sustain a disloyalty claim premised on the notion that disinterested directors intentionally disregarded their duties" and as to such a claim the judicial inquiry should be "whether those directors utterly failed to attempt to obtain the best sale price"

Business Judgment Rule Affirmed (cont.)

- Pre-signing market check required?
  - Pennaco and MONY cases also held that a pre-signing market check is not necessarily required in certain cases
  - Compare: Netsmart. Held that a micro-cap company, because of limited analyst following, should not rely only on a post-signing window shop provision but instead should conduct a pre-signing market check involving both strategic and private equity buyers

MAE Out Clause Developments

- Hexion v. Huntsman
  - Proving an MAE is difficult
    - Must be a severe, lasting change in the target's earning power vis-à-vis its past performance
  - Asserting party has burden of proof
  - Critical to carefully define MAE & exclusions
    - Such as, a failure to achieve projections or guidance, the effect of HSR delays (Oracle/Sun) or the deterioration of equity and credit markets
    - If worried about the difficulty of proving an MAE, Buyer can add a provision stipulating events "deemed" to be an MAE or that are a closing condition

"Just Say No" OK (absent self dealing)

- Gantler v. Stephens was a challenge to a board's decision to reject a merger proposal
- Deferential business judgment rule analysis applies to decision to "just say no" unless plaintiff can show that directors acted in their self-interest, in which case the entire fairness standard may apply

Troubled Company Issues

- Once nearing insolvency, directors and officers have a duty to maximize value for the whole enterprise (including creditors) and not take long shot risks to maximize return for shareholders
- Directors should look for warning signs of insolvency, ensure adequate process for decisions, document good faith exercise of business judgment, consult counsel and restructuring and valuation experts, demand management accountability, consult creditors and avoid insider transactions
- Director indemnification rights may not be enforceable against a debtor in bankruptcy, so it is important to have D&O insurance with non-rescindable Side A coverage to mitigate bankruptcy and rescission risks. Critical to obtain such coverage pre-insolvency

Acquisition Method of M&A Accounting

- SFAS 141R re Business Combinations, effective 12/15/08, dictates expanded use of fair value in acquisition accounting
- Deal costs must be expensed as incurred, not capitalized, so a buyer may want to defer closing to defer booking deal costs
- Stock issued in a deal is valued on the acquisition date, so deal price could fluctuate based on movement in trading price pre-closing, so buyer may push to close quickly
- In addition to being recorded as a liability at fair value on the acquisition date, earnouts must be marked to market each period through earnings, so it may be wise to shorten earnout periods to lessen post-deal earnings volatility
- In-process R&D intangible assets can no longer be immediately written off. Now, IPR&D must be recognized as an intangible asset at the acquisition date, then tested for impairment until projects are completed or abandoned
- These changes will increase earnings volatility, make accretive/dilutive effects more uncertain at closing and impact financial statements going forward as balance sheet amounts are re-measured based on current fair values

Anticipating Earnout Disputes

- Earnouts are contingent payments in a merger to narrow a valuation gap and help ensure retention
- Usually based on achievement of product, technology or financial milestones
- "Earn-outs are inherently difficult creatures":
  - Hard to anticipate every potential ambiguity and dispute
  - Hard to avoid diverging agendas and lack of incentive for new hires and buyer staff cooperation
  - Hard to reconcile target's concerns that post-closing operational decisions will adversely impact the earnout, and buyer's reasonable need for continued operational flexibility without regard to impact on the earnout

Anticipating Earnout Disputes

- Because of these difficulties, earnouts are "seldom earned but often paid"
  - Recent deal: $500M+ paid to settle, though targets unmet
- Favor technology/product, vs. financial, milestones
- If must use financial milestones:
  - Use bookings rather than revenue or net income
  - Anticipate future issues such as: revenue recognition complexities, contracts that will not qualify as a "booking", derivative products, bundling, discounts and impact of changes in reserves on earnings
- Use precise technology milestones:
  - Ensure clear, objective definitions and a 100% completion requirement

Anticipating Earnout Disputes

- Consider whether it is possible (or wise) to attempt to reconcile target's desire to keep current course, budget and headcount and buyer's need for operational flexibility
- Avoid promising "best efforts" obligation to maximize earnout
- Avoid metrics that may cause a divergence of goals
- Avoid resentment and ensure integration by insisting that deal value include a deduct for a bonus pool to incentivize new hires and buyer personnel who must cooperate to achieve milestones
- Have a well thought out dispute resolution mechanism
- Don't do an earnout with a party you don't trust to be reasonable