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Appraisal Rights: The Complicated World of Corporate Law's Consolation Prize

By John Jenkins, Calfee, Halter & Griswold LLP

Dissenting shareholders' rights of appraisal are corporate law's consolation prize. They came into being more than a century ago as states amended their corporate statutes to allow mergers and other transactions involving fundamental changes to the corporation's business to be adopted by less than unanimous shareholder consent. Since these amendments meant that those shareholders who did not agree would otherwise be compelled to retain an often illiquid investment that they did not originally sign up for, legislatures opted to provide them with a judicial route to liquidity in some circumstances.[1]

While appraisal rights may share a common origin, different justifications have been advanced for them over the years and jurisdictions differ in terms of the scope of those rights. Appraisal rights are available in Delaware only in very limited circumstances involving certain kinds of mergers. In contrast, appraisal rights can arise in a wide variety of settings in other jurisdictions. In addition to mergers, appraisal rights may be available in asset deals, stock swaps, and even in connection with the adoption of some kinds of charter amendments. What's more, appraisal rights may be available not only to the seller's shareholders, but to the buyer's shareholders as well.

Although most state statutes are derived from the Model Business Corporation Act (the "MBCA"), idiosyncrasies abound in terms of when those rights arise, who has them, and what "fair value" a dissenter can hope to obtain through their exercise. The variations among state appraisal regimes can create significant headaches for dealmakers.

When Do Appraisal Rights Arise?

In Delaware, appraisal rights arise *only* in merger transactions, and usually only in cash mergers. In contrast, jurisdictions following the MBCA's approach may provide for up to seven separate events that trigger appraisal rights. In addition to mergers, these include share exchanges, sales of assets, certain

[1] For a discussion of the development of appraisal rights, see Robert B. Thompson, *Exit, Liquidity, and Majority Rule: Appraisal's Role in Corporate Law*, 84 GEO. L.J. 1 (1995).

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charter amendments, certain domestication transactions, conversions of a corporation into a non-profit and conversions of a corporation into a non-corporate entity.[2]

In most states, there is a linkage between the right to vote on a transaction and the right to exercise appraisal rights. In other words, if shareholders do not have a right to vote on a particular transaction, they do not have the right to dissent from it. However, appraisal rights are also available in connection with "short form" mergers for which a shareholder vote is not required.[3]

A majority of the states have adopted some form of a "market out" provision that limits or eliminates the availability of appraisal rights in transactions involving a corporation with shares listed on a national securities exchange. Delaware's version of the market out denies appraisal rights to a shareholder of an actively traded corporation only if the merger consideration is also actively traded stock.[4] In contrast, some other states have a broader exception, and deny appraisal rights to any shareholder of an actively traded corporation, regardless of the type of consideration involved in the deal.[5]

Who Has Appraisal Rights?

Concerns about appraisal rights typically focus on their availability to the seller's shareholders, but depending on the particular jurisdiction of incorporation and the nature of the transaction, the buyer's shareholders may have appraisal rights as well.

A buyer's shareholders will almost never have appraisal rights in Delaware. Appraisal rights are tied to voting rights, and Delaware provides buyers with the ability to structure their transactions in such a way as to avoid a vote. That is because Delaware allows corporations to structure a deal as a triangular merger between the target company and a wholly owned subsidiary of the acquiring company. Since either the target or the subsidiary will be the "surviving company" in the merger, any statutory requirement for a shareholder vote will be satisfied by having the parent acquiror vote its shares in the subsidiary in favor of the transaction.[6]

Due to the broader range of events that give rise to appraisal rights in jurisdictions that follow the MBCA, a buyer's shareholders are much more likely to have appraisal rights, even in a transaction structured as a triangular merger. Under applicable state law, a stock-for-stock merger may also be regarded as a statutory share exchange or similar transaction as to which the parent acquiror's shareholders have voting and appraisal rights. For example, in Ohio, a merger in which the parent will issue shares that immediately after the transaction will allow the new holders to exercise one-sixth or more of the parent's voting power is a "majority share acquisition," and the parent's shareholders will have voting and appraisal rights with respect to that transaction.[7]

Appraisal rights generally may be exercised by persons who were record holders of the corporation at the relevant record date set for shareholders to act on the transaction. But there is less to that requirement than meets the eye, at least in the case of public companies. One of the more interesting developments in recent years is the potential for "appraisal rights arbitrage" created by the Delaware chancery court's decision in the *Transkaryotic Therapies* appraisal proceeding.[8] In that case, Chancellor Chandler refused to look behind DTC's record ownership to determine if individual beneficial owners were actually entitled to appraisal rights. As a result, investors could acquire or increase positions subsequent to

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[2] See MODEL BUS. CORP. ACT §§ 13.02(a)(1)–(4), (6)–(8) (ABA 1999).

[3] See Del. Code Ann. tit 8 §253(d).

[4] See Del. Code Ann. tit 8 §261(b)(1).

[5] See, *e.g.,* S.C. Code Ann §33-13-102(B) ("[N]o dissenters' rights under this section are available for shares of any class or series of shares which, at the record date fixed to determine shareholders entitled to receive notice of a vote at the meeting of shareholders to act upon the agreement of merger or exchange, were either listed on a national securities exchange or designated as a national market system security on an interdealer quotation system by the National Association of Securities Dealers, Inc").

[6] See Del. Code Ann. tit 8 §251(d). Under certain circumstances, a vote by the parent company shareholders may be required under stock exchange rules (see, *e.g.,* See New York Stock Exchange Listed Company Manual §312.03(c)), but appraisal rights do not come into play in connection with such a vote.

[7] See Ohio Rev. Code. §1701.01(R) and §1701.83 (2011). In contrast, an all cash transaction structured as a triangular merger in Ohio would not result in a buyer's shareholders having voting or appraisal rights.

[8] *In re Appraisal of Transkaryotic Therapies, Inc.*, 2007 WL 1378345 (Del. Ch. May 2, 2007).

the record date if they believed that fair value was higher than the consideration being paid, and then seek appraisal for their shares.

To What Are Dissenting Shareholders Entitled?

One thing that most jurisdictions agree on is that a shareholder is entitled to receive the "fair value" of his or her shares in an appraisal proceeding. However, there are important differences in how various jurisdictions define that term, the most notable of which relate to whether a minority discount or a control premium should be applied in determining fair value.

The most recent version of the MBCA expressly provides that fair value will be determined "using customary and current valuation concepts and techniques generally employed for similar businesses in the context of the transaction requiring appraisal and . . . without discounting for lack of marketability or minority status.. . ."[9]

Delaware takes a view similar to the MBCA's concerning minority and lack of marketability discounts. The Delaware Supreme Court has held that a dissenting stockholder is entitled to "his proportionate interest in a going concern,"[10] and that a minority discount "imposes a penalty for lack of control, and unfairly enriches the majority shareholders."[11] However, the extent to which Delaware's requirement to provide a dissenting shareholder with a "going concern" value requires that value to reflect a control premium is less clear. The most recent statement from the Chancery Court indicates that the addition of a control premium is appropriate when value is assessed on the basis of a comparable companies analysis, which looks to the trading prices of those entities—prices that arguably reflect a minority discount—but not when value is assessed on the basis of a discounted cash flow analysis, where a control premium is baked in to the analysis.[12]

While the MBCA and Delaware both agree that a minority discount is inappropriate, that is not a view shared by all jurisdictions. Some state statutes (notably Ohio and New Jersey) include language similar to that included in the 1984 version of the MBCA, which did not expressly exclude the possibility of a minority discount, and defined fair value as "the value of the shares immediately before the effectuation of the corporate action . . . excluding any appreciation or depreciation in anticipation of the corporate action. . . ."[13]

Ohio has pointed to this statutory language in rejecting Delaware's approach to minority interests. Ohio's appraisal rights statute says that a dissenting shareholder is entitled to receive the "fair cash value" of the shares, which the statute defines to mean "the amount that a willing seller who is under no compulsion to sell would be willing to accept and that a willing buyer who is under no compulsion to purchase would be willing to pay," and goes on to provide that, consistent with the language of the 1984 version of the MBCA, "[i]n computing fair cash value, any appreciation or depreciation in market value resulting from the proposal submitted to the directors or to the shareholders shall be excluded."[14]

In *Armstrong v. Marathon Oil*, the Ohio Supreme Court held that dissenting shareholders could only receive "the amount which their shares would have brought on the market had the transaction dissented from never occurred."[15] That essentially means, in most cases, that an Ohio dissenter in a publicly traded company gets the closing price on the day before the merger less any appreciation associated with the deal. Relying on *Marathon* and the statutory language quoted above, Ohio appellate courts have expressly

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[9] MODEL BUS. CORP. ACT §13.01(4) (ABA 1999).

[10] *Tri-Continental Corp. v. Battye*, 73 A.2d 71 (Del. 1950).

[11] *Cavalier Oil v. Hartnett*, 564 A.2d 1137 (Del. 1989)

[12] See, *e.g., Berger v. Pubco Corp.*, CA No. 3414-CC (Del. Ch. Ltr. Op. May 10, 2010 ("Under Delaware law, it is appropriate to add a control premium when appraisers use a comparable public company methodology. . . Authoritative commentators have likewise observed that it is improper and illogical to add a control premium to a discounted cash flow valuation.")

[13] MODEL BUS. CORP. ACT §13.01(3) (ABA 1984); N.J. Stat. Ann. 14A:11-3 (2011); Ohio Rev. Code. §1701.85 (2011).

[14] Ohio Rev. Code §1701.85(C) (2011).

[15] *Armstrong v. Marathon Oil Co.*, 513 N.E. 2d 776, 778 (Ohio 1987).

held that both minority and lack of marketability discounts may be applied in determining fair cash value in appraisal proceedings.[16]

Procter & Gamble, Gillette and the Eccentricities of Appraisal Rights

Perhaps no major transaction in recent years illustrates the bizarre impact that the convoluted multi-state appraisal rights regime can have on dealmakers better than Procter & Gamble's 2005 acquisition of Gillette. That multi-billion dollar transaction was structured as a stock-for-stock reverse triangular merger, with a newly formed merger subsidiary of Procter & Gamble merging into Gillette.

Gillette was a Delaware corporation, and as a result of the "market out" exception in Delaware's appraisal rights statute, its shareholders did not have appraisal rights in the merger. On the other hand, Procter & Gamble is an Ohio corporation, and even though Ohio's merger statute would not have entitled its shareholders to vote on a triangular merger like this one, since the transaction involved the issuance of shares representing almost 40% of its voting power, the merger was also a "majority share acquisition" under Ohio law. That meant that Procter & Gamble's shareholders had both voting and appraisal rights with respect to the transaction.

In a regime like Ohio's, appraisal rights create unique challenges for a buyer. Ohio's fair cash value standard entitles dissenters to receive what their shares would have received on the market, in the absence of a transaction, without any appreciation or depreciation associated with the deal. While that means a seller with appraisal rights might well be tagged with a minority discount, a buyer's shareholder could reap a significant windfall. That is because, in a large stock transaction like this one, a buyer may well face fairly significant *depreciation* in its stock price as a result of the deal.

Procter & Gamble was mindful of the potential for significant appraisal demands in connection with the transaction. As a result, it conditioned its obligations under the merger agreement on appraisal rights not being elected by the holders of more than 5% of its outstanding shares. While conditions on appraisal rights are not all that unusual, they are generally a condition that the buyer imposes with respect to the seller's shareholders, not its own. In this connection, the interplay between Ohio and Delaware law made for a very unusual appraisal rights condition—one that applied to the actions of the buyer's own shareholders.

Coping with Appraisal Rights

While there is no one path that will result in the best resolution of appraisal rights issues in each deal, there are several steps that lawyers and their clients should take in order to help develop an effective appraisal rights strategy.

- *Know Your Statutes*—If you take nothing else from the preceding discussion, you should appreciate that there is almost endless variation among the states in key aspects of appraisal rights statutes. Time invested in reviewing the statutory provisions that apply to your particular transaction is time well spent, and in the event that those rights are asserted, it can be invaluable. Appraisal statutes are notoriously intricate in terms of their procedural requirements, and courts have not been forgiving to dissenters who do not comply with them. Recently, however, cases have made it clear that corporations will be held to the same demanding standard.[17]

- *Chances Are, It's Not Like Delaware*—Appraisal rights statutes are one area of corporate law where Delaware's influence is far from pervasive. If you assume that the appraisal statute of a

[16] *English v. Artromick International*, 200 Ohio App. LEXIS 3580 (Aug. 10, 2000). In addition to Ohio, several other jurisdictions have allowed consideration of a lack of marketability discount in appraisal proceedings. See *Munshower v. Kolbenheyer*, 732 So.2d 385 (Fla. Dist.Ct.App.1999); *Weigel Broadcasting Co. v. Smith*, 682 N.E.2d 745 (1996),; *Ford v. Courier-Journal Job Printing Co.*, 639 S.W.2d 553 (Ky.Ct.App.1982); *King v. F.T.J., Inc.*, 765 S.W.2d 301 (Mo.Ct.App.1988). Proposed amendments to Ohio's appraisal statute would, if enacted, prohibit the application of minority and marketability discounts and the application of a control premium. See Sub. H.B. No. 48 (129th Gen. Assem. 2011-2012).

[17] See, e.g., Berger v. Pubco Corp., 976 A.2d 132, 144 (Del. 2009) ("case law is replete with examples where the dissenting minority shareholders that failed to comply strictly with certain technical requirements of the appraisal statute, were held to have lost their entitlement to an appraisal. . . fairness requires that the corporation be held to the same strict standard of compliance.")

particular jurisdiction will track Delaware, you are in for some unpleasant surprises. In addition to the items addressed in this article, states may vary from Delaware on such issues as the time period during which a demand for appraisal may be asserted, who will bear the costs of appraisal, and the corporation's obligation to make an upfront payment of what it contends to be fair value.[18]

- *Think Outside the Box*—Procter & Gamble's experience in the Gillette transaction illustrates both the importance of identifying where the potential risks of appraisal rights may arise and appreciating that they may come from where they are least expected.

- *Pay Attention to Your Process*—Last, but far from least, is the importance of process. Despite the complexity associated with appraisal rights, big appraisal problems tend to be associated with poor processes. In contrast, courts are often very deferential to what they perceive as a strong solicitation process. For example, in one case, Vice Chancellor Strine determined to put full weight on the market price as an indicator of the fair value of a target's common shares. Emphasizing the extensive solicitation process in which the target engaged, he noted that under the circumstances, "the use of alternative valuation techniques like a DCF [discounted cash flow] analysis is necessarily a second-best method to derive value."[19]

The idiosyncrasies of the appraisal regimes of various jurisdictions can create significant challenges for dealmakers, and the best method for resolving those challenges will differ from transaction to transaction depending upon the structure of the deal, the nature of the consideration to be paid, and the jurisdictions involved. Nevertheless, close attention to the availability and potential impact of appraisal rights at the outset of a transaction can help deal lawyers prevent corporate law's consolation prize from exacting an unexpected toll on their transaction.

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[18] For a review of the provisions of the MBCA and the states that have adopted them, see Mary Siegel, *An Appraisal of The Model Business Corporation Act's Appraisal Rights Provisions*, 74 Law and Contemp. Prob. 231 (2011)

[19] *The Union Illinois 1995 Inv. Ltd. Partnership v. Union Fin. Group Ltd.*, C.A. No. 19586, Strine, V.C. (Del. Ch. Dec. 19, 2003)

The Deal Lawyer's Guide to Hidden Employee Benefit Issues: An Update Regarding Successor Liability

By William Lawlor, David Jones and Eric Siegel, Partners, and Gregory Schernecke, Associate, of Dechert LLP

As noted in our article, *The Deal Lawyer's Guide to Hidden Employee Benefit Issues*—appearing in the March-April 2010 issue of *Deal Lawyers*—employee benefit issues can often substantially influence the structure of a deal, the amount of purchase price and the core nature of ongoing obligations between sellers and buyers. A recent federal court decision highlights this fact and serves as a reminder to deal participants that employee-related liabilities can raise issues which defy traditional m&a principles governing allocation of risk.

Does Buyer's Assumption of Liability Depend on Form of Transaction?

Under federal and state common law, the responsibility of a buyer for a seller's liabilities as a successor normally depends on the form of the transaction.[1] In an asset transaction, the general common law rule is that a buyer of assets is deemed to have assumed the liabilities of a seller only if (i) the buyer expressly agreed to assume the liabilities, (ii) the transaction amounted to a de facto merger, (iii) the buyer was a mere continuation of the seller (which requires commonality of ownership between the buyer and seller) or (iv) the transfer of assets was for the fraudulent purpose of escaping liability for the seller's debts.[2] The recent Third Circuit decision in *Einhorn v. M.L. Ruberton Construction Company*[3] diverged from this position and held that under federal common law, in an asset deal a buyer could be responsible for certain liabilities of a seller under the Employee Retirement Income Security Act of 1974 ("ERISA") if the buyer had notice of the liabilities and there was a "continuity of operations" between the buyer and seller.

In *Einhorn*, the seller was delinquent on contributions to two union multiemployer benefit plans. During negotiations among the buyer, the seller and a union representative for the seller's employees, the union representative told the buyer that the seller owed the union benefit plans "about a half a million dollars." The negotiations resulted in an agreement between the buyer and the union under which the buyer would hire the seller's workers under the existing CBA,[4] and an agreement between the seller and the union under which the seller would remit all future contributions owed to the benefit plans. Neither agreement specifically addressed the buyer's potential successor liability for the delinquent plan contributions.[5] Shortly after completion of the asset purchase, the union filed an action against the buyer, as the seller's successor, to recover the delinquent contributions.

The Third Circuit noted that federal common law could impose liability upon successors beyond the confines of the common law rule "when necessary to protect important employment-related policies."[6] The court stressed Congress' desire to protect plan participants by enacting ERISA, and held that an asset buyer could be held liable as a successor for ERISA liabilities if the buyer had notice of the liabilities and there was a "continuity of operations" linkage between buyer and seller. The continuity of operations linkage test does not require commonality of ownership, as is required under the general common law rule. Instead, the court pointed to such factors as continuity of the workforce, management, equipment and location, completion of existing work orders and constancy of customers as controlling.

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[1] Teamsters Pension Trust Fund of Phila. & Vicinity v. Littlejohn, 155 F.3d 206, 208-210 (3d. Cir. 1998) (in a merger, the surviving entity is liable for the debts of the predecessor entity regardless of whether the successor had any pre-merger notice of such debts).

[2] Upholsterers' Int'l Union Pension Fund v. Artistic Furniture of Pontiac, 920 F.2d 1323 (7th Cir. 1990). Note that certain states also recognize exceptions to the common law rule for other types of liabilities, such as product liability and environmental liabilities.

[3] 2011 U.S. App. LEXIS 1171 (agreeing with the Seventh Circuit's decision in *Artistic Furniture*).

[4] This accommodation to the union was actually used by the court to justify imposition of liability on the basis of continuity of operations.

[5] The court did not address what impact, if any, such an agreement would have had (*e.g.,* whether the union could have waived its right to assert claims against the buyer for these liabilities).

[6] See Golden State Bottling Co. v. NLRB, 414 U.S. 168 (1973) (imposing successor liability for back-pay following a wrongful termination under the National Labor Relations Act); Brzozowski v. Corr. Physician Servs., Inc., 360 F.3d 173 (3rd Cir. 2004) (holding the buyer responsible for damages related to the seller's gender discrimination).

Einhorn's notice and continuity of operations criteria to establish successor liability presents some open questions and practical concerns for most asset buyers. What degree of notice is sufficient? In *Einhorn*, the buyer was orally made aware of the nature and approximate amount of the liability directly by the party asserting the liability. Would general notice from the seller about a potential issue without the amount or other details suffice? What if it is in the context of disclosures schedules with typical disclaimers as to whether an actual liability exists? Should buyers attempt to avoid notice by limiting the level of due diligence undertaken in this area? To what degree can the typical buyer defeat the continuity of operations linkage? Among other things, how relevant is it that the buyer is not taking on the entire workforce subject to the employee liabilities?

Courts Imposing Liability on Buyers

Einhorn is just the latest in a line of federal cases in which the courts are willing to impose liability on buyers for a seller's employee-related liabilities.[7] As noted in *Einhorn*, in addition to ERISA liabilities, the courts have found that liability may be imposed on buyers for sellers' violations of the National Labor Relations Act, the Fair Labor Standards Act, the Age Discrimination in Employment Act and Title VII (employment discrimination).[8]

These decisions increase transaction costs and friction in certain deals because of the inability to predict with any degree of certainty whether the contractual wishes of the parties will be honored. As a result, where any of these liabilities could be significant and the business deal does not call for the buyer to assume such liabilities, buyers will need to buttress the contract with other liability insulating mechanisms, such as structural planning to avoid continuity of operations, escrows/holdbacks, seller credit enhancements and insurance.

Most of the time asset buyers will not face the successor concern because underfunding issues are not at play, the buyer has agreed to assume the subject liabilities, or the notice and continuity of operations linkage cannot be proved. But sometimes these areas bite, and bite hard. For this reason it is useful to run through a logic path when facing this issue along the lines set out below:

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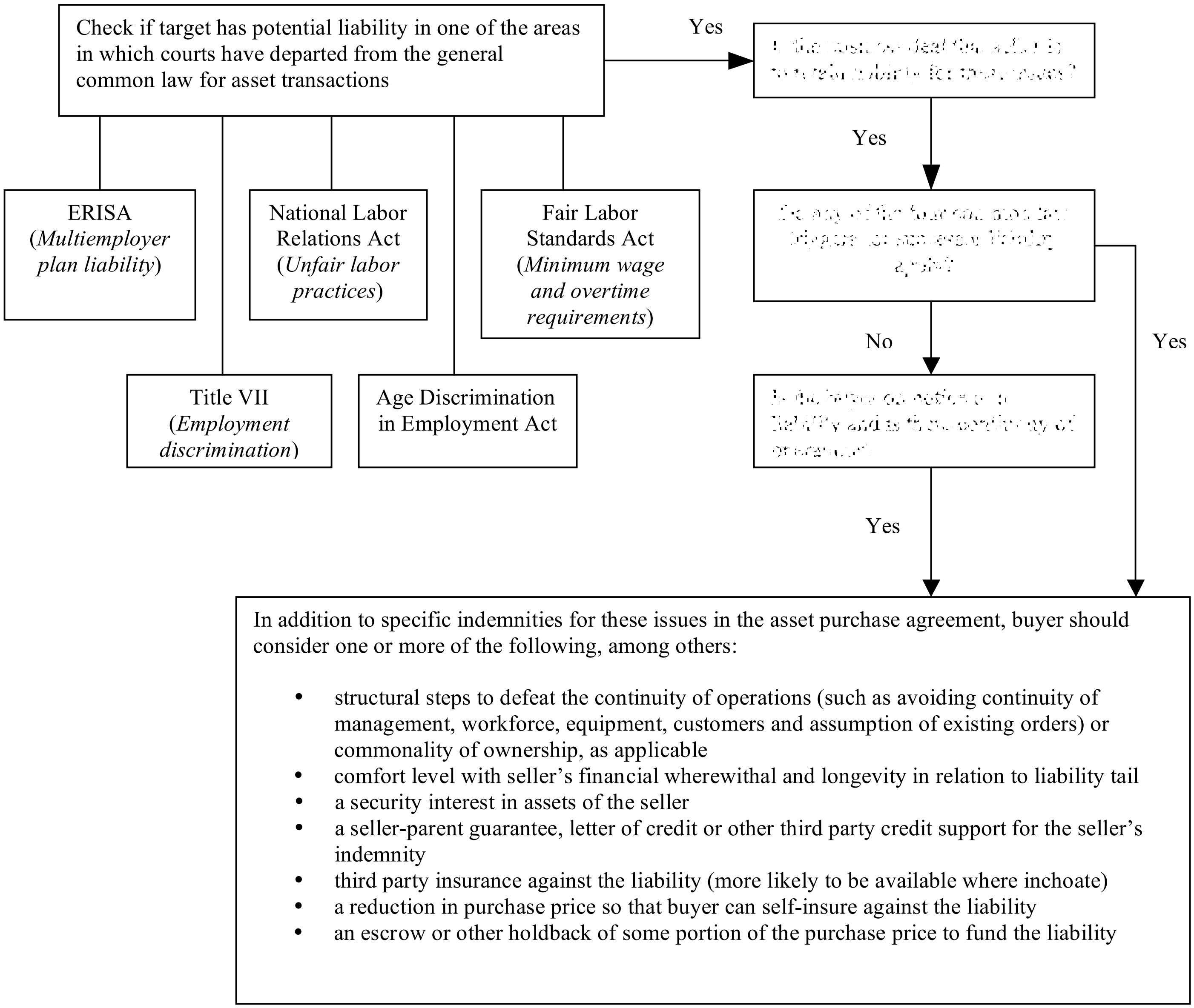
[7] Asset buyers should also be aware that Treasury regulations may subject them to liability for COBRA health plan continuation coverage for certain "qualified beneficiaries" if the buyer continues the business "without interruption or substantial change" and the seller ceases to provide health benefits to all employees in connection with the transaction. 26 C.F.R. §54.4980B-9. Even if buyer and seller contractually allocate this liability to seller, buyer will be responsible if seller defaults.

[8] Steinbach v. Hubbard, 51 F.3d 843 (9th Cir. 1995) (Fair Labor Standards Act) (finding that successor liability could be imposed for failure to pay minimum wage and overtime in accordance with the Fair Labor Standards Act, though not in this case because the business transfer was not permanent); Criswell v. Delta Air Lines, Inc., 868 F.2d 1093 (9th Cir. 1989) (Age Discrimination in Employment Act) (imposing liability for violations of the Age Discrimination in Employment Act for setting a mandatory retirement age and otherwise treating employees differently because of their age); Rego v. ARC Water Treatment Co. of Pa, 181 F.3d 396 (3rd Cir. 1999) (Title VII) (holding that liability could be imposed for discrimination based on national origin in violation of Title VII, though not in this case because there was insufficient continuity) and Brzozowski v. Corr. Physician Servs., Inc., 360 F.3d 173 (3rd Cir. 2004) (finding that liability could be imposed for discrimination based on gender in violation of Title VII). See also Sec'y of Labor v. Mullins, 888 F.2d 1448 (D.C. Cir. 1989) (Mine Safety and Health Act); EEOC v. Vucitech, 842 F.2d 936 (7th Cir. 1988) (Pregnancy Discrimination Act); Musikiwamba v. ESSI, Inc. 760 F.2d 740 (7th Cir. 1985) (race discrimination under 42 U.S.C. § 1981). These cases also typically cite as a factor the inability of the predecessor employer to provide relief. Cf. Sharon & Walter Construction Inc., No. 00-1402, 2010 WL 4792625 (a decision by the Occupational Safety and Health Review Commission applying a "substantial continuity" test to attribute a corporate predecessor's violations of the Occupational Safety and Health Act "repeat offender" penalty provisions to a successor via an asset transfer).

Successor Liability Logic Path



Delaware Case Highlights Need for Additional Due Diligence in Merger Acquisitions

By John Grossbauer, Michael Pittenger, and Cara Grisin of Potter, Anderson & Corroon[1]

In *Meso Scale Diagnostics, LLC v. Roche Diagnostics GmBH*,[2] the Delaware Court of Chancery declined to dismiss a claim that a reverse triangular merger (an "RTM") constituted an assignment "by operation of law" of certain intellectual property license rights in violation of a contractual provision that required the plaintiffs' prior consent. The decision has alarmed M&A practitioners who view the decision as calling into question the long-held view that RTMs, unlike other forms of M&A transactions, do not constitute an assignment of the target corporation's assets for purposes of nonassignment clauses in the target's third party contracts.

While the decision does suggest the need for more care in the due diligence review process in connection with acquisitions structured as RTMs, practitioners should also be mindful that the case was decided upon a unique, unusually complex set of facts, including an allegation that the entire purpose of the RTM at issue was to permit the acquiror to obtain certain intellectual property rights in contravention of an overarching purpose of the earlier transactions giving rise to the nonassignment clause at issue.

RTMs and Third Party Nonassignment Covenants

In an RTM, a new subsidiary of the acquiring entity—formed solely for the purpose of the transaction—merges with and into the target corporation, with the target corporation remaining as the entity surviving the merger. In exchange for their shares of the target corporation, former stockholders of the target typically receive cash and/or stock in the acquiring corporation. Because the corporate existence of the target corporation remains unchanged, and because the rights and obligations of the target corporation accordingly remain with the target corporation, an RTM is often a favored acquisition structure, in part because it has been generally viewed as a means of avoiding violation of nonassignment clauses in the target's third party contracts.

This view is supported by Section 259 of the General Corporation Law of the State of Delaware, which provides, in pertinent part, that "the separate existence of all the constituent corporations in a merger, except the one into which the other or others of such constituent corporations have been merged, . . . shall cease," confirming the continuation of the surviving corporation.[3] The fact that control of the surviving corporation in an RTM will change typically had not been considered problematic for nonassignment clauses in view of case law in Delaware and elsewhere holding that stock acquisitions, without more, constitute a mere change in ownership and not the assignment of any contractual rights or obligations of the corporation whose stock is sold.[4]

Until recently, no Delaware court had questioned this view with respect to RTMs, but the Court's decision in *Meso Scale* has caused some to doubt the soundness of practitioners' long-held view that RTMs do not constitute an assignment of the target's assets under Delaware law. Due to the context in which it arose and its procedural posture, however, that decision may have a more limited reach than feared.

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[1] John F. Grossbauer and Michael A. Pittenger are Partners and Cara M. Grisin is an Associate in the Wilmington, Delaware law firm of Potter Anderson & Corroon LLP. The views expressed are those of the authors and may not be representative of the firm or its clients.

[2] 2011 WL 1348438 (Del. Ch. Apr. 8, 2011).

[3] 8 Del. C. § 259(a) (emphasis added).

[4] See, e.g., Baxter Pharm. Prods., Inc. v. ESI Lederle Inc., 1999 WL 160148, at *5 (Del. Ch. Mar. 11 1999); Branmar Theatre Co. v. Branmar, Inc., 264 A.2d 526, 529 (Del. Ch. 1970). By contrast, Delaware courts have held that forward triangular mergers, in which the merger subsidiary of the acquiror is the surviving entity of a merger with the target corporation, do constitute an "assignment by operation of law" of the contractual rights and obligations of the target, as such rights and obligations vest in the surviving entity. Tenneco Auto Inc. v. El Paso Corp., 2002 WL 453930, at *2 (Del. Ch. Mar. 20, 2002); Star Cellular Tel. Co. v. Baton Rouge CGSA, Inc., 1993 WL 294847, at *6-7 (Del. Ch. Aug. 2, 1993), aff'd, 647 A.2d 382 (Del. 1994).

Meso Scale Diagnostics, LLC v. Roche Diagnostics GmBH

Facts

The Court's decision in *Meso Scale* arose in the context of a motion to dismiss breach of contract claims by plaintiffs Meso Scale Technologies LLC ("MST") and Meso Scale Diagnostics, LLC ("MSD" and together with MST, the "Plaintiffs") against defendants Roche Holding Ltd. ("Roche"), IGEN International, Inc. ("IGEN"), and BioVeris Corporation ("BioVeris").[5] In 1992, Roche obtained from defendant IGEN an exclusive, but narrow, license (the "1992 License") to use the then-patent holder's electrochemiluminescence ("ECL") technology. In 1995, IGEN entered into a joint venture with MST and MSD to develop the venture partners' ECL-related intellectual property. As part of the venture, IGEN granted MSD exclusive rights to certain broadly defined ECL fields ("MSD License").[6]

After a federal district court ruled in 2002 that Roche had violated the field restrictions of the 1992 License, Roche sought to reacquire an ECL license from IGEN.[7] As part of a transaction comprised of approximately one dozen contemporaneously executed agreements (the "Transaction"), Roche obtained a second nonexclusive license from IGEN in the field of individual patient human diagnostics (the "Roche License"). Also as part of the Transaction, Roche acquired IGEN, but before it did so, IGEN transferred all of its intellectual property assets, including its ECL patents and license rights and obligations under the Roche and MSD Licenses, to a newly created public corporation, defendant BioVeris.[8]

Plaintiffs, Roche, IGEN, and BioVeris entered into a Global Consent and Agreement (the "Global Consent"), which provided that the parties consented to the "Transaction Agreements and the consummation of the Transactions" and "grant[ed] all waivers and consents which are necessary under the MSD Agreements to permit the consummation of the Transactions and the performance by [IGEN, BioVeris], and each Consenting Party of their obligations under the Transaction Agreements in accordance with their terms."[9] In addition, the Global Consent contained a broadly worded nonassignment clause providing that none of the "the rights, interests or obligations under [the Global Consent] shall be assigned, in whole or in part, by operation of law or otherwise by any of the parties without the prior written consent of the other parties . . . ."[10]

After the closing of the Transaction, BioVeris alleged that Roche had violated the Roche License, threatening to seek "hundreds of millions of dollars" in damages from Roche for the alleged license violations.[11] Thereafter, Roche acquired BioVeris in 2007 by way of an RTM (the "Merger") in which newly created Roche subsidiary LLI Acquisition Corp. ("LAC") merged into BioVeris, with BioVeris stockholders receiving cash for their shares. BioVeris was the surviving entity and Roche became its sole stockholder. The effect of the Merger was that "all properties, rights, privileges, powers and franchises of [BioVeris] and [LAC] vested in [BioVeris], and all claims, obligations, debts, liabilities and duties of [BioVeris] and [LAC] [became] the claims, obligations, debts, liabilities and duties of [BioVeris]."[12] Shortly after the Merger, Roche announced layoffs, closures, and the discontinuation of product lines at BioVeris.[13]

Allegations

Plaintiffs alleged Roche and its affiliates, by consummating the Merger, breached provisions in (i) the Global Consent and (ii) the Roche License, which BioVeris had acquired in the Transaction. As to the Global Consent, Plaintiffs contended that under the terms of the Global Consent, BioVeris owned the same property that IGEN owned before its acquisition by Roche in the Transaction (including rights under the Roche License), and that, accordingly, the Roche License constituted rights of BioVeris "under" the Global Consent that could not be assigned without Plaintiffs' written consent. Plaintiffs argued that Defendants

[5] Meso Scale, 2011 WL 1348438, at *1.

[6] Id. at *2

[7] Id. at *2-3.

[8] Id. at *3.

[9] Id. at *5.

[10] Id.

[11] Id. at *6.

[12] Id.

[13] Id.

breached the nonassignment clause because the Merger constituted an assignment of the Roche License "by operation of law or otherwise."[14]

The Court of Chancery's Decision

In denying Roche's motion to dismiss on the basis that the nonassignment provision was inapplicable to the Roche License, the Court found two reasonable interpretations of the contract language: (1) the nonassignment clause could apply to all the rights, interests, and obligations arising from the Transaction in 2003, as argued by Plaintiffs; or (2) the clause could apply just to the rights, interests, and obligations specifically created "under" the Global Consent (and would not include the Roche License, which was granted under another Transaction agreement), as argued by Defendants.[15] Accordingly, it could not dismiss Plaintiffs' claims on this theory, given the plaintiff-friendly standard applied on a motion to dismiss.

The Court also rejected Defendants' argument that the change of control of BioVeris by way of the RTM was not an "assignment by operation of law or otherwise."[16] The Court explained that no Delaware court had considered the issue of whether an RTM is an assignment by operation of law or otherwise of the surviving corporation's assets for purposes of a nonassignment clause.[17] Roche argued that RTMs were analogous to stock acquisitions, citing to case law in which Delaware courts have found that stock acquisitions do not constitute assignments.[18]

Although the Court recognized similarities between stock acquisitions and RTMs, and noted that stock acquisitions "do exemplify a situation in which a mere change in ownership, *without more*, does not constitute an assignment as a matter of law," the Court ruled that stock acquisition case law was not controlling under the circumstances.[19] Plaintiffs had alleged more than a mere change in BioVeris's ownership status: they alleged that, within months of the Merger, Roche laid off all BioVeris employees, vacated a BioVeris facility, and discontinued all BioVeris product lines. The Court acknowledged that the Defendants' construction of "by operation of law" was reasonable, but noted that it had failed to find a case holding that an RTM cannot constitute an assignment by operation of law "in circumstances comparable to this case" where the subsidiary "essentially was gutted and converted into a shell company."[20]

Moreover, the Court was not convinced that Plaintiffs' construction of the nonassignment clause was unreasonable. Plaintiffs cited Delaware case law in the context of forward triangular mergers suggesting that mergers, regardless of their form, should be considered an assignment "by operation of law,"[21] as well as a California decision holding that an RTM was such an assignment.[22] Thus, because the parties offered two competing, reasonable interpretations of the term "by operation of law" in this context, the Court held that the use of that term in the Global Consent was ambiguous and denied Defendants' motion to dismiss.[23] In addition, the Court held that Plaintiffs had alleged sufficient facts to infer that they were harmed by the decision to proceed with the Merger without Plaintiffs' consent, and therefore, the dispute could not be resolved on Defendants' motion to dismiss.[24]

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14 Id. at *7.

15 Id. at *8-10.

16 Id. at *10-13.

17 Id. at *10.

18 Id. at *11 (citing Baxter, 1999 WL 160148, at *5; Branmar Theatre, 264 A.2d at 529).

19 Meso Scale, 2011 WL 1348438, at *12 (emphasis added).

20 Id. at *12-13.

21 See Tenneco, 2002 WL 453930, at *2; Star Cellular, 1993 WL 294847, at *6-7.

22 See SQL Sol'ns Inc. v. Oracle Corp., 1991 WL 626458 (N.D. Cal. Dec. 18, 1991).

23 Meso Scale, 2011 WL 1348438, at *13.

24 Id. at *14. Plaintiffs also asserted claims that Roche breached covenants in the Roche License by developing ECL-based products outside of the field for which Roche had licensed the technology. Before considering the merits of the Roche License claim, the Court addressed whether the claim should be arbitrated and whether that issue should be decided by the Court or the arbitrator. The Court held that the issue was substantive because it concerned "gateway questions" relating to the applicability of an arbitration provision in the Roche License, and therefore the underlying question was whether the parties decided in the contract to submit a particular dispute to arbitration. Id. at *15. Finding clear and unmistakable evidence of the parties' intent to arbitrate arbitrability, the Court ruled that the arbitrator should decide standing issues raised by Defendants and, if Plaintiffs have standing, the merits of the Roche License claim. Id. at *16-17. As a result, the Court stayed further proceedings as to the Roche License claim in favor of arbitration. Id. at *17.

Implications of *Meso Scale*

Because of its procedural posture as a motion to dismiss, *Meso Scale* leaves for another day the ultimate determination of whether (and under what circumstances) an RTM may constitute an assignment of the target corporation's assets by operation of law under Delaware law. It is doubtful, however, that future courts faced with the issue would interpret the case as requiring that RTMs constitute such an assignment under many common fact patterns. Rather, *Meso Scale* arguably provides precedent only for the proposition that an RTM could constitute an assignment by operation of law under very limited factual circumstances where the target is "gutted" and thereafter exists (if it exists at all) only as a shell company for convenience of the acquiror.

While the limited scope of the decision provides some comfort, it does not eliminate the need for greater care in conducting contractual due diligence on the buyer's side, and in drafting disclosure schedules on the seller's side. In providing advice to prospective buyers in connection with an RTM, counsel also should be aware of any plans to strip assets from a newly acquired subsidiary post-closing. The particular nonassignment language encountered in contracts also may provide comfort to the extent it does not expressly cover assignments by operation of law.

The Art of Written Consent Solicitations

***By Merrill Stone and Matthew Kane, Kelley Drye & Warren LLP*[1]**

Back in 2000, we discussed in Carl Hagberg's *Shareholder Service Optimizer* how would-be acquirers were increasingly using consent solicitations in attempts to ambush boards and to effect changes of control. Consent solicitations still hold a notable place in the corporate takeover landscape, even if they are perhaps not as widely publicized or notorious as they were a decade ago. This is a piece that we recently published in the *Optimizer* to update that article.

In the hostile takeover and unsolicited offer context, consent solicitations are most often employed to remove the target's directors who are opposed to the acquirer's advances and replace them with a hand-picked slate of friendly candidates who support the merger or acquisition. We noted in 2000 that this practice would likely persist because launching a consent solicitation is relatively inexpensive compared to other options and directors remain easy targets for shareholder backlash, often acting as magnets for blame and accusations of self-interest.

The Role of Written Consent Solicitations Today

Today, consent solicitation bids are often not carried out to fruition, but they are still alive and well as an important element of takeover strategy. Thus, companies and their directors should continue to think about them.

One reason that hostile consent solicitations were and still are viable options for many would-be acquirers is that Delaware law permits, as it did in 2000, any action that can be taken at an annual or special meeting of stockholders to be taken instead, without prior notice and without putting the matter to a formal vote, by the written consent of the minimum number of stockholders that would be necessary to act on the matter at a stockholder meeting at which all shares entitled to vote were present and voted.

Nevada, also a popular choice as a state of incorporation, has substantively similar statutory provisions. Other states, however, have more restrictive rules and offer more protection to existing boards. California, for example, has a similar written consent statute to that of Delaware except that it has a specific carve out for the election of directors that requires the written consent of *all* of the holders of outstanding stock, not just the number that would be required to act at a meeting.

Similarly, under New Jersey law, unless the certificate of incorporation provides for a more liberal standard, shareholders can not act by written consent in connection with the annual election of directors and in other contexts written consents must be signed by at least all shareholders entitled to vote. New York law also requires the consent of all stockholders entitled to vote for any actions taken outside of a meeting unless the certificate of incorporation permits the action to be taken by the minimum number of shareholders that would be necessary to act at a meeting at which all shares entitled to vote were present and voted. It is important to note that regardless of which "default" mechanism is contained in a state's statutes, a corporation may always restrict or eliminate the power of shareholders to act by written consent in its certificate of incorporation.

InBev and the Lessons Learned

One of the most high profile hostile takeovers to employ a consent solicitation in recent years involved InBev's 2008 acquisition of Anheuser-Busch. For InBev, the consent solicitation was an element of a larger strategic plan to acquire Anheuser-Busch. InBev initially announced an unsolicited non-binding proposal for a friendly combination of the two beer makers, offering to acquire all outstanding Anheuser-Busch common shares for $65 per share, which was a 35% premium over the then current market value and an 18% premium over the all-time high.

Two weeks later, the Anheuser-Busch board rejected the $65 per share offer but said it was open to higher value offers. InBev immediately filed a lawsuit in Delaware seeking a declaratory judgment that a

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consent solicitation could remove all thirteen of the directors on the Anheuser-Busch board,[2] and launched the formal consent solicitation shortly thereafter. InBev used this vehicle to avoid the delay and cost of going hostile while still maintaining negotiating strength. The two companies restarted negotiations the next day and a deal was approved within a week. The consent solicitation threat proved so effective that InBev never actually had to follow through on the effort. The companies agreed on a price of $70 per share, and Anheuser-Busch became a wholly owned subsidiary of InBev.

There are several noteworthy lessons from the InBev/Anheuser-Busch story. Perhaps the most far-reaching point is that while a consent solicitation can be costly and cumbersome, it has the potential to be such an effective tool that even threatening it in itself constitutes a strong bargaining chip. It is also important to note, however, that one of the reasons InBev was able to launch a fairly successful consent solicitation at all was that Anheuser-Busch did not have many of the standard take-over defense mechanisms in place to block such a move. Anheuser-Busch is a Delaware corporation and as such could have amended its certificate of incorporation to bar shareholders from acting by written consent altogether, but it did not. Anheuser-Busch also did not have different classes of stock, a staggered board, or a poison pill—all hallmarks of standard hostile takeover defenses. Accordingly, the St. Louis brewer made itself fairly easy prey for InBev.

How Consent Solicitations Have Been Used More Recently

Consent solicitations have also been used to defend against an unwanted transaction. Dynegy is a New York Stock Exchange-listed energy company that owns and operates power plants, provides wholesale power to utilities and municipalities and employs more than 1,800 people nationwide. In 2010, Carl Icahn, Dynegy's largest shareholder, helped Dynegy fend off a takeover bid by Blackstone Group. Following that successful defense, Icahn and the Dynegy board agreed on a deal for Icahn to acquire the company for $5.50 per share—fifty cents per share more than Blackstone offered. Dynegy's second largest shareholder, hedge fund Seneca Capital, publicly opposed the bid, arguing the price was inadequate and the company was really worth between $7.50–$8.50 per share.

In an effort to fight Icahn's tender offer, Seneca also filed a preliminary consent solicitation statement with the SEC, seeking, among other things, to remove two directors from Dynegy's board and replace them with Seneca's handpicked candidates. Seneca planned to use its new board seats, along with the seats it already had, to take the corporation in a new direction, one that would better maximize shareholder value according to the hedge fund. Ten days after Seneca filed its preliminary consent solicitation statement, Dynegy issued a press release announcing that it was terminating its merger agreement with Icahn because the tender offer failed. The press release also announced that its Chairman of the Board had resigned and the rest of its directors would stand down at the next annual meeting and that the company had offered a director position to a Seneca-named nominee.

In a similar situation, earlier this year hedge fund Ramius LLC launched a consent solicitation to remove six independent directors of Zoran Corporation. Zoran Corporation is a semiconductor company that specializes in digital audio and video imaging applications with 1,550 employees and $357.3 million in revenue in 2010. Ramius, a holder of 7.3 percent of Zoran's stock, felt that Zoran was underperforming because of poor management, that there was untapped stockholder value and that the existing board did not serve the stockholders' best interests. The consent solicitation was successful and ousted the board chair and two other directors, replacing them with three Ramius candidates. The Zoran board had urged stockholders not to vote with Ramius, and even announced a merger with CSR plc, a British wireless technology company, that gave Zoran shareholders a 40 percent premium over the current share price. This, however, was still not enough to save the existing board. This dramatic example of shareholder activism underscores just how vulnerable a corporation can be to a shareholder consent solicitation.

These examples show how consent solicitations continue to play an active role in corporate takeovers, both to push bids forward and to block them. Even just launching a serious solicitation threat can be an effective negotiating tool: InBev secured its friendly acquisition just days after launching its consent solicitation. Seneca Capital's preliminary consent solicitation statement was similarly [illegible] in the hedge

[2] A recent amendment to Anheuser-Busch's bylaws left some doubt whether all of the board members could be removed in this fashion.

fund's successful campaign to force the Dynegy board to abandon the Icahn acquisition. Finally, Ramius forced a new merger, in addition to taking over Zoran's board, with its successful consent solicitation.

Options to Limit Consent Solicitations

As noted in the InBev example, a hostile acquirer's ability to launch a consent solicitation depends on the laws of the state in which a corporation is organized. If a company is incorporated in Delaware or Nevada, or a state with a similar written consent statute, inserting a prohibition in the certificate of incorporation is the most effective way to insure that the company's board remains insulated from consent solicitations.

A certificate of incorporation, of course, cannot be amended without shareholder approval. While having to ask shareholders to enact provisions that limit their own rights could present risks from a shareholder relations perspective, according to published reports the majority of publicly held corporations located in Delaware have such restrictions in their certificates of incorporation. Amending the certificate of incorporation to prevent shareholders from acting by written consent was our recommendation in 2000, and it remains the most effective way to eliminate the risk of a hostile consent solicitation. Any board that considers this option should be aware, however, that the leading proxy advisors tend not to favor limiting shareholder power in this respect.

Historically, Institutional Shareholder Services effectively disapproved such measures across-the board. In its *2011 U.S. Proxy Voting Guidelines Summary*, however, while it continues generally to recommend that shareholders vote against such proposals, ISS has somewhat modified its position by stating:

> ISS acknowledges that a meaningful right to act by written consent is a fundamental shareholder right that enables shareholders to take action between annual meetings. However, the potential risk of abuse associated with the right that enables shareholders to take action by written consent such as bypassing procedural protections, particularly in a hostile situation, may outweigh its benefits to all shareholders in certain circumstances. Due to alternative mechanisms that have evolved for shareholders to express concern (*e.g.*, a majority vote standard, the right to call a special meeting) and an evolving governance landscape, ISS will be taking a more holistic evaluation of a company's overall governance practices and takeover defense when evaluating these proposals.

Glass Lewis also stated in its *Proxy Paper Guidelines: 2011 Proxy Season* that while it is generally in favor of permitting shareholders to act by written consent, it suggests requiring a shareholder to own at least 15 percent of outstanding shares before it is eligible to launch a consent solicitation in order to prevent abuse and waste by small shareholders. The point for companies to bear in mind, however, is that ISS and Glass Lewis may well scrutinize proposals to restrict acting by written consent before issuing a recommendation.

If amending the certificate of incorporation is not practical or possible, our other previous recommendation for companies incorporated in Delaware or similar states was to consider reincorporating in another state with a more favorable set of laws. Reincorporation could present similar investor relations risks. ISS recommends a case-by-case evaluation for any reincorporation proposals with careful attention to management's reason for the reincorporation.

Our final recommendation, from 2000 and now, is to do your homework on the rules governing your company. Check your state's laws to see whether unanimous shareholder consent is required to act without a meeting. Even if your company is incorporated in a state that requires the written consent of all shareholders to take action, review the corporation's certificate of incorporation and bylaws to confirm that no provisions in those documents modify the default laws in a manner that makes it easier for shareholders to act by written consent.

Finally, even if your corporation is protected against consent solicitations, directors should still be on guard against would-be acquirers trying to remove them. Hostile minority shareholders may still wage traditional proxy fights. Additionally, it is still too early to predict the extent to which the proxy access provisions of SEC Rule 14a-11, the effectiveness of which has been stayed pending resolution of legal challenges, will change the landscape if and when the rule begins to apply.

Helping Parties to Mergers Assess Risk and Negotiate Smarter Deals

By Paul Koenig, Managing Director of SRS | Shareholder Representative Services

In order to better assess risk and negotiate smarter deals when buying or selling a private company, parties should ask: *what really happens after closing?* Until recently, that has been somewhat of a mystery. Even experienced deal professionals didn't have much information on what to expect, how often claims are brought, or how this impacts expected payouts. The "2011 SRS M&A Post-Closing Claims Study," a new study published by SRS, helps answer these questions.[1]

The good news for sellers is that an average of 86% of the consideration set aside in escrow is eventually returned to them. The bad news is that 56% of deals receive some type of claim against the escrow, and in those deals claims were made against an average of 51% of the escrow. Both sides need to be prepared to potentially expend time and resources after closing. According to the study, indemnification claims take an average of eight months to resolve, and 4% of the deals with claims went to litigation or arbitration.

Here are some examples of statistics dealmakers should consider based on the data presented in the study:

1. Net working capital adjustments are very common when a deal has an adjustment mechanism ([illegible]% of the time an adjustment is made). These can favor either the buyer ([illegible]% of the time) or the seller ([illegible]% of the time). Further, when a buyer claims a negative adjustment, these are often not just minor shortfalls as sellers might expect (the average claim size represents about [illegible]5% of the escrow). Both sides should consider this risk when they value the deal. Also, the agreements should be clear as to the definition of working capital (or similar metric), and whether adjustments are to be prepared consistent with the selling company's past practices.

2. Financial statement claims are among the most frequent claim types, and they tend to be relatively large (they average [illegible]% of the escrow), but are often made in smaller deals (less than $100M). Even for small companies, it may be worth the cost to have their financials audited, which can help avoid issues regarding whether reporting was in accordance with GAAP. Additionally, this may help avoid claims asserting damages related to the inaccuracy of reported numbers that impacted a valuation based on a multiple of revenue or EBITDA.

3. Payouts on claims were reduced by indemnification "baskets" only [illegible]% of the time. These baskets may, however, have prevented small claims from ever having been submitted. Additionally, deals with first dollar baskets received on average approximately twice as many claims as deals with deductible baskets, presumably because buyers had an incentive to bring additional claims to get over the threshold amount of the basket.

4. Most deals ([illegible]%) established an expense fund in connection with the transaction. An expense fund is a separate fund set aside by the selling stockholders to fund expenses that may arise following closing, such as legal or accounting fees. A portion of these expense funds was used in [illegible]% of the transactions, but the average amount used was only [illegible]%.

5. Of the expired escrow periods surveyed in the study, about a third of the escrows were released late due to claims, with the average delay being [illegible] months after the end of the escrow period. Often, this is the case because the claim itself was submitted late ([illegible]% of transactions had claims in the last week of the escrow period). Selling shareholders should anticipate such possible delays for cash flow planning purposes.

[1] The summary of this study is available at http://www.shareholderrep.com/escrowstudy. The full study is only available to SRS clients and business partners.

Proposed Reform of U.K. Takeover Regulation

By Stuart Fleet, a Partner of Kaye Scholer LLP

On March 21st, the Code Committee of the U.K. Panel on Takeovers and Mergers published its consultation paper on proposed amendments to the City Code on Takeovers and Mergers. This follows a debate triggered by the bid by Kraft Foods Inc, for Cadbury plc, on whether the U.K. takeover rules make it too easy for a hostile bidder to gain control of a U.K. public company. The consultation paper proposes a number of detailed rule changes with a deadline for comments of May 27th. There is no fixed timetable for implementation, though the changes may take effect as early as the summer.

The principal changes proposed include:

- a requirement (subject to limited exceptions) to name a potential offeror in any announcement required under the City Code as to a possible offer and to require in those circumstances that a potential offeror within 28 days makes a further announcement either of its firm intention to make an offer or its decision not to proceed with any offer;
- a general prohibition (except in limited circumstances) on deal protection measures and inducement fees binding on an offeree company;
- disclosure in the offer documentation of an estimate of the fees of the offeror and the offeree company together with a breakdown by category of adviser, namely, financial advisers and corporate brokers, accountants, lawyers and public relations advisers;
- disclosure in greater detail of the financing facilities used to implement an offer, namely any debt facilities or other instruments entered into in order to finance the offer and/or to refinance the existing debt or working capital facilities of the offeree company; and
- increased emphasis on the need for disclosure by an offeror of its intentions with regard to strategic plans for the offeree company including their likely repercussions on employment and the locations of the offeree company's places of business and its intentions generally regarding the management and employees of the offeree company. This will include a requirement that an offeror be held to any statement made in its offer document or otherwise during the offer period with regard to such matters for a period of at least 12 months.

Principal Changes Proposed

1. Increased protection for an offeree against protracted virtual bid periods:

There are a number of proposed modifications to the current "put up or shut up" regime originally intended to protect companies from a possible "siege" by an unwelcome potential offer or:

a. A requirement in the announcement that commences an offer period, to name the potential offeror irrespective of who makes the announcement

b. Within 28 days following the date on which the potential offeror is publicly named, a publicly named potential offeror must:

   i. announce a firm intention to make an offer;

   ii. announce that it will not make an offer; or

   iii. make a joint application with the offeree for an extension of the deadline and if successful, announce the revised deadline for an announcement of a firm intention to make an offer

These changes are expected to mean that a prospective offeror will exercise greater care in maintaining confidentiality so as to avoid rumor and speculation and the possibility of any untoward movement in share price that might give rise to the need for an announcement identifying the potential offeror by name. Also, quite apart from the 28-day deadline, it is likely to mean that in most cases a potential offeror will be under pressure from an offeree company to conclude quickly whether it is prepared to announce a firm intention to make an offer, with possible implications for the nature and extent of the due diligence that it may be able to undertake in reaching that decision.

Exceptions from the general rule, include the following:

i. A formal sale process where the offer period commences with an announcement that the offeree company is seeking one or more potential offerors by means of a formal sale process. In such a case, a potential offeror who agrees to participate in that process and in respect of which an announcement is subsequently made would not be required to be publicly identified and would not be subject to the 28-day deadline.

ii. Where an announcement would otherwise be required as a result of rumor or speculation concerning an offer, the potential offeror will, if the Panel and the offeree so agree, be able to avoid being identified in a public announcement by ceasing all active consideration of the offer for a period of six months.

2. Prohibition on deal protection measures and inducement fees other than in certain limited cases:

The Panel is concerned that it has become common to negotiate inducement fees and similar arrangements with offeree companies and that this has potentially detrimental effects for offeree company shareholders in that they might deter competing offerors from making an offer and/or cause competing offerors to make an offer on less favorable terms than they would otherwise have done. The Panel therefore proposes to amend the City Code to include a general prohibition (save in certain limited circumstances) on deal protection measures and inducement fees.

Certain arrangements will be excluded from the general prohibition as follows:

a. Agreements or arrangements that impose obligations only upon an offeror or persons acting in concert with it (e.g., a reverse break fee).

b. Limited obligations to maintain the confidentiality of information, not to solicit the offeror's employees, customers or suppliers and to provide such assistance and information needed to satisfy offer conditions or certain regulatory approvals.

c. Irrevocable commitments and letters of intent to accept an offer given by the directors of the offeree company acting in their personal capacities as shareholders in the offeree company or by other shareholders who are or who are presumed to be acting in concert with the offeree company.

Provision is also to be made for further limited exceptions as follows:

a. Where following a hostile offer, a single preferred competing offeror ("white knight") emerges and an inducement fee arrangement is proposed with that single competing offeror, provided the value of the inducement fee is not more than 1% of the value of the offeree company calculated by reference to the competing offeror's offer at the time it is announced.

b. Where the offeree company has initiated a formal process to sell the company by means of a public auction, it will be able to enter into an inducement fee arrangement at the conclusion of that process with one offeror who participated in the process, provided that the value of the inducement fee is not more than 1% of the value of the offeree company calculated by reference to the offeror's offer at the time it is announced.

In practice, the Panel may also derogate from the general prohibition where the offeree company is in financial distress, although it is not proposed to include in the City Code any specific provision in respect of such an exception.

More generally, it seems likely that the prohibition on deal protection measures and inducement fees may have the greatest potential impact on private equity bidders, who will no longer be able to rely on an inducement fee as a means of covering or helping to cover the costs of an unsuccessful offer.

3. Proposals aimed at increasing transparency and improving the quality of disclosure:

a. Advisers and financing fees:

i. Each of the parties to an offer will be required to set out an estimate of their aggregate fees in the offer document or (in the case of an offeree) its first defense document together with a breakdown of the estimated fees by category of adviser, namely, financial advisers and corporate brokers, accountants, lawyers and public relations advisers.

ii. An offeror will be required in addition to separately disclose the fees and expenses expected to be incurred in relation to the financing of the offer

If during the course of an offer the estimated fees in aggregate or in a particular category should increase beyond what has been publicly disclosed or if by the end of the offer the final fees and expenses are greater than what has been publicly disclosed, this would have to be privately disclosed to the Panel, who, if it thinks fit, will require public disclosure of the revised estimate or of the final fees and expenses.

b. Financial information on offeror and offeree companies:

i. Currently, an offeror making a cash offer is normally required to provide less financial information on itself than would be the case if the consideration were comprised of securities in the offeror. The Panel has, however, concluded that various stakeholders in an offeree company will have an interest in the financial position of the offeror, even in the case of a cash offer, and therefore the same level of financial information should be disclosed for all offers. It will be possible to discharge this obligation by the inclusion in the offer document of a reference to a website address where the audited accounts and interim and preliminary statements of results for the last two years have been published.

ii. A concession for a cash offeror, however, is that it will not be required to include in its offer document details of any material changes to its financial or trading position since the publication of its last audited accounts. The reason is that the Panel understands that the costs involved in assessing whether there have been any material changes can be quite considerable, whereas the benefit of such a statement in the context of a solely cash offer is felt to be marginal.

iii. The Panel remains of the view that an offer document should contain details of the ratings and outlooks publicly accorded to the offeror and offeree companies prior to the commencement of the offer period, any changes in their ratings and outlooks during the offer period and prior to the publication of the offer document and a summary of the reasons given, if any, for any such changes.

iv. Offerors will be required to disclose a greater level of detail about the financing facilities used to implement the offer. Details will be required of the debt facilities or other instruments entered into in order to finance the offer and to refinance the existing debt or working capital facilities of the offeree company, including the amount of the facility or instrument, the repayment terms, interest rates, and names of the principal financing banks. However, it will not be necessary to disclose any headroom that may exist under the financing arrangements in order to finance any revised offer. Also, the Panel accepts that the structures by which equity is provided to private equity offeror vehicles may be commercially sensitive and so it will not require such equity structures to be disclosed in detail and in particular it will not be necessary to drill down within the private equity funds themselves.

4. Providing greater recognition of the interests of employees:

a. *Disclosure of the offeror's intentions regarding the offeree company and its employees.*

i. An offeror will be required to state in the offer document its intentions with regard to the future business of the offeree company and explain the long-term commercial justification for the offer. In addition, the following matters will need to be addressed:

- the offeror's intentions with regard to the continued employment of the employees and management of the offeree company;
- the offeror's intentions with regard to any material change in the conditions of employment of the employees of the offeree company;
- the offeror's strategic plans for the offeree company and their likely repercussions on employment and the locations of the offeree company's places of business;

- the offeror's intentions with regard to any redeployment of the of the fixed assets of the offeree company; and
- the offeror's intentions with regard to the maintenance of any existing trading facilities for the relevant securities of the offeree company.

ii. The Panel proposes that an offeror should be held to any statement made in the offer document in relation to any of the matters referred to in paragraph i above or otherwise made during the offer period in relation to any course of action it intends to take or not take (as the case may be) for a period of at least 12 months or such other period as may be stated by the offeror at the time the statement is made. This change is largely in response to the conduct of Kraft Foods Inc., in relation to statements it made concerning its intentions regarding the business of Cadbury plc.

b. *Improving the ability of employee representatives to make their views known on an offer.* The Panel considers that the City Code should be amended to improve communication between participants in an offer and their respective employees and employee representatives, and in that connection it is proposed that:

i. it should be made clear that the City Code does not prevent the passing of information in confidence in an offer period to employee representatives acting in their capacity as such;

ii. an offeree company board should be required to inform its employee representatives at the earliest opportunity of their right to circulate an opinion on the effects of an offer on employment; and

iii. it should be made clear that the offeree company's board has a responsibility to publish the employee representatives' opinion at the offeree company's expense.

c. *When to notify employees that an offer is being made.*

It is proposed that the point in time at which the offeror and offeree companies should notify their employees that an offer is being made should be brought forwards to the date of commencement of an offer period, even if that date is prior to the announcement of a firm intention to make an offer. In addition, the employee representatives or, if there are no employee representatives at that time, the employees themselves, should be reminded of the right for the employee representatives to have a separate opinion on the offer and for this to be circulated (as described above).

d. *Impact*

The effect of the increased emphasis on the participation of employee representatives in the bid process is difficult to gauge, though early thought will need to be given to the approach to dealing with the employees as part of the process of planning a bid. In addition, a potential offeror will need to give careful thought as to any statements it makes during the course of an offer as to its intentions with regard to the employees of the offeree company and any strategic plans for the business of the offeree company and their effect on employment. Given the possibility that there will be an obligation to adhere to any statement for a period of 12 months after the date upon which the offer becomes or is declared wholly unconditional, it may be that offerors will develop anodyne or non-committal wording from which it is very difficult to extract any clear meaning at all, which would rather frustrate the objective of improving the quality of disclosure in this area.

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