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Unbroken: 2014 In Review and What to Expect In 2015

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Is it too soon to shout from the rooftops that "DEALS ARE BACK??!" By all accounts, 2014 has been the best year for deals since the financial crisis. Worldwide announced deal volumes are up about 45%, elevated by a series of transformational deals of over $10 billion each. Most of that M&A volume was derived from North American deals. In fact, North American deal volume was up 70% in 2014 through the end of October. By contrast, the Western European M&A market continued to struggle a little bit, with 2014 deal volume to date at only half of Western Europe's pre-crisis announced deal volume.

In the midst of this exciting uptick in North American M&A, cross-border M&A volume represents more than a third of the global M&A market. Recently, most of the big cross-border deals have been transatlantic or intra-Western European deals, the former perhaps reflecting the dramatic surge in healthcare industry inversion transactions over the past couple years. There have also been several recent large U.S. transactions involving German acquirers. Meanwhile, there has been a notable lack of activity in Brazil, Russia, India and China, despite the unfettered exuberance of dealmakers regarding the BRIC countries just a few years ago. Indeed, the rate of growth of China's GDP is projected to continue its recent decline through 2015, even while the rate of growth of GDP in the U.S. and Europe is projected to increase, so it seems unlikely that M&A activity will pick up meaningfully in China in the near future.

The overall increase in deal volumes was widely dispersed across industries, led by healthcare and industrials, but with strong showings from consumer, real estate, energy and other sectors. Only financial institution transactions

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and not to insert additional conditionality tied to the performance of the portfolio company. Sponsors may also offer a "reverse termination fee" remedy with customary triggers if the transaction is not consummated when required in accordance with the acquisition agreement, perhaps with responsibility for any fee allocated by the sponsors to the party who is deemed responsible for the failure to close. Finally, sponsors may provide equity commitment letters to the acquisition vehicle and limited guarantees similar to those seen in a more typical leveraged buyout structure.

Three's Not a Crowd

New Club Deals are an attractive solution for sponsors that cannot act on an attractive add-on investment opportunity due to lack of capital or a desire not to over-lever their portfolio company. Such deals also provide an opportunity for the incoming sponsor to find exclusive or semi-exclusive opportunities in which they may be able to reap the benefit of strategic-like synergies. While the old saying goes that two's company but three's a crowd, three is a very welcome number for New Club Deals. Given the number of sponsors managing late stage funds and not raising new capital in the current market, we expect to see more New Club Deals in the future.

NOTES

1. Recent examples of simultaneous acquisitions include Clayton, Dubilier & Rice's acquisition of Brand Energy and Harsco Infrastructure and Apax Partners' acquisition of One Call Care Management and Align Networks.

Mitigating the Risk of M&A Litigation an Old-Fashioned Way: Delaware Law Favoring Stock-for-Stock Mergers

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Stockholder litigation has become an inevitable part of the M&A process. The announcement of a merger involving a public target company is virtually certain to generate multiple, parallel class action lawsuits, and those lawsuits are increasingly likely going to be filed in more than one jurisdiction.[1] Alongside these "traditional" M&A suits, statutory appraisal actions are becoming an increasingly prevalent fact of life in the M&A markets. Appraisal rights have become their own asset class, and a lot of money has been pouring into the strategy in recent years.[2]

Together, the ubiquity of traditional M&A class actions and the advent of appraisal arbitrage make litigation risk an increasingly important factor for merging parties to consider in any deal process, and sophisticated parties and their innovative advisors have developed new ways to mitigate this risk. Particularly in the wasteful area of multi-jurisdiction litigation, a promising new corporate law technology—the forum selection bylaw—has been developed and is being deployed with some success.[3] But there are also decades-old legal tools available that effectively mitigate this M&A litigation risk.

All else equal, in a negotiated merger between two widely held, publicly traded companies, structuring the deal as a stock-for-stock merger rather than a cash-out merger substantially increases the likelihood that a stockholder class action will be governed by the deferential business judgment rule standard, potentially decreasing both the time and cost of litigation.[4] At the same time, structuring the deal as a stock-for-stock merger rather than a cash-out merger eliminates appraisal rights.

As a result, simply by paying with stock instead of cash where the other transactional considerations allow it, merging parties can save millions of dollars and several years of litigation in the wake of a merger.

Cash mergers are governed by *Revlon*'s enhanced scrutiny standard, while stock-for-stock mergers are governed by the business judgment rule

Delaware has three standards of review for evaluating fiduciary duty claims against corporate directors and officers. The business judgment rule applies by default, and is the most deferential standard. It presumes that "in making a business decision the [fiduciaries] acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company."[5]

On the opposite end of the spectrum, entire fairness is the most onerous standard of review under Delaware corporate law. It applies when a plaintiff proves facts sufficient to overcome the presumptions of the business judgment rule, and requires the defendant fiduciaries "to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders."[6]

Enhanced scrutiny is Delaware's intermediate standard of review. It "applies when the realities of the decision-making context can subtly undermine the decisions of even independent and disinterested directors."[7] Importantly for present purposes, one context that frequently invokes enhanced scrutiny is the *Revlon* context.[8]

Despite the vivid imagery invoked by the Delaware Supreme Court in its landmark *Revlon* opinion,[9] "*Revlon* is now understood to be a form of enhanced scrutiny, . . . a standard of review under which the extent of judicial deference given to board decisions narrows from rationality to range-of-reasonableness."[10] "*Revlon* does not establish special duties or impose particular conduct obligations on directors,"[11] and there is "no single blueprint that a board must follow to fulfill its duties."[12]

The Delaware Supreme Court has established three *Revlon* triggers. First, *Revlon* applies "when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company."[13] Second, *Revlon* applies "where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the break-up of the company." Third, *Revlon* applies "when approval of a transaction results in a sale or change of control." The first two triggers are path-dependent and unaffected by the terms of the merger itself.

But the third trigger, namely the "sale or change of control" test, depends in large part on the form of merger consideration being paid in the merger. *Revlon* applies to a cash merger.[14] In a stock-for-stock merger, though, *Revlon* does not apply unless the "the stock to be received in the merger was the stock of a corporation under the control of a single individual or a control group."[15] In a mixed-consideration merger cases, where target stockholders receive a mixture of cash and stock, *Revlon* has been applied where the consideration was 62% cash,[16] and where the consideration was "split roughly evenly between cash and stock,"[17] but not where the consideration consisted "of a mix of 65% stock and 35% cash, with the stock portion being stock in a company whose shares are held in a large, fluid market."[18]

Thus, the standard of review to be applied in a suit challenging the arm's-length merger of two widely held public companies depends on whether the merger consideration is cash or stock. If it is cash, then *Revlon* applies, and the defendants will bear the burden of proving that the target fiduciaries acted reasonably. But if the acquiror pays with stock instead, then the deferential business judgment rule will govern the inevitable lawsuit challenging the deal. At least one empirical study suggests this could be a meaningful distinction in terms of the likelihood that litigation will result in a price increase for stockholders.[19] Importantly, this dichotomy affects post-closing litigation far more than the pre-closing preliminary injunction litigation. The pre-closing phase focuses on disclosures and deal protections, and neither of those areas implicates *Revlon*.[20]

Powerful voices have called for clarification of this area of the law, albeit in different ways. On one hand, Vice Chancellor J. Travis Laster published an article calling for the change-of-control test to be overturned, and arguing for *Revlon* enhanced scrutiny to apply to all negotiated mergers because they are all final-stage transactions.[21] On the other hand, leading corporate law scholar Stephen M. Bainbridge published an article calling for the change-of-control test to adhere more rigidly to its doctrinal foundations, and arguing for *Revlon* to apply only to deals where the post-transaction entity will emerge with a controlling stockholder.[22]

Nonetheless, the dichotomy remains unless and until the Delaware Supreme Court decides to change it.[23] And until then, a stock-for-stock transaction will be looked upon more favorably by a Delaware Court than would the same deal if cash were involved instead.

Cash mergers create appraisal rights for dissenting stockholders, stock-for-stock mergers do not

A similar dichotomy exists in the appraisal context. To understand why this is so requires one to navigate a circuitous route through Section 262(b) of the DGCL. Section 262(b) broadly decrees that "[a]ppraisal rights shall be available" to target stockholders in virtually all statutory mergers or consolidations under the DGCL.[24] But then, the "market-out" exception in Section 262(b)(1) undercuts the broad decree, eliminating appraisal rights for mergers in which the target is a public company. Under this exception, "no appraisal rights . . . shall be available for the shares of any class or series of stock . . . either (i) listed on a national securities exchange or (ii) held of record by more than 2,000 holders."[25] The market-out exception applies regardless of the form of consideration paid in the merger.

"But the appraisal statute continues. In what is known affectionately as the 'exception to the exception,' Section 262(b)(2) restores appraisal rights to a class or series of stock otherwise covered by the market-out exception if the holders are required to accept certain types of consideration."[26] Specifically, Section 262(b)(2) provides that notwithstanding the market-out exception in 262(b)(1), appraisal rights "shall be available" if a merger requires target stockholders to accept as merger consideration anything except: (a) stock of the surviving corporation, (b) stock of any other widely held, publicly traded corporation, (c) cash in lieu of fractional shares,[27] or (d) any combination thereof.[28]

Apart from the fractional shares scenario, cash is conspicuously absent from this list. As a result, under the cash exception to the market-out exception, target stockholders have appraisal rights if they are required to accept cash in the deal, but not if they receive widely held, publicly traded stock of the acquiror instead.[29] This means that even a mixed consideration deal, in which stockholders can elect to receive stock instead of cash, target stockholders have no appraisal rights for their shares.[30]

As with *Revlon*, scholars have called for change in this area of the law, too. Specifically, Professors Minor Myers and Charles R. Korsmo have argued that "[b]ecause the adequacy of the consideration paid in a merger does not . . . depend on the form of that consideration, neither should the availability of the appraisal remedy."[31] Nonetheless, the dichotomy remains unless and until the Delaware General Assembly decides to change it.

Conclusion

By excluding stock-for-stock mergers from *Revlon*'s reach and from the purview of the appraisal statute, Delaware law provides powerful medicine for both strains of stockholder litigation that threaten to infect M&A deals. As the class actions continue to take a small bite out of every deal, and the appraisal positions grow further into the nine-figures in any given case, this litigation factor takes on increasing importance to the success of a given deal and, correspondingly, the argument for stock-for-stock mergers instead of cash mergers becomes stronger.

NOTES

1. Leo E. Strine, Jr., Lawrence A. Hamermesh, Matthew C. Jennejohn, *Putting Stockholders First, Not the First-Filed Complaint*, 69 Bus. Law. 1, 8 (2013) ("In recent years, shareholder class actions challenging mergers and acquisitions have become more prevalent, and so have instances in which litigation of this sort has been brought more or less concurrently in multiple forums.9 In 2010 and 2011, 91 percent of all deals worth over $100 million were litigated, and these deals were targeted with an average of 5.1 lawsuits each.") (citations omitted).
2. *See* Charles R. Korsmo & Minor Myers, *Appraisal Arbitrage and the Future of Public Company M & A*, 92 Wash. U. L. Rev. __, at 14 (forthcoming 2015), *available at* http://ssrn.com/abstract=2424935 ("While appraisal may once have been a quiet corner of corporate law, it is now an area of active litigation undergoing a period of explosive growth. Furthermore, the parties driving that growth are a new group of sophisticated investors who appear to specialize in pursuing appraisal claims. In short, we have documented the rise of appraisal arbitrage.").
3. *See generally* Allison Frankel, *Forum Selection Clauses Are Killing Multiforum M&A Litigation*, Reuters (June 24, 2013), *available at:* http://blogs.reuters.com/alison-frankel/2014/06/24/forum-selection-clauses-are-killing-multiforum-ma-litigation/.
4. If nothing else, the applicability of *Revlon* to an arm's-length, third-party merger in which all of the defendant fiduciaries acted properly can mean the difference between dismissal at the pleadings stage and summary judgment. *See* J. Travis Laster, *Revlon is a Standard of Review: Why It's True and What It Means*, 19 Fordham J. Corp. & Fin. L. 5, 51-52 (2013) ("Complaints against *Revlon* transactions are subject to dismissal on the pleadings for failure to plead facts sufficient to overcome an exculpatory charter provision. Challenges to *Revlon* transactions are likewise susceptible to motions for summary judgment unless the plaintiff can produce evidence that the board 'utterly failed to attempt to attain' the transaction offering the best value for stockholders.") (citations omitted).
5. *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984).
6. *In re Walt Disney Co. Deriv. Litig.*, 906 A.2d 27, 52 (Del. 2006)
7. *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 457 (Del. Ch. 2011).
8. Laster, *supra* note 4, at 6.
9. *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986) ("The directors' role changed from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.").
10. Laster, *supra* note 4, at 6.
11. *Id.*
12. *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989); *see also In re Dollar Thrifty S'holder Litig.*, 14 A.3d 573, 595-96 (Del. Ch. 2010) ("[D]irectors are generally free to select the path to value maximization, so long as they choose a reasonable route to get there.") (footnote omitted).
13. *Arnold v. Soc'y for Sav. Bancorp, Inc.*, 650 A.2d 1270, 1290 (Del. 1994) (citations and internal quotation marks omitted).
14. *In re Smurfit-Stone Container Corp. S'holder Litig.*, 2011 WL 2028076, at *13 (Del. Ch. May 20, 2011) ("*Revlon* will govern a board's decision to sell a corporation where stockholders will receive cash for their shares.").
15. *In re Santa Fe Pac. Corp.*, 669 A.2d 59, 71 (Del. 1995) (A corporation does not undergo a change-of-control where control of the post-merger entity remains in a "large, fluid, changeable and changing market.") (internal quotation marks omitted); *Krim v. ProNet, Inc.*, 744 A.2d 523, 527 (Del. Ch. 1999) (*Revlon* "does not apply to stock-for-stock strategic mergers of publicly traded companies, a majority of the stock of which is dispersed in the market."); *Equity-Linked Investors, L.P. v. Adams*, 705 A.2d 1040, 1055 (Del. Ch. 1997) ("[W]here the stock to be received in the merger was the stock of a corporation under the control of a single individual or a control group, then the transaction should be treated for 'Revlon duty' purposes as a cash merger would be treated: there is no tomorrow for the shareholders (no assured long-term), the board's obligation is to make a good faith, informed judgment to maximize current share value, and the court reviews such determinations on a 'reasonableness' basis, which otherwise they would not do.").
16. *In re Lukens Inc. S'holders Litig.*, 757 A.2d 720, 732 n.25 (Del. Ch. 1999) ("Whether 62% or 100% of the consideration was to be in cash,

the directors were obliged to take reasonable steps to ensure that the shareholders received the best price available because, in any event, for a substantial majority of the then-current shareholders, there is no long run.") (internal quotation marks and citation omitted).

17. *Smurfit-Stone*, 2011 WL 2028076, at *1, 16.
18. *In re Synthes, Inc. S'holder Litig.*, 50 A.3d 1022, 1048 (Del. Ch. 2012).
19. *See* David H. Webber, *Private Policing of Mergers and Acquisitions: An Empirical Assessment of Institutional Lead Plaintiffs in Transactional Class and Derivative Actions*, 38 Del. J. Corp. L. 907, 974-75 (2014) (concluding that "cash-for-stock deals positively and statistically significantly correlate with improvements in the final price" as a result of M&A litigation, whereas stock-for-stock deals to do not correlate with such a bump"); *but see* Robert B. Thompson & Randall S. Thomas, *The New Look of Shareholder Litigation: Acquisition-Oriented Class Actions*, 57 Vand. L. Rev. 133, 196 (2004) (concluding that there are no substantial litigation gains for stockholders in *Revlon* deals).
20. *See Arnold*, 650 A.2d at 1277 (finding disclosure violation in stock-for-stock merger for misleading partial disclosures); *see also Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914, 931 (Del. 2003) (applying *Unocal* enhanced scrutiny to deal protections).
21. *See* Laster, *supra* note 4, at 53 ("Delaware law could be helpfully clarified and simplified if the Delaware Supreme Court clearly announced that (i) *Revlon* is a form of enhanced scrutiny, and (ii) enhanced scrutiny applies to negotiated acquisitions, regardless of the form of consideration, because of the final period problem."); *see also* Leo E. Strine, Jr., *Categorical Confusion: Deal Protection Measures in Stock-for-Stock Merger Agreements*, 56 Bus. Law. 919, 926-31 (2001) ("Under the *QVC* test, the [stock-for-stock] transaction would not be a change of control of [the target] because the current [target] stockholders would be able to share in any future control premium. In the real world, this theoretical reality would provide little solace to target] stockholders. They would rightly be worried about whether the current merger represented an unfair transfer of wealth from the [target] stockholders to the [acquiror] stockholders.").
22. *See* Stephen M. Bainbridge, *The Geography of Revlon-Land*, 81 Fordham L. Rev. 3277, 3338 (2013) ("Contrary to recent chancery court opinions, [the change-of-control test] is not dependent on the form of the consideration paid by the acquirer. If dispersed shareholders own the post-transaction combined entity in 'a large, fluid, changeable and changing market,' *Revlon* does not apply. If the post-transaction entity has a controlling shareholder, however, regardless of whether the corporation goes private or remains listed on a stock market, *Revlon* does apply. In other words, there must be a change of control, whether by sale or otherwise.").
23. *See* Laster, *supra* note 4, at 53 ("Only the Delaware Supreme Court sitting *en banc* can accomplish this change because it would require overruling the *Paramount* doctrine.").
24. 8 *Del. C.* § 262(b).
25. *Id.* § 262(b)(1). A generation ago, two titans of the Delaware corporate bar explained that "[t]he theory behind this denial of appraisal rights is that the stockholders have a 'market out' if they consider the terms of the merger unfair or inadequate since their shares are sufficiently widely held to permit ready sale." S. Samuel Arsht & Lewis S. Black, Jr., *The 1973 Amendments to the Delaware Corporation Law* 372 (1973). Accepting this, the empirical premise underlying the market-out exception would seem to be that a public market stock price is a fair substitute for statutory "fair value" as determined by an appraisal proceeding, which by its nature reflects information known only to the appraised company. The empirical economic foundation of the market-out exception, therefore, would seem to reflect the strong form of the efficient capital markets hypothesis, under which stock prices are assumed to reflect all available information, including confidential information. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549, 549-50 (1984) ("A market is strong form efficient if its prices reflect inside information that is privately held; by definition, the originator of such information wishes to prevent its dissemination."); *see generally* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. Fin. 383, 383 (1970).
26. *Krieger v. Wesco Fin. Corp.*, 30 A.3d 54, 57 (Del. Ch. 2011).
27. This is a reference to Section 155 of the DGCL, which, in conjunction with Section 242, permits a corporation to accomplish the equivalent of a freeze-out merger via a charter amendment and reverse stock split, paying cash in lieu of fractional shares. *See generally Reis*, 28 A.3d 442.
28. 8 *Del. C.* § 262(b)(2).
29. *See Krieger*, 30 A.2d at 60 ("The holders of Wesco common stock were not entitled to appraisal rights because they were not 'required by the terms of an agreement of merger or consolidation' to accept consideration other than stock listed on a national securities

exchange and cash in lieu of fractional shares.").

30. *Id*. Considering the *Revlon* precedents discussed above, it would seem that a mixed-consideration deal designed to consist of 70% stock and 30% cash that was structured in such a way that no stockholders were required to accept cash would not trigger *Revlon* or appraisal rights under existing Delaware law. *Id.*; *see also Synthes*, 50 A.3d at 1048.

31. *See* Korsmo & Myers, *Appraisal Arbitrage and the Future of Public Company M & A*, 92 Wash. U. L. Rev. (forthcoming 2015), *available at* http://ssrn.com/abstract=2424935.

Further Update on African COMESA

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On November 3, 2014, the COMESA Competition Commission ("CCC") adopted new guidelines aimed at easing confusion over its merger control regime (see "Update on Merger Control Filing Regime in African COMESA" in the October 2014 *The M&A Lawyer*).[1] Pending adoption of new Rules on the Determination of Merger Notification Thresholds, the new guidelines state that the CCC will interpret its jurisdiction by reference to the following three criteria:

- *first*, a deal will be considered to have an appreciable effect within COMESA and therefore subject to a filing obligation only if
  - (a) at least one party has gross assets or annual turnover exceeding $5 million in each of two or more member states, and
  - (b) the target operates in a member state;
- *second*, a deal will not fall within the CCC's exclusive jurisdiction if more than 2/3 of the annual turnover in COMESA of each of the parties is achieved within one and the same member state—in that case, the individual national merger control regimes of the member states, if any, may apply; and
- *third*, a merger will be deemed to restrict competition within COMESA only if it meets the SLC test discussed in the guidelines—therefore, no filing would arguably be required where the parties' activities do not overlap to any material extent in COMESA.

The parties may individually or jointly apply for "comfort letters" to confirm that no filing and fees are required in light of these criteria. The CCC is committed to respond to any such request within 21 calendar days.

In addition, the guidelines clarify that the standard 120 review period for a filing is now calculated in calendar days, not working days—somewhat contrary to the CCC's own practice to date. However, it remains the case that the parties may choose to close their deal prior to having obtained clearance from the CCC. Therefore, this change is unlikely to have any material impact on a deal timetable in practice.

COMESA stands for the Common Market for Eastern and Southern Africa and comprises the following member states: Burundi, Comoros, the Democratic Republic of Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Libya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia and Zimbabwe.

NOTES

1. COMESA Merger Assessment Guidelines 2014.