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Prospective Bidders: Will the Pershing Square/Valeant Accumulation of Allergan Stock Lead to Regulatory Reform?

By Victor Lewkow, Christopher Austin & David Brodsky, Cleary Gottlieb Steen & Hamilton LLP

As widely reported, a vehicle formed by Pershing Square and Valeant Pharmaceuticals acquired just under 5% of Allergan's shares. The Pershing Square/Valeant vehicle then crossed the 5% threshold and nearly doubled its stake (to 9.7%) over the next ten days, at which point it made the required Schedule 13D disclosures regarding the accumulation and Valeant's plans to publicly propose an acquisition of Allergan. The acquisition program has raised a number of questions.

Insider Trading Considerations

Based on public information, there is nothing to suggest insider trading. First, it appears that neither Valeant nor Pershing Square had obtained any material non-public information from Allergan. Second, it has been long established that a prospective bidder can accumulate a stake in a target without disclosure of its own plans (i.e., a bidder's own intention to pursue an acquisition is not "inside information").

There is, however, a special SEC insider trading rule that deals with tender offers. Rule 14e-3 provides that once a prospective bidder has "taken a substantial step or steps to commence a tender offer," then any person other than the bidder who is in possession of material non-public information relating to such tender offer is prohibited from acquiring shares in the prospective target. There may be some uncertainty as to whether or not the Pershing Square/Valeant vehicle would be subject to this rule given that one (but only one) of its parents is the prospective bidder. But that likely is irrelevant.

While the concept of "substantial steps to commence a tender offer" has been construed liberally, it is highly likely that Valeant has been careful to avoid any actions that could be characterized as steps towards commencement of a tender offer. Instead, Valeant is likely to pursue the acquisition by making public merger proposals ("bear hugs") together with a threatened or actual proxy contest or consent solicitation to change the board of directors.

One might ask why Rule 14e-3 is focused only on tender offers and not on other acquisition structures? The answer is simply that the Williams Act gave the SEC authority to adopt rules regulating tender offers

TABLE OF CONTENTS

– Prospective Bidders: Will the Pershing Square/Valeant Accumulation of Allergan Stock Lead to Regulatory Reform? 1

– Proposed Amendments to the Delaware General Corporation Law: Section 251(h) Mergers & More 3

– The Evolving Face of Deal Litigation 6

– Rural Metro: Potential Practice Implications Going Forward 8

– New Urgency for Corporate Inversion Transactions 12

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and this rule was adopted in 1980, at a time when tender offers were the principal means of acquisitions and there were concerns about people trading based on advanced knowledge of tender offers. This was during the era of "raiders," who often made tender offers, and well before the current era of "activists."

There also has been considerable discussion recently as to the appropriateness of trading by persons with knowledge of an activist investor's plans. For example, it has been reported that during the ten-day period prior to the filing of the Pershing Square/Valeant 13Ds there was unusually heavy volume in Allergan trading over and above the Pershing Square/Valeant trades. We have no reason to believe any such trading resulted from a tip by Pershing Square or Valeant and there is of course nothing wrong with an investor acquiring shares based on a recognition that increased volume may indicate an accumulation by a potential bidder. But even if third-party trading did result from a tip by an accumulator, that trading would not constitute insider trading under Rule 14e-3 if (as discussed above) no substantial steps had been taken to commence a tender offer.

It also would not constitute insider trading under Rule 10b-5 unless the tip violated a legal duty of trust or confidence (for example, if one participant in an accumulation tipped in violation of a duty of confidence to the other). Of course, if there were a tip and there were also an agreement or understanding (which need not be in writing) to act together between any such trader and one or both of the participants in the accumulation, the failure of the trader to file as part of the group filing the Schedule 13D would be a violation of Section 13(d) by both the filing parties and the trader, which could lead to SEC enforcement action and, in egregious circumstances, criminal prosecution.

The 13D Ten-Day "Window"

The Schedule 13D ten-day "window" (which does not require a filing until ten days after the 5% threshold is crossed and permits acquisitions in excess of 5% during the ten days) dates back to Congress's adoption of the Williams Act in 1968. For many years numerous market participants have urged Congress to shorten the window, noting that almost every other developed market has a much shorter period to make filings disclosing large positions (and some have filing thresholds at levels under 5%).

Eventually, the Dodd-Frank legislation (adopted in 2010) authorized the SEC to shorten the ten-day window. While many commentators assumed that the SEC would move quickly to substantially shorten it, activist hedge funds and their supporters argued that encouraging activism was good public policy (since it was a counterweight to "entrenched" boards of directors) and that the ten-day window encouraged activism by permitting acquisitions of larger stakes without disclosure (and the resulting run-up in share price). The SEC has not yet taken a position and has not exercised its authority to shorten the 13D window.

HSR Filing Requirements

Substantially the entire investment was in the form of American-style call options and forward purchase contracts. Thus, since the vehicle did not have the ability to vote any of the underlying shares, it appears that no filing had been required under the antitrust pre-notification filing requirement of the Hart-Scott-Rodino Act ("HSR"). An HSR filing would be required only when the underlying shares are acquired.

Will Congress or the SEC Take Action?

The recent high-profile events regarding Allergan may put pressure on the SEC (and potentially Congress) to address a number of important policy questions. These include (1) whether the 13D window should be substantially shortened, (2) whether all derivative positions, even purely economic positions, should be treated as "beneficial ownership" for 13D purposes (as is common under similar disclosure systems in many other countries and as the SEC now has the authority to require under Dodd-Frank) and (3) whether the Rule 14e-3 limitation on third-party trading in anticipation of a tender offer should be expanded to include other acquisition structures (which would likely require Congressional action). Importantly, these issues can be viewed as part of a growing debate as to whether there are cases of "illegitimate" imbalances of information beyond classic "insider trading" that regulators should address. These include, in addition to the 13D and 14e-3 issues raised above, high speed traders' use of informational advantage due to timing or visibility of order flow and possible informational advantages available in dark pools.

Proposed Amendments to the Delaware General Corporation Law: Section 251(h) Mergers & More

By Richards, Layton & Finger, P.A.*

In mid-April, the annual amendments to the Delaware General Corporation Law ("DGCL") were proposed and there are a number of significant amendments relevant to mergers and acquisitions involving Delaware corporations. In addition, a proposed amendment to the provisions of the Delaware Code relating to contractual limitations periods will permit, among other things, parties to a merger, stock or asset purchase or other agreement to contractually extend the statute of limitations applicable to covenants in the agreement beyond three years without having to execute the agreement under seal. These amendments are expected to be considered by the Delaware General Assembly during its current session. If enacted, the effective date for the proposed amendments would be August 1, 2014.

Section 251(h) Mergers

In 2013, the DGCL was amended to eliminate, subject to certain conditions, the need for a back-end merger vote in a two-step merger involving a front-end tender or exchange offer. Early experience with Section 251(h) demonstrated the statute's utility, but also gave rise to various questions among practitioners regarding certain aspects of its use and application. The proposed amendments to the DGCL are designed to address those questions.

The proposed amendments would eliminate the prohibition against the statute's use in transactions where a party to the merger agreement is an "interested stockholder" (as defined in Section 203 of the DGCL). This change would, among other things, eliminate any question as to whether an offeror's entry into certain voting agreements or other arrangements with existing stockholders would render the offeror an "interested stockholder" and therefore incapable of taking advantage of Section 251(h). The proposed amendments would also clarify various timing and other requirements in respect of the back-end merger.

The proposed amendments would replace the existing "ownership" requirement in respect of the target's stock with a requirement that, following the offer, the stock irrevocably accepted for purchase or exchange and received by the depository prior to the expiration of such offer, plus the stock owned by the consummating corporation, must equal at least the percentage of stock (and of each class or series) that, absent Section 251(h), would be required to adopt the merger. The proposed amendments would also replace the existing language requiring that shares of the target corporation "not to be canceled in the merger" receive the same consideration paid to holders of shares of the same class or series upon the consummation of the offer with language providing that shares that are the "subject of and not irrevocably accepted for purchase or exchange in the offer" must be converted into the same consideration paid for shares of the same class or series irrevocably accepted for purchase or exchange in the offer.

In addition, the proposed amendments would clarify that the merger agreement in respect of a transaction under Section 251(h) may either permit or require the merger to be effected under Section 251(h). Thus, the proposed amendments expressly enable the parties to provide in the merger agreement that the proposed merger under Section 251(h) may be abandoned in favor of a merger accomplished under a different statutory provision. As a related matter, the proposed amendments would clarify that the merger agreement must provide that the back-end merger shall be effected as soon as practicable after the offer if the merger is effected under Section 251(h). The proposed amendments would also clarify that the offeror's tender for all of the target corporation's outstanding voting stock may exclude stock that, at the commencement of the offer, is owned by the target corporation, the offeror, any person that directly or indirectly owns all of the stock of the offeror, and direct or indirect wholly-owned subsidiaries of the foregoing parties.

In furtherance of the foregoing changes, the proposed amendments would add a new paragraph to Section 251(h) setting forth the meaning of certain terms used in Section 251. Of particular note, the term "consummates" (and correlative terms) would be expressly defined to mean the time at which the offeror irrevocably accepts for purchase or exchange stock tendered pursuant to a tender or exchange offer, to help eliminate questions regarding the time at which the conditions to effecting the back-end merger have been satisfied. As with the legislation originally enacting Section 251(h), the synopsis to the proposed amendments states that the amendments to the subsection do not change the fiduciary duties of directors in connection with any merger accomplished under the subsection or the judicial scrutiny applied to any decision to enter into a merger agreement under the subsection.

If enacted, the amendments to Section 251(h) will be effective with respect to merger agreements entered into on or after August 1, 2014.

Escrowing Director Consents

Section 141(f) of the DGCL would be amended to clarify that any person, whether or not then a director, may provide, by instruction or otherwise, that a consent to board action will be effective at a future time, including a time determined upon the occurrence of an event, no later than 60 days after the instruction is given or other provision is made, and that the consent will be deemed to have been given at that effective time as long as the person is a director at the effective time and did not, prior to the effective time, revoke the consent.

The proposed amendment to Section 141(f) was adopted in response to concerns, stemming from *AGR Halifax Fund, Inc. v. Fiscina*, 743 A.2d 1188 (Del. Ch. 1999), over the validity of consents executed by persons who have not yet become directors in anticipation of their becoming directors. It has been common practice, for example, for the persons who will become the directors of the surviving corporation at the effective time of a merger to execute consents, to be held in escrow prior to the effective time of the merger, that authorize the execution of the financing documents for the merger on behalf of the surviving corporation. The amendment to Section 141(f) is intended to address concerns about this practice following the decision of the court in *U.S. Bank National Association vs. Verizon Communications Inc.*, C.A. No. 3:10 CV-1842-G (N.D. Tex. Aug. 8, 2012), which, relying on *AGR Halifax*, concluded that consents that had been executed in connection with a spin-off by persons the day prior to their becoming directors were invalid notwithstanding the directors' alleged intention that such consents were to be held in escrow until they were formally seated as directors. The proposed amendments would, among other things, enable acquisition financing transactions to be structured such that the person or persons who are to become the directors of the surviving corporation may execute consents, to be held in escrow, authorizing the financing and security transactions and related documents, which consents will become effective upon the signing person's or persons' becoming directors of the surviving corporation concurrently with the closing of the transaction.

Escrowing Stockholder Consents

Consistent with the bases for the proposed changes to Section 141(f), Section 228(c) would be amended to clarify that any person executing a stockholder consent may provide, by instruction or otherwise, that the consent will be effective at a future time, including a time determined upon the occurrence of an event, no later than 60 days after the instruction is given or other provision is made and, if evidence of the instruction or provision is given to the corporation, the later effective time will constitute the date of signature.

Amendments to the Certificate of Incorporation

The proposed amendments would effect two substantive changes to Section 242 of the DGCL, which deals with amendments to the corporation's certificate of incorporation. First, the proposed amendments would eliminate the requirement that the notice of the meeting at which an amendment to the certificate of incorporation is to be voted on contain a copy of the amendment itself or a brief summary of the amendment when the notice constitutes a notice of internet availability of proxy materials under the Securities Exchange Act of 1934. This amendment is intended to facilitate use of notice and access by Delaware corporations in stockholder meetings where amendments to the certificate of incorporation are proposed. Previously the notice requirement for such meetings required that the notice contain either the proposed amendment or a summary of such amendment–information always included in the proxy materials themselves, but not in the shortened notice advising stockholders of the internet availability of such materials. Second, the proposed amendments would authorize a corporation, by action of its board of directors, to amend its certificate of incorporation to change its name or to delete historical references to its incorporator, its initial board of directors or its initial subscribers for shares, or to provisions effecting changes to its stock (e.g., language effecting an earlier stock split), without the need to submit the amendment to a vote of stockholders. Accordingly, it will now be possible to change a corporate name by amendment without a stockholder vote and without having to use a short form merger to accomplish that result.

Voting Trusts

Section 218 of the DGCL currently requires that a voting trust agreement, or any amendment thereto, be filed with the corporation's registered office in the State of Delaware. The proposed amendments to Section 218 would provide that a voting trust agreement, or any amendment thereto, may be delivered to the corporation's principal place of business instead of its registered office.

Statute of Limitations

Section 8106 of Title 10 of the Delaware Code currently provides that the default statute of limitations applicable to claims based on contract is three years. Although the Delaware courts have held that this statute of limitations period may be shortened by contract, there had been some doubt as to whether parties to a contract could extend the statute of limitations beyond the three-year period without executing the contract under seal. *See generally GRT, Inc. v. Marathon GTF Technology, Ltd.*, 2011 WL 2682898, at *15 nn. 80-81 (Del. Ch. July 11, 2011).

The proposed amendment to Section 8106 would enable parties to contractually extend the three-year statute of limitations for a period of up to twenty years, provided that the contract involves at least $100,000, without the necessity of executing the contract under seal. The amendment to Section 8106 will become effective on August 1, 2014. Unlike the amendment to Section 251(h) of the DGCL, the amendment to Section 8106 does not expressly state that it applies only to contracts entered into on or after that date. Accordingly, it may give effect to a provision of an existing contract entered into prior to August 1, 2014 that is not under seal, but that provides for a survival period beyond the three-year statute of limitations that previously may have been applicable to such provision.

* * *

The 2014 Amendments to the Delaware General Corporation Law and statute of limitations provisions described above demonstrate the continued commitment of Delaware to having modern and flexible corporate and commercial laws that are responsive to the business needs of M&A lawyers.

The Evolving Face of Deal Litigation

By Daniel Wolf, Sarkis Jebejian, Yosef Riemer & Matthew Solum of Kirkland & Ellis LLP

As dealmakers put the finishing touches on public M&A transactions, the question is no longer if there will be a lawsuit, but rather when, how many and in what jurisdiction(s). And while many of the cases remain of the nuisance strike-suit variety, recently it seems every few weeks there is an important Delaware decision or other litigation development that potentially changes the face of deal litigation and introduces new risks for boards and their advisers. Now more than ever, dealmakers need to be aware of, and plan to mitigate, the resulting risks from the earliest stages of any transaction.

1. <u>Increasing Skepticism of Disclosure-Only Settlements</u>. Historically, a healthy majority of strike-suits have been resolved pre-closing with the target agreeing only to make a number of additional disclosures in exchange for the cases being settled with full releases. When the settlements came up for court approval post-closing, the plaintiffs' attorneys would seek and typically obtain an award of fees (typically less than $1 million) for extracting these additional disclosures. Companies were willing to pay this manageable "tax" on deal activity in exchange for a relatively efficient disposition of many of these nuisance cases, and to an extent, certain dealmakers became somewhat desensitized to the greater threat of substantive deal litigation.

   However, Delaware courts recently have become more skeptical of the value of these additional disclosures and the benefits they offer to shareholders. The courts are increasingly likely to critically assess the true materiality of the added information, and in some recent cases have awarded considerably reduced attorneys' fees (e.g., *Deltek* and *Amylin*) or even outright rejected the settlement (e.g., *Medis* and *Rural Metro*). Assuming this trend continues, it remains to be seen whether the long-term practical impact will be a more selective approach by the plaintiffs' bar in choosing which cases to bring and what jurisdiction to bring them in, and/or an increase in the number of cases pursued rather than settled.

2. <u>Risk of Significant Post-Closing Damages Awards</u>. The growing suspicion of disclosure-only settlements has been accompanied by explicit and implicit encouragement by the Delaware judiciary of pursuit by plaintiffs of the admittedly limited number of cases where real, rather than imagined, issues exist, most often in circumstances involving an actual or perceived conflict.

   In recent high-profile cases involving findings of material breaches of fiduciary duties by the target board or advisers, the court has awarded or signaled that it will award significant damages (in *Southern Peru* and *Rural Metro*) and attorneys' fees (in *Del Monte* and *El Paso*). Taken together with the disclosure settlement trend described above, the Chancery court appears to be using economic incentive (and disincentive) to seek to influence the behavior of the legal community in separating the wheat from the chaff in M&A litigation.

3. <u>Key Issues Getting Traction in Delaware Courts</u>. With this increased risk of post-closing litigation, the ever-evolving nature of deal-related litigation claims has presented a set of issues and trends that appear on a repeat basis in recent adverse opinions. Here is a short outline of topics currently garnering attention.

   a. *Financial Adviser Conflicts* — While acknowledging that staple financing may be value-generating for a target under appropriate circumstances and conditions, courts will be alert to the conflict of interest that may result from permitting, or at least not supervising, the efforts of a target financial adviser to seek, even unsuccessfully, a role in financing a bid by one or more potential buyers (*Del Monte* and *Rural Metro*). Together with other cases involving a variety of potential adviser conflicts (*El Paso*), these decisions highlight the risk of advisers that have potential financial incentives outside of their M&A advisory fees and the need for explicit evaluation by boards of any resulting perceived conflicts.

   b. *Board Independence and Supervision* — The courts expect that the board will critically assess the independence of its own members (*Orchard*), focusing specifically on the context of a particular transaction as opposed to merely applying the generic stock exchange standards. Similarly, courts expect boards to set ground rules and then supervise their own members and advisers to ensure they are acting within the proper scope of authority (*Del Monte* and *Rural Metro*).

   c. *Differential Interests of Large Stockholders and "Why Now?"* — Even in transactions where all target shareholders receive the same consideration, the courts are willing to entertain claims that the timing of the transaction may have been less than opportune because a director who is a large stockholder or affiliated with one may have been motivated to influence the timing and terms of a sale because of its own concerns (e.g., a director needing liquidity as in *infoGroup* or a financial investor needing a sale to bolster its track record while raising a new fund as in *Rural Metro*). The rationale for pursuing a transaction at a given time, and the reasons for selecting a particular path to achieving that aim, should be explicitly considered by boards and carefully documented.

d. *Disclosure Claims* — While claims relating to deficient disclosure have generally been treated as afterthoughts in post-closing damages suits, some recent cases (e.g., *Orchard*) have shown that material omissions or misstatements can be used as a wedge to assert broader breach of loyalty claims or as a means to seek a class-wide quasi-appraisal remedy based on the argument that the integrity of the shareholder approval or decision whether to seek appraisal was tainted by the fact that the shareholders were not fully informed.

e. *Changes to Projections or Valuation Analyses* — Courts will be suspicious of changes, particularly when sudden or sharp, which can appear geared towards indirectly justifying the fairness of a particular sale price. Boards and their advisers should carefully document the bridge between various iterations and develop an understanding of the reasoning behind any such changes (*Southern Peru* and *Rural Metro*). Similarly, where practical within the framework of a sale process, courts expect that the valuation exercise by a target board is one that develops over the course of the process, rather than being left as a seeming afterthought on the eve of announcement (*Rural Metro*).

4. Appraisal Rights as an Asset Class. As we noted in an earlier *M&A Update*, appraisal claims have become an increasingly prevalent alternative, and often more lucrative, avenue of attack for plaintiffs seeking economic opportunities in deal litigation. While not yet a feature of every deal like strike-suits, appraisal claims by significant financial investors have become a regular occurrence in the deal landscape over the past year. We have seen continuing growth in the range of long- and short-term investors willing to explore this remedy, as well as an increase in funds dedicated specifically to appraisal as an independent investment opportunity.

In a number of cases, significant buying activity occurred right before closing for the sole purpose of using those shares to pursue an appraisal claim, with the net effect of creating potentially significant economic uncertainty for acquirers, which can be particularly troublesome for financed transactions. The slow upturn in actual litigated appraisal cases, which can take years to work their way through the courts, has been complemented by growth in confidential, and often expensive, settlements at early stages of appraisal proceedings. In that regard, a recent decision by VC Glasscock (*CKx*) highlighted the potential coercive impact of accruing interest (at the Fed discount rate plus 5%) owed on the appraisal award (regardless of outcome), with the court explicitly encouraging policymakers to give close consideration to the interest provisions that create "rent-seeking" opportunities for plaintiffs generating "perverse litigation incentives."

5. Multiforum Litigation and Forum Selection Bylaws. Despite well intentioned efforts by the Delaware courts, the specter of overlapping cases in multiple jurisdictions remains a continuing reality for deal parties, adding complexity, expense and forum-shopping risk. Following the endorsement by the Delaware court in *Chevron*, a growing number of companies have been implementing forum selection bylaws that provide that Delaware courts are the exclusive forum for any fiduciary duty cases against the company. While some questions remain whether courts in other jurisdictions would defer to the bylaw provisions, a number of recent decisions in Louisiana (*Edgen*), New York (*Aspen*) and Illinois (*Beam*) suggest that courts are likely to respect the bylaws and grant motions to dismiss litigation brought outside Delaware in violation of the exclusivity term.

These cases have highlighted a number of practice pointers to enhance the likelihood that the forum selection bylaw will be effective in avoiding multiforum M&A litigation: (1) implementation of these bylaws on a clear day (i.e., before a sale process begins), or at least enactment early in the process, could enhance the prospect that a non-Delaware court evaluating fiduciary duty claims relating to a deal will respect the jurisdictional exclusivity and (2) there may be value in also adding to the bylaws a provision requiring shareholders who bring fiduciary duty claims to consent to personal jurisdiction in Delaware to increase the chances that, in the face of claims in another jurisdiction, the validity and effectiveness of the bylaw itself can be litigated in Delaware.

Rural Metro: Potential Practice Implications Going Forward

The following is an excerpt from the excellent webcast held on April 2nd on DealLawyers.com. The full transcript & audio archive are posted. Here are the speakers:

- **Kevin Miller**, Partner, Alston & Bird LLP (moderator)
- **T. Brad Davey**, Partner, Potter Anderson & Corroon LLP
- **C. Stephen Bigler**, Director, Richards Layton & Finger, PA
- **Stephen M. Kotran**, Partner, Sullivan & Cromwell LLP
- **Bill Lafferty**, Partner, Morris Nichols Arsht & Tunnell LLP

Bigler: We're going to spend the rest of our time talking about – what do we do about all of this. What does this mean for transactions going forward.

I'm going to start by asking Bill and Brad a question. If I came to you and said, "I want to set up a transaction where the investment bank that is representing the target is also going to provide financing to the buyer, and so I'll address that conflict by hiring a second bank available to give the fairness opinion," is there any scenario where that's really a viable structure at this point? Or is that a structure that is really too risky to proceed on?

Lafferty: I'll try to respond. I think the answer is, it is still viable. But the court, especially after this opinion, has to be on top of that, has to police it, and has to be proactive about controlling the bank and its communications about the staple and what not.

I think the recent opinions, including *Morton's* and another one from then Chancellor Strine, have still said that staple financing can be beneficial. I think it can be done. It just has to be managed very proactively.

Bigler: Do I have to be able to show that I need it? Do I need to make some assessment of what the credit markets are like at the time, such as, is financing easily available for these kinds of transactions? What kinds of questions should I be asking?

Davey: I certainly think that the questions you just raised would be relevant to the analysis and would be important for the court to understand. I know in the *Morton's* case, in fact, the buyer came in and asked that Jefferies provide the financing and explained that it needed the financing to increase the price.

That, in turn, went to the board and made the request. The board agreed to allow them to do it subject to several conditions, including that they get a fairness opinion and forgoing certain amounts of their compensation, so that it could then be used to retain another banker.

I don't think whether staple financing is needed or not is the be-all and end-all question. I would think that, if there was no need other than the bank's desiring to provide it, then the level of scrutiny might need to be enhanced, and keeping the financing bank out of the board room going forward would probably be more important.

Miller: I think you need to distinguish between two often muddled concepts. One is staple financing, and the other is "winning bidder" financing. *Morton's* was more of a winning bidder finance situation, where the bank was brought in, subject to all of the criteria that you mentioned, at the end of the process. There was no indication that its thoughts or its advice were corrupted during the process by the prospect of its being in the financing. It was something that was initiated by the buyer at the end of the process after the deal was essentially fully negotiated.

That's distinguishable from the staple financing model, where the sell-side advisor/bank is asked from the outset to facilitate bidders by offering up a uniform financing package. My view is that staple financing in the public company context is going to be difficult if not impossible to use going forward.

For the staple financing to be a useful product to the financial advisor/bank being asked to provide it, there needs to be a reasonable possibility that a buyer it is offered to will use it. I am reading *Rural/Metro* and some of the other cases to say that once the staple financing provider needs to modify or tailor that financial structure for an individual buyer – and sometimes that bank forms multiple trees – the incentives for the banker can potentially become too great for the court to be comfortable that it isn't going to tilt the playing field.

As a consequence, banks should be reluctant to tailor the financing. If they can't tailor the financing, they're probably not going to win the financing. And if they are not going to win the financing, why should they go to the effort of even offering a staple financing when they could just sit on the sidelines and avoid the risk and liability? If it's necessary for the transaction to close, they will be asked to participate in winning bidder financing. I just think the risk to the banks of offering staple financing in the public company context, given the restrictions that would apply to their ability to tailor that financing to an individual buyer, may be too great now.

Bigler: That may be the case for the winning bidder financing, Kevin. It seems like there are different shades of the same situation. In *Rural/Metro*, there were a lot of emails in the back room about essentially winning bidder financing and potentially financing in another deal, which were viewed as problematic.

There are other situations where they may not be as problematic. The situation that frequently comes up is when you start the deal, you may not know who the winning bidder is going to be, particularly if it's a strategic deal. What financing the buyer is going to need and who's going to provide it can be something you are not really going to know until the 11th hour.

Miller: That's absolutely right, particularly if they're going to want to tap their regular sources of financing and the regular sources of financing happen to be the sell-side financial advisor. There is no way of knowing that at the outset, and that presents a number of complications.

I would also add that, ever since *Toys'R'Us*, if not before, it has been abundantly clear that if the board thinks "no harm, no foul," that's not enough. There have to be demonstrable benefits to the seller, documented contemporaneously and appreciated by the board to support the decision to release a sell-side advisor to participate in the buyer's financing. And if there are other sources of financing reasonably available, I think the Delaware Court would expect a target company to avail themselves of the other sources.

Bigler: Right. Then I think you get into questions about disclosure, and trying to figure out upfront whether there are conflicts or potential conflicts. In some situations, you have a list of buyers, where you read the report and they say, "We went to the list of 45 buyers."

Do you have to ask whether one of your banks is doing financing work for everybody on the list? Or can you afford to wait until later on in the period?

We've all had circumstances where you are reading the banker disclosure in the proxy statement, down at the bottom where it's talking about the fees, and you read for the first time, when the proxy statements is being drafted, that, " XYZ Bank has an $X million line of credit with the buyer." And this is the first time that it has shaken out. Then everyone asks, "What do we do about this?"

But until you know who the buyer is going to be, I don't know how or whether there's a practical way to shake that out.

Miller: Particularly with the large global financial institutions, it can be problematic. You have a number of problems.

One problem is some of these institutions are so large that they don't really know what's going on in all parts of their spectrum of operations. Somebody may be calling on a sovereign wealth fund in Southeast Asia with a list of 10 prospective targets that they might think of acquiring, and a banker in New York or London may have no idea that the company they are pitching a sell-side assignment to is on the list provided to the sovereign wealth client in Asia.

The second thing is, a lot of the information regarding relationships is hidden behind informational barriers in other areas of the bank. Sometimes the last thing you want to do is to tell the bank you want to breach those informational barriers to gather information regarding potential relationships. It may have been much better for them to act innocently without knowledge of those relationships, because they were prevented from knowing about them by informational barriers erected for other regulatory and public policy reasons.

Bigler: Until you really know what exactly the transaction is, you can ask a banker up front, when they're doing their pitch, "Do you have a conflict?" But they may not know whether they have a conflict, and that will depend on who ultimately the buyer is.

You can try to put in some sort of restriction on what they can do. But it's going to be hard for a bank to agree to a blanket restriction if you're talking about 50 potential buyers, particularly if they are strategic buyers, that says, "We won't do any work during the scope of this engagement for any of the people on Schedule A."

If Schedule A happens to go on for two or three pages, it's just not viable.

Miller: You don't necessarily, though, particularly if you have a long-term trusted advisor. You are not going to want to deprive yourself of the ability to use that long-time trusted advisor just because of a potential conflict with a percentage of the potential buyers.

On the other hand, one thing that has bothered me, but maybe you have a different view on, is the notion that you may have a bank come in and provide a fair amount of advice throughout the process. And then when you are 80% of the way there, it turns out there's a material relationship with the most likely buyer.

They are very upfront about it. They let you know about it. They even acknowledge that it may make sense for you to bring in somebody else at that stage. And the board says, "We're still committed to pay that first advisor transaction fee, and what you're essentially telling us is that we're going to have to double down on the fees that we're going to have to pay."

Does that trouble you at all? Or is that just a price of doing a deal these days?

Bigler: What the Court seems to be saying is you should do what they did in *Morton's*, where the first banker agreed to give up a portion of its fee to finance the second banker. If that's not a viable alternative, I'm fine paying the second banker and paying the double fee to essentially get the insurance.

Miller: The difference in *Morton's* was that the first bank was willing to subsidize the second bank, because the first bank knew it was going to be getting a financing fee.

Bigler: Right.

Miller: But in a situation where the first bank is being conflicted after doing 80% of the work, and the board has decided to go down a particular path with another client of that bank, the bank is arguably going to say, "I didn't do anything wrong here. I have been upfront all along the way. As it turns out, you've picked a buyer that I have a disclosed relationship with and decided you now want somebody as your financial advisor that you think might be more independent or objective. I'm not giving up my fee. I am entitled to my fee. And we appreciate that you may have to pay more, but that's the price of picking that buyer."

Bigler: Yes. And you may start seeing people trying to put something in engagement letters about that. If the first banker ends up with a conflict at some point, some portion of the fee would end up being shared or lost. You may hear that being asked for. I think that is something that may well be on the table.

Miller: We're very close to running out of time. Are there other thoughts, Steve, that you would like to add?

Bigler: There are a few red flags. I think we have talked about most of them. Last-minute changes to the board books to adjust the ranges, particularly to make the transaction look more favorable, are going to be a red flag in virtually any situation.

There is a discussion in the opinion about board books, pitch books, and things like that. That whole process really needs to be looked at and managed very carefully.

My other comment is I think there is a pretty strong message in this case that the company's lawyers, and the lawyers for the financial advisors, need to be aware of what's going on in these deals. And if they have questions, they need to ask them and to make sure the answers are satisfactory. Because if you don't ask, or you ask and you don't get a satisfactory answer, and that comes up later, there are going to be questions about, "Why didn't you ask? And why did you let things go forward the way they ultimately did?"

Miller: A couple of last practice points — for those that aren't aware, Chief Justice Strine, in a number of seminars, panels, and other public settings, has made it clear that he thinks that the board books that bankers provide to boards of directors or special committees should be marked, or otherwise indicate the material changes from prior versions of the presentation. That's something that company counsel at well as investment banker counsel should be aware of.

The courts don't want us relying on the obviousness of changes, or an oral discussion of changes. They would like to either see a black line – which I don't think is technologically feasible, although you could manually do it – or a page identifying material changes in the board book.

There is also a concern about making sure that the board books are accurately described in proxy statements. I think we are expecting to see a lot more vigilance and diligence, maybe a bit more ticking and tying – something like a comfort letter – between board books and proxy statements.

New Urgency for Corporate Inversion Transactions

By David Miller and Linda Swartz, Partners of Cadwalader, Wickersham & Taft LLP*

Corporate inversions have constituted an active and successful part of the M&A market in 2013 and early 2014, as acquirors have typically traded up on the date of announcement. However, there is now a new urgency for U.S. corporations seeking to invert to identify merger partners and complete their transactions.

Major Inversion Transactions Announced or Completed in 2013 and early 2014:

- **Endo Health Solutions acquisition of Paladin Labs**
- **Applied Materials acquisition of Tokyo Electron**
- **Perrigo acquisition of Elan**
- **Omnicom Group merger with PublicisGroupe**
- **Chiquita Brands merger with Fyffes**

In an inversion transaction, a foreign corporation is interposed between a U.S. corporation and its shareholders, typically to allow the U.S. corporation to distribute the untaxed earnings of its foreign subsidiaries to the shareholders of the new foreign parent, or to reduce its future tax liability through deductible payments to the new foreign parent, each without U.S. tax.

For example, in Endo Health Solutions' 2013 acquisition of Paladin Labs, shareholders of Endo and Paladin exchanged their shares for those of a new holding company incorporated in Ireland, which will own the two companies as subsidiaries. This will allow Endo to reduce its effective tax rate from 28 percent to 20 percent, resulting in $50 million in annual tax savings.

Under the existing tax laws, tax-efficient inversions are possible only if the former shareholders of the U.S. corporation own no more than 80 percent of the combined company after the merger or acquisition.

In March 2014, however, the Treasury Department proposed to amend the anti-inversion rules, effective January 1, 2015, to permit tax efficient inversions only if the former shareholders of the U.S. corporation own no more than 50 percent of the combined company after the merger or acquisition – a change that would significantly reduce the possibility for corporate inversion transactions. Senator Carl Levin (D-Mich.) and his brother, House Ways and Means Committee ranking minority member Sander M. Levin (D-Mich.), have announced that they will introduce legislation that will closely follow the Treasury proposal.

The prospects for the enactment of the proposed legislation in the current year are uncertain at best, but the completion of any inversion transactions by December 31, 2014, would avoid the application of the proposed amendment and any similar amendments that Treasury re-proposes in 2015 or later with the same effective date of January 1, 2015. As a result, inversion transaction activity may well accelerate as we approach the end of the year.

For this reason, U.S. corporations seeking to invert should identify potential merger partners and work to complete a transaction before the inversion rules are tightened.

* This article first appeared in the March 2014 issue of Cadwalader's "Quorum" newsletter.

A sister publication of the popular newsletter, *The Corporate Counsel*, *Deal Lawyers* is a bi-monthly newsletter for M&A practitioners to keep them abreast of the latest developments and analyze deal practices.

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