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Materiality Scrapes Trending Upward in Private Deals

By William Greason, Kevin Smith and Nicholas Scannavino of Chadbourne & Parke LLP [1]

A "materiality scrape" (or "materiality read-out") is a buyer-friendly provision that has become one of the most commonly negotiated points in private M&A transactions. A materiality scrape provision "scrapes" or excludes materiality, material adverse effect (MAE) and other similar materiality qualifiers contained in the seller's representations and warranties for purposes of post-closing indemnification. In other words, these qualifiers are read out and disregarded for purposes of determining both whether a breach of a representation has occurred and the amount of losses that have resulted from such breach for indemnification purposes. This article identifies some of the principal arguments made by buyers and sellers with respect to including or excluding a materiality scrape, as well as common negotiated compromises and recent deal trends.

Materiality Scrape Provision

A basic example of a blanket materiality scrape provision reads as follows: "For purposes of this Article X [*indemnification article*], any inaccuracy in or breach of any representation or warranty made by the Seller in this Agreement shall be determined without regard to any materiality, Material Adverse Effect or other similar qualification contained in or otherwise applicable to such representation and warranty." An aggressive buyer might try to expand the materiality scrape additionally to read out knowledge qualifiers contained in the seller's representations and to apply to covenants made in the acquisition agreement.

Principal Arguments

Buyers

Buyers negotiate for a materiality scrape primarily as a way to counteract the limitation on the seller's indemnification obligations provided by an indemnity basket. An indemnity basket assures that a seller will not be liable for certain indemnification claims (typically limited to breaches of representations and warranties) until the aggregate amount of losses in respect of such indemnification claims exceeds a certain minimum amount (typically set at an agreed percentage of transaction value). Moreover, private acquisition agreements may also contain a "mini-basket" or "de minimis threshold" providing that a seller will not

[1] The authors would like to thank associate Alex Herman and summer associate Wossen Ayele for their contributions to this article.

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be liable for any individual or series of related losses which do not exceed a certain minimum amount (typically small). With an indemnity basket, the seller may not be as concerned about immaterial breaches of representations because losses arising out of such breaches may be below the de minimis threshold or otherwise fall within the indemnity basket and thus not give rise to indemnification obligations.

As such, buyers principally argue that materiality should be addressed through the indemnity basket, as the indemnity basket functions as a layer of materiality for breaches of representations and therefore without a materiality scrape buyers would be subject to "double materiality" (or "triple materiality" in the event the acquisition agreement contains a mini-basket). Buyers often also argue that a materiality scrape promotes efficient negotiations (*i.e.*, the parties will not have to spend so much time negotiating materiality qualifiers in representations and warranties) and reduces post-closing disputes (*i.e.*, the parties will not have to spend so much time disputing what "material" means).

Sellers

Sellers typically resist a blanket materiality scrape, arguing that materiality qualifiers in representations are important not only for purposes of being able to accurately make certain representations and warranties (especially in light of the typically broad and comprehensive scope of the seller's representations requested by the buyer) but also for purposes of determining a proper risk profile related to the sale of the target company, as it may be difficult in all cases for sellers to adequately evaluate the potential exposure arising out of breaches of representations for purposes of calculating an appropriate indemnity basket amount.

Sellers often also argue that a blanket materiality scrape would increase the seller's disclosure schedule burden, forcing the seller to disclose "everything under the sun" even if immaterial so as not to be in breach of a representation that would otherwise be qualified by materiality, which results in unnecessary time and expense for both parties. Furthermore, sellers often contend that the materiality scrape renders all of the materiality and MAE qualifiers negotiated into the seller's representations somewhat meaningless (especially if the materiality and MAE qualifiers are also read out of the "bringdown" closing condition (and replaced with an aggregate materiality or MAE standard), as is commonly the case).

As a business matter, sellers typically maintain that buyers should bear some level of risk in connection with buying a business, as every business has its fair share of surprises (both good and bad), and that recovery for breaches of representations should be somewhat difficult and should be limited to matters that are material to the target company. Otherwise, buyers would be incentivized to "nickel and dime" the seller with every claim no matter how small.

Compromise Positions

As the materiality scrape has become more common recently, various ways of limiting the scope or impact of the materiality scrape have emerged, including as set forth below.

- **Limit the materiality scrape to the calculation of losses arising out of a breach and not to the determination of whether or not there has been a breach**. This approach clarifies that if it is determined that the buyer is entitled to recover losses arising out of a breach of a seller's representation containing a materiality qualifier, then the buyer should recover the full amount of such losses (subject to any limitations on indemnification set forth in the acquisition agreement, such as a deductible), not just an amount of losses in excess of a material amount. Buyers often resist this approach, as parties generally already take the view that materiality qualifiers in representations will not impact the calculation of recoverable losses in any event. Moreover, scraping materiality qualifiers in representations for purposes of determining breaches of representations is the crux of the materiality scrape.
- **Increase the size of the indemnity basket**. A materiality scrape for purposes of determining breaches of representations requires the seller to rely on the protection afforded by the indemnity basket with respect to immaterial breaches of representations. Anecdotally, increasing the size of the indemnity basket has become a common negotiated compromise in deals where the seller agrees to a materiality scrape, the thought being that the amount of the indemnity basket (and mini-basket if included) will be exceeded sooner if immaterial breaches of representations are counted towards the indemnity basket.

- **Include a mini-basket or de minimis threshold (or increase the size of the mini-basket or de minimis threshold)**. As a complement to increasing the size of the indemnity basket, this approach further limits the seller's indemnification obligations by providing additional protection with respect to immaterial breaches of representations.

- **Structure the indemnity basket as a deductible**. Indemnity baskets can be structured as a deductible (*i.e.*, the seller would be liable only for losses in excess of the amount of the deductible), a threshold (*i.e.*, the seller would be liable for the total amount of losses from the first dollar once the threshold amount is exceeded) or a combination of the two (*i.e.*, the seller would be liable for the total amount of losses in excess of a deductible amount once a higher threshold amount is exceeded). Scraping materiality qualifiers for purposes of determining breaches of representations makes it more likely that the indemnity basket will be exceeded, as immaterial breaches will be counted towards the indemnity basket. From a seller's perspective, this makes it more advisable to structure the indemnity basket as a deductible so that the seller would be liable only for amounts in excess of the deductible.

- **Exclude certain representations and warranties**. Materiality is an essential component of certain representations, such as a full disclosure representation (which tracks the language of Rule 10b-5 of the Securities Exchange Act of 1934), a financial statement representation (which tracks standards under GAAP) and a no MAE representation (which would not make sense without the MAE qualifier), and parties sometimes agree to exclude such representations from the materiality scrape. Additionally, as a result of the increased disclosure burden that comes with a materiality scrape, parties sometimes also agree to exclude from the materiality scrape the representations that require lists of material items on disclosure schedules (such as material contracts and material licenses). Furthermore, sellers often seek to exclude from the materiality scrape the representations that are carved-out of the indemnity basket (since the materiality scrape is tied to the indemnity basket) as well as other representations that may be of particular concern to the seller (such as certain tax or environmental matters).

- **Replace MAE with a lower materiality threshold**. Owing to the fact that the MAE standard is such a high bar that is seldom crossed, sellers sometimes suggest replacing MAE qualifiers with a lower materiality threshold (such as "material" or "in all material respects") in lieu of a materiality scrape.

- **Use dollar thresholds instead of materiality qualifiers**. Rather than making a representation that the target company is in compliance in all material respects with all applicable laws, the seller could make a representation that the target company is in compliance with all applicable laws other than any such non-compliance which would not reasonably be expected to result in indemnifiable losses in excess of a specified dollar amount. This approach might help to eliminate some of the ambiguity around what constitutes materiality or an MAE and allows the parties to tailor dollar limits to specific representations, but the parties might find it difficult to quantify certain risks in order to agree on an appropriate dollar amount.

Deal Trends

The following sets forth a summary of recent deal trends with respect to materiality scrapes and indemnity baskets:

ABA Study

The 2013 Private Target M&A Deal Points Study published by the American Bar Association (the "ABA Study"), which analyzed publicly available acquisition agreements for transactions completed in 2012 with a signing value of at least US$17 million involving private companies being acquired by public companies,[2] indicated the following deal trends with respect to materiality scrapes and indemnity baskets:

- 28% of all deals contained a materiality scrape.

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[2] The sample size consisted of 136 deals analyzed by the M&A Market Trends Subcommittee of the Mergers & Acquisitions Committee of the American Bar Association's Business Law Section. The statistics reflected herein relate to a subset of deals containing indemnity baskets.

- Out of the 28% of deals that contained a materiality scrape, 41% of such deals limited the materiality scrape to the calculation of losses only.
- 59% of all deals (not just those containing a materiality scrape) had an indemnity basket structured as a deductible.
- 56% of all deals (not just those containing a materiality scrape) had an indemnity basket equal to .5% or less of transaction value; 32% of all deals (not just those containing a materiality scrape) had an indemnity basket equal to >.5%–1% of transaction value; 11% of all deals (not just those containing a materiality scrape) had an indemnity basket equal to >1%–2% of transaction value; and 1% of all deals (not just those containing a materiality scrape) had an indemnity basket equal to >2% of transaction value.[3]
- 30% of all deals (not just those containing a materiality scrape) had a mini-basket.

These statistics suggest that (1) the inclusion of a materiality scrape was a minority position, (2) where included, the materiality scrape was limited to the calculation of losses in almost half of deals, (3) most deals (whether or not containing a materiality scrape) had an indemnity basket structured as a deductible, (4) over half of all indemnity baskets (whether or not the deal contained a materiality scrape) were sized at .5% or less of transaction value and over 85% of all indemnity baskets (whether or not the deal contained a materiality scrape) were sized at 1% or less of transaction value, and (5) almost one-third of deals (whether or not containing a materiality scrape) had a mini-basket.

It should be noted that the ABA Study did not separately analyze indemnity baskets for deals that did and did not contain a materiality scrape, and, as indicated above, most deals analyzed in the ABA Study did not contain a blanket materiality scrape. As such, parties should bear in mind that these statistics may not accurately reflect what may be an appropriate indemnity basket size in instances where the acquisition agreement contains a materiality scrape (assuming a correlation between the size of the indemnity basket and the existence of materiality qualifiers throughout the seller's representations).

<u>Independent Study</u>

We conducted an independent study of deals signed in 2013 with a signing value of at least US$25 million involving the acquisition of private US companies,[4] which indicated the following deal trends with respect to materiality scrapes and indemnity baskets (percentages are approximate):

- 74% of all deals contained a materiality scrape.
- Out of the 74% of deals that contained a materiality scrape, 44% of such deals limited the materiality scrape to the calculation of losses only and 24% of such deals limited the materiality scrape by excluding certain representation and warranties.
- 78% of all deals (not just those containing a materiality scrape) had an indemnity basket structured as a deductible.
  - 78% of deals containing a materiality scrape had an indemnity basket structured as deductible.
- 33% of all deals (not just those containing a materiality scrape) had an indemnity basket equal to .5% or less of transaction value; 48% of all deals (not just those containing a materiality scrape) had an indemnity basket equal to >.5%–1% of transaction value; 15% of all deals (not just those containing a materiality scrape) had an indemnity basket equal to >1%–2% of transaction value; and 4% of all deals (not just those containing a materiality scrape) had an indemnity basket equal to >2% of transaction value.[5]
  - 28% of deals containing a materiality scrape had an indemnity basket equal to .5% or less of transaction value; 52% of deals containing a materiality scrape had an indemnity basket equal to >.5%–1% of transaction value; 14% of deals containing a materiality scrape had

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[3] Excludes 5 deals with redacted or indeterminable basket amounts.

[4] The sample size consisted of 284 deals containing indemnity baskets that were publicly-available through the SEC's EDGAR database.

[5] Excludes 8 deals with redacted or indeterminable basket amounts.

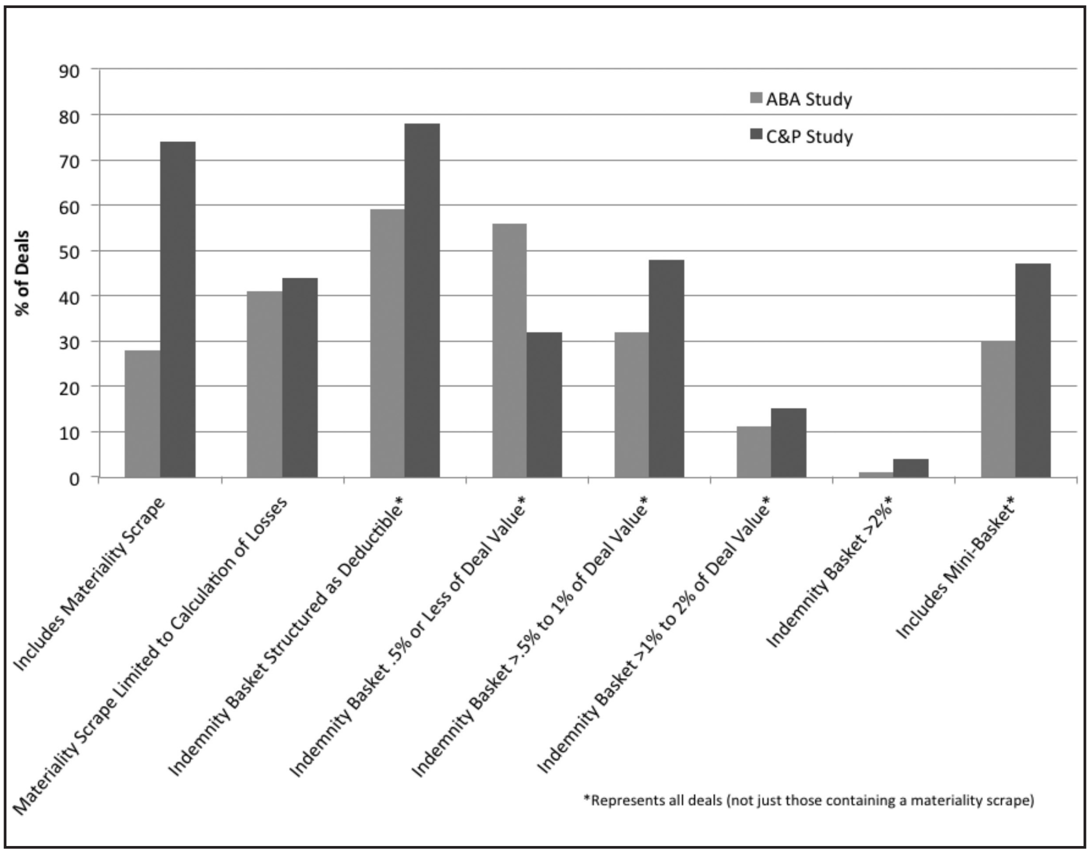
an indemnity basket equal to >1%–2% of transaction value; and 5% of deals containing a materiality scrape had an indemnity basket equal to >2% of transaction value.[6]

- 47% of all deals (not just those containing a materiality scrape) had a mini-basket.
  - 53% of deals containing a materiality scrape had a mini-basket.

These statistics suggest that: (1) the inclusion of a materiality scrape is trending upward; (2) where included, materiality scrapes tend to be limited in some way, with almost half of deals limiting the materiality scrape to the calculation of losses only; (3) deals containing a materiality scrape tend to have an indemnity basket structured as a deductible; (4) approximately half of deals containing a materiality scrape had an indemnity basket sized at >.5%–1% of transaction value and 64% of deals containing a materiality scrape had an indemnity basket sized at 1% or less of transaction value; and (5) approximately half of deals containing a materiality scrape had a mini-basket.

Interestingly, the most common size of the indemnity basket for all deals in this independent study and for only those deals in this independent study containing a materiality scrape was the same (>.5%–1%). As indicated above, parties should consider whether the standard size of the indemnity basket should be adjusted in light of the increasing prevalence of materiality scrapes in recent deals.

Deal Trends



Conclusion

Recent deal trends suggest that materiality scrape provisions are becoming more common and will continue to be used by buyers as a risk allocation mechanism in private M&A transactions. It remains to be seen whether the inclusion of a blanket materiality scrape in an acquisition agreement will evolve into a majority position in market practice, with the materiality issue being addressed solely through the indemnity basket and other indemnity provisions rather than through qualifications in the seller's representations. In any event, parties should closely consider the use and implications of a materiality scrape, including with respect to how it relates to the size of the indemnity basket.

[6] Excludes 5 deals with redacted or indeterminable basket amounts.

Hushmail: Are Activist Hedge Funds Breaking Bad?

By Mark Gerstein, Timothy FitzSimons, Bradley Faris, and John Newell of Latham & Watkins LLP

During the heyday of takeovers in the 1980s, so-called corporate raiders would often amass a sizable stock position in a target company, and then threaten or commence a hostile offer for the company. In some cases, the bidder would then approach the target and offer to drop the hostile bid if the target bought back its stock at a significant premium to current market prices. Since target companies had fewer available takeover defenses at that time to fend off opportunistic hostile offers and other abusive takeover transactions, the company might agree to repurchase the shares in order to entice the bidder to withdraw. This practice was referred to as "greenmail," and some corporate raiders found greenmail easier, and more profitable, than the hostile takeover itself.

Some of the boards of directors of the target companies that paid greenmail were sued by their stockholders, who alleged that the payments were made for the purpose of management entrenchment, the boards impermissibly favored the greenmailers over other stockholders and the price paid was excessive. However, Delaware courts generally upheld the board's decision to pay greenmail, on the grounds that it was a reasonable response by the board to the threat of an abusive or coercive hostile takeover.

Nevertheless, there was widespread outcry about the practice from target companies, institutional investors and the investing public. Federal and state laws were enacted in an effort to prohibit or restrict the payment of greenmail.[1] Also, companies developed more effective takeover defenses, making greenmail unnecessary as a defense. By the end of the 1980s, greenmailing was relegated to the sidelines of takeover history.

Hushmail in the Age of Activist Investing

Although greenmail has largely disappeared in the hostile takeover arena, the recent explosion of activist investing by hedge funds has brought about a related phenomenon, which can be referred to as "hushmail." Texas businessman H. Ross Perot coined the term in 1986, using it to describe an offer made to him by General Motors to buy out his GM stock at a premium price, in exchange for his agreement to stop publicly criticizing GM's management.

Activist hedge funds often start their campaigns against public company targets by taking large stock positions and then publicly agitating for changes, such as stock repurchases, extraordinary dividends, dispositions of non-core businesses or an outright sale of the company. There is often an implicit or explicit threat of a proxy contest to remove some or all of the target board members and management if their demands are not met. Ultimately, the activist may receive one or more seats on the target company board, either through a settlement with the target, or success at a stockholder meeting.

After a period of time pressing its case, the activist may desire to exit the investment. However, if it were to dump its shares in the market in large volume, the stock price realized in the sale may suffer. The situation becomes trickier for activists that have obtained board representation, because insider trading policies and SEC rules may significantly restrict their ability to dispose of shares quickly.

In order to exit quickly at the highest possible price, the activist sometimes seeks to have the target company buy back its stock. The buyback price is typically at a slight discount to the current market price, but occasionally it is at a premium. As part of the purchase agreement, the activist may enter into a standstill and non-disparagement agreement with the target. If the activist has representatives on the board of the target, the representatives typically would resign their director positions after the repurchase, given the activist's lack of ongoing economic interest.

In the last year, there have been numerous examples of companies buying back stock from activist investors.[2] For example, in April 2014, activist investor KSA Capital sold a 9 percent block of shares

[1] In response to the widespread outbreak of greenmail in the mid-1980s, several states, including New York, Ohio and Pennsylvania, adopted corporate laws prohibiting the payment of greenmail without disinterested stockholder approval. Congress amended the Internal Revenue Code to provide for a 50 percent excise tax on greenmail payments in certain limited situations. In addition, some corporations took matters into their own hands, adopting charter and bylaw amendments prohibiting the payment of greenmail without disinterested stockholder approval.

[2] In the last 12 months, nine companies have repurchased shares from activists, which is more than the previous six years combined, according to data from FactSet SharkWatch.

back to AEP Industries at a 4.5 percent premium to the current market price. After the buyback, KSA still owned 21 percent of the outstanding stock. As part of the deal, KSA signed a two-year standstill and non-disparagement agreement with AEP, and agreed to vote its remaining block in favor of director nominees nominated by the AEP board at the next two annual meetings of stockholders.

Breaking Bad?

In the modern era, activist hedge funds often proclaim that they are working to enhance value for all stockholders, and deny that they are seeking only personal financial gain. Activist investors have worked hard in recent years to improve their image with institutional investors, the investing public and companies.

In demanding a stock buyback, are activists breaking bad? Not unlike Walter White, who made the journey from devoted family man to [illegible], an activist investor who seeks a hushmail buyout can fairly be said to be putting the activist's short-term interest in liquidity ahead of the interests of other stockholders, who are not offered the same deal. If activists increasingly seek hushmail buybacks, especially at premium prices, they run the risk of creating a broader market backlash, such as what occurred with the demonization of greenmailers in the 1980s.

Notwithstanding the reputational risks to activists, hushmail demands seem to be on the rise. Public companies need to be prepared to consider whether a buyback from an activist (whether framed as hushmail or otherwise) is in the best interests of the company and its stockholders, even if the motivations of the activist are self-interested.

There are many situations in which a buyback could be viewed as beneficial to the company, particularly if the company had previously authorized or was already considering repurchasing its stock and the opportunity exists to do so at a discount to market value. In situations in which the activist's board representatives demand that the company implement a business strategy or financial transaction that the other members of the board have clearly rejected, then a buyback may be the most expeditious path to a resolution of the controversy in the best interests of the company and its stockholders, particularly in situations where the activist board member has become disruptive to the proper function of the board and the company's ability to execute its business strategy.

Factors to Consider in Reviewing a Buyback of Stock From an Activist

Any stock buyback must be undertaken carefully, after appropriate review by the board of a number of important factors. If a board approves a repurchase of stock from an activist investor, it may face criticism from stockholders on the grounds that the opportunity to sell is not made available to all stockholders, the stock repurchase is motivated by management entrenchment, and the repurchase price is excessively high and therefore unfair to the company or its other stockholders.

It is well established that a Delaware corporation has the power to deal in its own stock and that the corporation may deal selectively with its stockholders in the acquisition of shares. As discussed below, the Delaware courts have long held that there are a variety of sound reasons why a board may agree to buy back its shares from a dissident stockholder, even at a premium to the current market price. Assuming that management entrenchment and stockholder disenfranchisement are not the primary purposes of the stock buyback, the board's decision to authorize the buyback should receive the benefit of the business judgment rule.

The Delaware Supreme Court has held that, if a stock buyback is not made in response to an actual or potential threat to corporate policy, then, "in the absence of evidence of fraud or unfairness, a corporation's repurchase of its capital stock at a premium over market from a dissident stockholder is entitled to the protection of the business judgment rule."[3]

The applicable standard of review of the board's decision will therefore turn initially on whether or not the purpose of the buyback was a defensive response against an actual or potential threat to corporate control. If it is viewed as defensive, the board's actions may be subject to enhanced scrutiny review under the Delaware law. The board should carefully consider and document the reasons for entering into the

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[3] *See Grobow v. Perot*, 539 A.2d 180, 189 (Del. 1988); *See also Polk v. Good*, 507 A.2d 531, 536 (Del. 1986); *Kahn v. Roberts*, 679 A.2d 460, 465 (Del. 1996).

transaction in order to create an effective record of its rationale for approving the buyback. If the board is composed of a majority of outside directors, and advised by expert legal and financial advisors, it will help to establish that the board acted in good faith and made a reasonable investigation.

The following are several examples of typical stock buyback scenarios, and how the board's actions have been evaluated by courts in the past.

1. Buyback as a Favorable Financial Transaction

Often, the primary reason that the board decides to buy back shares from a dissident stockholder is because the board determines, in the exercise of its business judgment, that it is desirable from a capital allocation standpoint for the company to buy back stock at the present time. If a buyback makes financial sense, the board may determine that a repurchase of a block from a large stockholder who is eager to sell is a more efficient method to execute the repurchase than buying shares in the market. In that regard, if the company has an existing stock buyback program in place, the program may provide additional support for the board's position that the repurchase from the activist is being done for financial rather than defensive reasons. In the absence of entrenchment motives or an outside threat to control of the company, the board's decision should be entitled to the protection of the business judgment rule.[4]

2. Buyback to Address an Internal Rift Caused by a Dissident Stockholder

Another reason to buy back shares from a dissident stockholder could be that the stockholder is a source of controversy or friction with consequences adverse to the interests of the company and its stockholders generally, and the board wishes to buy out the stockholder to remove the source of the dispute. In the Delaware Supreme Court case of *Grobow v. Perot*,[5] referenced earlier, Perot was a director of General Motors, the chairman of GM's EDS division and also one of GM's most outspoken critics. Perot demanded that the GM board either give him full control of the EDS division, or buy him out of his GM stock. When GM offered to buy him out, Perot proposed that he be paid *double* the current market value for his shares. To Perot's surprise, GM agreed.

The court found that the primary purpose of the GM board's decision was not to "buy Perot's silence," but to "rid itself of the principal cause of the growing internal policy dispute over EDS's management and direction." Concluding that there was no outside threat to control of GM that would trigger a concern that the directors were acting in their self-interest, the court ruled that the business judgment rule was applicable and the board's actions were not subject to enhanced scrutiny.

3. Defensive Buybacks

In some cases, activist hedge funds may present an actual or potential threat to corporate policy and effectiveness. A buyout of the activist's shares may be considered a defensive action by the board in response to the threat, which could trigger a heightened standard of review of the board's actions. Under the Delaware law principles established in the well-known cases of *Unocal Corp. v. Mesa Petroleum Co.* and *Unitrin v. American General Corp.*, if the directors initiated the repurchase in response to a threat to corporate policy related to a potential change in control of the corporation, then "a heightened standard of judicial review applies because of the temptation for directors to seek to remain at the corporate helm in order to protect their own powers and perquisites."[6]

The heightened standard of review under *Unocal/Unitrin* consists of two prongs. The first is the reasonableness test, which is satisfied by a demonstration that the board of directors had reasonable grounds for believing that a danger to corporate policy and effectiveness existed.[7] In reaching this determination, the independent members of the board, with the advice of legal and financial advisors, should make an investigation as to the threat posed, and be able to articulate clearly the nature of the threat.

Ownership by an activist hedge fund of a significant stock position may present a number of legitimate threats to corporate policy and effectiveness. Activist hedge funds often acquire large stock ownership positions through open market purchases, sometimes without adequate disclosure of their purchases and

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[4] *Kahn v. Roberts, supra,* at 464.

[5] *Grobow v. Perot, supra,* at 190.

[6] *Kahn v. Roberts, supra,* at 465.

[7] *Unitrin, Inc. v. American General Corp.,* 651 A.2d 1361, 1373 (Del. 1995).

intentions. This could present a risk of "creeping control," in which effective control is acquired by the hedge fund without payment of a control premium to the other stockholders. There can also be a threat of "negative control," in which the hedge fund has the ability effectively to block corporate actions through voting power and other influence. Activists and other hedge funds also sometimes work collectively to acquire stock by means of "wolf pack" tactics, which can also present further threats of creeping control and negative control.[8]

The second prong of the *Unocal/Unitrin* analysis is a "proportionality test, which is satisfied by a demonstration that the board of directors' defensive response was reasonable in relation to the threat posed." The board's defensive actions must not be "draconian, by being either preclusive or coercive," and must fall "within a range of reasonable responses to the threat" posed.[9]

The repurchase of stock from an activist hedge fund, even at a premium, in response to a threat of creeping control or negative control is neither coercive nor preclusive. The other stockholders of the target are free to mount their own proxy contest and are free to vote their shares as they choose.

The second prong of *Unocal/Unitrin* also requires that the defensive action (in this case, the stock buyback) must be within a range of reasonable responses to the threat posed. The stock buyback would effectively eliminate the threat from the particular dissident stockholder, but the cost of doing so would have to be considered.

In *Polk v. Good*, the Delaware Supreme Court reviewed the settlement of a case involving a 9.8 percent stockholder of Texaco, known as the Bass group. The Bass group had suggested that it might increase its ownership to 20 percent or commence a hostile tender offer, at a time when Texaco's board viewed the stock as undervalued. The Texaco board identified a threat of creeping control, as well as a possible hostile offer at an unfair price. In response, Texaco bought back the Bass group's stake at a [illegible] percent premium to the current market price. The court noted that the payment "seemed reasonable in relation to the immediate disruptive effect and the potential long-term threat which the Bass group imposed. Clearly, that was a benefit to the company and most of its stockholders."[10]

In addition to buying back the activist's stock, the target company may also require that the activist enter into standstill and non-disparagement covenants. If the perceived threat is creeping control by the hedge fund, or negative control, then covenants preventing the activist from acquiring additional shares, or working alone or with other stockholders to influence control of the target through public criticism, should be considered to be reasonable responses to the threats posed.

Alternative Responses to Hushmailers

With the rise of greenmail in the 1980s, some companies adopted charter or bylaw amendments prohibiting the payment of greenmail. If hushmailing continues its rise, companies may consider adopting similar provisions to address hushmail, such as requiring disinterested stockholder approval of a stock repurchase. Institutional investors are likely to be supportive of these changes, because they would alleviate concerns about hushmail being paid for entrenchment purposes, as well as concerns that activist stockholders are getting special treatment not available to other stockholders.[11] By declaring that a hushmail payment is not an option, activist hedge funds seeking a quick payoff may look elsewhere for a more vulnerable target. At the same time, these changes may reduce the flexibility of the board in responding to real activist demands and, in that sense, may reduce the utility and benefits of this strategy.

Conclusion

Activist hedge funds are increasingly seeking hushmail payments. In doing so, they risk being painted as villains rather than heroes. Nevertheless, if the target board believes that a repurchase of a significant block of stock from an activist is in the best interests of all stockholders, there is a path to do so under existing law.

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[8] *See "Third Point LLC v. Ruprecht*—Activism Confronts the Rights Plan," Latham & Watkins Client Alert, May 2014.

[9] *Unitrin, supra,* at 1367.

[10] *Polk v. Good, supra,* at 537.

[11] The voting policies of proxy advisory firms ISS and Glass Lewis both recommend in favor of anti-greenmail charter and bylaw provisions.

Recent Trends: Antitrust & Regulatory Risk-Shifting in M&A Agreements

By Kevin Mills and Jacqueline Grise of Cooley LLP

The recent drumbeat of aggressive antitrust and regulatory merger enforcement has put a spotlight on the importance of understanding the antitrust and regulatory risks raised by a potential deal, and efficiently allocating that risk in the transaction agreement. While transactions in dynamic technology, healthcare/life sciences, new media and telecom industries remain at the very top of the antitrust and regulatory enforcement agenda, the agencies will not hesitate to investigate matters in mature industries—for example, the FTC's recent 9 month investigation of Tesoro Corporation's $1.1 billion acquisition of petroleum assets from BP, which ultimately closed without a challenge in 2013. Several recent transactions also underscore the substantial antitrust risk that parties may face even in smaller, non-reportable matters.

There is no "one size fits all" approach, but there is often a premium on structuring the transaction to achieve the benefits of clear risk allocation and certainty that are commensurate with the amount of risk that the transaction presents, rather than relying on a broadly and generically worded "efforts" provision. In some instances where the target is being sold in a competitive process, a buyer may be compelled to take more antitrust/regulatory risk in order to win the bid, making it critical for the buyer to have confidence in its underlying antitrust/regulatory analysis. Market dynamics and regulatory landscapes also can change from deal-to-deal or even between signing and closing of a pending transaction; raising questions of how the parties should allocate the regulatory risks that are, in a contractual sense, unknowable at the time of signing. Whatever the facts may be, in transactions that present potential antitrust and regulatory risk, it is essential to establish close coordination between transaction counsel and antitrust and regulatory counsel to effectively negotiate the contractual risk shifting provisions.

The recently announced Comcast/Time Warner transaction, which is pending DOJ and FCC review, is illustrative of a trend towards efficient allocation of antitrust/regulatory risk in the negotiated transaction agreement. Industry observers generally expect this transaction will get intense DOJ and FCC review but is likely to be approved with conditions. The parties did not negotiate a reverse break-up fee or even an obligation to litigate with the agencies. Rather, the parties negotiated a customized and limited "divestiture" covenant—a sort of anticipatory "fix-it-first" approach. Specifically, Comcast agreed to (1) divest up to three million of the company's combined subscribers, (2) accept other conditions that are consistent in scope and size to those imposed on other U.S. domestic cable system deals valued at $500 million or more within the past twelve years, and (3) implement undertakings set out on a schedule to the merger agreement (not publicly disclosed). If the DOJ and FCC do not clear the deal by the outside date or impose "burdensome conditions" (defined as divestitures or other undertakings beyond those Comcast has expressly agreed to make or take), Comcast may terminate the merger agreement without liability.

Comcast's covenant to divest three million subscribers would hold Comcast's total national market share under 30% of video subscribers (based on an FCC cable ownership cap that applied in previous cable deals but has since been vacated by the courts). The second commitment would encompass conditions imposed in Comcast's acquisitions of AT&T in 2002 and Adelphia in 2006 (the 1st and 5th largest cable operators at the time) (e.g, anti-discrimination protections for rival multi-channel video distributors and independent network owners, especially regional sports networks). Finally, Comcast has already publicly announced its intention to abide by certain behavioral conditions imposed on Comcast when it acquired NBC in 2011 across the Time Warner Cable systems (*e.g.*, this could include net neutrality conditions from the NBC deal even though the FCC needs to rewrite the rules based on a recent court ruling).

While some concerns that these types of provisions may raise rather than mitigate regulatory risks because such provisions provide a "roadmap" to the agencies, or even worse, provide the agencies with negotiating leverage to demand overbroad divestitures/remedies. The outcomes in numerous recent merger investigations reveal that these types of provisions do not necessarily create a path to a self-fulfilling prophecy, particularly when the contractual terms are well-crafted and the process is managed effectively. For example, in the Tesoro/BP matter, despite the fact that the acquisition agreement expressly provided for the divestiture of a specific refinery by Tesoro (as well as a reverse break-up fee and a ticking fee), the FTC closed its investigation after nine months without taking action, concluding that the transaction would not "lessen competition substantially" in the relevant market in California.

Of course, antitrust and regulatory risk allocation is not negotiated in isolation—parties bargain over many price and non-price terms. For instance, just as Comcast is not required to pay a reverse break-up fee if the parties are not able to obtain regulatory clearance, Time Warner Cable is not required to pay a break-up fee if its stockholders vote against the deal.

All M&A lawyers involved in industries or transactions with competitive, FCC or other regulatory issues should become familiar with market approaches to contractual risk-shifting and have knowledgeable and experienced antitrust and regulatory counsel on their deal teams.

Respecting Boilerplate: Preamble

By Rob James of Pillsbury Winthrop Shaw Pittman LLP[1]

Boilerplate refers to the legal clauses of general application typically found at the very front and very end of complex agreements (or the flip side of printed forms, or the "click-through" screens of online forms). The charts in this series of *Respecting Boilerplate* articles are intended to facilitate the process of drafting, reviewing, negotiating, and respecting boilerplate provisions.

The common topics are illustrated in the first column by a "reference" clause—which is generally not a universally recommended text, and which is neither the most simple nor the most complete possible provision, but one that illustrates the basic purposes. For each reference clause, the second column identifies questions or other comments to consider. Not every reference clause is necessary or sufficient for any particular deal, and neither the table nor the comments are exclusive (this sentence sounds like boilerplate itself). Nonetheless, the chart may help you select an appropriate subset of general clauses for a specific transaction.

REFERENCE CLAUSE	COMMENTS
I. PREAMBLE	Good negotiators distinguish style from substance. Some drafters may choose to follow time-honored conventions, while others might select a contemporary approach. Reviewers should courteously edit within the confines of the drafter's selected mode, not overturn the choice or try to use elements of different styles in the same document.
THIS ___ AGREEMENT (the "Agreement") is entered into as of [date] (the "Effective Date") by ______, a [state] [legal entity] ("[defined term]"), and ______, a [state] [legal entity] ("[defined term]").	Contemporary style is for this preamble to be a complete sentence. Traditional style employs a noun clause, ending in a comma, and a new paragraph consisting of the centered and often letter-spaced word "WITNESSETH:". Pay attention to "as of" dates. Watch especially for backdating, an effective date prior to execution and delivery of the agreement. Would third parties be prejudiced by establishing a date earlier (or later) than the date on which the parties actually execute the agreement? Some preambles include addresses or states of residence, or descriptors like "and a wholly-owned subsidiary of X" in a party's defined name. If the current or ongoing truth of that description is important to a Party, it should consider using a representation or covenant. Addresses may be less reliable than other forms of identification in some parts of the world. For example, customary practice in Oman is to include a national identification number in place of an address when identifying an individual.

[1] For the complete charts, see http://www.pillsburylaw.com/siteFiles/Publications/RespectingBoilerplate131022.pdf.

REFERENCE CLAUSE	COMMENTS
This Agreement is made with respect to the following recitals:	Contemporary style is for this full-sentence introduction to precede full-paragraph recitals (often identified by capital letters A, B, C for each recital paragraph); the entire passage is sometimes entitled "RECITALS" or "BACKGROUND." Traditional style uses paragraph clauses each ending in a semicolon (or colon for the last clause), with each recital opening with the impressive "WHEREAS." Recitals often recount prior history needed to understand the current transaction and provide a brief statement of motivation (especially if the Parties desire some particular tax or regulatory treatment of their deal). Watch for substantive information in a recital that, if false, would matter to your client. In many states, recitals in a written contract (other than of consideration) are conclusively presumed to be correct as between the parties (*e.g.*, California Evidence Code § 622).
[In consideration of the mutual promises made herein, and intending to be legally bound,] the Parties [therefore] agree as follows:	Contemporary style has the agreement proper open in this manner. Traditional style culminates in the florid "NOW, THEREFORE, in consideration of the foregoing recitals and the mutual promises contained herein and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the Parties, intending to be legally bound, hereby agree as follows:".

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