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THE FORCE AWAKENS: A RESURGENCE OF M&A IN 2015

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After close to a decade of anemic M&A, 2015 was "the big year" that dealmakers have been expecting for the last several years. Significant deals took place across a wide range of sectors and geographies. Dealmaking in health care and life sciences continued to be very active, but we also saw a lot of deals in consumer and retail (Kraft/Heinz, AB InBev/SABMiller), media (Cablevision/Altice, Charter/Time Warner) and chemicals (Dow/DuPont, Cytec/Solvay), to name a few industries. Many of the deals were huge. Before the ball dropped in Times Square, we saw more than 50 deals that exceeded $10 billion.

Notably, almost all of 2015's big deals involved only strategic buyers. Industrial acquirors, rather than financial sponsors, led the surge in M&A activity. With acquisition leverage still essentially capped at six times EBITDA, sponsors are finding it hard to compete with the frothy synergy-driven pricing offered by strategic bidders. Some strategic buyers are also borrowing sponsor strategies by levering up their deals or financing them with equity offerings. In fact, 2015 saw an increasing number of in-bound acquisitions by European buyers financed with rights offerings.

Even amidst this strong M&A market, there were signs of choppiness. The Dow plunged in September and the IPO markets have been slow to gather steam, with very few successful IPOs in the fourth quarter. We hate to say it, but the current exuberant pace of M&A deals may not be sustainable unless the capital markets can continue to deliver new, up and coming companies into the mix of potential buyers and targets. Meanwhile, the Fed's decision to raise interest rates will also surely have an impact on the M&A environment as well.

Best of Enemies: Activism Developments

Activism was somewhat old news in 2015 because activism has largely matured into being the "new normal." The level of engagement between issuers, activists and institutional investors has risen to dizzying heights, with all the attendant professionalization of

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ing and listing a CVR may theoretically enhance value, a CVR which is nontransferable reduces complexity since it eliminates the time and expense of SEC registration, exchange listing, and reporting requirements. A nontransferable CVR may also reduce liability risk since such a CVR could then be structured to not constitute a "security" for federal law purposes. If a CVR is not a "security," claims (if any) that an acquirer could be subject to would likely be limited to state law contractual claims and not federal securities law claims. State law contractual claims often have restrictions on liability (*e.g.*, no "lost profits" damages) as well as limitations on the availability of class action status for classes encompassing out-of-state parties.

Third, keep it transparent. Clear and full disclosure about the uncertainty of triggering events and the uncertainty of valuation is critical in the CVR context. Such disclosure should help substantially reduce liability risks.

Fourth, keep it collective. To the extent permissible by law, any actions regarding the enforceability of, or claims under, a CVR should require the consent of at least a majority of the CVR holders. If individual actions by CVR holders are not permitted, and if shareholders knowingly waive their rights to bring such actions and agree to be bound by whatever decisions or settlements are entered into by the majority, the liability risk of the CVR may be reduced.

RURAL METRO GOES TO DOVER: DELAWARE SUPREME COURT AFFIRMS

By S. Michael Sirkin

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The April 2014 issue of ***The M&A Lawyer*** featured an article[1] about the Delaware Court of Chancery's March 7, 2014 post-trial decision in *In re Rural Metro Corp. Stockholders Litigation*.[2] The article summarized the Court's detailed factual findings and nuanced legal rulings. It also discussed some potential deal-making implications of the decision, the first of its kind, in which a Delaware court held a sell-side financial advisor liable for aiding and abetting its clients' breaches of fiduciary duty. After discussing the Court of Chancery decision and its lessons for market participants, the article observed in conclusion that the Delaware Supreme Court would have the final word.

The Supreme Court has now spoken. On November 30, 2015, the Court affirmed the Court of Chancery in a meticulous, 105-page opinion. As a result, although the Court of Chancery decisions in the case remain instructive, the language of the Supreme Court's opinion will become the case's precedential legacy,[3] giving definitive guidance to market participants, their advisors, and their advisors' advisors, about how to stay out of the stockholder plaintiffs' lawyers' "target zone."[4]

Accordingly, after a brief primer of facts for relevant context,[5] this article highlights some of the key points that emerge from the Supreme Court's Appellate Decision for all deal-makers, and particularly for sell-side financial advisors and their counsel.

Background Facts

In December 2010, a special committee of the board of Rural/Metro Corporation was empowered to explore strategic alternatives, including: (1) continuing to operate as a standalone company according to the company's business plan; (2) selling the company; and (3) pursuing a synergistic transaction with a company called EMS, Rural's largest competitor.[6] Shortly thereafter, EMS publicly put itself up for auction, and the Rural special committee scrambled to hire a financial advisor.[7]

Following interviews with potential financial advisors, the special committee engaged RBC. "[U]nlike the other firms," RBC "devoted the bulk of its presentation to a sale" as opposed to the broader exploration of alternatives that the committee was charged with.[8] RBC pushed for a sale of the company from its pitch because it "hoped to offer staple financing to the potential buyers,"[9] and RBC's engagement letter permitted it to do so at the request of Rural's board or special committee.[10] But RBC also secretly hoped that a sell-side engagement with Rural would give it pole position in the race for a lucrative buy-side financing role in the pending sale of EMS.[11] Although this prospect never bore fruit, it created a conflict of interest that RBC never disclosed to its client.[12]

As the Rural sale process unfolded, RBC redoubled its efforts to provide staple financing to bidders for Rural.[13] At the same time, RBC manipulated its financial analyses to make the high bid look more attractive from Rural's perspective. RBC needed the merger to close, both to obtain payment of the "Sale Transaction Fee," and also to keep alive the possibility of buy-side financing fees.[14] RBC never disclosed to its client that it continued to pursue buy-side financing fees up until the signing of the merger agreement.[15]

The Appellate Decision

By affirming the Court of Chancery on appeal, the Supreme Court preserved the lower court's two post-trial decisions on liability[16] and on remedies and contribution,[17] and those opinions merit careful study. But the Supreme Court also thoroughly addressed the facts and issues presented by this headline-making case, and the Appellate Decision, of course, merits careful study as well.

Below is a brief discussion that highlights some of the key points addressed by the Supreme Court, as framed by the parties' arguments on appeal.

*When Does **Revlon** Scrutiny Begin?*

RBC argued on appeal that the Court of Chancery erred in applying *Revlon*'s enhanced scrutiny to assess the conduct of the sell-side directors while they were supposedly "exploring strategic alternatives," including but not limited to a sale, long before a cash-out merger became inevitable.[18]

The Supreme Court rejected that argument as a matter of fact and law. As a matter of fact, the Court held that the special committee initiated an active bidding process seeking to sell the company, and thereby triggered *Revlon* scrutiny, "without genuinely exploring other strategic alternatives" during the period in question.[19] As a matter of law, the Court held that if *Revlon* only applied to the very endpoint of a sale process as the financial advisor argued, the law would "afford the [b]oard the benefit of a more lenient standard of review where the sale process went awry, partially due to the [b]oard's lack of oversight," and would therefore "potentially incentivize a board to avoid active engagement until the very end of a sale process by delegating the process to a subset of directors, officers, and/or advisors."[20] Unsurprisingly, the Supreme Court refused to adopt such a rule.

As a result, the Appellate Decision makes it more important going forward for a financial advisor to understand and document its mandate. The financial advisor's assignment should be congruent with the mandate of its client, whether it be a special committee or the full board. To avoid one of the pitfalls of *Rural Metro*, a committee charged with exploring strategic alternatives, broadly defined, should be careful to engage a financial advisor to explore strategic alternatives, broadly defined, and both advisor and client should ensure that their activities match their respective mandates. To the extent that business conditions change or a course correction requires a committee or its advisor to shift its focus, they would be well-suited to update their formal mandates as well. Doing so will help to clearly delineate the beginning of the enhanced scrutiny period and protect the exploration of strategic alternatives that often serves as the precursor to a sale process, at least to the extent a sale is not viewed as the inevitable outcome at the start of a financial advisor's engagement.

What Is the Value of a Passive Market Check in M&A Litigation Defense?

RBC argued on appeal that the Court of Chancery's decision gave insufficient weight to the board's "passive market check" of the merger, in the form of a post-signing window in which interested bidders could have come forward with topping bids.[21]

The Supreme Court rejected that argument, despite acknowledging the importance of a passive market check in most cases.[22] Specifically, the Court was careful to note that flaws in the sale process undermined the confidence the Court would otherwise place in a passive market check.[23] Most critically, the Court was concerned by the functional exclusion of several likely bidders who were concurrently bidding on a competitor in the industry, and by the RBC's undisclosed conflicts of interest.[24] The Court had little faith that the possibility of a post-signing topping bid could cure these ills.

One lesson that emerges, particularly for M&A litigation counsel, is that a passive market check can be a powerful litigation defense tool, but it begins to lose its potency once "discovery disturb[s] the patina of normalcy surrounding the transaction."[25] Although a passive market check can provide a potent defense to a preliminary injunction and help bolster an early dispositive motion,[26] once serious process flaws are detected by plaintiffs, established by record evidence, and proven to the court's satisfaction, the value of the "window shop" can vanish.

What is the Value of a "Cleansing Bank"?

RBC argued on appeal that its alleged misconduct and conflicts of interest could not have been the proximate cause of any damages suffered by Rural stockholders because the special committee engaged a second financial advisor to provide a second fairness opinion and generally "cleanse" the process of RBC's conflicts.[27]

The Supreme Court rejected that argument, and took little comfort from the presence of a cleansing bank in this case, given how they were engaged and treated by the Rural special committee.[28] In particular, the Court observed that the second bank's compensation was, like RBC's, contingent on a successful closing, thereby incentivizing even the "cleansing bank" to guide towards closing of a transaction. The Court also observed that the financial analysis done by the second bank was always treated as secondary to that of RBC.[29]

As a result, where circumstances warrant the presence of a second sell-side financial advisor, the sell-side directors and financial advisors should consider whether to structure the second bank's engagement such that it's compensation is substantially non-contingent on a deal being done. The sell-side directors and financial advisors should also ensure that both bankers' analyses are given equal attention, and that both bankers are given equal access to company information and key personnel.

In short, the second bank should be treated as a full-fledged financial advisor rather than a litigation insurance policy. Ironically, only if the second bank is not treated as an insurance policy can it effectively function as one.

Are Financial Advisors "Gatekeepers"? And What Must They Disclose to Their Clients?

RBC argued on appeal that the Court of Chancery mischaracterized the role of a financial advisor in a legally significant way by labeling financial advisors "gatekeepers." At oral argument before the Supreme Court, Plaintiff's counsel argued that the "gatekeepers" descriptor, however controversial, had no legal significance in the Court of Chancery's decision, and could be excised from the opinion without consequence.

The Supreme Court accepted Plaintiff's argument. Indeed, in perhaps the only area of departure from the Court of Chancery, the Supreme Court made clear that financial advisors are not gatekeepers, but rather contract counterparties.[30] As the Court described, "the role of a financial advisor is primarily contractual in nature, is typically negotiated between sophisticated parties, and can vary based upon a myriad of factors."[31] As a result, "it is for the board, in managing the business and affairs of the corporation, to determine what services, and on what terms, it will hire a financial advisor to perform in assisting the board in carrying out its oversight function."[32]

But at the same time, the Court reminded that "directors need to be active and reasonably informed when overseeing the sale process, including identifying and responding to actual or potential conflicts of interest."[33] To that end, the Court suggested that "[b]ecause the conflicted advisor may, alone, possess information relating to a conflict, the board should require disclosure of, on an ongoing basis, material information that might impact the board's process."[34]

In short, it appears that a financial advisor may be liable for causing a breach of fiduciary duty, but should not be liable for failing to prevent one. One way for a financial advisor to stay on the right side of that line is to disclose promptly any information that could be seen as material to sell-side directors, even if this means requiring periodic updates to conflicts disclosures made at the outset of an engagement. A fully disclosed conflict is less likely to lead to a primary breach, and less likely to lead to secondary liability because it is less likely to satisfy the knowing participation element. As a result, increased disclosure from financial advisors to their clients serves both parties well, at least in the context of resulting litigation.

Conclusion

In time, *Rural Metro* will likely be remembered as the result of settled legal principles applied to a set of historically bad facts, as found by the reviewing courts. But it also will stand as a shining example of Delaware's willingness, in the right case, to award significant damages even in the context of what appears to be a third-party, market-checked deal.

ENDNOTES:

[1] S. Michael Sirkin, *Banker Conflicts, Redux: Court of Chancery Tags Financial Advisor With Aiding and Abetting Liability Following Trial*, THE M&A LAWYER, Thomson Reuters, Apr. 2013, at 13-19.

[2] 2014 WL 971718 (Del. Ch. Mar. 7, 2014).

[3] *See generally RBC Capital Markets, LLC v. Jervis*, —- A.3d —-, 2015 WL 7721882 (Del. Nov. 30, 2015) (the "*Appellate Decision*").

[4] *See generally* Leo E. Strine, Jr., *Documenting the Deal: How Quality Control and Candor Can Improve Boardroom Decision-Making and Reduce the Litigation Target Zone*, 70 Bus. Law. 679, 679 (2015) ("[T]he focus of my remarks is on what you can do as legal and financial advisors to conduct an M&A process in a manner that: i) promotes making better decisions; ii) reduces conflicts of interests and addresses those that exist more effectively; iii) more accurately records what happened so that you and your clients will be able to recount events in approximately the same way; and iv) as a result, reduces the target zone for your favorite plaintiffs' lawyers.").

[5] The April 2014 article contains a more fulsome recitation of the facts as found at trial by the Court of Chancery. *See* Sirkin, *supra* note 1, at 13-14.

[6] *Appellate Decision*, at *5.

[7] *Id.* at *6.

[8] *Id.* at *5.

[9] *Id.*

[10] *Id.*

[11] *Id.* at *7.

[12] *Id.*

[13] *Id.* at *12-16.

[14] *Id.* at *13-19.

[15] *Id.* at *20-21.

[16] *In re Rural Metro Corp. S'holders Litig.*, 88 A.3d 54 (Del. Ch. 2014); *see generally* Sirkin, *supra* note 1.

[17] *In re Rural/Metro Corp. S'holders Litig.*, 102 A.3d 205 (Del. Ch. 2014).

[18] *Appellate Decision*, at *23-26.

[19] *Id.* at *25.

[20] *Id.* at *26 n.121.

[21] *Id.* at *28.

[22] *Id.* (" 'When a board exercises its judgment in good faith, tests the transaction through a viable passive market check, and gives its stockholders a fully informed, uncoerced opportunity to vote to accept the deal,' a court will have difficulty determining that such board violated its *Revlon* duties.") (quoting *C & J Energy Servs., Inc. v. City of Miami Gen. Emps.' & Sanitation Emps.' Ret. Trust*, 107 A.3d 1049, 1053 (Del. 2014)).

[23] *Appellate Decision*, at *28.

[24] *Id.*

[25] *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813, 817 (Del. Ch. 2011).

[26] *See generally C & J Energy Servs.*, 107 A.3d 1049.

[27] *Appellate Decision*, at *34.

[28] *Id.* at *35.

[29] *Id.*

[30] *Id.* at *35 n.191.

[31] *Id.*

[32] *Id.*

[33] *Id.* at *27.

[34] *Id.*; *see also id.* at *27 n.130 ("For instance, the board could, when faced with a conflicted advisor, as a contractual matter, treat the conflicted advisor at arm's-length, and insist on protections to ensure that conflicts that might impact the board's process are disclosed at the outset and throughout the sale process.").

A RETURN TO EVANSTON: FTC REVISITS OLD GROUND IN YET ANOTHER HOSPITAL MERGER CHALLENGE

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In late 2015, the Federal Trade Commission ("FTC" or "Commission") authorized staff to file an administrative complaint to seek in federal court a temporary restraining order and a preliminary injunction to block the proposed merger of Advocate Health Care Network (Advocate) and NorthShore University HealthSystem (NorthShore) in the Chicago area.[1] The FTC alleged that the combined entity would operate the majority of the hospitals in the North Shore area of Chicago, and control more than 50% of the general acute care inpatient hospital services.

Health care antitrust enthusiasts may recognize some of the hospitals in this new case. In 2004, as a result of the FTC hospital merger retrospective, the FTC sued NorthShore (then known as Evanston Northwestern Healthcare), alleging that its 2000 acquisition of Highland Park Hospital had resulted in higher prices. In 2007, the full Commission found the transaction to be anticompetitive and ordered a conduct remedy requiring the parties to negotiate separate contracts with managed care plans.

This new matter stems from the September 2014 affiliation agreement between Advocate and NorthShore—a transaction valued at $2.2 billion. Advocate, a not-for-profit health system, is the largest hospital system in the Chicago metropolitan area with 11 general acute care hospitals and a children's hospital. Five of its general acute care hospitals are located in Cook County, Illinois, and two are in Lake County, Illinois. NorthShore is a not-for-profit health system with four general acute care hospitals—three in Cook County and one in Lake County.

This is the FTC's third hospital merger challenge in recent weeks, following the agency's actions seeking to block proposed transactions in Pennsylvania and West Virginia. As with those two challenges, the FTC here alleged that the proposed merger would result in increased bargaining leverage against health