



Directors Roundtable

Trends in M&A Litigation and Shareholder Rights Bylaws

October 21, 2016

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Topics of Discussion

- M&A Litigation Trends:
 - Increased Judicial Scrutiny of “Disclosure-Only” Settlements
 - Increased Judicial Scrutiny After Shareholder Approval of Transaction
 - Increased Judicial Scrutiny of Direct Shareholder Class Action for Breaches of Fiduciary Duty
- Bylaws to Reduce Frivolous Shareholder Litigation:
 - Fee-Shifting Bylaw Provisions
 - Exclusive Forum Selection Provisions
 - Minimum-Stake-to-Sue Bylaws
- Shareholder Activism



M&A Litigation Pre-*Trulia*, Corwin

Background

- Until mid-2015, plaintiffs filed lawsuits challenging 93% of deals valued at more than \$100 million.¹
- In almost 80% of the lawsuits settled each year before *Trulia*, the defendants settled by agreeing only to provide supplemental disclosure in the merger-related proxy statement, with no money paid to stockholders.²
- In these disclosure-only settlements, the plaintiff's lawyers are the greatest beneficiaries, receiving an average fee of approximately \$500,000.³

¹ Cornerstone Research, Shareholders Litigation Involving Mergers and Acquisitions, Review of 2014 M&A Litigation, available at <https://www.cornerstone.com/Shareholder-Litigation-Involving-Acquisitions-2014-Review>

² See *id.*

³ Jill E. Fisch, Sean J. Griffith and Steven Davidoff Solomon, Confronting The Peppercorn Settlement in Merger Litigation: An Empirical Analysis and A Proposal For Reform, 93 Tex. L. Rev 557, 568 (February 2015).



Round 1: Increased Judicial Scrutiny of Disclosure-Only Settlements

- In mid-2015, Delaware Chancery Court began rejecting some disclosure-only settlements, e.g., *In re Aruba Networks, Inc. Stockholder Litigation* (Del. Ch. October 9, 2015), rejecting disclosure-only settlement of litigation relating to Hewlett-Packard’s \$2.7 billion acquisition of Aruba Networks.
- In rejecting the proposed settlement, Vice Chancellor Laster cited a number of factors:
 - The case was not meritorious when filed;
 - The plaintiffs’ lawyers’ discovery was “weak”;
 - The plaintiffs’ proposed release to the defendants was expansive; and
 - The representations of plaintiffs’ counsel were “one-sided.”



Increased Judicial Scrutiny of Disclosure-Only Settlements

- *In re Trulia, Inc.*, 129 A.3d 884 (Del. Ch. January 22, 2016), the Delaware Chancery Court continued to criticize disclosure settlements.
- In rejecting the proposed settlement, Chancellor Bouchard observed:
 - Disclosure settlements will be met with “continued disfavor” unless disclosures address a “plainly material misrepresentation or omission” and the release does not cover all unknown claims.
 - “[I]t should not be a close call that the supplemental information is material.”
 - Financial advisors’ methodology and key assumptions, and management projections are likely to be material
 - Specific financial data, such as synergy numbers, comparable transaction multiples, etc. are not likely to be material.



Increased Judicial Scrutiny of Disclosure-Only Settlements

- Chancellor Bouchard also addressed the concern that his decision would lead to forum shopping, with merger litigation being filed in more receptive jurisdictions:
 - He reminded corporations that “It is within the power of a Delaware corporation to enact a forum selection bylaw to address th[e] concern” that plaintiffs will sue in other jurisdictions.
 - “We hope and trust that our sister courts will reach the same conclusion if confronted with the issue.”



Increased Judicial Scrutiny of Disclosure-Only Settlements

Other Courts Are Following *Trulia*:

- *In re Walgreen Co. Stockholder Litigation* (7th Cir. August 10, 2016), the Seventh Circuit Court of Appeals reversed a district court decision approving a disclosure-only settlement.
 - Judge Posner observed that the supplemental disclosures were “worthless,” and the class action case was “no better than a racket.” The Court directed the district court to consider appointing new class counsel or dismissing the suit.
- *Vergiev v. Aguero, et al.*, No. L-2776-15 (N.J. Super. 2016) (relying on *Trulia* to reject settlement)



Increased Judicial Scrutiny of Disclosure-Only Settlements

BUT: Disclosure-only settlements have not completely disappeared in the wake of *Trulia*.

- Delaware has approved three disclosure settlements this year
 - The supplemental disclosures consisted of key information from the DCF analysis and information regarding NDAs and potential topping bids
 - The scope of the release was limited to disclosure claims or fiduciary duty claims relating to the decision to approve the merger
 - Shift to dismissal of disclosure claims once supplemental disclosures are provided, followed by a “mootness fee,” rather than a disclosure-only settlement with global release
- Courts in seven other states have approved disclosure settlements this year



Round 2: Shareholder Vote Can Eviscerate *Revlon*, Disqualify Class Members

- Vote by majority of stockholders after adequate disclosure can render *Revlon* “heightened scrutiny” standard inapplicable
 - *Corwin v. KKR Fin. Hldgs LLC*, (Del. October 2, 2015), the Delaware Supreme Court affirmed the Chancery Court’s dismissal of post-closing damages claims under the business judgment rule.
 - The Supreme Court held that BJR, not *Revlon*, was the appropriate standard in a post-closing damages suit when the merger has been voluntarily approved by a fully informed majority of disinterested stockholders and the merger is not subject to the entire fairness standard.



Shareholder Vote Can Eviscerate *Revlon*, Disqualify Class Members

- The Delaware Supreme Court explained:
 - “[T]he long-standing policy of our law has been to avoid the uncertainties and costs of judicial second-guessing when the disinterested stockholders have had the free and informed chance to decide on the economic merits of a transaction for themselves. There are sound reasons for this policy. When the real parties in interest—the disinterested equity owners—can easily protect themselves at the ballot box by simply voting no, the utility of a litigation-intrusive standard of review promises more costs to stockholders in the form of litigation rents and inhibitions on risk-taking than it promises in terms of benefits to them. The reason for that is tied to the core rationale of the business judgment rule, which is that judges are poorly positioned to evaluate the wisdom of business decisions and there is little utility to having them second-guess the determination of impartial decision-makers with more information (in the case of directors) or an actual economic stake in the outcome (in the case of informed, disinterested stockholders).”



Shareholder Vote Can Eviscerate *Revlon*, Disqualify Class Members

- Several cases have followed *Corwin*:
 - *E.g., City of Miami Retirement Trust v. Comstock*, C.A. No. 9980-CB (Del. Ch. August 24, 2016) (“I conclude that plaintiff's claims for post-closing damages against C&J’s directors and officers are subject to the business judgment presumption under [*Corwin*] because of the legal effect of the stockholder vote, and that judicial review of plaintiff’s fiduciary duty claims (and related aiding and abetting claims) thus ends there.”).
 - *Larkin v. Shah*, C.A. No. 10918-VCS (Del. Ch. August 25, 2016) (dismissing claims under business judgment rule).
 - *In re OM Group, Inc.*, C.A. No. 11216-VCS (Del. Ch. October 12, 2016) (BJR applied despite “disquieting” aspects of transaction, where transaction approved by majority of “disinterested, uncoerced and fully informed stockholders”).



Shareholder Vote Can Eviscerate *Revlon*, Disqualify Class Members

Even if *Revlon* standard applied, informed shareholder vote can also result in exclusion from class of those stockholders voting in favor of the transaction:

- *E.g., MAZ Partners LP v. Shear*, No. 11-11049-PBS (D. Mass. January 14, 2016) (limiting class certification to shareholders who voted against the merger).



Round 3: Increased Judicial Scrutiny of Direct Shareholder Lawsuits

- Some courts are beginning to hold that post-closing stockholder cases for director breach of duty are **derivative**, rather than direct. *E.g.*,
 - *IBEW Local No. 129 v. Tucci*, No. 2015-2120-BLS-1 (Mass. Super. 2015) (dismissing claim after court found that it was derivative and statutory demand requirements were not met).
 - *In re Syntroleum Shareholder Litigation*, (Tulsa Cnty. Dist. Ct. 2016) (awarding fees to defendant under derivative suit fee-shifting statute).



Takeaways from *Trulia*, *Corwin*, and *Progeny*

- Plaintiffs' lawyers are changing tactics:
 - Fewer cases are being filed in Delaware
 - 60% of fiduciary duty cases were filed in Delaware before *Trulia*
 - 26% of fiduciary duty cases were filed in Delaware in the last 9 months
- Reduction in legal fees for disclosure-only settlements.
- Increased pursuit by larger, institutional investors of appraisal actions

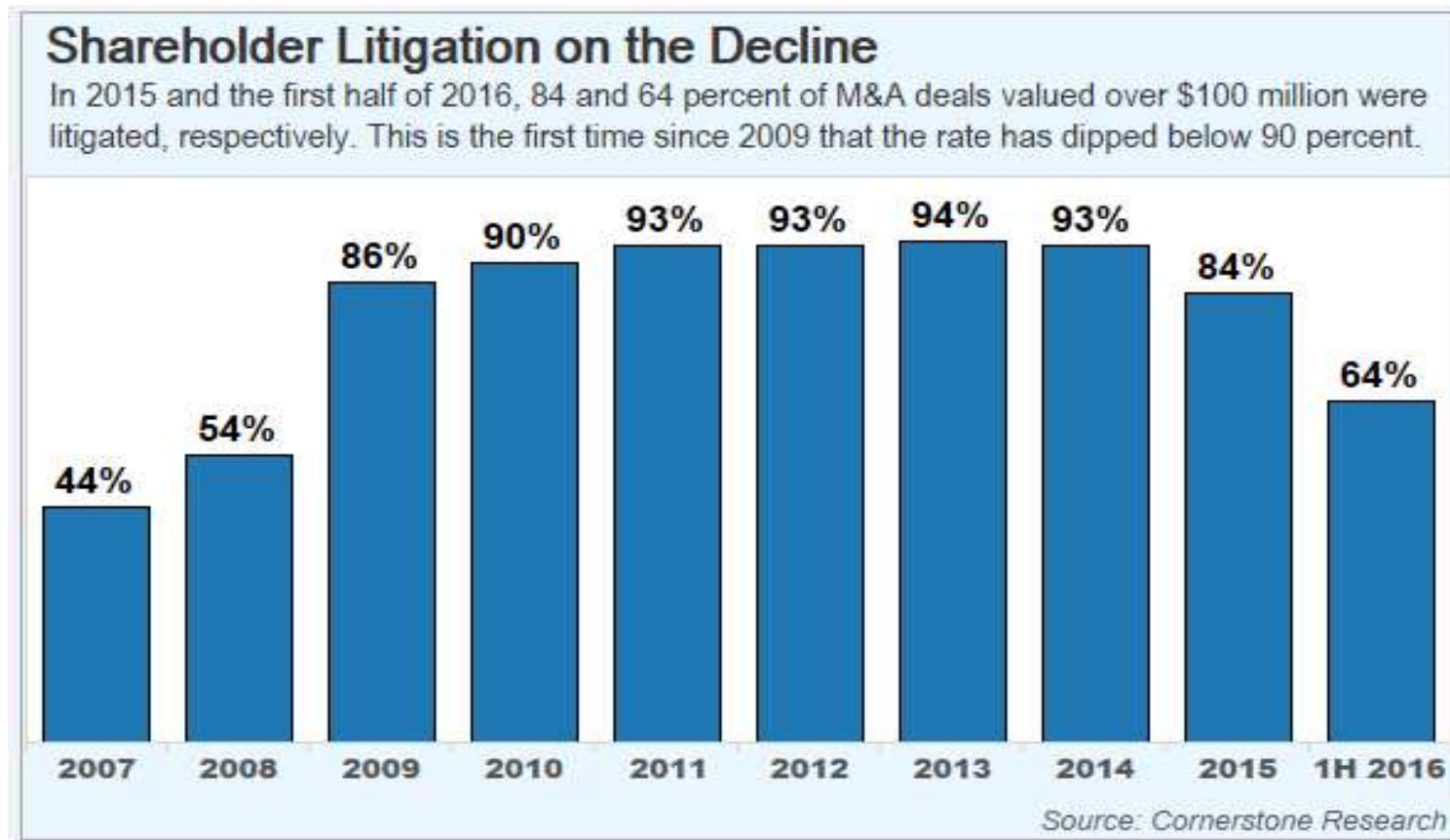


Takeaways from *Trulia*, *Corwin*, and *Progeny*

- Plaintiffs are recasting claims as federal disclosure claims under proxy or tender offer rules
- Companies are focusing on pre-vote disclosures
 - After *Trulia*, fewer supplemental disclosures are made before closing; adequacy of disclosures tested post-closing in order to avoid the cleansing effects of “informed” shareholder vote.
 - Companies incentivized to increase disclosures before a shareholder vote, to avoid disclosure claims before closing or damages claims after closing.

Impact of *Trulia*, *Corwin*, and *Progeny*

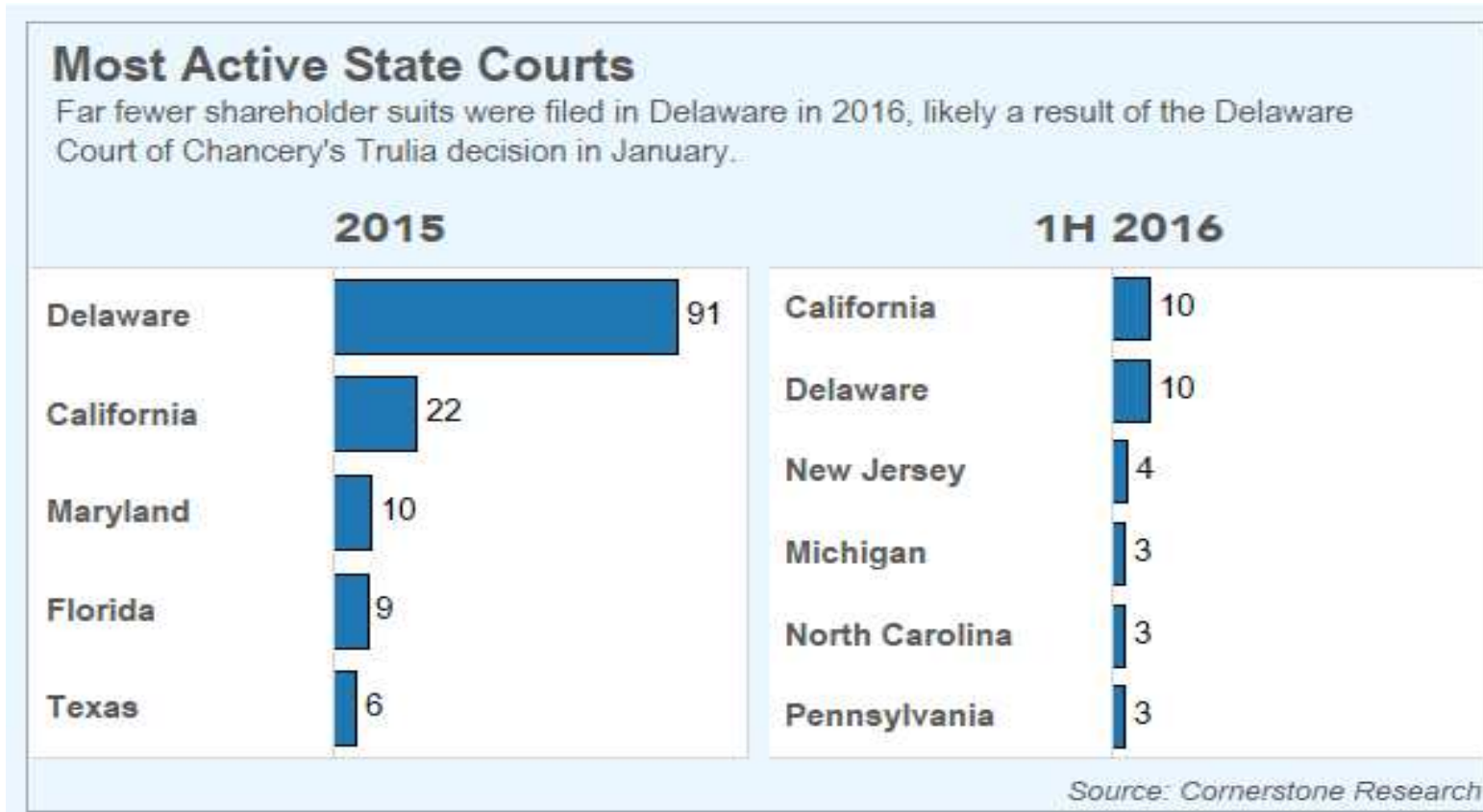
- Fewer cases are being filed:





Impact of *Trulia*, *Corwin*, and *Progeny*

- Fewer cases are being filed in Delaware:





Bylaws to Curb Frivolous Shareholder Suits

- Fee-shifting Bylaws and Statutes
- Forum Selection Bylaws
- Minimum-Stake-To-Sue Bylaws



Fee-Shifting Bylaw Provisions

- In a typical shareholder lawsuit, each party bears its own legal fees and expenses regardless of the outcome of the litigation.
- A fee-shifting provision, typically found in a corporation's charter or bylaws, provides that the shareholder plaintiff must reimburse the company for its legal fees and costs if the company is the prevailing party.



Delaware Bans Corporate Fee-Shifting Bylaws

- Delaware recently enacted new legislation to prohibit stock corporations from adopting fee-shifting bylaws and charter provisions.
- The new fee-shifting prohibition adds new Section 102(f) and amends Section 109 of the Delaware General Corporation Law (DGCL).



Delaware Bans Corporate Fee-Shifting Bylaws

- 8 Del. C. § 102(f) states:

“The certificate of incorporation may not contain any provision that would impose liability on a stockholder for the attorneys’ fees or expenses of the *corporation* or any other party in connection with an internal *corporate* claim, as defined in § 115 of this title.”
- As defined in new Section 115 of DGCL, internal corporate claims are “claims, including claims in the right of the corporation, (i) that are based upon a violation of a duty by a current or former director or officer or stockholder in such capacity, or (ii) as to which this title confers jurisdiction upon the Court of Chancery.”



ATP Tour, Inc. v. Deutscher Tennis Bund, 91 A.3d 554 (Del. 2014)

- These DGCL amendments close a door that was previously opened by the Delaware Supreme Court in *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014), which held that “fee-shifting provisions in a non-stock corporation’s bylaws can be valid and enforceable under Delaware law.”
- The members of the Delaware Bar Association expressed concern that these fee-shifting provisions would deter stockholders from enforcing their rights in the courts, since “few stockholders will rationally be able to accept the risk of exposure to millions of dollars in attorneys’ fees to attempt to rectify a perceived corporate wrong, no matter how egregious.”
- The new fee-shifting law effectively limits the scope of the ATP decision to non-stock corporations.



Fee-Shifting Bylaws – Other Jurisdictions

- The laws of other jurisdictions may vary from those of Delaware.
- The Oklahoma legislature has adopted a provision mandating the shifting of fees in derivative suits.
- The Oklahoma provision specifically applies to derivative suits “instituted by a shareholder” where there is a “final judgment.” In those circumstances, the court “shall require the non-prevailing party or parties to pay the prevailing party or parties the reasonable expenses, including attorney fees . . . incurred as a result of such action.”
- *In re Syntroleum Corporation Shareholder Litigation*, (Tulsa Cnty. Dist. Ct.), the court ruled that the plaintiffs had not made sufficient allegations of individual harm for their claims to be direct claims. It awarded fees against plaintiffs and in favor of the acquiring party that had “prevailed” in the case when its motion to dismiss was granted.



Authorization of Exclusive Forum Selection Provisions

- New Section 115 of the DGCL authorizes Delaware corporations to adopt provisions in their certificates of incorporation or bylaws that “require, consistent with applicable jurisdictional requirements, that any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State.”
- Section 115 codifies the Delaware Court of Chancery’s holding in *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013), allowing Delaware corporations to designate courts in Delaware (including both the state courts and the federal courts) as the exclusive forums for litigation involving their internal affairs.



Authorization of Exclusive Forum Selection Provisions

- Section 115 of the DGCL mandates that “no provision of the certificate of incorporation or the bylaws may prohibit bringing such claims in the courts of this State.”
- This portion of the law effectively overrules another Delaware Court of Chancery decision, *City of Providence v. First Citizens Bancshares, Inc.*, 99 A.3d 229 (Del. Ch. 2014), which had upheld a corporate bylaw designating a non-Delaware jurisdiction as the exclusive forum for litigation involving the company’s internal affairs.



Authorization of Exclusive Forum Selection Provisions

- Section 115 does not expressly prohibit charter or bylaw provisions that select a forum other than the Delaware courts as an *additional* forum in which an internal corporate claim may be brought.
- The amendments do not prohibit a clause selecting a forum other than Delaware as the exclusive forum if placed in a stockholders agreement or other writing signed by a stockholder against whom the forum selection clause is sought to be enforced.
- The amendments do not shield from judicial review a claim that a forum selection provision operates unreasonably under the circumstances, or that the manner in which the provision was adopted was inequitable.



Exclusive Forum Selection – Other Jurisdictions

State of Incorporation	No. of Corps. with Exclusive Forum provision	State of Incorporation	No. of Corps. with Exclusive Forum provision
DE – Delaware	1140	Foreign – Marshall Islands	3
MD – Maryland	154	TN – Tennessee	3
NV – Nevada	43	UT – Utah	3
MA – Massachusetts	21	NJ - New Jersey	3
PA – Pennsylvania	16	KS – Kansas	3
NY - New York	15	AZ – Arizona	2
FL – Florida	14	OK – Oklahoma	2
CA – California	11	WA – Washington	2
VA – Virginia	10	MS – Mississippi	2
IN – Indiana	9	IA – Iowa	2
MN – Minnesota	8	MO – Missouri	2
TX – Texas	7	KY – Kentucky	1
NC – North Carolina	7	DC – District of Columbia	1
OH – Ohio	6	SC – South Carolina	1
MI – Michigan	6	SD – South Dakota	1
GA – Georgia	4	NM – New Mexico	1
CO – Colorado	4	AR – Arkansas	1
OR – Oregon	3	Foreign – Netherlands	1
RI – Rhode Island	3	Foreign – Taiwan	1
IL – Illinois	3	Foreign – Luxembourg	1
WI – Wisconsin	3	Grand Total	1523



Minimum-Stake-to-Sue Bylaws

- Emergent Capital, Inc. (f/k/a Imperial Holdings, Inc.), Mexico Equity and Income Fund and the Special Opportunities Fund, have adopted a restrictive bylaw provision requiring consent of at least three percent (unless a lower percentage is authorized by an applicable statute) of the company's shareholders before a derivative lawsuit or class action could be filed.
- This provision is designed to ensure that any shareholder filing a lawsuit on behalf of the company or a class of shareholders has a minimum degree of shareholder support and adequately represents shareholders' interests.



Minimum-Stake-to-Sue Bylaws

- In implementing this provision, Emergent focused on the need for shareholder plaintiffs to adequately represent the general best interest of shareholders in litigation so that the corporation could be confident that once the lawsuit is resolved, it will be binding and final regarding the issue without the risk of re-litigation.
- Moreover, from a sense of fairness to the shareholders, the rules for governing intra-corporate litigation should ensure that shareholders purporting to act on behalf of all shareholders are genuinely acting in the best interest of all shareholders rather than for their selfish, personal benefit.
- Note that this bylaw provision has been adopted due to the efforts of Phillip Goldstein of Bulldog Investors, a noted activist.



Minimum-Stake-to-Sue Bylaws

- In a shareholder lawsuit against Emergent and its directors brought in the United States District Court for the Southern District of Florida, a shareholder plaintiff challenged the board's adoption of the minimum-stake-to-sue bylaws.
- The court dismissed the suit with prejudice and the lead plaintiff in the lawsuit stated: "after further investigation and the opportunity to meet with representatives of the board of directors, I now believe that they acted in good faith and did not engage in any improper behavior in adopting the bylaw or otherwise. Consequently, I have concluded that it is in the best interest of the Company and its shareholders that the case be dismissed."



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Trends in M&A Litigation and Shareholder Rights Bylaws

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Shareholder Activism Update

October 21, 2016

Presented by Patrick G. Quick



Overview

■ Shift in Focus

- Historically, a company's concern focused primarily on dealing with hostile takeover activity, particularly actions that are coercive, untimely or abusive
- More recently, focus expanded to dealing also with actions by certain shareholders or other parties intended to pressure the Board to take action it was not then contemplating

Players

- Shareholders
 - Control-oriented activists (e.g., hedge funds)
 - Institutions – top holders and smaller holders who are vocal
 - Individuals – retail holders
 - Gadflies – individual shareholders with nominal holdings trying to influence management
 - Ownership reports – all institutions (13F), active 5% (13D), passive 5% (13G)
- Analysts
 - Sell side – prepare reports for brokers to use sell stock
 - Buy side – prepare analyses to support client funds
- Proxy advisory firms – ISS, Glass-Lewis, Egan Jones
 - Advise clients regarding voting and other subjects, but receive direction from clients
 - Publish guidelines on how they will recommend shareholders vote on various governance and compensation issues
- Financial press and other media

Control Activist Trends

- Control-oriented activist shareholders' willingness to assert leverage and exercise power has increased in recent years
 - Some shareholders' business models are to drive events at public companies
 - Hedge funds' emergence
 - 230+ hedge fund campaigns in 2015 alone
 - Higher profile activists (e.g., Icahn, Peltz)
 - More firepower has led to larger and more iconic companies being increasingly targeted
 - Examples include Apple, GE, GM, Microsoft

Control Activist Trends (continued)

- Increasing numbers of first-time activists and part-time activists
 - Passive investors adopting activist tactics or privately campaigning for change
 - 49 campaigns by first-time activists in 2015, up from 36 in 2014 and 15 in 2011 (Wall Street Journal report)

Control Activist Trends (continued)

- Common control-oriented activist goals
 - Sale of the company
 - Restructuring (e.g., spin-off of business)
 - Governance structure or board changes
 - Capital allocation – dividends, buybacks
 - Cost reduction
 - Board refreshment
- Often seek Board representation
- Settlements with these activists are becoming more routine and resolutions are reached more quickly
 - Research by Activist Insight indicates an average of 56 days from disclosure to settlement in 2015, down from 83 days in 2010
 - Greater willingness to accept “outsiders” on Board

How Control Activism May Unfold

- Phone call
- Letter
- 13D filing – 5% ownership & related disclosure of intentions
- Request for meeting
- Notice under bylaws of nomination or other business

Governance Activist Trends

- Governance-oriented institutional shareholders and gadflies remain active in shareholder proposals
 - Shareholders may use proxy statement to present a proposal using SEC Rule 14a-8 process
 - Recent changes in SEC Staff interpretations on shareholder proposals have made it easier for proposals to be included in issuer proxy statements
- Focus of shareholder proposals continues to be on large-cap companies
 - 75% of shareholder proposals voted on in 2016 through June 30 were received by S&P 500 companies
 - However, some governance activists have indicated they eventually intend to shift focus to smaller companies (e.g., CalSTRS)

Governance Activist Trends (continued)

- There are “hot” shareholder proposal topics that change from year to year
 - Proxy access was a dominant subject in 2015 and 2016
 - Approximately 200 proxy access proposals made in 2016
 - 78 went to a vote
 - Approximately half received majority support
 - Average support of approximately 48% when ISS supported the proposal
 - Proxy access proposals typically failed where the company had previously adopted a proxy access bylaw
 - Around 190 S&P 500 companies have now adopted proxy access
 - Shareholders generally asking for proxy access at the thresholds of 3% ownership held over 3 years, with the ability to nominate up to 25% of the board
 - Generally do not include aggregation limits
 - Latest approach: proposals attacking details of existing bylaws
 - When will shareholders say “enough is enough”?

Governance Activist Trends (continued)

- There are “hot” shareholder proposal topics that change from year to year (continued)
 - Other popular proposals in 2016
 - Independent board chair
 - 46 proposals in 2016 averaging 29% support
 - Majority voting
 - 18 proposals in 2016 averaging 70% support
 - Eliminating supermajority voting thresholds
 - 15 proposals in 2016 averaging 59% support
 - De-staggering the board
 - 6 proposals in 2016 averaging 77% support
 - Shareholder ability to call special meetings
 - 18 proposals in 2016 averaging 42% support
 - Shareholder ability to act by consent
 - 17 proposals in 2016 averaging 41% support

How Governance Activism May Unfold

- Shareholder proposal submission under Rule 14a-8
 - Company will review for potential bases for exclusion
 - If there is a basis for exclusion, may require submission to SEC for no-action relief
 - Depending on the proponent, may be able to negotiate
- Letter to Board of Directors, Chair or Chief Executive Officer

Other Shareholder Activism/Influence

- Beyond 14a-8, shareholders own a company and have power in addition to just selling stock
 - Vote “against” director candidates, or withhold vote, as a “protest”
 - Vote “no” on other shareholders meeting agenda items (*e.g.*, compensation plan or “say on pay”)
 - Vote “for” 14a-8 proposals
 - Initiate or vote “for” other proposals
 - Nominate and vote “for” their own director candidates or vote “for” nominees of another shareholder, including through proxy access where a company has a proxy access bylaw

“Risk Factors” for Activism

- For all types of activism:
 - Stock price or other financial underperformance
 - Certain corporate governance practices
 - Staggered board
 - Plurality voting in director elections
 - Pay for performance “disconnect”
 - Absence of proxy access

“Risk Factors” for Activism (continued)

- For control-oriented activism
 - Perception that stock is undervalued
 - Low capitalization
 - Diverse stable of businesses
 - Other like-minded investors
 - High trading liquidity
 - Shareholder-friendly state of incorporation
- For governance activism
 - Large capitalization
 - Negative say on pay outcomes
 - Negative proxy advisor evaluations
 - Disfavored governance practices – staggered board, combined Chair/CEO role, supermajority voting, etc.

“Defenses” to Activism

- Good stock price performance
 - Not a guarantee
- Under common bylaw provisions, a shareholder must give advance notice of intent to propose business or nominate a director
- “Pay attention” to what investors and analysts are saying
- Shareholder engagement
- Technicalities and formalities are not a defense
- Rights plan “on the shelf”
- State statutes, *e.g.*, business combination statute

Role of Investor Relations – Shareholder Engagement

- Investors want access and want to be heard
- Company engagement with shareholders is key, particularly on proxy access, say on pay, equity plan and other governance and compensation issues
- Investors do not want to hear from you only when you need their support
- Trending: shareholders desire to interact with directors

Shareholder Engagement

- Engagement opportunities
 - Methods:
 - Enhancements to proxy statements
 - Surveys
 - Group meetings
 - One-on-one meetings, including via a road show
 - Earnings conference calls
 - Analyst day
 - Other conference calls
 - E-Forums
 - Investor conferences
 - Additional soliciting material

Shareholder Engagement

- Engagement opportunities (continued)
 - Timing: prior to proxy season and when convenient for and desired by a shareholder
 - Institutions have limited resources to take meetings and may pass on an invitation
 - Designation of shareholder engagement “spokesperson(s)”
 - Board and Board committee involvement

Shareholder Engagement

- Shareholder interaction with directors
 - This requires preparation
 - Consider this possibility when vetting director candidates
 - Also consider it when populating Board committees and planning committee rotations
 - Especially committee chairs, particularly compensation and governance committees
 - Who could handle this responsibility?
 - If the company may face a dicey issue in a year (e.g., compensation), begin preparing director(s) for this possibility well in advance

Shareholder Engagement

- **Reminder**: Be mindful of the securities laws when engaging shareholders
 - Regulation FD
 - Discussions should be limited to corporate governance and executive compensation
 - Discuss topics at a high level, and avoid or limit discussions of operations, corporate strategy or financial results
 - It is better to listen rather than speak to the extent possible
 - Rule 14a-12
 - Requirement to file written soliciting material even before furnishing a proxy statement
 - Includes letters, e-mails, scripts, talking points, etc.
 - Focus engagement efforts on receiving feedback on existing or potential governance or compensation policies; be careful if discussing matters in anticipation of proposals to be voted on at the upcoming annual meeting
 - Oral communications should be the primary method of engagement

Recommendations

- Involve Board with strategic plan
- Monitor shifts in shareholder base
- Pursue shareholder engagement activities
 - Generally, open communications subject to limitations of Regulation FD
- Consider rights plan on the “shelf”
- Pay attention to what analysts and others say about company strategy
 - Prepare to respond to and undercut “great ideas”
 - Through IR measures, try to influence discussion

Recommendations (continued)

- Periodically review other defensive measures
- Monitor and understand “pressure points” for governance activists
- Understand impact of a change-in-control on executive employment arrangements and equity awards
- Anticipate possibility of direct communications between shareholders and one or more directors

Recommendations (continued)

- Prepare and maintain an action plan, including policies/procedures to deal with unsolicited inquiries
 - One spokesperson for the Company
 - “No comment” policy
 - Advisors engaged and ready to assist



Shareholder Activism Update

October 21, 2016

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**TAKEOVER LAW AND
PRACTICE**

2016

This outline describes certain aspects of the current legal and economic environment relating to takeovers, including mergers and acquisitions and tender offers. The outline topics include a discussion of directors' fiduciary duties in managing a company's affairs and considering major transactions, key aspects of the deal-making process, mechanisms for protecting a preferred transaction and increasing deal certainty, advance takeover preparedness and responding to hostile offers, structural alternatives and cross-border transactions. Particular focus is placed on recent case law and developments in takeovers. This edition reflects developments through mid-March 2016.

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Takeover Law and Practice

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Takeover Law and Practice

I.

Current Developments

A. Executive Summary

The last several decades have witnessed a number of important legal, financial and strategic developments relating to corporate transactions. Each of these developments has added complexity to the legal issues that arise in connection with mergers and acquisitions, tender offers and other major corporate transactions. Changes in stock market valuations, macroeconomic developments, the financial crisis and domestic and foreign accounting and corporate governance crises have added their own complexities. The substantial growth in hedge funds and private equity, the growing activism of institutional investors and the increased influence of proxy advisory firms have also had a significant impact.

The constantly evolving legal and market landscapes highlight the need for directors to be fully informed of their fiduciary obligations and for a company to be proactive and prepared to capitalize on business-combination opportunities, respond to unsolicited takeover offers and shareholder activism and evaluate the impact of the current corporate governance debates. In recent years, there have been significant court decisions relating to fiduciary issues and takeover defenses. In some instances, these decisions reinforce well-established principles of Delaware case law regarding directors' responsibilities in the context of a sale of a company. In others, they raise questions about deal techniques or highlight areas where other states' statutory provisions and case law may dictate a different outcome than would result in Delaware or states that follow Delaware's model.

Section I of this outline identifies some of the major developments in M&A activity in recent years. Section II reviews the central responsibilities of directors, including basic case law principles, in the context of business combinations and takeover preparedness. Section III focuses on various preliminary aspects of the sale of a company, including the choice of method of sale and confidentiality agreements, while Section IV discusses the various structural and strategic alternatives in effecting takeover transactions, including pricing options available in public company transactions. Section V focuses on the mechanisms for protecting an agreed-upon transaction and increasing deal certainty. Section VI summarizes and updates central elements of a company's

advance takeover preparedness, particularly the critical role of a rights plan in preserving a company's long-term strategic plan and protecting a company against coercive or abusive takeover tactics and inadequate bids. Section VII discusses the special considerations that apply to cross-border transactions.

B. M&A Trends and Developments

1. Deal Activity

2015 was a record year for M&A. Global M&A volume hit an all-time high of over \$5 trillion, surpassing the previous record of \$4.6 trillion set in 2007. U.S. M&A made up nearly 50% of the total. The "mega-deal" made a big comeback, with a record 69 deals over \$10 billion, and 10 deals over \$50 billion, including two of the largest on record: Pfizer's \$160 billion agreement to acquire Allergan and Anheuser-Busch InBev's \$117 billion bid for SABMiller. Cross-border M&A reached \$1.56 trillion in 2015, the second highest volume ever.

A number of factors provided directors and officers with confidence to pursue large, and frequently transformative, merger transactions in 2015. The economic outlook had become more stable, particularly in the United States. Many companies had trimmed costs in the years following the financial crisis, but still faced challenges generating organic revenue growth. M&A offered a powerful lever for value creation through synergies. Bucking historical trends, in a number of cases, the price of a buyer's stock rose on announcement of an acquisition, as investors rewarded transactions with strong commercial logic. Equity prices in 2015 were strong, if flat, providing companies with valuable acquisition currency (50% of all U.S. public deals announced in 2015 included equity as a component of the consideration). For at least the first half of the year, strong appetite from debt investors (particularly for quality credits) and low interest rates enabled acquirors to obtain financing on attractive terms, though increasing choppiness in the leveraged finance markets later made high-yield financing of acquisitions more difficult.

Industry trends also played a significant role in M&A activity in 2015. There was consolidation in pharmaceuticals (including the pending Pfizer-Allergan transaction and AbbVie's \$21 billion acquisition of Pharmacyclics), technology (including Dell's pending \$67 billion acquisition of EMC and Avago's \$37 billion acquisition of Broadcom), insurance (including Anthem's pending \$54 billion acquisition of Cigna, Aetna's pending \$37 billion acquisition of Humana and ACE's \$28 billion acquisition of Chubb), and oil and gas (including Energy Transfer Equity's pending \$38 billion combination with Williams Companies and Royal Dutch Shell's pending \$70 billion acquisition of BG Group).

Continuing a recent trend, tax-free spin-offs remained a popular means to unlock value and restructure operations. A spin-off can create shareholder value when a company's businesses may command higher valuations if owned and managed separately, rather than as part of the same enterprise. These increased valuations can arise from capital markets factors, such as the attraction of investors who want to focus on a particular sector or growth strategy, and from more focused management and corporate initiatives that clarify the business' vision and mission. In addition to the potential for value enhancement, spin-offs also can be accomplished in a manner that is tax-free to both the parent and its shareholders. While the number of announced spin-offs declined in 2015 to 46 from a high of 80 in 2014, 2015 saw record spin-off volume of over \$257 billion.

2015 brought important changes to the tax landscape for spin-offs. The IRS will no longer issue rulings as to the tax-free treatment of certain "cash-rich" spin-offs, where a very large percentage of the asset value of the parent or the spun-off corporation consists of cash or a non-controlling stake in another publicly traded entity. The IRS also will no longer rule on whether the "active trade or business" requirement for a tax-free spin-off is satisfied if the fair market value of the gross assets of the active trade or business on which either company is relying is less than 5% of the total fair market value of the gross assets of the company. This appeared to lead Yahoo! to abandon its planned tax-free spin-off of a company that would hold its stake in Alibaba. In addition, Congress amended Section 355 of the Internal Revenue Code in December of 2015 to provide that a spin-off in which only the spun-off company (or the parent company) is a REIT cannot qualify for tax-free treatment. Spin-offs by REITs of other REITs or of certain taxable REIT subsidiaries can still qualify as tax-free, however. As a result, the popular activist tactic of pushing for "OpCo/PropCo" separations—in which an operating company with significant real estate holdings spins its properties off into a separate publicly traded REIT and leases them back—has become less attractive.

Another notable recent trend is a significant increase in outbound investment by Chinese state-owned enterprises and other firms. Significant recent transactions include ChemChina's pending \$43 billion acquisition of Syngenta AG, Haier Group's pending \$5.4 billion acquisition of GE's appliances business, HNA Group's pending \$6 billion acquisition of Ingram Micro, Chongqing Casin Enterprise Group's pending acquisition of the Chicago Stock Exchange and Anbang Insurance Group's \$2 billion acquisition of The Waldorf Astoria Hotel. As discussed in Part VII.B.1 below, such transactions may involve review by the Committee on Foreign Investment in the United States, even outside of the defense sector. Successful completion of such transactions (like cross-

border transactions more generally) requires thorough consideration of the regulatory implications, as well as an appreciation of different legal regimes and cultural norms as to negotiation and business practices.

2. Hostile and Unsolicited M&A

Hostile and unsolicited M&A have increased dramatically in recent years, from \$145 billion of bids, representing 5% of total M&A volume, in 2013 to \$577 billion of bids, representing about 20% of total volume, in 2015. Notable recent bids include Anheuser-Busch InBev's unsolicited but eventually agreed \$117 billion bid for SABMiller, 21st Century Fox's \$80 billion offer for Time Warner, which was ultimately withdrawn; Cigna's bid for Anthem, resulting in an agreed \$54 billion merger; Mylan's \$35 billion bid for Perrigo, which was defeated; Teva's \$40 billion bid for Mylan, which was ultimately withdrawn; DISH Network's \$26 billion bid for Sprint Nextel, which was ultimately withdrawn; and Energy Transfer Equity's bid for Williams Companies, resulting in an agreed \$38 billion combination.

The Perrigo situation, which involved an inverted target domiciled in Ireland, demonstrates that it is possible for a target board to successfully resist a hostile takeover attempt, even without the ability to use a poison pill or other customary defenses. And where a poison pill is permissible, it can be a powerful means of protecting shareholder value, as illustrated by the Airgas situation: in December 2015, in vindication of the Airgas board's judgment and confirmation of the wisdom of the Delaware case law (particularly the Delaware Chancery Court's 2011 Airgas opinion validating the use of the poison pill), Airgas agreed to be sold to Air Liquide at a price of \$143 per share, in cash, nearly 2.4 times Air Products' original \$60 offer and more than double its final \$70 offer, in each case before considering the more than \$9 per share of dividends received by Airgas shareholders in the intervening years.

3. Private Equity Trends

Private equity firms have played a less visible role in the current M&A boom than they did 10 years ago, when PE firms led a number of \$10 billion+ leveraged buyouts, sometimes in "club deals" along with other firms. Aside from a few high-profile large PE buyouts (such as the \$67 billion acquisition of EMC by Dell Inc., Michael Dell, MSD Partners and Silver Lake, and the acquisition of Kraft Foods by H.J. Heinz, 3G Capital and Berkshire Hathaway), much of 2015's PE buyout activity was in the middle market. This has been driven by a variety of factors, including relatively high public market valuations, which provided strategic bidders competing with PE buyers with a valuable acquisition currency and led sponsors to conclude that targets were richly valued in

some cases; strategic bidders' ability to extract synergies, which allowed them to dig deeper when bidding against PE firms; and the leveraged lending guidelines issued by the FDIC, the Federal Reserve and the OCC, which constrained banks' ability to lend into more heavily leveraged transactions.

Despite these factors, PE firms hardly stayed on the sidelines of M&A. In some cases, sponsors teamed with strategics to bid on an asset, bringing together expertise in financial structuring and operational management, as well as the ability to create synergies. Notable examples of such transactions include the Kraft/Heinz/3G Capital/Berkshire Hathaway transaction, and the \$9 billion acquisition of Suddenlink by Altice, BC Partners and CPP Investment Board. In other cases, PE firms used portfolio companies as a platform for M&A, again combining the strengths of private equity and strategic firms. PE firms also used creative deal structures, such as a rollover by a PE seller of part of its stake in a portfolio company for the stock of the acquiror, which can help bridge a valuation gap and preserve a portion of the upside for the PE seller. Similarly, a company may sell a business to a PE firm and retain a stake in the divested business, which could ease the sales process, facilitate ongoing relationships and reduce the need for debt financing. With their capital commitment coffers full from the last few years of strong fundraising, PE sponsors can be counted on to continue to seek creative approaches to both deal sourcing and deal structuring to navigate a competitive deal environment where capital nevertheless must be deployed and pulling back is not a viable option.

Private equity exit value and volume grew in 2015 for the sixth consecutive year, resulting in over \$550 billion in aggregate value from more than 2,300 deals.¹ Corporate acquisitions remained the primary exit ramp for private equity sellers, accounting for over 54% of total exits and 65% of exit value.² Next in line were niche sponsors counting on their operational expertise and sector knowledge to bid aggressively for PE-backed companies in their niche. By contrast, IPO exit volume fell by over about 40% year-over-year in 2015.³

a. Fundraising

Fundraising across traditional buyout, infrastructure, real estate and debt funds, among others, continued apace. 2015 saw almost \$400 billion of capital raised globally, with 623 funds closing⁴—slightly down from 2014, but nevertheless a robust fundraising performance on par with the years leading up to the financial crisis. U.S. PE fundraising surpassed \$185 billion in committed capital, with buyout funds accounting for roughly two-thirds of capital raised.⁵ One of the largest post-crisis fund raises was concluded in December when Blackstone's latest flagship PE

fund closed on \$18 billion in commitments. The overwhelming majority of funds in the market met or exceeded their fundraising targets—and concluded fundraising far more quickly than in previous years—due to pent-up investor demand and sizable cash distributions from funds launched during the pre-crisis market. Although the “flight to quality” among institutional investors seeking to prune their sponsor relationships continued to favor large and established sponsors, middle-market sponsors also had a successful fundraising year as investors sought to put excess and/or recently returned capital to work and diversify their alternative asset portfolios. In 2015, committed capital outstripped contributed capital, adding to what was already a large overhang of “dry powder” (by some estimates exceeding half a trillion dollars in the U.S. alone⁶) and promising intense competition for deals, in an environment in which sponsors may seek an edge through niche strategies, operational excellence and creative dealmaking.

b. Investor and Regulatory Trends

Throughout the private equity world, from sponsors managing single buyout funds to diversified alternative asset management businesses, there continues to be a steady push towards more sophisticated governance structures and greater transparency, spurred by both investor demands and regulatory action. In 2015 both Blackstone and KKR were the target of enforcement actions by the SEC that were focused on the treatment, allocation and disclosure of fees and expenses charged to fund investors, whether directly or through transaction, monitoring and other special fees paid to managers by portfolio companies. Such high-profile enforcement actions, coupled with public calls for greater transparency by large institutional investors such as the California Public Employees’ Retirement System (CalPERS),⁷ have led to a revisiting of sponsor procedures as well as fund limited partnership agreements and portfolio company fee arrangements. Many sponsors are more proactive in keeping investors informed about fund and portfolio developments during the entire life cycle of funds, whether through visits to investors, enhanced disclosures or more frequent reporting. Limited partner advisory committees are consulted more frequently, even where such consultation is not contractually required, as a means of managing conflicts and improving transparency. The compliance function at many sponsors has been strengthened and given greater authority, as all indications are that fees, disclosure, conflicts and controls will remain in the regulatory spotlight in 2016. In addition to enforcement actions, the expanding regulatory landscape affecting funds and their sponsors—such as the European Union’s Alternative Investment Fund Managers Directive (AIFMD) and the U.S. Foreign Account Tax Compliance Act (FATCA)—have also contributed to the need for more sophisticated operational

oversight. While these trends play out with differing intensity and speed for different sponsors, they generally have precipitated a shift towards stronger governance, internal control and risk management systems.

4. Acquisition Financing

Last year's robust acquisition financing market helped drive the headline-grabbing deals and record volume of M&A in 2015. At the same time, credit markets were volatile in 2015 and appeared to have shifted fundamentally as the year went on—and with them, the types of deals that could get done and the available methods of financing them. U.S. and European regulation of financial institutions, monetary policy, corporate debt levels and economic growth prospects have coalesced to create a more challenging acquisition financing market than has been seen in many years. As a result, 2016 is likely to be a year in which financing costs, availability and timing have significant influence over the type, shape and success of corporate deal-making.

a. Investment Grade Acquisition Financing

Investment grade acquisition financing activity showed continued strength in 2015, with bridge commitments for “mega-mergers” leading the way. In March, Morgan Stanley and The Bank of Tokyo-Mitsubishi UFJ provided an \$18 billion bridge commitment to backstop AbbVie Inc.'s acquisition of Pharmacyclics. In November, AB InBev announced the largest corporate loan on record when it obtained commitments for \$75 billion in connection with its acquisition of SABMiller.

In prior credit cycles, deterioration in acquisition financing markets has tended to creep up the ratings scale, with bank risk management during a persistent downturn resulting in changes to pricing, terms, and permanent financing take-out methods for not only high-yield but also cross-over and low investment grade acquirors. Moreover, as equity and credit investors become increasingly concerned with business risks attendant to higher corporate leverage, it may become less desirable to use cash to finance M&A activity. Combined with lower equity valuations, these dynamics could negatively affect deal activity, particularly for acquirors at the lower end of the investment grade range, many of whom have added significant leverage to their balance sheet over the past couple of years.

b. Leveraged Acquisition Financing

In the high-yield financing market, challenging conditions in the first half of 2015 worsened after August, and weakness previously limited to certain sectors (oil and gas, mining and retail) could be seen among

lower-rated borrowers generally. High-yield bank loan and bond mutual funds and ETFs experienced substantial outflows during the year, which accelerated at year-end. These trends persisted, and continued to worsen, into the start of 2016. Market volatility and investors' flight to safety tend to exert their greatest pressure on high-yield issuers—absent significant market changes, leveraged borrowers should expect to face a dramatically different financing landscape in 2016 than at any time since the mid- to late- 2000s.

Critically, for the first time since 2008, banks are facing the prospect of taking significant losses on a large backlog of leveraged buyout loans (by some accounts reaching as high as \$15 billion). Garnering headlines, a \$5.5 billion bank and bond deal to finance Carlyle's takeover of Symantec Corp.'s data-storage business, Veritas, was pulled in November 2015, leaving the commitments on the books of the lead banks. Other deals that got done in late 2015 were restructured, and many priced well outside their anticipated range. Accordingly, financing sources have begun insisting on a broader toolkit for exiting their bridge commitments, including expanding the types of markets they could require borrowers to use to permanently refinance a commitment as well as wider rights to "flex" pricing, structure and other terms. Not surprisingly, upward pricing flexes outnumbered downward pricing flexes 3:1 in fourth-quarter 2015 syndications. In rapidly changing financial markets, where conditions, terms and pricing available to support deals may change on a weekly basis, careful and creative construction of the financing plan early in a transaction process will increase the likelihood of success and allow acquirors to seize on optimal market conditions when they arise. Advance planning for deals with experienced and thoughtful legal and financial advisors will be increasingly important in meeting the challenges of the year ahead.

5. Shareholder Litigation

Over the past several years, there has been a dramatic rise in stockholder litigation challenging mergers. Multiple stockholder lawsuits are commonly filed shortly after the announcement of major transactions. Such suits commonly contained rote allegations that the selling corporation's directors breached their fiduciary duties by agreeing to a deal at an inadequate price following an inadequate process and with inadequate disclosure. Stockholder lawsuits were filed to challenge 92% of deals with a transaction value greater than \$100 million in 2014 and those deals were each subject to an average of 4.3 different lawsuits.⁸ In over 30% of those transactions, lawsuits were filed in more than one jurisdiction, thereby forcing the merging corporations and their directors to defend against substantially the same claims at the same time in

multiple courts with no guarantee of coordination.⁹ Until recently, the vast majority of these merger objection lawsuits were settled, typically for nonmonetary consideration such as additional disclosures or minor amendments to deal terms (like the lowering of a termination fee).¹⁰ In the last two years, however, the Delaware and New York courts have announced in a series of decisions that “disclosure only” settlements will rarely, if ever, pass muster in the courts, and that “disclosure light” settlements (ones that combine disclosure with some non-price deal-term alteration or prospective corporate governance change) will be subject to far greater scrutiny.¹¹ In adopting these changes in approach, the Delaware (and New York) courts believe they are serving stockholder interests by reducing the incentives to plaintiff-side law firms to bring cookie-cutter challenges to arm’s-length mergers. Whether the new approaches will have their intended effects remains to be seen, but the early data suggests that fewer suits are being filed in the wake of these decisions.

Additionally, there has been a drop in the amount of multijurisdictional litigation. In 2013, the Delaware Court of Chancery upheld the legality of “exclusive forum” bylaw provisions that bar stockholder challenges to mergers from being filed in courts outside of Delaware.¹² In 2015, Delaware’s legislature specifically authorized such provisions by statute. Such bylaws have become an increasingly common tool to fight against multijurisdictional litigation. Courts throughout the country—including state and federal courts in California, Illinois, Louisiana, Ohio, Oregon, New York and Texas—have enforced exclusive forum bylaws and dismissed or stayed litigation filed in violation thereof.¹³ Such exclusive forum bylaws are beginning to reduce multijurisdictional litigation and we expect this will continue.¹⁴

Another notable recent development in shareholder litigation is Delaware’s 2015 amendment of the Delaware General Corporation Law to provide that no certificate of incorporation of a Delaware corporation may contain a provision shifting fees on to a stockholder for bringing an unsuccessful fiduciary action against a director.¹⁵

C. Shareholder Activism and Engagement

1. Hedge Fund Activism

Recent years have seen a resurgence of raider-like activity by activist hedge funds, both in the U.S. and abroad, often aimed at forcing the adoption of policies with the aim of increasing short-term stock prices, such as increases in share buybacks, the sale or spin-off of one or more businesses of a company or the sale of the entire company. Matters of business strategy, capital allocation and structure, CEO succession,

options for monetizing corporate assets and other economic decisions have also become the subject of shareholder referenda and pressure. Hedge fund activists have also pushed for governance changes as they court proxy advisory services and governance-oriented investors and have run (or threatened) proxy contests, usually for a short slate of directors, though increasingly for control of the board. Activists have also worked to block proposed M&A transactions, mostly on the target side but also sometimes on the acquiror side.

a. Large Companies and New Tactics

In recent years, it has become clear that even household-name companies with best-in-class corporate governance and rising share prices are liable to find themselves targeted by shareholder activists, represented by well-regarded advisors. Shareholder activism, in its latest incarnation, is no longer a series of isolated approaches and attacks; instead, it is creating an environment of constant scrutiny and appraisal requiring ongoing monitoring, awareness and engagement by public companies. The trend of targeting (and sometimes achieving settlements at) mega-cap, high-profile companies in diverse industries continued from 2014, through 2015 and into 2016, as illustrated by campaigns at Apple, General Electric, PepsiCo, Qualcomm, Yahoo!, eBay and DuPont, among others.

Campaigns by large institutional investors and asset managers that are not dedicated activist funds have also burst onto the activism scene, as illustrated by Artisan Partners' campaign against \$280 billion Johnson & Johnson and the efforts by PAR Capital Management and Altimeter Capital Management to install former Continental CEO Gordon Bethune as Chairman of United Continental Holdings' board and replace six incumbent nominees, and Relational Investors' partnership with the California State Teachers' Retirement System (CalSTRS) to pressure Timken to break up the company.

Against this backdrop, however, there have recently been signs of a growing recognition that the excesses of shareholder activism threaten the sustainability and future prosperity of the American economy; for example, several major institutional investors have gone on the record to criticize—and have voted against—the typical activist playbooks, and have sought to establish and publicize their long-term mindset. DuPont's 2015 defeat of Trian Partners' proxy fight to replace four DuPont directors provided an important reminder that well-managed corporations executing clearly articulated strategies can still prevail against an activist, even in the face of pro-dissident recommendations by the major proxy advisory services and a campaign by a well-credentialed activist. Notable features of the DuPont-Trian campaign include the parties having engaged for nearly two years before the election contest commenced, DuPont

implementing substantive business change (including active portfolio management, cost-cutting acceleration, and increased return of capital) and board refreshment, aggressive use of rapid response online, hardcopy and media communication tools by both sides (including dedicated “fight” websites, videos and newspaper advertisement), and several key institutional shareholders being willing to publicly announce their positions for or against the company in advance of the vote. Additionally, retail shareholders—who represented over 30% of DuPont’s shareholder base—played a major role in determining the outcome of the proxy fight. DuPont used a variety of creative methods to reach this constituency. The aftermath of the DuPont battle nevertheless featured a subsequent change in CEO and announcement of a combination with Dow Chemical that was supported by Trian.

In addition to becoming more ambitious, activists have become more sophisticated, hiring investment bankers and other seasoned advisors to draft sophisticated “white papers,” aggressively using social media and other public relations techniques, consulting behind the scenes with traditional long-only investment managers and institutional shareholders, nominating director candidates with executive experience and industry expertise, invoking statutory rights to obtain a company’s non-public “books and records” for use in a proxy fight, deploying precatory shareholder proposals, and being willing to exploit vulnerabilities by using special meeting rights and acting by written consent. Special economic arrangements among hedge funds have also become more common, such as Pershing Square and Sachem Head’s profit-sharing arrangements involving Zoetis and the arrangements the four hedge funds targeting General Motors entered into with their consultant and director nominee Harry Wilson.

Economic activists have also deployed non-binding shareholder proposals to seek to force corporate change. While shareholder proposals were historically the domain of governance activists (under the Rule 14a-8 proposal framework), in 2013 activist shareholder Relational Investors teamed up with CalSTRs to pressure Timken to break up the company by submitting to a shareholder vote a successful and ISS- and Glass Lewis-supported Rule 14a-8 shareholder proposal calling for a spin-off. In 2014, Carl Icahn deployed shareholder proposals in pursuit of economic agendas at both Apple and eBay, with such proposals to be considered at the companies’ regularly scheduled annual meetings. After arguing for a \$150 billion buyback by Apple, Icahn presented a precatory proposal to be voted on by shareholders requesting a \$50 billion buyback. At eBay, Icahn sought to increase pressure on the company to separate its PayPal business by, in addition to running two of his employees as alternative director candidates in an election contest, submitting a non-binding

proposal for a spin-off of the PayPal business (after preliminary proxy materials had been filed by both parties, Icahn ultimately withdrew his proposal following a negotiated settlement in which eBay appointed a mutually agreed independent director to its board and entered into a confidentiality agreement with Icahn; eBay later announced a separation of PayPal).

The successful “withhold the vote” campaign launched by hedge fund H Partners Management against Tempur Sealy in May 2015 was also notable for its use of majority voting to advance hedge fund activism. Having missed the advance notice deadline for director nominations, H Partners, a 10% shareholder, nevertheless waged an economic-based campaign to get shareholders to withhold votes from three sitting directors, specifically the CEO, the Chairman of the Board, and the Chair of the Nominating and Corporate Governance Committee, and argued that the CEO should be replaced and that the hedge fund’s founder should be appointed to the board. ISS ultimately backed H Partners’ campaign and the targeted directors failed to receive majority support. In accordance with the company’s majority vote resignation policies, the directors tendered their resignations for the board to consider. A few days after the annual meeting had concluded, the board ultimately accepted the resignations, announced a settlement with H Partners in which its founder joined the board, and started a CEO search.

b. M&A Activism and Appraisal Arbitrage

Aside from activism pushing for a sale of the company, M&A deal activism should be anticipated in which, after a deal is announced, activists may seek a higher price, encourage a topping bid for all or part of the company, dissent and seek appraisal, try to influence the combined company and its integration, or even try to scuttle a deal entirely, leveraging traditional disruptive activist campaign tactics in their efforts. Deal activists may have little to lose, particularly when they exploit inherent deal uncertainty to buy the target’s stock at a discount to the deal price and agitate for additional consideration. Even if there is no bump in transaction consideration for all shareholders, activists may still seek to profit from hold-up tactics and extract private benefits that may come at the expense of other shareholders. And just as U.S. investors have exported general activism abroad, U.S. hedge funds increasingly consider agitating against non-U.S. deals, often leveraging the idiosyncrasies of local laws to seek special benefits while deploying other U.S.-style tactics.

Additionally, M&A activism increasingly involves appraisal arbitrage, where hedge funds invoke (or buy claims giving them the right to invoke) statutory rights giving shareholders who object to a cash offer

the right to dissent and seek a higher price through litigation, at the cost of not receiving the merger consideration.

In particular, stockholders of Delaware corporations acquired in merger transactions in which the consideration consists of cash, or a mix of cash and stock (unless all stockholders are entitled to receive only stock consideration at their election), are entitled to seek a judicial appraisal from the Delaware Court of Chancery of the fair value of their shares rather than accept the merger consideration. Most other jurisdictions also have some form of appraisal rights available, although the details vary from state to state. In order to perfect appraisal rights in Delaware, stockholders must comply with various procedural requirements, including not voting in favor of the merger and delivering a written demand to the company by the applicable statutory deadline (generally, before the vote is taken regarding a merger or before the consummation of a tender offer). The Court of Chancery appraises the shares by determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger, plus interest which is generally computed from the closing date of the merger through the date of payment of the judgment based on 5% over the Federal Reserve interest rate.

The fundamental dynamic driving the phenomenon of appraisal arbitrage is that under current law, the worst-case scenario for appraisal arbitrageurs is that they will receive the deal value (assuming that the court views the deal value as the appropriate metric of fair value) plus the generous Delaware statutory interest rate, and studies indicate that billions of dollars in capital have been allocated to appraisal arbitrage strategies. Appraisal petitions were filed following 33 mergers in the Delaware Court of Chancery in 2015, compared with 24 in 2014.

Recent developments in the appraisal area have involved three questions: Can the appraisal court rely on the “M&A market” driving a robust sales process to help establish that the merger price was fair? Will Delaware amend its appraisal statute to provide that companies will no longer have to pay the statutory pre-judgment interest rate of 5% over the Federal Reserve discount rate on appraisal awards, which increases the potential returns of appraisal? And, can a stockholder who cannot demonstrate that the shares it owns were voted against the merger nonetheless pursue appraisal?

In several cases decided in 2014 and 2015, the Court of Chancery has shown itself increasingly willing to rely on market processes as an indication that stockholders received fair value, provided that a third party was not prevented from making a higher offer.¹⁶ Not every appraisal case will be appropriate for the application of this approach (for example, cash-

out mergers by controlling stockholders may not fit the mold), but where the facts support an inference of a robust market-derived price, plaintiffs will find it difficult to argue that fair value exceeds the merger consideration. Further, the Court of Chancery has also shown itself willing to deduct the value of synergies from the merger price, on the ground that the value attributable to synergies is not part of the fair value of the company as a stand-alone entity.¹⁷ These decisions confirm that the market still matters in appraisal proceedings, sometimes conclusively, and that appraisal arbitrage is not without risk.

In 2015 and again in 2016, amendments to the appraisal statute were proposed that would affect the amount of interest owed on any appraisal award; to date, however, these amendments have not been adopted. Finally, the Delaware courts reaffirmed in 2015 that an appraisal plaintiff is not required to show that the shares as to which appraisal is sought were shares that were not voted in favor of the merger.¹⁸ This result arises out of the difficulty of applying the language of the appraisal statute itself to the typical pattern of current share ownership involving the Depository Trust Company and, thus, a stockholder not only can purchase shares after the announcement of the transaction and pursue appraisal claims, but is not even required to hold shares on the record date for the vote on the transaction.

In this environment of hedge fund activism, including activism against some of the largest and most well-known U.S. companies, advance preparedness for activist pressure as well as for unsolicited takeovers is critical to improving a company's ability to create sustainable value over the long term and control its corporate destiny, deter coercive or inadequate bids, secure a high premium in the event of a sale of control of the corporation and otherwise ensure that the company is adequately protected against novel takeover tactics. Advance preparation for defending against shareholder opposition or an unsolicited takeover also may be critical to the success of a preferred transaction that a company has determined to be part of its long-term plan. Companies that build and maintain constructive engagement with shareholders, including shareholder activists, are better able to diffuse potentially confrontational situations before they become public, bloom into a full-fledged fight or result in the company being put "in play."

2. Governance Activism

Companies face a rapidly evolving corporate governance landscape defined by heightened scrutiny of a company's articulation of long-term strategies, board composition and overall governance *bona fides*, frequent implementation by companies of shareholder proposals and increasing direct shareholder engagement. As many companies have, in

recent years, taken steps such as instituting majority voting, declassifying their boards of directors, eliminating takeover defenses, granting special meeting rights and, in certain cases, splitting the roles of chairman and chief executive officer, there are fewer targets for shareholder proposals on such topics. The potential for “withhold the vote” recommendations against directors has also emerged as an important consideration impacting boardroom decision-making, and majority shareholder support is increasingly common for certain shareholder proposals. One of the explanations for increasing shareholder support of governance changes is voting by institutional shareholders in accordance with recommendations of shareholder advisor services, such as ISS and Glass Lewis, which provide analysis or advice with respect to shareholder votes. These shareholder advisory services publish proxy voting guides setting forth voting policies on a variety of common issues that are frequent subjects of shareholder proposals. By outsourcing judgment to consultants or otherwise adopting blanket voting policies on various governance issues, institutional shareholders increasingly do not review individual shareholder proposals on a company-by-company basis and are thereby ignoring an individual company’s performance or governance fundamentals. As a result, many shareholder votes may unfortunately be preordained by a blanket voting policy that is applied to all companies without reference to the particulars of a given company’s situation. Notable exceptions to this general trend involve some large funds, such as BlackRock, State Street and Vanguard, which have formed their own large internal governance departments and have been more proactive in engaging directly with companies. Major institutional investors are feeling increasing pressure to avoid rote reliance on advisory firm recommendations and instead engage in case-by-case, pragmatic assessment of governance issues. Proxy advisory firms themselves have become subject to heightened scrutiny, with the SEC issuing regulatory guidance in June 2014 concerning the proxy voting responsibilities of investment advisors and their use and oversight of proxy advisory firms, and the SEC’s Office of Compliance Inspections and Examinations specifically including in its 2015 National Examination Program Priorities plans to “examine select proxy advisory service firms, including how they make recommendations on proxy voting and how they disclose and mitigate potential conflicts of interest” and “examine investment advisors’ compliance with their fiduciary duty in voting proxies on behalf of investors.” In July 2015, the chair of a U.S. Senate economic policy subcommittee formally asked the U.S. Government Accountability Office to examine proxy advisory firms, and NASDAQ and the U.S. Chamber of Commerce have also launched initiatives focused on the use and impact of proxy advisory firms and their recommendations.

Proxy Access. Over the past decade, expanding shareholders' ability to nominate their own director candidates by permitting them to do so using the company's own proxy statement and proxy card rather than using their own proxy materials has been a fertile area for activism, discussion, rule-making and litigation. Although the SEC's mandatory proxy access rule was struck down, amendments to Rule 14a-8 have facilitated private ordering by permitting shareholders to submit proxy access proposals to individual companies. In the 2015 proxy season, a coordinated "Boardroom Accountability" campaign by the New York City Comptroller and various pension funds led to the filing of precatory shareholder proposals seeking proxy access at over 100 companies. While a majority of companies recommended that shareholders vote against these precatory proposals at their 2015 annual meetings, most, though by no means all, nevertheless passed at large-cap companies, gaining the support not only of the pension funds but also of many mainstream institutional investors, with targeted companies subsequently implementing proxy access provisions. Some major institutions like TIAA-CREF pursued private engagement in 2015, encouraging companies to adopt proxy access unilaterally even if they did not receive a shareholder proposal, and later began filing formal shareholder proposals themselves. Proxy access efforts by shareholders continued into the 2016 proxy season, and by early 2016, over 200 U.S. companies had implemented proxy access, often through negotiations with shareholder proponents or even proactively in advance of receiving a shareholder proposal. While some companies that had previously adopted proxy access bylaws received a second round of shareholder proposals asking for revisions, the proxy access "market" has now appeared to coalesce around "3/3/20/20" headline formulations requiring eligible shareholders to have continuously owned at least 3% of the company's outstanding stock for at least 3 years, limiting the maximum number of proxy access nominees to 20% of the board with appropriate crediting of previously elected nominees and permitting reasonable levels of aggregation and grouping (e.g., up to 20 shareholders) to meet the 3% threshold; treatment of other terms varies by company.

Defensive Provisions. Shareholder proposals requesting companies to repeal staggered boards continue to be popular, and such proposals have passed 86.4% of the time since 2005 at S&P 500 companies. However, some institutional investors are evaluating whether "one-size-fits-all" objections to classified boards have been overdone, especially in light of recent, well-regarded econometric studies showing that classified boards can promote long-term value creation. At year-end 2015, approximately 10% of S&P 500 companies had a staggered board, according to SharkRepellent figures, down from 47% as recently as 2005. Staggered boards are more prevalent among smaller companies, with 31.52% of the

companies in the S&P 1500 having a staggered board at the end of 2015. As distinct from rights plans, a company that gives up its staggered board cannot regain a staggered board when a takeover threat materializes because it cannot be adopted unilaterally without shareholder approval, which would be difficult to obtain.

Over the past ten years, governance activists have sponsored precatory resolutions seeking repeal of or a shareholder vote on shareholder rights plans, also known as “poison pills.” One result of this activism has been a dramatic decline in the proportion of large public companies that have rights plans in place, and an increase in the number of companies choosing instead to have “on-the-shelf” rights plans ready to be adopted promptly following a specific takeover threat. According to SharkRepellent, at year-end 2015, only 4% of S&P 500 companies had a shareholder rights plan in effect, down from approximately 45% as recently as the end of 2005. Shareholder rights plans are somewhat more prevalent for smaller companies, with 6.2% of the companies in the S&P 1500 having a rights plan in effect at the end of 2015 (a decline from 8.87% at the end of 2014). As discussed in Section VI.A, a number of companies have adopted rights plans with 4.9% triggers intended to protect valuable tax assets. Importantly, unlike a staggered board, a company can adopt a rights plan quickly if a hostile or unsolicited activist situation develops. However, ISS recommends an “against” or “withhold” vote for directors who adopt a rights plan with a term of more than 12 months or renew any existing rights plan (regardless of term) without a shareholder vote. ISS also recommends voting on a case-by-case basis for boards adopting a rights plan for less than 12 months without shareholder approval.

Additionally, governance advisors have increased their focus on defensive charter and bylaw provisions adopted by newly public companies. For the 2016 proxy season, ISS issued new voting guidelines under which it generally will make adverse recommendations for directors at the first shareholder meeting of a newly public company if that company has bylaw or charter provisions that are “materially adverse to shareholder rights.” Unless an adverse provision is reversed or submitted to a vote of public shareholders, ISS will make voting recommendations on a case-by-case basis on director nominees in subsequent years. Glass Lewis’ guidelines provide for a one-year grace period for companies that have recently completed an IPO in which Glass Lewis refrains from issuing voting recommendations on the basis of corporate governance best practices, except in egregious cases. However, Glass Lewis will consider recommending to vote against the members of the board who served when an antitakeover provision such as a shareholder rights plan or a classified board was adopted if the board (i) did not also commit to submit such

provision to a shareholder vote within 12 months of the IPO or (ii) did not provide a sound rationale for adopting such provision. The Council of Institutional Investors issued a draft statement laying out investor expectations as to various governance features of newly public companies. In addition, shareholder activists have pressured companies to remove, or agree not to include, several antitakeover defenses in spin-off companies' governance documents. After DuPont announced that its performance chemicals spin-off company, Chemours, would have a classified board and several other customary antitakeover protections for a spin-off or IPO company, Trian Fund Management criticized the DuPont board and subsequently launched a proxy fight. DuPont later revised Chemours' governance so that the classified board would be subjected to approval by the Chemours shareholders at the first annual meeting of Chemours stockholders. Carl Icahn has also entered into agreements with eBay, Manitowoc and Gannett that require their respective spin-off companies to, for a period of time after the spin-off, have an annually elected board, permit shareholders to call special meetings, and refrain from adopting a shareholder rights plan with a threshold below approximately 20% or a duration of more than a specified number of days without stockholder ratification.

Majority Voting. Beginning mostly in 2004, in the face of then-stalled efforts to provide investors with "proxy access," shareholder activists began to agitate against the traditional plurality voting standard, under which the director nominees receiving the highest number of votes are elected as directors, without regard to votes "against" or "withheld." Shareholder activists called on companies to instead adopt majority voting, under which a director nominee is elected only if the votes for his or her election exceed votes against or withheld. While majority voting remains a shareholder activist concern, hundreds of public companies have adopted a true majority voting standard for the election of directors in uncontested elections and a resignation policy for directors receiving less than a majority vote (often contained in the bylaws). Today, majority voting is on a path to becoming universal among large companies, as over 88% of S&P 500 companies currently have a majority voting policy in place.

Action by Written Consent. Governance activists have been seeking to increase the number of companies that may be subject to consent solicitations. 70% of S&P 500 companies prohibit shareholder action by written consent as of the end of 2015 (or require such consent to be unanimous). During 2005-2009, only one Rule 14a-8 shareholder proposal was reported to have sought to allow or ease the ability of shareholders to act by written consent. From 2010 to 2015, however, there were just over 160 such proposals (Approximately 20% of which

passed). Hostile bidders and activist hedge funds have effectively used the written consent method to facilitate their campaigns, and companies with written consent provisions should carefully consider what safeguards on the written consent process they can legally and appropriately put in place.

Special Meetings. Institutional shareholders have also been pushing for the right of shareholders to call special meetings in between annual meetings, and shareholder proposals seeking such a right can generally be expected to receive significant support, depending on the specific threshold proposed by the shareholder and the company's governance profile. Over 60 percent of S&P 500 companies now permit shareholders to call special meetings in between annual meetings. Among the companies that permit shareholders to call special meetings, there remains significant variation with respect to the minimum threshold required to call a special meeting and as to the procedural requirements and substantive limitations on the exercise of this right. Economic activists and hostile bidders have been able to use the special meeting right to great effect to increase pressure on target boards, including by seeking to remove directors or submit precatory economic proposals. Care should be taken in drafting charter or bylaw provisions relating to special meeting rights to ensure that protections are in place to minimize abuse while avoiding subjecting institutional shareholders who wish to support the call of a special meeting to unduly onerous and unnecessary procedural requirements.

Say on Pay. Since the implementation of the mandatory say-on-pay vote, it has become increasingly important for companies to consider proactive outreach to shareholders regarding executive compensation. Now, more than ever, shareholder perception of company performance drives say-on-pay recommendations and voting at least as much as actual pay practices. Consequently, all companies are susceptible to a "no" recommendation or vote based on a perceived disconnect between pay and stock price performance, regardless of how carefully they adhere to so-called "best practices" in matters of compensation. In 2016 and the years ahead, well-established relationships with significant investors can be outcome-determinative when it comes to the mandatory say-on-pay vote.

3. Shareholder Engagement

Given the current hedge fund and governance activist environment discussed above, it has become very important for companies to nurture relationships with long-term shareholders and cultivate their understanding of the company's point of view, especially with respect to investments that have a long-term horizon. Leading institutional investors have also been developing a new paradigm for corporate governance in which these institutions would engage with a company and its independent

directors to understand its long-term strategy and ascertain that the directors participated in the development of the strategy, were actively monitoring its progress and were overseeing its execution. The value of shareholder engagement has been recently endorsed by entities as diverse as the SEC, BlackRock, Vanguard, State Street, the Council of Institutional Investors, ISS and Glass Lewis, as well as by a host of corporate executives and board members, lawyers and commentators. Companies often engage with major shareholders in order to make the case for the corporate strategy, respond to shareholders' concerns and avoid capitulation to harmful demands from shareholder activists. The evolving trend is not only an increase in the frequency and depth of engagement, but also a more fundamental emphasis on the roles and responsibilities of both companies and shareholders in facilitating thoughtful conversations instead of reflexive, off-the-shelf mandates on corporate governance issues, and cultivating long-term relationships that have the potential to curb short-term pressures in the market. While corporate governance debates in the last decade or so have largely been framed oppositionally in terms of board/management versus shareholders, it may be that the next phase in corporate governance evolution features more debates between different types of shareholders—for example, activist hedge funds versus index funds or other large mutual fund groups. In some cases, activist funds have opposed each other's agendas. In short, shareholder engagement is no longer limited to the "proxy season" or special situations, and has become a regular, ongoing initiative of corporate governance and investor relations teams at public companies, with direct engagement with portfolio managers and governance professionals of key shareholders increasingly a year-round effort. In appropriate cases, director-level shareholder engagement may also serve to enhance credibility, preempt shareholder resolutions/contests and defuse contentious situations.

D. Regulatory Trends

The U.S. antitrust agencies continue to actively investigate and pursue enforcement actions involving transactions in many sectors of the economy. The overall level of merger enforcement during 2015 was roughly in line with the aggressive levels of the past few years, with the Federal Trade Commission ("FTC") and U.S. Department of Justice's Antitrust Division ("DOJ") on a combined basis initiating court challenges to block seven proposed transactions and requiring remedies in 23 additional transactions. In addition, companies abandoned four transactions due to opposition from the antitrust agencies.¹⁹

Enforcement Trends and Issues

Enforcement activity in 2015 shows that the FTC and DOJ are prepared to pursue aggressive theories with respect to market definition and competitive effects. In a number of cases, the agencies defined product markets based on narrow customer groups that purportedly have different requirements that only a few suppliers can satisfy and that may be vulnerable to discriminatory treatment. This approach substantially limits the number of competitors that the agency counts as being in the relevant market and increases the competitive significance of the merging parties, thereby supporting a claim of competitive harm. The agencies have also shown a willingness to shift the focus of their competitive analysis away from local overlaps between the parties, focusing instead on a merger's effects at the national level. While in 1997 the FTC alleged that the merger of Staples and Office Depot would harm local competition, this year's suit alleges that the transaction will reduce competition across the U.S. Similarly, in the Comcast situation, the DOJ focused on Comcast's "control" of access to a large share of broadband customers nationally. This approach has important implications for the parties' ability to identify remedies that are sufficient to address the agencies' concerns.

During 2015, the agencies continued to be stringent in their approach to merger remedies, increasingly requiring that the parties identify an acceptable "upfront buyer" before accepting divestiture packages. This requirement can add months to the review process, as the merging parties need to identify a buyer, negotiate a divestiture agreement, and have the proposed divestiture buyer and package vetted by the agencies before the main deal can proceed. The agencies also continued to require broad divestiture packages, which in some recent cases included assets outside the relevant market of concern. For example, the FTC conditioned clearance of the merger of Holcim and Lafarge on the divestiture of several cement plants and terminals, including a plant and a terminal in Canada, which the FTC alleged were necessary to remedy competitive concerns in northern U.S. markets.

The recent "failed" divestiture in connection with Albertsons' acquisition of Safeway is likely to prompt even more scrutiny of proposed remedies. In January 2015, Albertsons agreed to sell 146 supermarkets to Haggen Holdings, a small regional supermarket chain, to obtain FTC's approval to acquire Safeway. In September, a few months after it acquired the stores, Haggen filed for bankruptcy, announcing a plan to reorganize with only 37 stores. Numerous store closures will likely result in a loss of competition, frustrating the FTC's efforts to maintain competition at the pre-merger level. Following the Albertsons situation and a similar failed divestiture in connection with Hertz's 2012 acquisition of Dollar Thrifty, merger parties should be prepared for a thorough review of divestiture

buyers and protracted consent negotiations in transactions that raise concerns requiring relief.

Yet even in this atmosphere of vigorous antitrust enforcement, a number of difficult transactions were approved either unconditionally or with remedies. In September, the DOJ announced that it would not challenge Expedia's acquisition of Orbitz, a transaction that faced significant opposition from the hotel industry. The DOJ found that the acquisition was unlikely to harm competition because Orbitz only constitutes a small source of bookings for hotels, airlines and car rental companies, and the online travel business is rapidly evolving with several new services being launched to compete with the existing providers. In February, the FTC approved Zillow's proposed acquisition of Trulia, respectively the first and second largest web portals for home buying that sell advertising space to real estate agents. Although the parties' internal documents showed that "Zillow and Trulia compete closely with one another for consumer traffic and for real estate agent advertising dollars," the evidence also showed that real estate agents use numerous methods in addition to the parties' platforms to attract customers. The FTC found insufficient evidence that real estate agents would face higher prices post-merger, or that the combined company would have a reduced incentive to innovate.

Most enforcement actions in 2015 were resolved through consent orders requiring remedial action. Notable cases include Dollar Tree's acquisition of Family Dollar Stores and the merger of RJ Reynolds and Lorillard. In Dollar Tree, the FTC asserted that the two chains competed head-to-head in terms of price, product assortment and quality as well as location and customer service in local markets across the country. The agency required divestiture of 330 Family Dollar stores to resolve competitive concerns. The FTC's clearance of the merger of Reynolds and Lorillard, respectively the second and third largest U.S. cigarette manufacturers, was subject to the divestiture of four cigarette brands to Imperial Tobacco. The FTC alleged that, absent the divestiture, the merger would have raised significant concerns by eliminating current and emerging head-to-head competition between the parties in the highly concentrated cigarette market, thereby increasing the chances of unilateral price hikes as well as coordinated interaction between Reynolds and Altria, the industry leader.

The U.S. competition authorities also continue to vigorously enforce compliance with the HSR pre-merger notification requirement and waiting periods, including taking action with respect to both failures to file and so-called "gun-jumping" violations. For example, in August 2015, the FTC announced that Third Point LLC and three Third Point funds had

agreed to settle charges that it had violated the HSR Act in connection with purchases in 2011 of Yahoo! stock. The HSR Act and Rules provide an exemption for acquisitions of up to 10% of a company's voting stock if the acquisitions are made solely for the purpose of investment and the acquirer "has no intention of participating in the formulation, determination or direction of the basic business decisions of the issuer." According to the FTC's complaint, the funds acquired voting securities in Yahoo! in excess of the \$66 million (the 2011 HSR threshold) in August 2011 and continuing through September 8, 2011, when Third Point filed its Form 13D with the U.S. Securities and Exchange Commission, without having filed its HSR notification and observed the HSR waiting period. Although Third Point claimed that these purchases occurred when it had only investment intentions, the FTC found that Third Point "took actions that belied an investment-only intent." Specifically, Third Point had contacted third parties to determine their interest in replacing the current Yahoo! CEO or serving as a director of Yahoo!, internally considered launching a proxy fight, and made public statements concerning an alternative board slate.

The FTC's Bureau of Competition issued a blog post the same day explaining the long FTC history in narrowly construing the "investment only" exemption. The FTC construes the term not to apply should the company even be seriously considering a takeover, including possibly nominating someone for a seat on the board of directors. Similarly, the Premerger Office has indicated that the exception is unavailable if the acquirer attempts to influence the management's decisions.

Since the actions cited in the FTC's complaint were deemed by the FTC to be Third Point's first violation of the HSR Act, the Commission decided not to seek civil penalties. Rather, the order expressly prohibits Third Point from making acquisitions in reliance on the investment-only exemption if Third Point has engaged in certain enumerated conduct. The FTC's blog makes clear that while "activist investor conduct can be—but is not inevitably—beneficial," requiring compliance with the HSR Act does not inhibit activist conduct itself.

State attorneys general also continue to play a role in certain high-profile merger reviews, raising both strictly local as well as national concerns. In addition, in regulated industries (*e.g.*, energy, public utilities, gaming, insurance, telecommunications, financial institutions and defense contracting), state and federal regulatory agencies also have separate jurisdiction to review transactions.

The U.S. is not alone in its careful review of M&A transactions as further discussed in Section VII. For instance, in December 2015 the Canadian Competition Commission also brought an action before the

Tribunal to block the Office Depot/Staples transaction. In addition, in September 2015, telecom providers TeliaSonera AB and Telenor Group abandoned their proposed combination to create Denmark's largest mobile phone operator, citing as the cause the failure to reach an agreement with the European Commission on acceptable conditions. With pre-merger notification regimes in nearly 100 jurisdictions, it is not unusual for a multinational transaction to require a dozen or more notifications. In large transactions, competition authorities in the U.S., Europe and Canada frequently coordinate their investigations of transactions, and even the remedies they might require before granting clearance.

Getting the Deal Done

In light of the heightened global emphasis on antitrust enforcement, even more attention must be paid to the antitrust-related provisions contained in transaction agreements, including so-called "efforts" clauses, cooperation obligations, termination provisions and reverse termination fees. The trend toward sizeable antitrust-related termination fees in strategic transactions, such as the \$2.5 billion reverse termination fee in 2011's Google—Motorola Mobility transaction and the \$3 billion reverse termination fee in AT&T—T-Mobile (coupled with significant spectrum transfers), continued in 2014 and 2015. In the Electrolux/GE transaction, which GE terminated during the antitrust trial, the break up fee paid to GE was \$175 million, and the Office Depot/Staples deal currently in litigation has a \$250 million termination fee. The pending Charter/Time Warner Cable transaction includes a \$2 billion reverse termination fee.

Looking forward, with many industry-shaping mergers still under review this year—the Obama Administration's last year—is likely to continue to be a period of vigorous antitrust enforcement. As in 2015, the agencies are likely to continue to pursue new theories of competitive harm, take a tough approach to merger remedies, and subject difficult transactions to lengthy reviews. In this enforcement environment, careful analysis and planning will remain important for parties considering potential transactions. Merger partners should thoroughly evaluate the substantive antitrust issues raised by the transaction, considering both traditional and alternative theories of competitive harm, and develop an effective remedy strategy early on. Finally, risk allocation and other antitrust-related provisions in transactions agreements will continue to be critical and will need to reflect the increased risk of protracted investigations and potential litigation.

II.

Board Considerations in M&A

The basic duties of corporate directors are to act with care and loyalty. But the level of scrutiny with which courts will review directors' compliance with their duties varies with situation and context. The default rule is the business judgment rule, which holds that directors' business decision-making generally will not (absent a personal conflict of interest) give rise to personal liability. Certain contexts, including when directors defend against a threatened change to corporate control or policy or engage in a sale of control of a company, invoke a heightened level of scrutiny under the *Unocal* and *Revlon* doctrines. Finally, in transactions involving a conflict of interest, an "entire fairness" standard may apply.

A. Directors' Duties

Directors owe two fundamental duties to shareholders: the duty of care and the duty of loyalty. Simply put, a director satisfies his duty of care if he has sufficient knowledge and data to make a well-informed decision. A director satisfies his duty of loyalty if he acts in good faith and in the interests of the shareholders and the corporation (rather than in his own personal interest).

1. Duty of Care

To demonstrate that a board has not met its duty of care, a plaintiff must prove that directorial conduct has risen to the level of "gross negligence," measured under the standard announced in 1985 by the Delaware Supreme Court in *Smith v. Van Gorkom* (the "*Trans Union*" case).²⁰ Delaware statutory law permits directors in exercising their duty of care to rely on advice from experts such as financial and legal advisors:

A member of the board of directors, or a member of any committee designated by the board of directors, shall, in the performance of such member's duties, be fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees, or committees of the board of directors, or by any other person as to matters the member reasonably believes are within such other person's professional or expert competence and who has been selected with reasonable care by or on behalf of the corporation.²¹

At its core, the duty of care may be characterized as the directors' obligation to act on an informed basis after due consideration of relevant

information and appropriate deliberation. Due care means that directors should act to assure themselves that they have the information required to take, or refrain from taking, action; that they devote sufficient time to the consideration of such information; and that they obtain, where useful, advice from counsel, financial advisors and other appropriate experts.²²

Directors who act without adequate information, or who do not adequately supervise a merger sales process, risk criticism from the courts. Regardless of whether a transaction is a “change in control,” directors should take an active role in the decision-making process and remain fully informed throughout that process.²³

Because a central inquiry in a duty of care case is whether the board acted on an informed basis, a board should carefully document the basis for its decisions. While the use of competent advisors will generally protect directors from potential liability and help a board demonstrate that its decisions should not be set aside by the courts, ultimately business decisions must be made by directors—they cannot be delegated to advisors, and the Delaware Supreme Court has recently emphasized that advisors are not “gatekeepers” responsible for the overall adequacy of board process.²⁴

Importantly, Section 102(b)(7) of the Delaware General Corporation Law allows corporations to include in their certificates of incorporation a provision to exculpate directors (but not officers) from monetary liability for breaches of the duty of care. Section 102(b)(7) provisions cannot, however, exculpate breaches of the duty of loyalty (including breaches arising from bad faith conduct), and they do not prevent a court from ordering equitable relief against violations of any duty.²⁵ In addition, even an exculpated breach of the duty of care can form the basis of a claim against a non-exculpated party (a financial advisor or officer, for example) for aiding and abetting the breach.

2. Duty of Loyalty

Every director has a duty to act in what he or she believes to be in the best interests of the corporation and its stockholders. This includes a duty *not* to act in a manner adverse to those interests by putting a personal interest or the interests of someone to whom the director is beholden ahead of the corporation’s or the stockholders’ interests.²⁶ The classic manner of showing that a director has not met his or her duty of loyalty involves proof that the director has engaged in a “self-dealing” transaction. However, any time a majority of directors are either (a) personally interested in a decision before the board or (b) not independent from or otherwise dominated by someone who is interested, courts will be concerned about a potential violation of the duty of loyalty and may

review the corporate action under the “entire fairness” level of scrutiny, described more fully below.²⁷

The duty of loyalty also encompasses the concept of good faith. In its 2006 decision in *Stone v. Ritter*, the Delaware Supreme Court clarified that “the obligation to act in good faith does not establish an independent fiduciary duty that stands on the same footing as the duties of care and loyalty.”²⁸ Instead, the traditional duty of loyalty “encompasses cases where the fiduciary fails to act in good faith.”²⁹ A director violates his or her good faith obligations where the fiduciary “intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his [or her] duties.”³⁰

Understanding what rises to a duty of loyalty violation is especially important in light of Section 102(b)(7), because corporations may not exculpate their directors for breaches of the duty of loyalty (in contrast to breaches of the duty of care). The Delaware Supreme Court has held that if a plaintiff has failed to plead a duty of loyalty claim against a director, that director may be dismissed from the litigation, even where the plaintiff may have adequately pleaded loyalty claims against other members of the board.³¹

In *Lyondell Chemical Co. v. Ryan*, the Delaware Supreme Court rejected stockholder claims that directors had breached their duty of loyalty and good faith in selling the company. The *Lyondell* Court assumed that the directors did nothing to prepare for an impending offer and did not even consider conducting a market check before entering into a merger agreement containing a no-shop provision and a 3.2% break-up fee.³² The Court stated that in order to show a lack of good faith, the plaintiffs would need to show that the board “utterly failed” to try to meet its obligations or otherwise acted for some purpose other than advancing the best interests of the corporation.³³ Because the board had engaged in some level of negotiation and pushed back (albeit unsuccessfully) on the acquiror, the Supreme Court reversed the Court of Chancery, noting that the directors needed only to make decisions that were “reasonable, not perfect.”³⁴ *Lyondell* is a powerful statement that courts appreciate the complex decisions directors must make in selling the company, and will not treat all attacks on board process as raising issues of good faith.³⁵

B. The Standards of Review

The fiduciary duties of care and loyalty are standards of conduct describing a director’s obligations to the corporation.³⁶ Whether a court determines that directors breached their fiduciary duties can depend

heavily on the standard of review the court applies to the directors' decision-making.

1. Business Judgment Rule

The traditional business judgment rule is the default standard of review applicable to directors' decisions. Under the business judgment rule, "directors' decisions are presumed to have been made on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."³⁷ In other words, the business judgment rule is a presumption that directors are complying with their fiduciary duties. The purpose of the rule is to "encourage[] corporate fiduciaries to attempt to increase stockholder wealth by engaging in those risks that, in their business judgment, are in the best interest of the corporation 'without the debilitating fear that they will be held personally liable if the company experiences losses.'"³⁸ In the case of a Delaware corporation, the statutory basis for the business judgment rule is Section 141(a) of the Delaware General Corporation Law, which provides that "[t]he business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors."³⁹

In cases where the traditional business judgment rule applies, directors' decisions are protected unless a plaintiff is able to plead facts showing that a board has in fact acted disloyally, in bad faith, or with gross negligence.⁴⁰ This rule prevents courts and stockholders from interfering with managerial decisions made by a loyal and informed board unless the decisions cannot be "attributed to any rational business purpose."⁴¹ Indeed, the Court of Chancery has described business judgment review as a "bare rationality test."⁴² If a plaintiff is able to rebut the presumptive protections of the business judgment rule, the court will review the action or decision for entire fairness.⁴³

2. Enhanced or Intermediate Scrutiny

There are certain situations in which Delaware courts will not defer to board decisions under the traditional business judgment rule. These include a board's (a) adoption of defensive mechanisms in response to an alleged threat to corporate control or policy,⁴⁴ and (b) approval of transactions involving a sale of control.⁴⁵

In these circumstances, board action is subject to judicial review under an "enhanced scrutiny" standard, which examines the substantive reasonableness of both the board's process and its action. The Court of Chancery has explained that "[e]nhanced scrutiny applies when the realities of the decision-making context can subtly undermine the decisions of even independent and disinterested directors."⁴⁶ The

decision-making process, including the information relied on, must satisfy the court's enhanced, or intermediate, standard. In addition, under the enhanced scrutiny tests, unlike under the traditional business judgment rule, the court will need to be satisfied that the directors' decisions were objectively *reasonable* rather than merely rational.⁴⁷ It is important to note that these tests have most application before a stockholder vote and when a third-party bidder or other plaintiff is seeking injunctive relief.⁴⁸ The Delaware Supreme Court has recently confirmed that when a board decision that would otherwise be subject to enhanced scrutiny is approved via a fully-informed, uncoerced vote of a majority of the disinterested stockholders, the standard of review is business judgment.⁴⁹

a. *Unocal*

Directors who adopt defensive measures against a potential threat to control carry the burden of proving that their process and conduct satisfy the enhanced standard established in 1985 by *Unocal Corp. v. Mesa Petroleum Co.*⁵⁰ This standard requires that the board meet a two-pronged test:

- first, the board must show that it had “reasonable grounds for believing that a danger to corporate policy and effectiveness existed,” which may be shown by the directors’ reasonable investigation and good faith belief that there is a threat; and
- second, the board must show that the defensive measure chosen was “reasonable in relation to the threat posed,” which in *Unitrin, Inc. v. American General Corp.* the Delaware Supreme Court defined as being action that is not “coercive or preclusive” and otherwise falls within “the range of reasonableness.”⁵¹

Under the first prong of this test, a court may take issue with defensive action when a board is unable to identify a threat against which it may justifiably deploy anti-takeover efforts. For example, in *Unitrin*, the Court viewed the first prong of *Unocal*—whether a threat to corporate policy exists—as satisfied based on the board’s conclusion that the price offered in an unsolicited takeover bid was inadequate, although it described the threat as “a mild one.”⁵² *Unitrin* also made clear that a board has discretion to act within a range of reasonably proportional responses to unsolicited offers,⁵³ *i.e.*, not limited by an obligation to act in the least intrusive way.

However, board discretion under the *Unocal* standard is not unlimited. In the 2000 case *Chesapeake Corp. v. Shore*, the Delaware Court of Chancery invalidated the adoption of a supermajority voting

bylaw by a board confronted with a combined consent solicitation and tender offer.⁵⁴ Applying *Unocal*, the Court found that the only threat the board met its burden to show—price inadequacy—was “mild.”⁵⁵ The Court then examined the board’s response to this threat, and found that the target board failed to demonstrate that the supermajority voting bylaw was not preclusive in light of such factors as the target management’s control of nearly 24% of the voting power and the probable percentage of stockholders who would vote in the consent solicitation. The Court noted that the target company’s other defensive provisions, such as its rights plan, the inability of its shareholders to call a special meeting and the board’s power to set the record date for consent solicitations, provided protection against coercion by the bidder and gave the board time to consider other alternatives. The Court recognized that “*Unitrin* emphasized the need for deference to boards that make reasoned judgments about defensive measures,” but stated that “[i]t in no way suggests that the court ought to sanction a board’s adoption of very aggressive defensive measures when that board has given little or no consideration to relevant factors and less preclusive alternatives.”⁵⁶

The landmark 2011 decision in *Air Products & Chemicals, Inc. v. Airgas, Inc.*, upholding the Airgas board’s refusal to accept a premium cash bid from Air Products, is the most important recent decision reviewing the law applicable to board responses to unsolicited takeover efforts.⁵⁷ The Delaware Court of Chancery upheld under *Unocal* the Airgas directors’ decision to block a hostile tender offer by refusing to redeem its “poison pill” shareholder rights plan. In ruling for the Airgas board, the Court found that the directors had acted in good faith in determining that Air Products’ “best and final” tender offer was inadequate. In making this finding, the Court relied on the fact that the board was composed of a majority of outside directors, that the board had relied on the advice of outside legal counsel and three separate financial advisors, and that the three Airgas directors nominated to the Airgas board by Air Products (and elected by the stockholders) had sided with the incumbents in concluding that Air Products’ offer should be rejected. The Court’s opinion held that “in order to have any effectiveness, pills do not—and cannot—have a set expiration date.”⁵⁸ The Court continued that while “this case does not endorse ‘just say never.’ . . . it does endorse . . . Delaware’s long understood respect for reasonably exercised managerial discretion, so long as boards are found to be acting in good faith and in accordance with their fiduciary duties (after rigorous judicial fact-finding and enhanced scrutiny of their defensive actions). The Airgas board serves as a quintessential example.”⁵⁹

Even in the absence of a hostile bid, deal protection devices included in friendly merger transactions such as termination fees, force-

the-vote provisions, expense reimbursements and no-shop provisions generally are reviewed under the *Unocal* standard. This is because, as one Delaware Court of Chancery case put it, “[w]hen corporate boards assent to provisions in merger agreements that have the primary purpose of acting as a defensive barrier to other transactions not sought out by the board, some of the policy concerns that animate the *Unocal* standard of review might be implicated.”⁶⁰ Generally, Delaware courts will consider the effect and potentially excessive character of “all deal protections included in a transaction, taken as a whole,” in determining whether the *Unocal* standard has been met.⁶¹

Further, limits on the board’s discretion under the *Unocal* standard are especially relevant where “defensive conduct” impacts the shareholder franchise or a proxy contest. In such situations the *Unocal* standard will often be applied with particular acuity and reference to *Blasius Industries, Inc. v. Atlas Corp.*⁶² In *Blasius*, the directors of the target increased the size of the board so that a proxy insurgent, which was running a short slate, could not have a majority of the board even if all of its candidates won. The Delaware Court of Chancery invalidated the bylaw as impermissible interference with the stockholder franchise. In *Blasius*, the court held that a board must show “compelling justification” for any conduct whose primary purpose is to thwart effective exercise of the franchise. Subsequent decisions have clarified that this “non-deferential” standard is “rarely applied,” and, when it is applied, it should generally be done as part of a *Unocal* analysis.⁶³

In *MM Companies Inc. v. Liquid Audio, Inc.*,⁶⁴ the Delaware Supreme Court applied *Blasius* scrutiny within a *Unocal* framework to a board’s appointment of two new directors immediately prior to a contested election, because such appointments were done for the purpose of frustrating stockholder attempts to gain influence on the board. MM sought to replace the two members of Liquid Audio’s five-person staggered board up for re-election that year. The record reflected that the decision was “taken for the primary purpose of impeding the shareholders’ right to vote effectively in an impending election.”⁶⁵ The Court explained that *Blasius* scrutiny may apply even where defensive actions do “not actually prevent the shareholders from attaining any success in seating one or more nominees in a contested election” and where an “election contest [does] not involve a challenge for outright control of the board.”⁶⁶

However, more recently, Delaware courts have stressed that “the reasoning of *Blasius* is far less powerful when the matter up for consideration has little or no bearing on whether the directors will continue in office.”⁶⁷ Thus, in *Mercier v. Inter-Tel*, the Court of Chancery expressed doubt that *Blasius* review should apply to a board’s decision to

adjourn a stockholder meeting to solicit additional support for a proposed merger transaction, even where the board knew that the transaction would be voted down if the meeting went forward and even in the midst of a proxy fight. But, in any event, the court was satisfied that the board satisfied the “compelling justification” standard, because directors “act for a compelling reason in the corporate context” when they “act for the purpose of preserving what the directors believe in good faith to be a value-maximizing offer.”⁶⁸

b. *Revlon*

Transactions involving a “sale of control” or “change of control” of a corporation (*i.e.*, a merger in which all or a preponderant percentage of the consideration is cash, or in which there will be a controlling shareholder post-merger) will also be subject to enhanced judicial review.⁶⁹ In *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, the Delaware Supreme Court held that in a sale of control context, directors must attempt to achieve the highest value reasonably available for shareholders.⁷⁰

When *Revlon* review is triggered, “[t]he directors’ role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.”⁷¹ Under this conception of *Revlon*, provided a board is choosing between two or more capable bidders presenting transactions that are comparable in terms of timing and likelihood of consummation, it must look solely to price. Specifically, a board comparing two or more cash offers cannot, for example, choose the lower one because it has advantages for “constituencies” other than common shareholders, such as employees, customers, management, and preferred shareholders.

However, it is also true that “there is no single blueprint that a board must follow to fulfill its duties” in the *Revlon* context.⁷² The Delaware Supreme Court has held that “[i]f a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board’s determination.”⁷³ This flexibility is particularly significant in determining a board’s *Revlon* obligations when it is considering a friendly merger for cash but does not wish to engage in pre-signing negotiations with more than one partner. The Court has recently stressed that “[w]hen 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,” the board’s *Revlon* obligations are met.⁷⁴

1. When does *Revlon* apply?

The *Revlon* “duty to seek the best available price applies only when a company embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control.”⁷⁵ The most common example of this is where the board of a non-controlled company decides to enter into a definitive agreement to sell the company in an all-cash deal. But, where the board does not embark on a change-of-control transaction, such as when it is arguably put “in play” by the actions of outsiders,⁷⁶ *Revlon* review will not apply. Accordingly, enhanced scrutiny is not triggered by a board’s refusal to engage in negotiations where an offeror invites discussion of a friendly (or unfriendly) deal.⁷⁷ Nor will *Revlon* apply to a merger transaction in which there is no change of control, such as in a purely stock-for-stock merger between two non-controlled companies. The Delaware Supreme Court held in its seminal 1989 opinion in *Time-Warner* that in stock-for-stock mergers with no sale of control, the ordinary business judgment rule applies to the decision of a board to enter into a merger agreement.⁷⁸ But a stock-for-stock merger is considered to involve a sale of control when there would exist a post-merger controlling shareholder. This was the case in *Paramount Communications, Inc. v. QVC Network Inc.*, where Viacom had a controlling shareholder who would have had voting control of the post-merger combined company.⁷⁹ The reason that pure stock-for-stock mergers between non-controlled entities do not result in a *Revlon*-inducing “change of control,” is that such combinations simply shift “control” of the seller from one dispersed generality of public shareholders to a differently constituted group that still has no controlling shareholder. Accordingly, the future prospect of a potential sale of control at a premium is preserved for the selling company’s shareholders. This principle applies even if the acquired company in an all-stock merger is very small in relation to the buyer. Despite the formal difference between the standards of review applicable to stock-for-stock transactions, the Delaware courts have indicated in recent decisions that the doctrinal distinction is not absolute, and, even in all-stock transactions, directors are well advised to consider means of maximizing stockholder value.

Nor is there a “change of control” in the cash (or stock) sale of a company with a controlling shareholder to a third party.⁸⁰ Where a company already has a controlling shareholder, “control” is not an asset owned by the minority shareholders and, thus, they are not entitled to a control premium. The Court of Chancery has expressly held, therefore, that the sale of controlled companies does not invoke *Revlon* review.⁸¹

Though, as discussed, it is clear that all-cash deals invoke *Revlon* review and all-stock deals do not, the courts are still struggling with

situations in which the consideration is mixed. In *In re Santa Fe Pacific Corp.*, the Delaware Supreme Court held that a transaction in which cash represented 33⅓% of the consideration would not be subjected to *Revlon* review.⁸² However, more recently, the Delaware Court of Chancery ruled that the *Revlon* standard would likely apply to half-cash, half-stock mergers, reasoning that enhanced judicial scrutiny was in order because a significant portion “of the stockholders’ investment [] will be converted to cash and thereby be deprived of its long-run potential.”⁸³

Revlon applies only once the board actually makes the decision to embark on a change of control transaction and not while it is exploring whether or not to do so.⁸⁴ Accordingly, the board may change its mind at any time before making the decision to enter into a transaction. However, once a board makes a decision that attracts the heightened *Revlon* level of scrutiny, courts may look back at the board’s behavior during the exploration process and may be critical of actions taken that appear unreasonable and inconsistent with the board’s duty to maximize stockholder value.⁸⁵ For this reason, it is important for boards and their advisors to keep a good record of their reasons for taking the actions they did.

2. What is maximum value?

Revlon does not require boards to simply accept the highest nominal offer for a company. A board may conclude that even a cash offer, although “higher” in terms of price than another cash offer, is substantially less likely to be consummated; the risk of non-consummation is directly related to value. And the difficulties that may arise in valuing stock and other consideration are discussed in Section IV.B.4; the related board decisions require the exercise of informed judgment. Directors “should analyze the entire situation and evaluate in a disciplined manner the consideration being offered. Where stock or other non-cash consideration is involved, the board should try to quantify its value, if feasible, to achieve an objective comparison of the alternatives.”⁸⁶ In the context of two all-cash bids, under certain circumstances a board may choose to take a bid that is “fully financed, fully investigated and able to close” promptly over a nominally higher, yet more uncertain, competing offer.⁸⁷ Bids that present serious issues concerning regulatory approval or the buyer’s ability to close may be viewed as less attractive, although nominally higher, than offers that are more certain of consummation.

An example of judicial deference to a board’s strategic decisions when conducting a sale of control is *In re Dollar Thrifty Shareholder Litigation*,⁸⁸ where the Delaware Court of Chancery denied a motion to enjoin the completion of Dollar Thrifty’s merger with Hertz, finding that the Dollar Thrifty board had not violated its *Revlon* duties in declining a

higher bid from Avis. From 2007 through 2009, Dollar Thrifty had engaged in unsuccessful negotiations with both Hertz and Avis. Following a turnaround effort led by a new CEO, the Dollar Thrifty board decided to reengage with Hertz, and, after months of bargaining, Dollar Thrifty agreed to be acquired by Hertz for \$41 per share. The merger agreement also included a robust reverse termination fee, a no-shop provision, matching rights, and a provision requiring Hertz to make substantial divestitures if necessary to secure antitrust approval of the merger. Following the announcement of the Hertz deal, Avis made an offer at \$46.50 per share, although its offer lacked the certainty of the merger agreement with Hertz. The Dollar Thrifty board rejected the Avis bid in favor of the deal with Hertz. The Court wrote that “directors are generally free to select the path to value maximization [under *Revlon*], so long as they choose a reasonable route to get there.”⁸⁹ The Court concluded that the board acted reasonably in rejecting the Avis offer in light of the facts that Avis lacked the resources to finance the deal and that a deal with Avis was subject to greater antitrust risk. As the Court noted, “[v]alue is not value if it is not ultimately paid.”⁹⁰ Similarly, the Court of Chancery refused to enjoin a stockholder vote on a proposed merger between Family Dollar Stores, Inc. and Dollar Tree, Inc. when the Family Dollar board turned down a facially higher bid from Dollar General, Inc.⁹¹ The Court held that the independent directors properly complied with their fiduciary duties and were justified in concluding that “a financially superior offer on paper does not equate to a financially superior transaction in the real world if there is a meaningful risk that the transaction will not close for antitrust reasons.”⁹²

3. What sort of sale process is necessary?

Boards have substantial latitude to decide what tactics will result in the best price. As the Delaware Supreme Court recently reaffirmed, “*Revlon* and its progeny do not set out a specific route that a board must follow when fulfilling its fiduciary duties, and an independent board is entitled to use its business judgment to decide to enter into a strategic transaction that promises great benefit, even when it creates certain risks.”⁹³ Directors are not required “to conduct an auction according to some standard formula” nor does *Revlon* “demand that every change of control of a Delaware corporation be preceded by a heated bidding contest.”⁹⁴ Courts have recognized that, in general, disinterested board decisions as to how to manage a sale process are protected by the business judgment rule. In *Mills Acquisition Co. v. Macmillan, Inc.*, the Delaware Supreme Court stated that “[i]n the absence of self-interest . . . , the actions of an independent board of directors in designing and conducting a corporate auction are protected by the business judgment rule.”⁹⁵ The Court continued that “like any other business decision, the board has a

duty in the design and conduct of an auction to act in ‘the best interests of the corporation and its shareholders.’”⁹⁶ A board approving any sale of control must also be fully informed concerning the development of the transaction, alternatives, valuation issues and all material terms of the merger agreement. Thus, even in the change-of-control context reviewed under *Revlon*’s enhanced scrutiny, a board retains a good deal of authority to determine how to obtain the best value reasonably available to shareholders.

In *In re Toys “R” Us, Inc. Shareholder Litigation*, the Delaware Court of Chancery strongly endorsed the principle that well-advised boards have wide latitude in structuring sale processes.⁹⁷ The Court’s noteworthy holdings included, among others: (1) rejection of the plaintiffs’ claims that a 3.75% break-up fee and matching rights unreasonably deterred additional bids; (2) approval of the board’s decision to permit two of the competing private equity firms in the deal to “club” together, which potentially reduced the number of competing bidders in later rounds but was designed to facilitate bidding; (3) the rejection of allegations of a conflict of interest on the part of the CEO arising out of his stock and option holdings; and (4) the rejection of claims that the board’s financial advisor’s advice was tainted by the terms of its engagement letter, which provided for greater fees in the event of a sale of the whole company versus some smaller transaction. The Court’s opinion reaffirmed the principle that courts will not second-guess well-informed, good faith decisions that need to be made to bring a sale process to successful conclusion.

Similarly, in *In re Topps Co. Shareholders Litigation*, the Court endorsed the Topps board’s decision not to conduct a public auction but instead to negotiate, essentially on an exclusive basis, with a particular buying group.⁹⁸ The Court also approved the array of deal protection terms in the Eisner agreement (including matching rights and a 4.3% break-up fee). The Court found that the Topps board was justified in signing the deal at a time when Topps’ chief competitor, Upper Deck, had already communicated its interest in a transaction. However, the Court found that the Topps board had erred in failing to conduct serious negotiations with Upper Deck during the “go-shop” period prescribed under the merger agreement, clarifying that (if *Revlon* duties apply) once a premium price is put on the table by a *bona fide*, financially capable overbidder, the target board must fully engage on both price and non-price terms to determine if a truly “superior” transaction is available. As a result, the Court entered an injunction requiring a waiver of the standstill with Upper Deck during the “go-shop” period to permit Upper Deck to make an “all shares, non-coercive tender offer” at a price no less than its most recent proposal.

In *In re Smurfit-Stone Container Corp. Shareholder Litigation*, the Court rejected plaintiffs' contention that the Smurfit-Stone board had improperly failed to conduct an auction and that the deal protection provisions in the merger agreement with Rock-Tenn Corporation—including a 3.4% termination fee, customary no-shop provisions with a fiduciary out and standard matching rights—were impermissible under Delaware law. The Court noted that a board could forego a pre-signing market check if the merger agreement permitted the emergence of a higher bid after signing, and it upheld the deal protection measures as standard in form. The Court also noted with approval that the Smurfit-Stone board “took firm control of the sales process,” “asserted its control over the negotiations” with multiple bidders and “engaged in real, arm’s-length dealings with potential acquirors.”⁹⁹ Similarly, in *In re Plains Exploration & Production Co. Stockholder Litigation*, the Court of Chancery rejected claims challenging the reasonableness of a board’s single-bidder sales strategy, holding that “there is no bright-line rule that directors must conduct a pre-agreement market check or shop the company.”¹⁰⁰ *Plains* explained that “as long as the Board retained ‘significant flexibility to deal with any later-emerging bidder and ensured that the market would have a healthy period of time to digest the proposed transaction,’ and no other bidder emerged, the Board could be assured that it had obtained the best transaction reasonably attainable.”¹⁰¹ The Court there also upheld the board’s decision to leave day-to-day negotiations to the company’s CEO, even though the CEO was “interested” in the transaction by virtue of future employment with the post-transaction company, in part because this conflict was fully disclosed to the board, and the board believed that the CEO was best-positioned to advance the company’s interest.¹⁰²

The key thread tying these cases together is that compliance with *Revlon* requires the board to make an informed decision about the path to maximizing stockholder value. As one Delaware Supreme Court case explained, “[w]hen the board is considering a single offer and has no reliable grounds upon which to judge its adequacy, [the] concern for fairness demands a canvass of the market to determine if higher bids may be elicited. When, however, the directors possess a body of reliable evidence with which to evaluate the fairness of a transaction, they may approve that transaction without conducting an active survey of the market.”¹⁰³

A case where the board was held to be inadequately informed is *In re Netsmart Technologies, Inc. Shareholders Litigation*, wherein the Court of Chancery temporarily enjoined the acquisition of Netsmart Technologies, Inc. by two private equity funds, in part because the board failed to fully inform itself about all possible bidders in its auction process.¹⁰⁴ While Netsmart’s advisors contacted a number of potential

private equity buyers, the company failed to contact any potential strategic buyers because its management and investment bankers believed that no such buyers would be interested. The Court found a likely fiduciary violation because of this tactical decision, in part because of the concern that “[t]he private equity route was . . . a clearly attractive one for management” due to the likelihood that management would retain control and receive equity in a private equity deal but not in a strategic deal.¹⁰⁵ While the Court refused to permanently enjoin the transaction on this basis, it did require more accurate disclosure of the board’s decision-making process, including its failure to contact potential strategic buyers. The *Netsmart* decision may be unusual, in part because it seemed to be influenced by the fact that the target was a micro-cap company, but it emphasizes the importance of conducting a process that allows the board to be fully informed of all reasonable options.

The Court of Chancery also strongly criticized a board’s sales process even while refusing to enjoin the transaction in *Koehler v. NetSpend Holdings Inc.*¹⁰⁶ There, the Court expressed concern about the board’s decision to forego a market check where the deal price was well below the low end of the share price implied by its bankers’ discounted cash flow analysis and two private equity firms that had previously considered investing in the company had signed standstill agreements that barred them from requesting a waiver (so-called “don’t ask, don’t waive” provisions). Nevertheless, the Court declined to issue an injunction because the risk of scuttling the premium transaction outweighed the potential benefit of putting off the deal in the faint hope of a higher bidder (especially as the two potential private equity bidders did not show any interest once the “don’t ask, don’t waive” provisions were withdrawn).¹⁰⁷ The *NetSpend* decision serves as a reminder that boards engaging in single-bidder sales strategies and deploying contractual features such as “don’t ask, don’t waive” standstills must do so as part of a robust and carefully designed strategy.

The Delaware Supreme Court recently upheld the decision of the Court of Chancery to impose substantial aiding-and-abetting liability on the lead financial advisor of the Rural/Metro ambulance company in that company’s sale to a private equity firm.¹⁰⁸ The sales process was found to be flawed because the company’s lead financial advisor (a) deliberately timed the sales process to coincide with a strategic process involving another ambulance company in order to try to obtain lucrative financing work, (b) attempted to provide stapled financing to whoever bought Rural and (c) presented flawed valuation materials.¹⁰⁹ The advisor did not disclose these conflicts to the board. Indeed, the board was not aware of the financial advisor’s efforts to provide buy-side financing to the buyer, had not received any valuation information until a few hours before the

meeting to approve the deal and did not know that the advisor had manipulated the valuation metrics.¹¹⁰ Applying enhanced scrutiny under *Revlon*, the Court of Chancery found that the directors had acted unreasonably and therefore violated their fiduciary duties. The Court then held that the financial advisor had aided and abetted this fiduciary breach and was liable for almost \$76 million in damages to the shareholders, even though the company that was sold entered bankruptcy shortly afterward.¹¹¹ On appeal, the Supreme Court affirmed and ruled that the presence of a secondary financial advisor did not cure the defects in the lead advisor's work, and that the post-signing market check could not substitute for the board's lack of information about the transaction.¹¹² The Rural/Metro case is further discussed in Section III.C.

The Court of Chancery also preliminarily enjoined the private equity buyout of the Del Monte Foods Company because of an apparent *Revlon* violation by its board of directors, aided and abetted by the buyer.¹¹³ There, the Del Monte board engaged Barclays to oversee a limited, non-public auction of the company. Potential financial bidders all signed confidentiality agreements with "no-teaming" provisions that prevented the bidders from forming clubs. Dissatisfied with the offers it received, the Del Monte board told Barclays "to shut [the] process down and let buyers know the company is not for sale."¹¹⁴ But Barclays, unbeknownst to the board, encouraged several of the bidders to work together, in violation of the "no teaming" provisions, to submit a joint bid. Several private equity buyers, led by KKR, joined together and made a bid. Despite the apparent violation of the "no teaming" provisions, the board asked no questions and decided to engage in one-on-one negotiations with the KKR-led group. Later, having never uncovered Barclays' behind-the-scenes efforts to cobble together a bid, the board also allowed Barclays to participate in buy-side financing. The Court found that the plaintiffs were likely to succeed on their claim that the board had acted unreasonably in the sales process by failing to oversee its advisors and the process and therefore committed a fiduciary breach, and that KKR had likely aided and abetted this conduct. As a remedy, the Court granted an injunction effectively requiring Del Monte to run a go-shop process.¹¹⁵

c. Third-Party Overbids

Announcement of a merger agreement may provoke an unsolicited competing bid by a third party. Since such a third-party bid could represent a threatened change of control, a target's directors' actions with respect to that bid, including any changes to the original merger agreement, will be governed by the enhanced-scrutiny *Unocal* standard. The *Time-Warner* decision makes clear, however, that so long as the initial merger agreement did not itself involve a change-of-control

transaction, the appearance of an unsolicited bid (whether cash or stock) does not in and of itself impose *Revlon* duties on the target board. Rather, the seller in a strategic stock-for-stock deal, as a matter of law, is free to continue to pursue the original proposed merger, assuming it has satisfied the applicable standard. As the Court said, “Directors are not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy.”¹¹⁶ In other words, a *Revlon* situation cannot be unwillingly forced upon a board that has not itself elected to engage in a change-of-control transaction. Absent the circumstances defined in *Revlon* and its progeny, a board is not obligated to choose short-term over long-term value and, likewise, “is not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover.”¹¹⁷ Thus, even if an unsolicited bid provides greater current value and other short-term value than a stock-for-stock merger, the target’s board may attempt to preserve or achieve for its shareholders the business benefits of the original merger transaction so long as the original merger does not itself constitute a change of control. (Of course, if the original transaction requires stockholder approval, the board’s preference may not prevail.)

In these circumstances, actions taken defensively against the potential change-of-control overbid will be evaluated under the *Unocal* standard. The Delaware Supreme Court in *Time-Warner* allowed directors great latitude in determining when a threat to a previously agreed merger exists. The Time board was permitted to act based on: (1) the “concern . . . that Time shareholders might elect to tender into Paramount’s cash offer in ignorance or a mistaken belief of the strategic benefit which a business combination with Warner might produce”; (2) its view of whether the conditions attached to Paramount’s offer introduced “a degree of uncertainty that skewed a comparative analysis”; and (3) the issue of whether the “timing of Paramount’s offer to follow issuance of Time’s proxy notice was . . . arguably designed to upset, if not confuse, the Time stockholders’ vote.”¹¹⁸

Notably, more than one standard of review can apply to directors’ decisions during the same transaction. For example, the approval of a friendly stock-for-stock merger may be governed by the traditional business judgment rule, but modifications of that transaction after the appearance of a third-party hostile bidder may be subject to the *Unocal* standard.¹¹⁹ Similarly, the *Unocal* standard will continue to apply so long as a board’s response to a third-party bid is defensive in an effort to keep the company independent, but once a board pursues an alternative transaction that constitutes a change of control, the board’s decision will generally be subject to *Revlon* scrutiny.

3. Entire Fairness

The “entire fairness” standard is “Delaware’s most onerous standard [of review].”¹²⁰ It imposes the burden of proof upon directors to show the fairness of both the price and process of the transaction they approved. A court will review a board’s actions under the entire fairness standard in the following situations:

- when a majority of the board has an interest in the decision or transaction that differs from the stockholders in general;¹²¹
- when a majority of the board lacks independence from or is dominated by an interested party;¹²² or
- when the transaction at issue is one where the directors or a controlling stockholder “stand[] on both sides” of a transaction.¹²³

There is no bright-line test to determine whether an individual director is conflicted, or a majority of directors are conflicted, for purposes of determining whether the entire fairness standard will be applied. A conflict must be “material” if it is to be considered disabling.¹²⁴ Potential conflicts can take many shapes, including when a director receives certain payments,¹²⁵ has certain family relationships with,¹²⁶ or has certain significant prior business relationships with, a party to the transaction,¹²⁷ and other instances where a director will benefit or suffer a detriment in a manner that is not aligned with the interests of the public stockholders. A key consideration is whether the director can be said to stand on both sides of the transaction in question, or whether he or she has obtained some benefit not ratably shared with public stockholders.

Entire fairness review can be triggered even though a majority of directors are disinterested:

[A] financial interest in a transaction that is material to one or more directors less than a majority of those voting is “significant” for burden shifting purposes . . . when the interested director *controls* or *dominates* the board as a whole or when the interested director *fails to disclose his interest* in the transaction to the board *and* a reasonable board member would have regarded the existence of the material interest as a significant fact in the evaluation of the proposed transaction.¹²⁸

The entire fairness standard is also frequently applied in a “squeeze-out” merger in which a controlling stockholder buys out the public minority stockholders. The entire fairness standard of review may even apply in the context of a transaction ostensibly with an unaffiliated

third party. The cases where this occurs typically involve situations where different groups of stockholders arguably are not treated equally in connection with the transaction. In these controlling stockholder situations, certain procedural protections (*e.g.*, the use of a special committee of disinterested, independent directors; a nonwaivable majority-of-the-minority approval condition) may help avoid entire fairness review or at least shift the burden of disproving entire fairness to the plaintiffs.¹²⁹

Since the 2014 decision in *Kahn v. M&F Worldwide Corp.*, a controlling stockholder has been able to obtain business judgment review treatment if it and the board follow specific guidelines. To qualify for such treatment, the following conditions must be satisfied: “(i) the controller conditions the procession of the transaction on the approval of both a Special Committee and a majority of the minority stockholders; (ii) the Special Committee is independent; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care in negotiating a fair price; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.”¹³⁰ The Court also noted that the proper use of *either* special committee *or* majority-of-the-minority approval alone “would continue to receive burden-shifting within the entire fairness standard of review framework.”¹³¹ In *Swomley v. Schlecht*, the Court of Chancery, in a bench ruling, applied the *M&F Worldwide* standard to dismiss a challenge to a squeeze-out merger involving SynQor led by the company’s managers and employees, who held 46% of the stock.¹³² The Court noted that a plaintiff that wished to plead that a special committee had not satisfied its duty of care would need to show gross negligence or even recklessness, which was a “very tough standard to satisfy.”¹³³ The Supreme Court summarily upheld this decision in a unanimous *en banc* order.¹³⁴

When analyzing a transaction to determine whether it satisfies the entire fairness standard, a Delaware court will consider both process (“fair dealing”) and price (“fair price”) although the inquiry is not a bifurcated one; rather, all aspects of the process and price are considered holistically in evaluating the fairness of the transaction.¹³⁵ As the Delaware Court of Chancery stated in *In re John Q. Hammons Hotels Inc. Shareholder Litigation*:

The concept of entire fairness has two components: fair dealing and fair price. These prongs are not independent, and the Court does not focus on each of them individually. Rather, the Court determines entire fairness based on all aspects of the entire transaction. Fair dealing involves questions of when the transaction was timed, how it was initiated, structured, negotiated,

disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. Fair price involves questions of the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock.¹³⁶

A "fair price" has been described as follows:

A fair price does not mean the highest price financeable or the highest price that fiduciary could afford to pay. At least in the non-self-dealing context, it means a price that is one that a reasonable seller, under all of the circumstances, would regard as within a range of fair value; one that such a seller could reasonably accept.¹³⁷

With respect to process, the Delaware Supreme Court has long encouraged boards to utilize a "special committee" of independent directors when a conflict transaction is proposed. As discussed at greater length below, a special committee attempts to reproduce the dynamics of arm's-length bargaining. To be effective, a special committee generally should: (1) be properly constituted (*i.e.*, consist of independent directors); (2) have an appropriately broad mandate from the full board (*e.g.*, not be limited to simply reviewing an about-to-be-agreed-to transaction); and (3) have its own legal and financial advisors.¹³⁸ As noted above, the use of a well-functioning special committee can shift the burden of proof to the plaintiff. Approval of a take-private merger with a controlling shareholder by a majority of the minority shareholders also shifts the burden, provided the disclosures to the shareholders are deemed sufficient.¹³⁹ The quantum of proof needed under entire fairness is a "preponderance of the evidence," which has led the Delaware Supreme Court to note that the effect of a burden shift is "modest," as it will only prove dispositive in the rare instance where the evidence is entirely in equipoise.¹⁴⁰ Nevertheless, the Supreme Court has also stressed that it views the use of special committees as part of the "best practices that are used to establish a fair dealing process," and thus, in spite of the only "modest" benefit from a burden standpoint, special committees remain important in conflict transactions.¹⁴¹ And, in light of *M&F Worldwide*, a controller's agreement in advance to "voluntarily relinquish[] its control" by conditioning a transaction "upon the approval of both an independent, adequately-empowered Special Committee that fulfills its duty of care, and the uncoerced, informed vote of a majority of the minority stockholders" will result in the achievement of business judgment review rather than entire fairness review.¹⁴²

Decisions of the Delaware courts have repeatedly emphasized the need for the members of a special committee to be independent of the transaction proponent, well informed, advised by competent and independent legal and financial advisors, and vigorous in their negotiations of the proposed transaction.¹⁴³

C. Controlling Stockholders, Conflicts and Special Committees

Conflict transactions (such as those involving controlling stockholders), and the closely related issues of how to structure special committee processes have received a lot of judicial attention in recent years.

1. Controlling Stockholders

Any stockholder controlling a majority of a company's voting power is a controlling stockholder. A minority stockholder will also be considered a controlling stockholder if it exercises "a combination of potent voting power and management control such that the stockholder could be deemed to have effective control of the board without actually owning a majority of stock."¹⁴⁴ For a minority stockholder to be considered a controlling stockholder, a plaintiff must allege well-pled facts showing "actual domination and control" over the board by the minority stockholder.¹⁴⁵

"Control" is a complex and fact-intensive concept under Delaware law, which can make it difficult to predict with confidence whether certain influential stockholders could be deemed to be "controlling stockholders" either generally or with respect to a particular transaction. Although voting power is a critical component in the control analysis for non-majority stockholders, it is not outcome-determinative. Instead, the Court will focus on the stockholder's influence and authority over board action. Thus, in *In re Western National Corp. Shareholders Litigation*, the Court of Chancery held that a 46% stockholder was not a controller as the plaintiffs could not show that the large stockholder took steps to dominate or interfere with the board of directors' oversight of the company.¹⁴⁶ In contrast, the Court denied a motion to dismiss in *Williamson v. Cox Communications, Inc.* where the complaint alleged that a group of stockholders with a combined 17.1% voting power was a control group in light of its board-level appointment and veto power over major corporate actions.¹⁴⁷ In litigation concerning the merger of KKR Financial Holdings with KKR, the Delaware courts put an even greater emphasis on the importance of the board of directors in the control analysis. Plaintiffs alleged that a 1% stockholder who, pursuant to a management agreement, supplied the company with all of its employees and "managed the day-to-day operations of the company" should be deemed a controlling

stockholder. However, the Supreme Court disagreed and affirmed the Court of Chancery's ruling that such a minority stockholder could not be deemed a controlling stockholder unless it could exercise actual control over a majority of the board. The Court held that there was no indication that the directors "could not freely exercise their judgment in determining whether or not to approve and recommend to the stockholders" the transaction at issue, or, put differently, that the managing minority stockholder would be able to take retributive action by removing the directors if they failed to approve the merger.¹⁴⁸

2. Conflicts and Director Independence

Where a corporation engages in a transaction with a controlling stockholder, the use of an independent special committee can affect the judicial scrutiny applied to the ultimate transaction by shifting the burden of proving unfairness to the plaintiff. However, such committees are only effective when their members are disinterested and independent. In determining director independence and disinterestedness, a board should have its directors disclose their compensatory, financial and business relationships, as well as any significant social or personal ties that could be expected to impair their ability to discharge their duties. The Delaware Supreme Court has stressed that all these factors must be considered "in their totality and not in isolation from each other."¹⁴⁹ Paying close attention to which directors are selected to serve on a special committee is important, and care should be taken to vet the true independence of those selected.¹⁵⁰ The use of a special committee will not shift the burden of proving unfairness to the plaintiffs if the directors on the committee are viewed as " beholden " to a controlling stockholder.¹⁵¹ Even if a director does not have a direct personal interest in the matter being reviewed, the director will not be considered qualified if he or she lacks independence from the controlling stockholder or some other person or entity that is interested in the transaction. Certain compensatory relationships can lead to independence concerns. For example, in the 2004 case *In re Emerging Communications, Inc. Shareholders Litigation*, the Court questioned the independence of a member of a special committee because he was a paid consultant of an affiliate of the controlling stockholder.¹⁵² Familial relationships may also be disqualifying. In *Harbor Finance Partners v. Huizenga*, the Court of Chancery held that a director who was the brother-in-law of the CEO and involved in various businesses with the CEO could not impartially consider a demand adverse to the CEO's interests.¹⁵³ And the confluence of business and social relationships may together compromise a director's independence. Thus, in *Delaware County Employees' Retirement Fund v. Sanchez*, the Supreme Court ruled that allegations that a director had "a close friendship of over half a century with the interested party" and that "the director's primary employment . . .

was as an executive of a company over which the interested party had substantial influence” adequately raised a doubt that the director was not independent.¹⁵⁴

Not all relationships between special committee members and management or controlling stockholders will give rise to independence concerns, and Delaware courts have offered broad guidance on this topic. For example, the Delaware Supreme Court has rejected the concept of “structural bias,” *i.e.*, the view that the professional and social relationships that naturally develop among members of a board impede independent decision-making.¹⁵⁵ In *Yucaipa American Alliance Fund II, L.P. v. Riggio*, the Court of Chancery found a director independent despite her having previously served as an executive under the company’s founder and former CEO 10 years prior.¹⁵⁶ Nor is the fact that a stockholder had elected a director a sufficient reason to deem that director lacking independence.¹⁵⁷ The Court of Chancery has also refused to accept a “transitive theory” of conflict, rejecting the argument that a director lacks independence from an alleged controller because the director is allegedly beholden to someone else who, in turn, is allegedly beholden to the controller.¹⁵⁸ In *M&F Worldwide*, the Delaware Supreme Court reinforced that “[a] plaintiff seeking to show that a director was not independent must satisfy a materiality standard” and that neither “the existence of some financial ties between the interested party and the director” nor “allegations that directors are friendly with, travel in the same social circles as, or have past business relationships with the proponent of a transaction” are sufficient to rebut the presumption of independence.¹⁵⁹ Notably, the Supreme Court approved then-Chancellor Strine’s finding that the directors’ satisfaction of the NYSE independence standards was informative, although not dispositive, of their independence under Delaware law.¹⁶⁰

3. The Special Committee’s Procedures and Role

The purpose for which the special committee is created may also be relevant in determining whether its directors are independent. As the Delaware Supreme Court said in *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, “[i]ndependence is a fact-specific determination made in the context of a particular case. The court must make that determination by answering the inquiries: independent from whom and independent for what purpose?”¹⁶¹ For example, special litigation committees are analyzed differently from transactional special committees because, as a defendant in a lawsuit, the board itself is interested in the outcome of the litigation and whether it should be pursued. In *Stewart*, the Delaware Supreme Court explained that a personal friendship or outside business relationship, standing alone, is

insufficient to raise a reasonable doubt about a director's independence in the context of pre-suit demand on the board.¹⁶²

The function of a special committee is to protect stockholder interests in cases where the interests of certain directors (such as directors participating in a management buyout or representing a controlling stockholder) differ significantly from those of the public stockholders by delegating a decision to a group of independent, disinterested directors. The influence (and number) of interested directors on a board may be relevant in determining the desirability of forming a special committee. For example, a board consisting of a majority of independent directors may not be significantly affected by management directors promoting a leveraged buyout. It may be sufficient for interested directors to recuse themselves from any deliberations and votes in connection with a proposed transaction. As the Court of Chancery has explained, "[t]he formation of a special committee can serve as 'powerful evidence of fair dealing,' but it is not necessary every time a board makes a decision."¹⁶³

If directors who have a personal interest conflicting with those of the public stockholders constitute a minority of the board, the disinterested majority can act for the board, with the interested members abstaining from the vote on the proposal. But if a majority of the board is not disinterested, under Delaware law, absent appropriate procedural protections, the merger will be reviewed under the "entire fairness" standard, with the burden of proof in any stockholder litigation placed on the board.¹⁶⁴

The need for a special committee may shift as a transaction evolves. Acquirors that begin as third-party bidders may become affiliated with management directors, or management may organize and propose a management buyout in response to an unsolicited bid from a third party. Throughout a sale process, the board and its advisors must be aware of any conflicts or potential conflicts that arise. Failure to disclose such conflicts may result in substantial difficulties in defending the board's actions in court.¹⁶⁵

Even where a majority of directors are independent, delegation of negotiation or review functions to a special committee may be appropriate or expedient in certain contexts; however, there is no automatic need to create a special committee of directors, or to layer on separate newly retained advisors (legal or financial) in every instance where there may potentially be conflicts.

Delaware courts closely review the conduct of parties in controlling stockholder transactions and have in several cases been skeptical of processes that did not involve the active participation of a

special committee. In 2000, the Delaware Court of Chancery held in *In re Digex, Inc. Shareholders Litigation* that the conflicted directors on a board controlled by a majority stockholder had likely breached their fiduciary duties by agreeing to waive the protections of the Delaware business combination statute in favor of the acquiror of that majority stockholder over the opposition of the independent directors.¹⁶⁶ The same year, in *McMullin v. Beran*,¹⁶⁷ the Delaware Supreme Court reversed a dismissal of a challenge to the directors' conduct where, in connection with the approval of a merger agreement between a controlled subsidiary and a third party, an already established special committee was not empowered to participate in the sale process and the majority stockholder controlled the process and allegedly had interests divergent from those of the public stockholders.¹⁶⁸

In order for use of a special committee to shift the burden of proof to the plaintiff, the special committee must follow proper procedures. For example, in the context of a transaction with a majority stockholder, "the special committee must have real bargaining power that it can exercise with the majority stockholder on an arm's length basis."¹⁶⁹ The special committee should receive independent financial and legal advice, negotiate diligently and without the influence of the controlling stockholder and possess all relevant material information.¹⁷⁰ In *Kahn v. Lynch Communication Systems, Inc.*, the Delaware Supreme Court suggested that even where a special committee obtains independent legal and financial advice and negotiates diligently, the requisite degree of independence may still be lacking if the committee and controlling stockholder fail to establish that the committee has the power to negotiate independently.¹⁷¹

The special committee should have a clear conception of its role, which should include a power to say no to the potential transaction.¹⁷² In the 2011 *Southern Peru* case,¹⁷³ the Delaware Court of Chancery criticized the role of the special committee in reviewing a merger proposal from a controlling stockholder. The Court stated that the special committee's "approach to negotiations was stilted and influenced by its uncertainty about whether it was actually empowered to negotiate" and that the special committee "from inception . . . fell victim to a controlled mindset and allowed [its controlling stockholder] to dictate the terms and structure of the [m]erger."¹⁷⁴ The Delaware Supreme Court affirmed the Court of Chancery's rulings and adopted its reasoning.¹⁷⁵ Indeed, the Delaware Court of Chancery has held, on a motion to dismiss, that, although there is no "*per se* duty to employ a poison pill to block a 46% stockholder from engaging in a creeping takeover," the failure to employ a pill, together with other suspect conduct, can support a claim for breach of the duty of loyalty.¹⁷⁶ A special committee that does not recognize, even in the

context of a takeover bid by a controlling stockholder, that it may refuse to accept the offer might bear the burden of proving the entire fairness of the transaction in court.¹⁷⁷ The ability to say no must include the ability to do so without fear of retaliation. In *Lynch*, the Court was persuaded that the special committee's negotiations were influenced by the controlling stockholder's threat to acquire the company in a hostile takeover at a much lower price if the committee did not endorse the controlling stockholder's offer.

Special committees and their advisors should be proactive in seeking all relevant information (potentially including valuation information and information held by management or the transaction proponent) and in negotiating diligently on behalf of stockholders.¹⁷⁸ The records of the deliberations of a special committee and the full board should reflect careful and informed consideration of the issues.¹⁷⁹

4. Selecting Special Committee Advisors

The best practice is for the special committee itself, rather than management or a controlling stockholder, to choose its own financial and legal advisors. In *Macmillan*, the Delaware Supreme Court was critical of the conduct of an auction to sell the company in which a financial advisor selected by the company's CEO, rather than by the special committee, played a dominant role.¹⁸⁰ In *TCI*,¹⁸¹ Chancellor Chandler found that the special committee's decision to use TCI's legal and financial advisors rather than retaining independent advisors in itself "raise[d] questions regarding the quality and independence of the counsel and advice received." And in 2006 in *Gesoff v. IIC Industries Inc.*,¹⁸² Vice Chancellor Lamb strongly criticized a special committee's use of advisors who were handpicked by the majority stockholder seeking a merger.

Whether the special committee should retain advisors with a previous corporate relationship is a context-specific decision. While having a special committee advised by firms that have close ties to the company may raise independence concerns, it is not in all cases better for the special committee to choose advisors who are unfamiliar with the company or to avoid hiring advisors who have done prior work for the company. In one case, Justice Jacobs (sitting as a Vice Chancellor) criticized a process in which the company's historical advisors were "co-opted" by the majority stockholder, leaving the special committee with independent advisors who did not know the company well and who lacked the information available to the majority stockholder's advisors.¹⁸³

As a practical matter, some companies may have had at least some prior dealings with close to all of the financial or legal advisors who would have the relevant experience and expertise to advise a special

committee on a transaction that is particularly complicated or of a certain size. If the special committee chooses to engage an advisor with such prior dealings, it should carefully document any potential conflict, the reasons the special committee considered it important to engage the advisor, and the measures the special committee took to mitigate any such conflict. Such measures may include negotiating carefully worded confidentiality provisions and structuring the advisor's fee to prevent any misaligned incentives. The committee may also choose to hire a second advisor for a particular role, although it should take care to ensure that the second advisor's presence will successfully mitigate the conflict that has been identified—for example, by ensuring that the new advisor is not merely a “secondary actor,” and by not compensating it on a contingent basis.¹⁸⁴ Interviewing several advisors will also help to show that a special committee was aware of its options and made an informed decision in hiring its advisors, without delegating the decision to management.

5. Transactions Involving Differential Consideration

Transactions that provide different consideration to different stockholders—whether it be different consideration to a controlling stockholder or different consideration for different series or classes of stock—can be subject to entire fairness review as well. For example, in *TCI*, AT&T acquired TCI in an arm's-length all-stock merger in which the holders of TCI's high-vote shares—including TCI's controlling stockholder—received an approximate 10% premium over the consideration received by the low-vote holders.¹⁸⁵ The Court concluded that, although AT&T was a third-party buyer, the transaction would be subject to entire fairness review because a majority of the TCI directors held high-vote shares that received a premium relative to the low-vote shares. And, in *In re Trados Inc. Shareholder Litigation*, the Delaware Court of Chancery held that a common stockholder's allegations were sufficient to rebut the business judgment presumption with respect to a board's decision to approve a merger, where the merger triggered the preferred stockholders' large liquidation preference and allowed them to exit their investment while leaving the common stockholders with nothing, and a majority of the board was designated by preferred stockholders and had other alleged relationships with those preferred stockholders.¹⁸⁶

Even in the absence of director affiliations with a certain class of stock, differential consideration in a merger can give rise to entire fairness review absent certain procedural protections. In *In re John Q. Hammons Hotels Inc. Shareholder Litigation*, the Delaware Court of Chancery held that entire fairness applied to a merger where the controlling stockholder and the minority stockholders received slightly different consideration, noting that they were “in a sense ‘competing’” for portions of the

consideration offered by an unaffiliated third-party buyer, and the procedural protections employed were insufficient to invoke the business judgment rule.¹⁸⁷ As part of its analysis, the Court made clear that, generally, the *Lynch* line of cases does not mandate entire fairness review of a sale of a company where minority stockholders were cashed out but the controlling stockholder received a continuing interest in the surviving company.¹⁸⁸ The Court concluded that all defendants would be protected by the business judgment rule “if the transaction were (1) recommended by a disinterested and independent special committee, and (2) approved by stockholders in a [fully informed and] non-waivable vote of the majority of all the minority stockholders.”¹⁸⁹ The Court went on to rule, however, that for business judgment review to apply, “there [must] be robust procedural protections in place to ensure that the minority stockholders have sufficient bargaining power and the ability to make an informed choice of whether to accept the third party’s offer for their shares.” The protections actually employed in *John Q. Hammons* did not qualify “both because the vote could have been waived by the special committee and because the vote only required approval of a majority of the minority stockholders voting on the matter, rather than a majority of all the minority stockholders.”¹⁹⁰ Nevertheless, in a post-trial opinion, the Court of Chancery found that the transaction was entirely fair.¹⁹¹

In the 2012 *In re Delphi Financial Group Shareholder Litigation*¹⁹² decision, the special committee approved a merger that paid the founder, CEO and controlling stockholder an additional premium for his high-vote shares, even though the company’s charter prohibited holders of such high-vote shares from receiving disparate consideration in any merger. The special committee had formed a special sub-committee to act on its behalf “with respect to any matters related to [the founder] and differential merger consideration.”¹⁹³ Although the special committee attempted to persuade the founder to accept the same price as the low-vote stockholders, the founder “remained obstinate, refusing to back down on his demand for some level of disparate consideration.”¹⁹⁴ The record showed that the special committee members believed that the founder would “jettison” the deal and deprive the low-vote stockholders of the opportunity to realize a “circa-100%” premium on their shares.¹⁹⁵ The special committee therefore approved the differential merger consideration. Applying entire fairness review (on account of the differential merger consideration paid), the Delaware Court of Chancery refused to enjoin the vote on the merger. Vice Chancellor Glasscock reasoned that because of the high premium offered to the low-voting stock, the fact that there were no other potential topping bidders and the fact that damages against the founder were an available remedy, stockholders should “decide for themselves” whether to accept the merger consideration.¹⁹⁶ The Court did, however, conclude that plaintiffs were

likely to demonstrate at trial that the founder violated his fiduciary duties, largely because he had already “sold his right to a control premium” to the low-vote stockholders via the charter (even though stockholders approved an amendment of this provision in connection with the deal).¹⁹⁷

III.

The M&A Deal-Making Process

A. Preliminary Agreements: Confidentiality Agreements and Letters of Intent

Companies considering M&A transactions should be cognizant of certain risks arising from negotiations that take place and agreements that are entered into before the execution of definitive transaction agreements. Preliminary agreements, such as confidentiality agreements and letters of intent, are sometimes seen as routine or relatively inconsequential. Because of this, parties sometimes enter into these agreements without sufficient consideration of their provisions, sometimes without involving counsel at all, only to later find themselves restricted or obligated in ways they had not anticipated. It is important to appreciate that the merger process begins with (or even before) the first discussions and that each step in the process may have significant consequences.

1. Confidentiality Agreements

Often, the first legally binding undertaking in a merger negotiation is the execution of a “confidentiality agreement,” which is sometimes referred to as a “Non-Disclosure Agreement” or “NDA.” It is entirely understandable that a company providing its proprietary or nonpublic information to another company would want to protect its confidentiality; however, this seemingly innocuous document often includes important substantive agreements. For example, a confidentiality agreement will often contain an express “standstill” provision restricting the ability of the party (or parties, if it is mutual) receiving information from taking various actions with respect to the other party, including commencing a takeover bid, buying shares, participating in proxy contests and engaging in other acts considered “unfriendly” to the party providing the information. This standstill agreement will continue for a set period or until a specified “fall-away” event, such as the announcement of a transaction with a third party. Even in the absence of an explicit standstill provision, a confidentiality agreement may give rise to claims that the agreement acts as an implied “standstill” barring unsolicited bids. Such agreements should be carefully reviewed by counsel before execution.

In addition to requiring that information provided be kept confidential, confidentiality agreements typically restrict the use of the information provided for the purpose of evaluating and negotiating a transaction (sometimes a specifically contemplated transaction) between the parties. Until *Martin Marietta Materials, Inc. v. Vulcan Materials*

Co.,¹⁹⁸ Delaware courts had not considered whether a violation of disclosure and use restrictions would be a basis for blocking a takeover bid. The Delaware Court of Chancery's May 2012 decision, which subsequently was affirmed by the Delaware Supreme Court, determined that Martin Marietta breached both the use and disclosure restrictions in two confidentiality agreements. Although then-Chancellor Strine found the wording to be ambiguous (but more consistent with Vulcan's reading), after an exhaustive interpretive analysis of the language of the agreements and parsing of whether a business combination "between" the parties applies to a hostile takeover and proxy contest, he concluded that the parties—especially Martin Marietta—intended the agreement to preclude use of the information exchanged in a hostile transaction. He also held that Martin Marietta had willfully breached its nondisclosure commitments by disclosing details of the parties' confidential negotiations in tender and other materials, without complying with the required procedures under the agreements. Consequently, the Court enjoined Martin Marietta's unsolicited takeover bid for four months, which effectively ended its hostile bid.

More recently, a California court in *Depomed Inc. v. Horizon Pharma, PLC*¹⁹⁹ preliminarily enjoined a hostile bidder on the ground that it misused information in violation of a confidentiality agreement, effectively ending the hostile takeover attempt. Unlike in *Vulcan*, the confidentiality agreement at issue was not even signed directly between acquirer and target. In 2013, Horizon, while pursuing a co-promotion arrangement concerning a particular drug asset owned by Janssen Pharmaceuticals, Inc. ("Janssen"), signed a confidentiality agreement with Janssen containing customary provisions limiting the use of Janssen proprietary information solely to evaluate Horizon's interest in pursuing a business relationship with Janssen. Without signing a new confidentiality agreement, Horizon later participated in an auction process that Janssen ran for the drug asset. Depomed also participated, winning the auction and acquiring the U.S. rights to the drug asset. Two years later, Horizon launched a hostile bid for Depomed, which sued for injunctive relief, asserting that Horizon was improperly using information relating to the drug asset in evaluating and prosecuting its hostile bid. In a ruling applying the plain terms of the agreement, the court rejected arguments that the confidentiality agreement only applied to the earlier co-promotion transaction structure, and concluded that it was likely Depomed had acquired the right to enforce the confidentiality restrictions against Horizon "because a different conclusion would be illogical" as it would mean that Depomed could not protect the confidential information about its asset.²⁰⁰ The court held that Horizon had misused confidential information in formulating its takeover proposal, and Horizon withdrew its bid the following day.

Since *Vulcan*, parties have generally focused more on making clear the extent, if any, to which the confidentiality agreement should be interpreted to prevent a hostile bid. *Depomed* is a further reminder that parties should beware of the serious obligations attendant to confidentiality agreements, especially where the possibility of assigning such agreements can transform the nature of the original obligation and cause unanticipated limitations on future strategic opportunities.

When they are included, standstill provisions are typically worded very tightly to prevent a party that has obtained confidential information about a company from making an unsolicited bid or otherwise taking harmful action against the disclosing party. To prevent evasion of the standstill, these provisions typically specify that the bound party may not even request a waiver lest that result in the disclosing company being put “in play.” Delaware courts have in recent years focused on these provisions, which they call “don’t ask, don’t waive” clauses, to ensure that they do not unduly restrict a board of directors from complying with its *Revlon* duties to maximize shareholder value once a decision is made to sell the company. The courts have recognized, however, that a “don’t ask, don’t waive” provision may sometimes be appropriate. For example when conducting an auction to sell the company, the board may decide to include a “don’t ask, don’t waive” provision to incentivize bidders to put their best foot forward in the auction rather than holding back, knowing they can overbid the auction winner later. These provisions and the developments in Delaware case law on this issue are discussed in Section V.A.2.

Other typical provisions in confidentiality agreements have also had far-reaching consequences for the parties to a potential transaction. For example, a party providing confidential information often insists that the confidentiality agreement contain broad disclaimer and non-reliance language making clear that the providing party has not made any representation or warranty to the receiving party as to the accuracy or completeness of the information provided, and that the providing party will not have any liability to the receiving party arising from the use of the information. Delaware courts have enforced broad disclaimer and non-reliance language that effectively allocates to the potential buyer the risk that information provided by the potential seller may be inaccurate until a definitive transaction agreement is entered into, even in the case of allegations of fraud.

2. Letters of Intent

Another common preliminary agreement is the letter of intent, sometimes referred to as a “memorandum of understanding” or “MOU.” Letters of intent are more common in private transactions than in public

company deals, although it is not uncommon even in public deals for parties to negotiate term sheets, which are similar in that they spell out the most critical terms of a proposed transaction but are typically unsigned. Even when executed by the parties, a letter of intent usually is mostly (but not entirely) a nonbinding agreement to agree.²⁰¹ Letters of intent can identify any deal-breakers early on in negotiations, saving the parties from unfruitful expenditure of time and money. While most provisions included in letters of intent typically are intended to be nonbinding, some provisions are expressly intended to be binding (for example, the grant of an exclusivity period or an expense-reimbursement provision).

Whether to negotiate a letter of intent or proceed straight to definitive documentation is dependent upon the facts in each case. Letters of intent can serve several purposes at the outset of negotiations, including demonstrating both parties' commitment to the possible transaction, allocating responsibility for certain documents, establishing a timeframe for executing definitive agreements, allocating responsibility for expenses, and serving to provide preliminary documentation to third parties requesting it (such as lenders). A letter of intent can also be used to make a Hart-Scott-Rodino antitrust filing so as to commence the requisite waiting period even if it is not binding. On the other hand, letters of intent can take time to negotiate, leading to the possibility of leaks, might impact the dynamics between the parties, and can raise disclosure questions in the case of public companies.

It is essential that the parties are clear as to whether, and to what extent, a letter of intent is intended to be binding and enforceable. The enforceability of a letter of intent typically turns on two questions: "(1) whether the parties intended to be bound by the document; and (2) whether the document contains all the essential terms of an agreement."²⁰² Because they are cursory in nature, letters of intent typically state that the document is meant to be nonbinding in nature and that the parties will only be bound upon execution of definitive agreements. The absence of such language could lead a court to hold the letter of intent enforceable. For example, the Delaware Court of Chancery ruled in a 2009 bench decision on a motion for a temporary restraining order that a jilted bidder had asserted colorable claims that a target had breached the no-shop/exclusivity and confidentiality provisions of a letter of intent, as well as its obligation to negotiate in good faith.²⁰³ In reaching its decision, the Court stated that parties that wish to enter into nonbinding letters of intent can "readily do that by expressly saying that the letter of intent is nonbinding," and that contracts "do not have inherent fiduciary outs"—points that practitioners representing sellers should keep in mind from the outset of a sale process.

In *SIGA Technologies, Inc. v. PharmAthene, Inc.*, SIGA and PharmAthene negotiated a licensing agreement term sheet (the “LATS”) that was unsigned and had a footer on both pages stating “Non-Binding Terms.”²⁰⁴ The LATS was later attached by the parties to a merger agreement and loan agreement, both of which provided that if the merger agreement was terminated, the parties would nevertheless negotiate a licensing agreement in good faith in accordance with the terms of the LATS. After terminating the merger agreement, SIGA claimed that the LATS was nonbinding and attempted to negotiate a licensing agreement with economic terms drastically different from those in the LATS. In 2013, the Delaware Supreme Court affirmed the Court of Chancery’s finding that the parties intended to negotiate a license agreement on economic terms substantially similar to those in the LATS and that SIGA’s failure to so negotiate was in bad faith. The Court ruled that the LATS was not a mere “jumping off point,” but rather the parties had agreed to an enforceable commitment to negotiate in good faith.²⁰⁵ Turning to the remedy, the Court held that, where the parties would have reached an agreement but for the defendant’s bad faith negotiations, the plaintiff may be awarded expectation damages.²⁰⁶ After further proceedings in the Court of Chancery and another appeal, the Delaware Supreme Court held that when a contract is breached, expectation damages can be established as long as the plaintiff can prove the *fact* of damages with reasonable certainty.²⁰⁷

By contrast with *SIGA*, the Delaware Supreme Court held in *Ev3, Inc. v. Lesh* in 2014 that a nonbinding provision of a letter of intent does not become binding simply because the merger agreement contains an integration clause providing that the letter of intent is not superseded.²⁰⁸ The parties in *Ev3* had negotiated a nonbinding letter of intent that included a “Funding Provision” under which the acquiror committed to providing capital to help the target achieve certain development milestones, which were conditions to the payment of the merger consideration. Though the integration clause of the merger agreement provided that the letter of intent was not superseded, the merger agreement also provided that the acquiror could fund and pursue the milestones in its “sole discretion, to be exercised in good faith” and that such provision would override any other provision in the merger agreement to the contrary.²⁰⁹ The Supreme Court held that the nonbinding nature of the Funding Provision and the direct conflict between the Funding Provision and the provision in the merger agreement meant that the selling stockholders were not able to rely on the Funding Provision to argue that the acquiror had failed to perform its contractual duties.²¹⁰

Parties that do not wish to be bound by provisions of a letter of intent should avoid statements or actions that may indicate that a letter of

intent was understood by the parties to be binding. Parties that desire maximum flexibility to not be bound by a letter of intent should also consider expressly disclaiming an obligation to negotiate in good faith and making clear that negotiations may be terminated without liability at any time until a definitive agreement has been entered.

B. Techniques for a Public Sale

A merger transaction may impose special obligations on a board. But every transaction is different, and courts have recognized that a board should have significant latitude in designing and executing a merger process. As the Delaware Supreme Court recently reiterated, there is “no single blueprint” that directors must follow in selling a company.²¹¹ This is true even if *Revlon* applies: directors are not guarantors that the best price has been obtained, and Delaware case law makes clear that “[n]o court can tell directors exactly how to accomplish that goal [of getting the best price in a sale], because they will be facing a unique combination of circumstances, many of which will be outside their control,”²¹² and thus *Revlon* “does not . . . require every board to follow a judicially prescribed checklist of sales activities.”²¹³ Rather, the board has reasonable latitude in determining the method of sale most likely to produce the highest value for the shareholders. As a result, even in a change-of-control setting, a board may determine to enter into a merger agreement after an arm’s-length negotiation with a single bidder, as opposed to putting the company up for auction or conducting a market canvass, if it determines in good faith that a single-bidder strategy is the most desirable. Even after a competitive bidding process has begun, a board may, under proper circumstances, favor one bidder over another “if in good faith and advisedly it believes shareholder interests would be thereby advanced.”²¹⁴

1. Formal Auction

In a “formal” auction, prospective acquirors are asked to make a bid for a company by a fixed deadline, in one or several “rounds” of bidding. A company, usually with the assistance of an investment banker, may prepare a descriptive memorandum, known as a “confidential information memorandum” or an “offering memorandum” (or just a short “teaser” since, in a public company sale, the material information is already public) that is circulated to prospective bidders. Prior to the bidding, a company will typically send a draft contract and related documentation, along with a bid letter setting forth the auction process, to multiple parties. Interested bidders are allowed to engage in due diligence (subject to entering into a confidentiality agreement) and then submit their bids, together with any comments on the draft contract. A formal auction often has more than one round and typically involves simultaneous negotiations with more than one bidder.

A significant advantage of a formal auction is that it can be effective even if there is only one bidder. Absent leaks, a bidder has no way of being certain whether there are other bidders, and this will create an incentive to put forward its best bid. In addition, the seller in a formal auction can negotiate with bidders to try to elicit higher bids. A formal auction may be conducted openly (typically by announcing that the company has hired an investment bank to “explore strategic alternatives”) or conducted without an announcement. Even without an announcement, however, it is difficult to conduct a formal auction without rumors of a sale leaking into the marketplace. Companies may also engage in a limited or “mini-auction,” in which only the most likely bidders are invited to participate. One difficulty in any auction process is that the true “value” of a bid, which must take into account not only the price to be paid but also the likelihood and timing of consummation and the related financing and regulatory approval risks, may be difficult to discern with certainty (and some bidders may propose stock or part-stock deals, which implicate considerations regarding valuation and pricing mechanisms, as further discussed below in Section IV). The optimal sale process to be employed depends on the dynamics of the particular situation and should be developed in close consultation with financial and legal advisors.

2. Market Check

An alternative to the auction technique is a “market check,” whereby the seller gauges other potential buyers’ interest without conducting a formal bidding process. A market check may be preferable to an auction for a number of reasons, including a reduced likelihood of leaks and a shortened negotiating timeframe. A seller may also forgo an auction because it determines that an auction is unlikely to yield other serious bids or because it strategically accedes to an attractive bidder’s refusal to participate in an auction. It is important to note that a seller may appropriately conclude, depending on the circumstances, that it should negotiate only with a single bidder, without reaching out to other potential bidders pre-signing. A market check may occur either before or after the signing of a merger agreement, and may be active or passive.

In a pre-signing market check, a company, usually through its financial advisors, attempts to determine which parties may be interested in acquiring the company at the best price prior to signing an agreement without initiating a formal auction. A pre-signing market check may occur even if not initiated by the company, for example, when there are public rumors that the company is seeking an acquiror or is the subject of an acquisition proposal (*i.e.*, is “in play”).

In a post-signing market check, provisions in the merger agreement provide an opportunity for other bidders to make competing offers after

execution of the agreement.²¹⁵ An advantage of a post-signing market check is that it ensures that the seller may secure the offer put forth by the first bidder while leaving the seller open to considering higher offers. Acquirors, of course, will typically seek to limit the market check and will negotiate for so-called “deal protections” such as a “no-shop” covenant, restricting the seller’s ability to solicit or discuss alternative transactions, and termination or “break-up” fees, in the event that the initial transaction is not consummated due to the emergence of a superior proposal. For a post-signing market check to be effective, potential bidders must be aware of the opportunity to bid, have sufficient information and time to make a bid, and not be unduly deterred by unreasonable break-up fees or deal protections afforded to the first bidder.

Post-signing market checks may either be active, where the seller actively seeks out new bidders—through a so-called “go-shop” provision—or passive, where new bidders must take the first step of declaring their interest after hearing about the transaction (and knowing that the target company would have a “fiduciary out” to consider higher bids), which is sometimes referred to as a “window shop” form of market check.

Go-shop provisions became a popular feature of financial sponsor and management buyouts in the last buyout boom, although they have been used less in the last few years. Go-shop provisions offer buyers (often financial buyers) the benefit of avoiding an auction and the assurance of a break-up fee if a deal is topped (which is usually an acceptable outcome for financial buyers). On the other hand, a go-shop enables a company being sold to a private equity firm to “lock-in” an acceptable transaction without the risks of a public auction, while mitigating the potentially heightened fiduciary concerns that can arise in such deal settings. These provisions allow the target to solicit competing offers for a limited time period (typically 30 to 50 days) after signing an acquisition agreement—permitting the target during that interval to, in the words of then-Vice Chancellor Strine, “shop like Paris Hilton.”²¹⁶ They also often provide for a lower break-up fee if the agreement is terminated to accept a superior proposal received during the go-shop period. For example, the agreed-upon break-up fee in the 2013 buyout of Dell Inc. by Michael Dell and Silver Lake Partners was 60% lower for bids received during the 45-day go-shop period. Similarly, in Lone Star Funds’ 2015 buyout of Home Properties, Inc., the agreed-upon break-up fee was 66% lower for bids received during the 30-day go-shop period. Other recent buyouts that have made use of a go-shop provision include those of EMC Corporation, Solera Holdings, Dole Food Company, BMC Software, Duff & Phelps Corporation, Safeway Inc. and CEC Entertainment, Inc.

Delaware courts have generally found go-shops to be a reasonable, but not mandatory, approach to satisfying *Revlon* duties.²¹⁷

To date, go-shops have not become commonplace in strategic deals (although they have perhaps become somewhat more common in recent years). This is because corporate acquirors have strategic interests in their targets and receiving a break-up fee is usually a suboptimal outcome for them. They understand that the directors of their target must satisfy their fiduciary duties but do not like to affirmatively invite their competitors to consider interloping. There have also been some tailored variations on the go-shop theme, like the “qualified pre-existing bidder” provision that U.S. pork processor Smithfield and Chinese meat processor Shuanghui employed in their 2013 combination. The agreement for that transaction carved out two pre-existing bidders from the no-shop provision and provided for a reduced break-up fee (\$75 million, versus \$175 million in other scenarios) for 30 days following execution of the agreement with respect to deals pursued with these bidders. Along these lines, an alternative approach to the standard go-shop that some strategic deals have taken has been to more broadly couple a no-shop with a lower break-up fee for a specified period of time (for example, the Pfizer/Wyeth deal).

When a go-shop provision is employed to satisfy the board’s fiduciary duty, it is important that there be an active and widespread solicitation. The requisite information must be made available to competing bidders who emerge, even though they may be competitors and the buyer and management may not want to provide sensitive information to them. In rare cases, where the seller’s investment bank may have an incentive to support the transaction with the original buyer because of relationships or because they are providing financing for the transaction (which can raise its own conflict concerns), it may be appropriate to bring in another bank to run the go-shop process.²¹⁸

A board may sell a company through a single-bidder negotiation coupled with a post-signing, passive market check. Although this method is more likely to be closely scrutinized by courts than those previously described, it is permissible so long as the board is informed of the downsides of this approach and has an appropriate basis for concluding that they are outweighed by the benefits, and the transaction provides sufficient opportunity for competing bids to emerge. In the *Fort Howard* case in 1988, which has recently been reaffirmed by the Delaware Supreme Court, Chancellor Allen ruled that the company’s directors had satisfied their fiduciary duties in selling the company by negotiating for an approximately month-and-a-half-long period between the announcement of the transaction and the closing of the tender offer in which new bidders could express their interest.²¹⁹ The Chancellor ruled that the market check

was not “hobbled” by deal protection measures and noted that he was “particularly impressed with the announcement [of the transaction] in the financial press and with the rapid and full-hearted response to the eight inquiries received.”²²⁰ Similarly, in 2011, Vice Chancellor Parsons ruled in *In re Smurfit-Stone* that an active market check was unnecessary because the selling company had been “in play” both during and after its bankruptcy, yet no competing offers were made.²²¹

The Delaware Court of Chancery has provided valuable guidance for sellers considering forgoing an active market check. In *In re Plains*, Vice Chancellor Noble found that the directors were experienced in the industry and had “retained ‘significant flexibility to deal with any later-emerging bidder and ensured that the market would have a healthy period of time to digest the proposed transaction.’”²²² When no competing bids surfaced in the five months after the merger was announced, the Plains board could feel confident it had obtained the highest available price. In contrast with *Plains*, in *Koehler v. NetSpend*, Vice Chancellor Glasscock criticized the NetSpend board’s failure to perform a market check, given the other facts surrounding the merger.²²³ NetSpend’s suitor entered into voting agreements for 40% of the voting stock and bargained for customary deal protections in the merger agreement, including a no-shop, a 3.9% termination fee and matching rights. Most critically, the merger agreement also prohibited the NetSpend board from waiving “don’t ask, don’t waive” standstills that NetSpend had entered into with two private equity firms that had previously expressed an interest in investing in the company, but had not been part of a pre-signing auction or market check. Even though the record showed that the investment bank advising NetSpend’s board had advised that a private equity bidder was unlikely to match the buyer’s offer, Vice Chancellor Glasscock found that, by agreeing to enforce the “don’t ask, don’t waive” standstills, the NetSpend board had “blinded itself” to the two most likely sources of competing bids and, moreover, had done so without fully understanding the import of the standstills.²²⁴ This, combined with reliance on a “weak” fairness opinion and an anticipated short period before consummation, led Vice Chancellor Glasscock to conclude that the sales process was unreasonable.²²⁵ *Plains* and *NetSpend* reinforce that the terms of a merger agreement and its surrounding circumstances will be viewed collectively, and, in the *Revlon* context, the sales process must be reasonably designed to obtain the highest price.

C. Investment Bankers and Fairness Opinions

The board, in exercising its business judgment as to the appropriate form and valuation of transaction consideration, may rely on experts, including counsel and investment bankers in reaching an informed view.

In merger transactions, an investment banker's unbiased view of the fairness of the consideration to be paid and the related analyses provide a board with significant information with which to evaluate a proposed transaction. Since Delaware's 1985 *Smith v. Van Gorkom* decision, it has been common in a merger transaction involving a public company for a fairness opinion to be rendered to the board of the seller (and, sometimes, to the buyer). In Delaware, Section 141(e) of the DGCL provides protection from personal liability to directors who rely on appropriately qualified advisors. A board is entitled to rely on the expert advice of the company's legal and financial advisors "who are selected with reasonable care and are reasonably believed to be acting within the scope of their expertise," as well as on the advice and analyses of management.²²⁶ The analyses and opinions presented to a board, combined with presentations by management and the board's own long-term strategic reviews, provide the key foundation for the exercise of the directors' business judgment.²²⁷ Courts reviewing the actions of boards have commented favorably on the use by boards of investment bankers in evaluating merger and other transaction proposals (although generally receipt of a fairness opinion by independent investment bankers is not required as a matter of law).²²⁸

Particularly in situations where directors are choosing among competing common stock (or other non-cash) business combinations, a board's decision-making may be susceptible to claims of bias, faulty judgment and inadequate investigation of the relative values of competing offers. Because the stock valuation process inherently involves greater exercise of judgment by a board than that required in an all-cash deal, consideration of the informed analyses of financial advisors is helpful in establishing the fulfillment of the applicable legal duties.

In a stock-for-stock fixed exchange ratio merger, the fairness of the consideration often turns on the relative contributions of each party to the combined company in terms of revenues, earnings and assets, not the absolute dollar value of the stock being received by one party's shareholders based on its trading price at a particular point in time. Parties to a stock-for-stock merger customarily opt to sign a merger agreement based on the fairness of the exchange ratio at the time of signing, without a bring-down. This structure enhances the probability of consummating the merger by not giving either party a right to walk away if the fairness opinion would otherwise have changed between signing and closing.

Great care should be exercised by investment bankers in preparing the analyses that support their opinions and in the presentation of such analyses to management and the board. The wording of the fairness opinion and the related proxy statement disclosures must be carefully

drafted to accurately reflect the nature of the analyses underlying the opinion and the assumptions and qualifications upon which it is based.²²⁹

Courts and the SEC will scrutinize perceived conflicts of interest by the investment bank giving the fairness opinion. Since 2007, FINRA's rules require specific disclosures and procedures addressing conflicts of interest when member firms provide fairness opinions in change-of-control transactions.²³⁰ FINRA requires disclosure in the fairness opinion as to, among other things, whether or not the fairness opinion was approved or issued by a fairness committee, whether or not the fairness opinion expresses an opinion regarding the fairness of the amount or nature of the compensation to be received in such transaction by the company's officers, directors, employees or class of such persons, relative to the compensation to be received in such transaction by the shareholders, and disclosure of whether the compensation that the member firm will receive is contingent upon the successful completion of the transaction, for rendering the fairness opinion and/or serving as an advisor, as well as whether any other "significant" payment or consideration is contingent upon the completion of the transaction, and any material relationships that existed during the past two years or that are mutually understood to be contemplated in which any compensation was received or is intended to be received as a result of the relationship between the member and any party to the transaction that is the subject of the fairness opinion.²³¹

The SEC Staff also requires, in transactions subject to the proxy rules, detailed disclosure of the procedures followed by an investment banker in preparing a fairness opinion, including a summary of the financial analyses underlying the banker's opinion and a description of any constraints placed on those analyses by the board. Detailed disclosure about previous relationships between the investment banker and the parties to the transaction is also required.

The courts have also had a voice in deciding what constitutes a conflict of interest on the part of financial advisors to a transaction. For example, although FINRA does not ban the practice of contingent fee arrangements for financial advisors, in some circumstances, certain contingent fee arrangements will cause Delaware courts to find triable issues of bias. In *TCI*, the Court held that the fact that the fairness opinion rendered by a special committee's financial advisor was given pursuant to a contingent fee arrangement—\$40 million of the financial advisor's fee was contingent on the completion of the transaction—created "a serious issue of material fact, as to whether [that advisor] could provide independent advice to the Special Committee."²³² Although certain contingent fee arrangements in specific factual contexts have been questioned by the Delaware Court of Chancery, contingent fee

arrangements “ha[ve] been recognized as proper by [the] courts,”²³³ as *Toys “R” Us* acknowledged.

Disclosure of contingent fees may also be required.²³⁴ For example, in *Crawford*,²³⁵ the bulk of the investment bankers’ compensation was contingent on either the completion of the Caremark/CVS transaction or on the completion of an alternate transaction *after* the announcement of the CVS deal. Because this fee would only be payable if Caremark announced the CVS deal (which would be unlikely unless the investment bankers provided a fairness opinion in favor of that transaction), the Court found that the particulars of the fee arrangement had to be disclosed so that shareholders could consider the bankers’ potential conflict of interest in recommending the deal. Similarly, in *In re Atheros Communications, Inc.*, the Court held that where 98% of the financial advisor’s fee was contingent on the closing of the transaction which, as a “practical matter,” the financial advisor would receive only if it rendered a fairness opinion in favor of the transaction, the portion of the fee that was contingent had to be disclosed to shareholders.²³⁶

In an important decision concerning the role played by outside financial advisors in the board’s decision-making process, the Delaware Court of Chancery held in 2011 that a financial advisor was so conflicted that the board’s failure to actively oversee the financial advisor’s conflict gave rise to a likelihood of a breach of fiduciary duty by the board. In *In re Del Monte Foods Co. Shareholders Litigation*,²³⁷ the Court found that after the Del Monte board had called off a process of exploring a potential sale, its investment bankers continued to meet with several of the bidders—without the approval or knowledge of Del Monte—ultimately yielding a new joint bid from two buyout firms. While still representing the board and before the parties had reached agreement on price, Del Monte’s bankers sought and received permission to provide financing to the bidders. The financial advisor was then tasked with running Del Monte’s go-shop process, even though the financial advisor stood to earn a substantial fee from financing the pending acquisition. The Court stated that, although “the blame for what took place appears at this preliminary stage to lie with [the bankers], the buck stops with the Board,” because “Delaware law requires that a board take an active and direct role in the sale process.”²³⁸ The Court also faulted the board for agreeing to allow the competing bidders to work together and the bankers to provide buy-side financing without “making any effort to obtain a benefit for Del Monte and its stockholders.”²³⁹ The case ultimately settled for \$89 million, with the investment bank bearing roughly a quarter of the cost.

In 2014, in *In re Rural Metro Corporation Stockholders Litigation*,²⁴⁰ the Delaware Court of Chancery found that Royal Bank of

Canada aided and abetted fiduciary duty violations of the board of directors of Rural/Metro Corporation in its sale of the company to a private equity firm. The Court noted that, although RBC did tell the board upfront it was interested in providing staple financing, RBC never disclosed to the Rural board of directors that it was lobbying the private equity firm to participate in buy-side financing, even as the board sent RBC to negotiate against the private equity firm on behalf of the company. RBC was found to have failed to disclose certain critical information to the board “to further its own opportunity to close a deal, get paid its contingent fee, and receive additional and far greater fees for buy-side financing work.”²⁴¹ The Court concluded that “RBC knowingly participated in the Board’s breach of its duty of care by creating the informational vacuum that misled the Board,” in part by revising its valuation of Rural downward so as to make it appear that the private equity firm’s offer was fair to and in the best interests of Rural’s shareholders.²⁴²

In 2015, the Delaware Supreme Court affirmed the Court of Chancery’s ruling in *Rural Metro*, but emphasized its narrow nature and provided clarification on the practical steps boards and their financial advisors can take to manage potential conflicts.²⁴³ The Court refused to adopt the Chancery Court’s *dictum* describing the financial advisors role as a “gatekeeper,” stating that its holding was “a narrow one that should not be read expansively to suggest that any failure on the part of a financial advisor to prevent directors from breaching their duty of care gives rise to a claim for aiding and abetting a breach of the duty of care.”²⁴⁴ The Court accepted the practical reality that banks may be conflicted, but put the onus on directors to “be especially diligent in overseeing the conflicted advisor’s role in the sale process” and explained that “because 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.”²⁴⁵

Del Monte and *Rural Metro* are examples of cases where, based on the records before them, the courts found serious improper behavior by the investment banks. Such cases are rare and, moreover, the Court of Chancery has also ruled that a fully informed stockholder vote may effectively insulate a financial advisor from aiding and abetting liability, just as it may insulate directors.²⁴⁶ It is nonetheless important that banks and boards take a proactive role in encouraging the disclosure and management of conflicts. Banks should faithfully represent their clients and disclose fully any actual or potential conflicts of which they are aware so that such conflicts can be managed appropriately.²⁴⁷ Though boards cannot know and do not have a responsibility to identify every conflict their financial advisors may have, they should seek to ensure that these

conflicts are brought to light as they arise throughout the transaction process, and to appropriately manage any such conflicts.

Transactions involving a target with different classes of stock that receive differential consideration present special issues regarding fairness opinions. In the *TCI* decision, the special committee's financial advisor rendered an opinion concluding that the consideration to be received by holders of low-vote shares was fair and, separately, that the same was true as to holders of high-vote shares. But the Court indicated that the financial advisor should also have opined that the premium to be received by the holders of the high-vote shares was fair to the low-vote holders—a so-called “relative fairness” opinion.²⁴⁸ However, it may be difficult in practice to render a “relative fairness” opinion, and major investment banks, in contrast to certain boutique banks, historically have resisted giving such opinions, a trend that generally has continued with few exceptions even in the 10 years since *TCI*.

D. Use and Disclosure of Financial Projections

Financial projections are often prepared by the management of the target company (or both companies in a stock-for-stock deal) and can play a critical role in the decision-making process of both the acquiror and target boards with respect to the amount and nature of consideration. These projections may also serve as the foundation for certain analyses supporting a fairness opinion given by a financial advisor. Despite their usefulness, the creation of and reliance on financial projections may trigger certain disclosure obligations under both Delaware law and SEC rules. Failing to understand and follow the disclosure requirements may result in costly shareholder litigation claiming that the company's disclosure to shareholders was inadequate and misleading, which could lead to delay in completing a transaction.

As it did in the *Netsmart* decision, the Delaware Court of Chancery often requires disclosure of management projections underlying the analyses supporting a fairness opinion.²⁴⁹ Courts have also indicated that partial or selective disclosure of certain projections can be problematic.

Not all projections will be deemed sufficiently material or reliable as to require proxy disclosure. Nor is the mere receipt or review of certain projections by parties or advisors to a transaction enough to require disclosure.²⁵⁰ For one thing, the development of financial projections is an iterative process, which often involves deliberation between the board (or special committee), the financial advisors and management as to which assumptions are reasonable. Additionally, financial projections often contemplate a base case, an upside case and a downside case, not all of which are necessarily material and required to be disclosed.²⁵¹ As

explained in *In re Micromet, Inc. S'holders Litig.*, “Delaware law does not require disclosure of inherently unreliable or speculative information which would tend to confuse stockholders or inundate them with an overload of information.”²⁵²

In *In re BEA Systems, Inc. Shareholders Litigation*, the plaintiffs argued that certain financial data considered by BEA’s financial advisor had been presented to the board and thus had to be disclosed.²⁵³ The Delaware Court of Chancery found that neither the financial advisor nor the board considered the contested data reliable or actually relied upon that data in forming their views on valuation and that the information did not have to be disclosed, noting that disclosure of such unreliable information “could well mislead shareholders rather than inform them.”²⁵⁴ The *BEA* case indicates that Delaware courts have not imposed *per se* disclosure standards for financial projections or other aspects of a financial advisor’s work; case-specific materiality is the touchstone for disclosure.

The SEC also imposes its own disclosure requirements. For example, the SEC typically requires disclosure of a target company’s projections that were provided to the acquiror or its financial advisors, or the target’s own financial advisors for purposes of giving a fairness opinion. While the SEC is receptive to arguments that certain projections are out of date or immaterial, it is normally the company’s burden to persuade the SEC that projections that were provided to certain parties should not be disclosed. In light of the timing pressure facing many transactions, where even a few weeks’ delay may add unwanted execution risk, companies may prophylactically disclose projections that they would have otherwise kept private. Such prophylactic efforts help accelerate the SEC review process and also help to minimize the likelihood that a successful shareholder lawsuit will enjoin a transaction pending further disclosure found to be required by a court. Nevertheless, a company must take heed not to include so many figures in its disclosure so as to be confusing or misleading to shareholders. Companies should consult with their legal and financial advisors well in advance of a filing to ensure that they are well informed of how to strike the delicate balance between under- and over-disclosure of projections.

Delaware law and the views of the SEC Staff on how much disclosure to require (both of target projections and, in the case of transactions involving stock consideration, buyer projections) continue to develop, however, and parties should consider at the outset of their negotiations the possibility that such disclosure may be required in the future.

IV.

Structural Considerations

A. Choosing a Transaction Form

The legal form of an M&A transaction is a critical initial structuring consideration. The legal structure may have important consequences for the deal, including the tax treatment of the transaction, the speed at which the transaction will be completed, and the standard of review the transaction will receive in litigation. Parties to a transaction should be mindful of the consequences of the transaction structure they select.

1. Federal Income Tax Considerations

As a result of both an acquiror's need to conserve cash and the desire of shareholders of the target to have the opportunity for tax deferral (and/or to participate in future value creation by the combined company), the consideration paid by the acquiror in many mergers includes acquiror stock that is intended to be received on a tax-free basis by the target shareholders. For tax-free treatment to apply, a number of requirements must be met, as described below. The requirements vary depending on the form of the transaction. For all forms of transaction (other than the so-called "double-dummy" structure) a specified minimum portion of the consideration must consist of acquiror stock.

a. Direct Merger

In this structure, the target merges with and into the acquiror. It is also possible for the target to merge into a wholly owned limited liability company that is a direct subsidiary of the acquiror. This will generally be nontaxable to the target, the acquiror and the target's shareholders who receive only stock of the surviving corporation (excluding "nonqualified preferred stock" as described below), provided that acquiror stock constitutes at least 40% of the total consideration. For these purposes, stock includes voting and non-voting stock, both common and preferred. Target shareholders will be taxed on the receipt of any cash or "other property" in an amount equal to the lesser of (1) the amount of cash or other property received and (2) the amount of gain realized in the exchange, *i.e.*, the excess of the total value of the consideration received over the shareholder's adjusted tax basis in the target stock surrendered. For this purpose, "other property" includes nonqualified preferred stock. Nonqualified preferred stock includes any class of preferred stock that does not participate in corporate growth to any significant extent and:

(1) is puttable by the holder within 20 years, (2) is subject to mandatory redemption within 20 years, (3) is callable by the issuer within 20 years and, at issuance, is more likely than not to be called or (4) pays a variable rate dividend. However, if acquiror nonqualified preferred stock is received in exchange for target nonqualified preferred stock, such nonqualified preferred stock is not treated as “other property.” Any gain recognized generally will be capital gain, although it can, under certain circumstances, be taxed as dividend income.

Historically, the requirement that acquiror stock constitute at least 40% of the total consideration was, in all cases, determined by reference to the fair market value of the acquiror stock issued in the merger (*i.e.*, on the closing date). Treasury regulations issued in 2011 permit the parties, in circumstances where the consideration is “fixed,” to determine whether this requirement is met by reference to the fair market value of the acquiror stock at signing rather than at closing, adding flexibility and certainty on an issue essential to achieving tax-free treatment. The regulations also clarify that this signing date rule is available in certain variable consideration transactions with collars.

b. Forward Triangular Merger

In this structure, the target merges with and into an at least 80% owned (usually wholly owned) direct subsidiary of the acquiror, with the merger subsidiary as the surviving corporation. The requirements for tax-free treatment and the taxation of non-stock consideration (including nonqualified preferred stock) are the same as with a direct merger. However, in order for this transaction to be tax-free, there are two additional requirements. First, no stock of the merger subsidiary can be issued in the transaction. Thus, target preferred stock may not be assumed in the merger but must be reissued at the acquiror level or redeemed prior to the merger. Second, the merger subsidiary must acquire “substantially all” of the assets of the target, which generally means at least 90% of net assets and 70% of gross assets. This requirement must be taken into account when considering distributions, redemptions or spin-offs before or after a merger.

c. Reverse Triangular Merger

In this structure, a merger subsidiary formed by the acquiror merges with and into the target, with the target as the surviving corporation. In order for this transaction to be tax-free, the acquiror must acquire, in the transaction, at least 80% of all of the target’s voting stock and 80% of every other class of target stock in exchange for acquiror voting stock. Thus, target non-voting preferred stock must either be given a vote at the target level and left outstanding at that level, exchanged for

acquiror voting stock or redeemed prior to the merger. In addition, the target must retain “substantially all” of its assets after the merger.

d. Section 351 “Double-Dummy” Transaction

An alternative structure is for both the acquiror and the target to be acquired by a new holding company in a transaction intended to qualify as a tax-free exchange under Section 351 of the Internal Revenue Code. As a corporate matter, this would be achieved by the holding company creating two subsidiaries, one of which would merge with and into the acquiror and the other would merge with and into the target in two simultaneous reverse triangular mergers. In addition to each merger potentially qualifying as a tax-free reverse triangular merger, shareholders of the acquiror and the target would receive tax-free treatment under Section 351 to the extent that they received holding-company stock, which may be common or preferred (other than nonqualified preferred stock), voting or non-voting, provided that the shareholders of the acquiror and the target, in the aggregate, own at least 80% of the voting stock and 80% of each other class of stock (if any) of the holding company immediately after the transaction. Unlike the other transaction forms discussed above, there is no limit on the amount of cash that may be used in this transaction as long as the 80% aggregate ownership test is satisfied. Cash and nonqualified preferred stock received will be taxable up to the amount of gain realized in the transaction.

e. Multi-Step Transaction

A multi-step transaction may also qualify as wholly or partially tax-free. Often, an acquiror will launch an exchange offer or tender offer for target stock to be followed by a merger that forces out target shareholders who do not tender into the offer. Because the purchases under the tender offer or exchange offer and the merger are part of an overall plan to make an integrated acquisition, tax law generally views them as one overall transaction. Accordingly, such multi-step transactions can qualify for tax-free treatment if the rules described above are satisfied. For example, an exchange offer in which a subsidiary of the acquiror acquires target stock for acquiror voting stock followed by a merger of the subsidiary into the target may qualify for tax-free treatment under the “reverse triangular merger” rules described above. These multi-step transactions provide an opportunity to get consideration to target shareholders more quickly than would occur in single-step transactions, while also providing tax-free treatment to target shareholders on their receipt of acquiror stock.

f. Spin-Offs Combined with M&A Transactions

A tax-free spin-off or split-off that satisfies the requirements of Section 355 of the Internal Revenue Code can be used in combination with a concurrent M&A transaction, although there are limitations on the type of transactions that could be accomplished in a tax-free manner as described in more detail below. For example, “Morris Trusts” and “Reverse Morris Trusts” transactions effectively allow a parent corporation to separate a business and combine it with a third party in a transaction that is tax-free to parent and its shareholders if certain requirements are met. In a traditional Morris Trust transaction, all of the parent’s assets other than those that will be acquired by the third party are spun off or split off into a new company and then the parent immediately merges with the acquiror in a transaction that is tax-free to parent stockholders (*i.e.*, involving solely stock consideration). By contrast, in a Reverse Morris Trust transaction, all assets to be acquired by the third party are spun off or split off into a new company and then the new company immediately merges with the acquiror in a transaction that is tax-free to parent stockholders.

In order to qualify as tax-free to parent, the Morris Trust and Reverse Morris Trust structures generally require, among other things, that the merger partner be smaller (*i.e.*, that the shareholders of parent own more than 50% of the stock of the combined entity). Recent examples of Reverse Morris Trust transactions include the announced spin-off of Lockheed Martin’s Information Systems & Global Solutions business and merger of such businesses with Leidos Holdings, the acquisition by Olin Corporation of the chlor-alkali and downstream derivatives businesses that was split off by The Dow Chemical Company, and PPG Industries’ 2013 split-off of its commodity chemicals business and merger of such business with Georgia Gulf (since renamed Axiall Corporation).

A tax-free spin-off also can be combined with a significant investment transaction in a so-called “sponsored spin-off.” In this type of transaction, the parent distributes the shares of the subsidiary in a tax-free spin-off that is immediately followed by the acquisition by a sponsor of less than 50% of either the parent or the company being spun off. The sponsor’s investment allows the parent to raise proceeds in connection with the spin-off without having to first go through an IPO process, and can help demonstrate the value of the target business to the market. Sponsored spin-offs raise a number of complexities, including as to valuation, capital structure and governance.

Certain requirements for tax-free treatment under Section 355 of the Internal Revenue Code are intended to avoid providing preferential tax treatment to transactions that resemble corporate-level sales. Under

current law, a spin-off coupled with a tax-free or taxable acquisition will cause the parent to be taxed on any corporate-level gain in the spun-off company's stock if, as part of a plan (or series of related transactions) that includes the spin-off, one or more persons acquire a 50% or greater interest in the parent or the spin-off company.

Acquisitions occurring either within the two years before or within the two years after the spin-off are presumed to be part of such a plan or series of related transactions. Treasury regulations include facts and circumstances tests and safe harbors for determining whether an acquisition and spin-off are part of a plan or series of related transactions. Generally, where there have been no "substantial negotiations" with respect to the acquisition of the parent or the spin-off company or a "similar acquisition" within two years prior to the spin-off, a post-spin acquisition of the parent or the spin-off company solely for acquiror stock will not jeopardize the tax-free nature of the spin-off.

As described above, post-spin equity transactions that are part of a plan remain viable where the historic shareholders of the parent retain a greater-than-50% interest (by vote and value) in the parent and the spin-off company after the merger transaction. Where the merger partner is larger than the parent or spin-off company to be acquired, it may be possible to have the merger partner redeem shares or pay an extraordinary distribution to shrink its capitalization prior to the merger transaction.

Additional rules apply when the post-spin-off transaction is taxable to the former parent shareholders (*e.g.*, acquisitions involving cash or other taxable consideration). Because post-spin transactions can cause a spin-off to become taxable to the parent corporation (and, in the case of a taxable acquisition, its shareholders), it is customary for the tax matters agreement entered into in connection with a spin-off to impose restrictions with respect to such transactions and to allocate any tax liability resulting from the spin-off to the corporation the acquisition of whose stock after the spin-off triggered the tax.

2. Tender Offers

A tender offer involves the acquiror making a direct offer to the target's public shareholders to acquire their shares, commonly conditioned on the acquiror holding at least a majority of each class of target stock upon the close of the tender offer. Usually, following the tender offer, the acquiror and the target merge pursuant to a previously signed merger agreement, ensuring the completion of the transaction. In cases where, upon consummation of the offer, the acquiror holds at least the statutorily prescribed percentage (usually 90%, or 50% in the case of a transaction effected pursuant to Section 251(h) of the DGCL, as discussed below) of

each class of target stock entitled to vote on the merger, the acquiror can complete the acquisition by a short-form merger,²⁵⁵ thereby avoiding the need to solicit proxies or hold a shareholders' meeting. In order to overcome shortfalls in reaching the short-form merger threshold in non-DGCL 251(h) transactions, the market has relied upon workarounds that have become commonplace features of merger agreements contemplating such tender offers. Namely, the merger agreement may provide for a "subsequent offering period" during which the acquiror may purchase additional tendered shares following the close of the initial tender period and for a "top-up option" (discussed further below), which permits the acquiror to purchase newly issued shares directly from the target in order to reach the requisite threshold. As discussed further below, to hedge against the risk of delays from not acquiring sufficient shares for a short-form merger in a non-DGCL 251(h) transaction even with the aforementioned features, or from an extended regulatory approval process, acquirors in recent years occasionally have pursued a "dual-track" process (or "Burger King" structure after a 2010 namesake buyout) by beginning the process for a one-step merger in conjunction with that of a two-step tender offer followed by a merger.

Section 251(h) of the DGCL, effective August 1, 2013 and amended as of August 1, 2014, has had a significant impact on the use of tender offers. As described below, Section 251(h) permits, in certain cases, a merger agreement to eliminate the need for a stockholder meeting to approve a second-step merger following a tender offer, so long as the buyer owns sufficient stock following the tender offer to approve the merger. Where applicable, Section 251(h) diminishes the need for a top-up option, or for a dual-track approach where the threshold for exercising the top-up option exceeds the threshold for a short-form merger. The provision also adds speed and certainty to some acquisitions by allowing them to close upon completion of the tender offer without having to wait for a shareholder vote, the result of which—because the acquiror already holds sufficient shares to approve the merger—is a foregone conclusion.

a. Advantages of the Tender Offer Structure

1. Speed

Amendments to the tender offer rules effective in 2000 reduced the timing disparity between all-cash tender offers and tender offers with consideration including securities (or "exchange offers") by allowing the 20-business-day time period for certain exchange offers to begin as early as upon filing of a registration statement, rather than upon effectiveness of the registration statement. The SEC typically will endeavor to work with an offeror to clear a registration statement in time for the exchange offer to

be completed within 20 business days, although this outcome is not assured.

A two-step structure involving a tender offer is not always preferable to or faster than a one-step merger; the decision of which structure to employ must be made in light of the particular circumstances of the transaction. For example, in a transaction that involves a lengthy regulatory approval process, the tender offer would have to remain open until the regulatory approval was obtained, and if the tender offer did not result in the acquiror holding sufficient shares to effect a short-form merger, additional time would be needed to effect the back-end merger. On the other hand, structuring such an acquisition as a one-step merger would permit the parties to obtain shareholder approval during the pendency of the regulatory process, and then close the transaction promptly after obtaining regulatory approval. An acquiror may prefer a merger in this circumstance, as fiduciary-out provisions in a merger agreement typically terminate upon shareholder approval, while a tender offer remains subject to interloper risk so long as it remains open. In addition, if there is a possibility of a time gap between closing of the tender offer and closing of the second-step merger, the tender offer structure poses financing-related complications—albeit not insuperable ones—because financing for the tender offer will be needed at the time of its closing, before the acquiror has access to the target’s balance sheet; the Federal Reserve Board’s margin rules restrict borrowings secured by public company stock to 50% of its market value.

2. Dissident Shareholders

In addition to speed, another potential advantage of the tender offer structure is its relative favorability in dealing with dissident shareholder attempts to “hold up” friendly merger transactions. The tender offer structure may be advantageous in overcoming hold-up obstacles because:

- (1) tender offers do not suffer from the so-called “dead-vote” problem that arises in contested merger transactions when the holders of a substantial number of shares sell after the record date and then either do not vote or change an outdated vote;
- (2) ISS and other proxy advisory services only occasionally make recommendations or other commentary with respect to tender offers because there is no specific voting or proxy decision, making it more likely for shareholders to vote based on their economic interests rather than on ISS’s views (that may reflect non-price factors); and
- (3) recent experience indicates that dissident shareholders may be less likely to try to “game” a tender offer than a merger vote,

and therefore the risk of a “no” vote (*i.e.*, a less-than-50% tender) may be lower than for a traditional voted-upon merger.

3. Standard of Review

As discussed in Section II.C.1, transactions with a controlling shareholder are typically subject to entire fairness review. However starting in 2001, several decisions by the Delaware courts offered a method for a parent company to acquire the outstanding minority shares in a controlled subsidiary without having to satisfy the entire fairness standard. This method involves a tender offer for the minority shares, followed by a short-form merger if the parent bidder is able to obtain ownership above 90% of the target in the tender offer. In 2001, in *In re Siliconix*, the Delaware Court of Chancery ruled that a parent company has no obligation to offer a fair price in a tender or exchange offer for the minority shares, unless a minority shareholder can show actual coercion or disclosure violations, because a tender offer is a voluntary transaction.²⁵⁶ The same year, in *Glassman v. Unocal Exploration Corp.*, the Delaware Supreme Court held that the parent company does not have to establish entire fairness in a short-form merger, and, absent fraud or illegality, the “only recourse” for a minority shareholder dissatisfied with the merger is an appraisal.²⁵⁷

In 2010, Vice Chancellor Laster rejected the *Siliconix* line of cases in *CNX Gas*.²⁵⁸ In *CNX Gas*, the Court held that a tender offer/short-form merger transaction with a controlling shareholder receives business judgment review only if the offer is conditioned on the affirmative recommendation of a special committee of independent directors and included a non-waivable majority-of-the-minority shareholder approval condition. Otherwise, the Court ruled, a *Siliconix* transaction that was structurally non-coercive and free of disclosure violations would be reviewed under the entire fairness standard.²⁵⁹

b. DGCL Section 251(h)

Before the adoption of DGCL Section 251(h), a second-step merger following a tender offer always required a stockholder vote—even if the outcome was a formality because the buyer owned enough shares to singlehandedly approve the transaction—unless the buyer reached Delaware’s short-form merger 90% threshold. Despite the inevitability of the vote’s outcome, the extended process of preparing a proxy statement and holding a meeting would impose transaction risk, expense and complexity on the parties. The prospect of such delays had been a significant deterrent to the use of tender offers, especially by private equity buyers, who need to close on the first and second steps concurrently in order to facilitate their acquisition financing.

In order to address this shortfall, the market evolved a workaround in the form of the top-up option. While the top-up option has been used to obviate the need for a shareholder vote, this device may be unviable due to restrictions on the target's ability to issue shares. Other approaches, such as the subsequent offering period and the dual-track structure, are similarly imperfect workarounds that do not ensure the timing benefits of the tender offer followed by short-form merger.

In 2013, Delaware amended its corporate law to add Section 251(h), which permits the inclusion of a provision in a merger agreement eliminating the need for a stockholder vote to approve a second-step merger following a tender offer under certain conditions—including that following the tender offer the buyer owns sufficient stock to approve the merger pursuant to the DGCL and the target's charter (*i.e.*, 50% of the outstanding shares, unless the target's charter requires a higher threshold or the vote of a separate series or class).²⁶⁰ The provision requires that the offer (i) extend to any and all outstanding voting stock of the target (except for stock owned by the target itself, the acquiror, any parent of the acquiror (if wholly owned) and any subsidiaries of the foregoing); (ii) that all non-tendering shares receive the same amount and kind of consideration as those that tender; and (iii) that the second-step merger be effected as soon as practicable following the consummation of the offer.

By eliminating in applicable transactions the need to obtain the 90% threshold, Section 251(h) has significantly diminished the prominence of the workarounds noted above. Despite their reduced importance, the top-up option, dual-track structure and subsequent offering period remain relevant because Section 251(h) may not always be available or optimal for the parties. For one thing, it would not be available for targets that are not incorporated in Delaware. Section 251(h) is likewise unavailable if the target's charter expressly requires a stockholder vote on a merger or if the target's shares are not publicly listed or held by more than 2,000 holders.

In August 2014, amendments to the DGCL expanded the scope of transactions that could be effected under Section 251(h). Most notably, the amendments eliminated a provision that had prohibited the section's use where a party to a merger agreement was an "interested stockholder" under Section 203 of the DGCL (*i.e.*, a 15% stockholder, and potentially even a buyer that had entered into a tender and support agreement with a 15% stockholder). The amendments further clarified that Section 251(h) applies to merger agreements that "*permit*" or "*require*" (rather than strictly require) the merger to be consummated pursuant to Section 251(h). As a result, contracting parties may preserve the option of a 251(h) merger at the time of signing a deal without precluding the possibility of

consummating the merger pursuant to a different statutory provision if circumstances later warrant. Finally, the 2014 amendments clarified that, for purposes of determining whether sufficient shares were acquired in the first-step tender offer, shares tendered pursuant to notice of guaranteed delivery procedures cannot be counted by the acquiror towards the threshold until the shares underlying the guarantee are actually delivered.

By simplifying and accelerating combinations via the two-step tender offer and merger format, Section 251(h) has increased the use of this transaction structure. Recently, it has begun to be used for exchange offers as well as cash-only deals, including Expedia's acquisition of HomeAway, Alexion Pharmaceuticals' acquisition of Synageva BioPharma and AbbVie's acquisition of Pharmacyclics, each announced and completed in 2015. It should be noted, however, that Section 251(h) does not change the fact that, as discussed above, tender offers are not always preferable to one-step mergers (*e.g.*, when a lengthy regulatory approval process is expected).

c. Top-Up Options

One deal feature historically associated with tender offers is the top-up option. Such an option, exercisable after the close of the tender offer, permits the acquiror to purchase a number of newly issued shares directly from the target such that the acquiror may reach the short-form merger statute threshold, thereby avoiding a shareholder vote and enabling an almost immediate consummation of the transaction. However, a top-up option is limited by the amount of authorized but unissued stock of the target. In addition, parties should keep in mind that stock exchange rules require a stockholder vote for share issuances over a certain size. Before the adoption of DGCL Section 251(h), top-up options had become a standard feature of two-step tender offers. While the increased prevalence of top-up options had triggered litigation and judicial scrutiny, decisions of the Delaware Court of Chancery demonstrate that properly structured top-up options are valid under Delaware law.²⁶¹ Nevertheless, the availability of DGCL Section 251(h) has significantly reduced the use of top-up options in tender offer transactions where targets are incorporated in Delaware.

d. Dual-Track Tender Offers

A number of years ago, some private equity firms began utilizing a dual-track approach that involves launching a two-step tender offer (including a top-up option) concurrently with filing a proxy statement for a one-step merger. The logic behind this approach is that, if the tender offer fails to reach the minimum number of shares upon which it is conditioned—which in combination with the shares issued pursuant to a

top-up option would allow for a short-form merger—the parties would already be well along the path to the shareholder meeting for a fallback long-form merger (it should be noted that while the SEC will begin review, it will not declare the proxy statement effective until after the expiration of the tender offer). Examples of this approach include 3G Capital/Burger King, Bain Capital/Gymboree and TPG/Immucor. As noted above, the use of dual-track tender offers has diminished as a result of the adoption of DGCL Section 251(h).

Dual-track structures continue to be potentially useful, however, even where Section 251(h) is available. Some strategic transactions (*e.g.*, Alexion/Synageva, Verizon/Terremark, Georgia Pacific/Buckeye Technologies) also have employed a dual-track approach, for example, where there is uncertainty at the outset as to whether regulatory hurdles, such as an antitrust “second request,” will involve a lengthy process that could subject an acquiror in a tender offer to prolonged interloper risk. If regulatory approval is promptly received, the acquisition can close pursuant to the tender offer route (and the second-step merger can be effected pursuant to Section 251(h), if available); if not, the shareholder vote can be taken on the long-form merger route, thereby cutting off interloper risk.

3. Mergers of Equals

Combinations between large companies of similar sizes are often referred to as “mergers of equals” or “MOEs.” MOEs can offer an attractive avenue for growth by allowing a company to enhance shareholder value through merger synergies at a lower cost than high-premium acquisitions (since MOEs are typically low- or no-premium-to-market transactions). They also provide an alternative to an outright sale of a company, which is often undesirable for a variety of business, economic and social reasons. Although there are no formal legal requirements for what qualifies as an MOE, MOEs are typically structured as tax-free, stock-for-stock transactions, with a fixed exchange ratio without collars or walk-aways, and with a balanced contract often containing matching representations, warranties and interim covenants from both parties. Recent examples include the combination of MeadWestvaco and Rock-Tenn, the merger of Willis Group Holdings and Towers Watson, and the recently announced merger of Johnson Controls and Tyco International plc. MOEs differ from other types of mergers in a number of important respects. Like many stock-for-stock mergers, MOEs usually do not involve a “sale of control” of either party within the meaning of the applicable case law on directors’ fiduciary duties; instead, control remains with the public shareholders as a group (absent a controlling shareholder of the post-merger entity). Accordingly, *Revlon*

review is generally not triggered and directors have broad discretion under the business judgment rule to pursue an MOE transaction that they deem to be in the best long-term interests of the company, its shareholders and its other important constituencies, even if they recognize that an alternative sale or merger transaction could deliver a higher premium over current market value. It is prudent, nonetheless, for a board, as part of its deliberative process, to consider what alternative business strategies might exist, including an analysis of what potential acquirors could pay in an acquisition context.

MOEs often provide little or no premium above market price for either company. Instead, an exchange ratio is set to reflect relative metrics, such as assets, earnings and capital contributions, and market capitalizations, of the two merging parties—typically, but not always, resulting in a market-to-market exchange. Assuming a proper exchange ratio is set, MOEs can provide a fair and efficient means for the shareholders of both companies to benefit from merger synergies.

Due to the absence or modesty of a premium to market, MOEs are particularly vulnerable to dissident-shareholder campaigns and competing bids. While no protection is iron-clad, steps can be taken to protect an MOE transaction. As a preliminary matter, it is important to recognize that the period of greatest vulnerability is the period before the transaction is signed and announced. Parties must be cognizant that leaks or premature disclosure of MOE negotiations can provide the perfect opening for a would-be acquiror to submit a competing proposal or pressure a party into a sale or auction. A run-up in the stock price of one of the companies—whether or not based on merger rumors—also can derail an MOE, because no company wants to announce a transaction with an exchange ratio that reflects a substantial discount to market. MOE agreements should generally include robust structural protections, such as break-up fees, support commitments, no-shops and agreements not to terminate the merger agreement in the face of a competing offer without giving the shareholders a fair opportunity to vote on the merger, and utilization of a rights plan may also be appropriate. Since an MOE generally does not involve a sale of control of the company, parties to an MOE should send a strong signal that they have no intention of engaging in a sale-of-control transaction, even if their MOE transaction is voted down by shareholders. Once the deal has been made public, it is critical to advance a strong business rationale for the MOE in order to obtain a positive stock market reaction and thus reduce both parties' vulnerability to shareholder unrest and/or a competing offer. The appearance and reality of a true combination of equals, with shareholders sharing the benefits of the merger proportionately, are essential to winning shareholder support in the absence of a substantial premium.

Achieving the reality and perception of a true combination of equals presents an MOE transaction with unique structural and governance challenges. Structurally, the companies may choose to have both companies' stock surrendered and a new company's stock issued in their place to, among other possible benefits, promote the market's understanding of the transaction as a true combination of equals, rather than a takeover of one company by the other. Similarly, parties to an MOE should carefully consider the post-merger governance and management of the combined company. Among the issues that will need to be addressed are the combined company's name, the location of the combined company's headquarters and key operations, the rationalization of the companies' separate corporate cultures and the selection of officers and directors. In most of the larger MOEs there has been substantial balance, if not exact parity, in board representation and senior executive positions. This approach allows for a selection of the best people from both organizations to manage the combined company, thereby enhancing long-term shareholder value. Frequently, the CEO of one company becomes the Chairman of the combined company, with the other CEO continuing in his role, thus providing for representation at the helm from both constituent companies.

B. Consideration and Pricing

The pricing structure used in a particular transaction (and the allocation of risk between the acquiror and the target and their respective shareholders) will depend on the characteristics of the deal and the relative bargaining strength of the parties. All-stock and part-stock mergers raise difficult pricing and market risk issues, particularly in a volatile market. In such transactions, even if the parties come to an agreement on the relative value of the two companies, the value of the consideration may be dramatically altered by market changes, such as a substantial decline in financial markets, industry-specific market trends, company-specific market performance or any combination of these. Although nominal market value is not the required legal criterion for assigning value to stock consideration in a proposed merger, a target in a transaction may have great difficulty in obtaining shareholder approval of a transaction where nominal market value is less than, or only marginally greater than, the then-current market value of the target's stock. In addition, a stock merger proposal that becomes public carries substantial market risk for the buyer, whose stock may fall due to the anticipated financial impact of the transaction. Such a market response may put pressure on the buyer to offer additional make-whole consideration to seller, worsening the impact of the transaction from an accretion/dilution perspective, or to abandon the transaction altogether.

This Section discusses the key structural and pricing decisions that must be faced in all-stock or cash-stock hybrid transactions, some of which are also relevant in the context of an all-cash transaction.

1. All-Cash Transactions

The popularity of stock as a form of consideration ebbs and flows with economic conditions. All-cash bids have the benefit of being of certain value and will gain quick attention from a target's shareholders, particularly in the case of an unsolicited offer. In addition, the acquiror's stock price is often less adversely affected by an all cash offer as compared to an all-stock offer because no shares of the buyer are being issued. Of course, some bidders may not have sufficient cash and financing sources to pursue an all-cash transaction. In such cases, the relative benefits and complexities of part-cash/part-stock and all-stock transactions must be considered.

2. All-Stock Transactions

a. Pricing Formulas and Allocation of Market Risk

The typical stock merger is subject to market risks on account of the typically lengthy interval between signing and closing and the volatility of security trading prices. A drop in the price of an acquiror's stock between execution of the acquisition agreement and the closing of the transaction can alter the relative value of the transaction to both acquiror and target shareholders: Target shareholders might receive less value for their exchanged shares or, if additional shares are issued to compensate for the drop, the transaction will be less accretive or more dilutive to the acquiror's earnings per share. Such market risk can be addressed by a pricing structure that is tailored to the risk allocation agreed to by the parties. These pricing structures may include using a valuation formula instead of a fixed exchange ratio, a collar, or, more rarely, so-called "walk-away" provisions permitting unilateral termination in the event the acquiror's share price falls below a certain level.²⁶²

1. Fixed Exchange Ratio

The simplest, and most common, pricing structure (especially in the context of larger transactions) in a stock-for-stock transaction is to set a fixed exchange ratio at the time a merger agreement is signed. The advantage of a fixed exchange ratio for an acquiror is that it permits the acquiror to determine at the outset how much stock it will have to issue in the transaction (and thus to determine with some certainty the impact on per-share earnings and whether a stockholder vote may be required on such issuance pursuant to rules of the applicable stock exchange). On the

other hand, a fixed exchange ratio with a post-signing decline in the market value of the acquiror's stock could jeopardize shareholder approval and/or invite third-party competition (by decreasing the value that target's shareholders will receive at closing). From an acquiror's perspective, these are generally risks that can be dealt with if and when they arise, and the acquiror typically prefers the certainty of a fixed number of shares. And to the extent an acquiror and a target are in the same industry, industry-specific events could very well affect their stock prices similarly and therefore not affect the premium to be afforded by the exchange ratio (which would explain why a fixed exchange ratio is frequently used in a merger of equals).

The fixed exchange ratio is also the most common (but far from exclusive) pricing alternative in all-stock transactions with a larger aggregate dollar value. This may be due in part to the fact that large public companies typically have actively traded stocks, and the acquiror may persuasively argue that the market will soon reflect the value of the merged company. A fixed exchange ratio promotes maximum risk-sharing between the target's shareholders and the acquiror's shareholders.

Even where the market moves adversely to the acquiror's stock, companies that are parties to pending strategic mergers have been able to successfully defend their deals based on the long-term strategic prospects of the combined company. Nevertheless, in cases where there is concern that shareholders may vote down a transaction because of price fluctuation, the parties may turn to other pricing mechanisms to allocate market risk.

2. Fixed Value With Floating Exchange Ratio; Collars

In many situations, one or both parties (typically the target) will be unwilling to permit market fluctuation to impair its ability to achieve the benefits of the bargain that was struck at signing. One solution is to provide for a floating exchange ratio, which will deliver a fixed dollar value of the acquiror's stock (rather than a fixed number of shares). The exchange ratio is set based on an average market price for the acquiror's stock during some period, normally 10 to 30 trading days, prior to closing. Thus, the acquiror would agree to deliver a fixed value (*e.g.*, \$30) in stock for each of the target's shares, with the number of acquiror's shares to be delivered based on the market price during the specified period. An acquiror bears the market risk of a decline in the price of its stock since, in such event, it will have to issue more shares to deliver the agreed value. Correspondingly, an acquiror may benefit from an increase in the price of its stock since it could deliver fewer shares to provide the agreed value. Because a dramatic drop in the acquiror's stock may require the acquiror

to buy its target for far more shares than had been intended at the time the transaction was announced, companies should carefully consider the possibility of dramatic market events between signing and closing. A target's shareholders bear little market risk in this scenario and correspondingly will not benefit from an increase in stock prices since the per-share value is fixed.

In order to mitigate the risk posed by market fluctuations, parties may desire a longer measuring period for valuing the acquiror's stock. Longer measuring periods minimize the effects of market volatility on how many acquiror shares will be issued as merger consideration. Additionally, acquirors favor longer measuring periods because, as the transaction becomes more likely and approaches fruition, the acquiror's stock may fall to reflect any anticipated earnings dilution. By contrast, a target may argue that the market price over some period immediately prior to consummation provides a better measure of consideration received.

However, merely lengthening the valuation period is often insufficient to protect acquirors against large price declines. The number of shares that an acquiror may have to issue pursuant to a floating exchange ratio based upon the acquiror's stock price is limited only by the amount by which the stock price can decline. Consequently, acquirors must be cognizant of the fact that the price of their stock may decline precipitously based on events or circumstances having little or nothing to do with the value of the acquiror. While such declines may be only short-lived, the acquiror will still have to compensate the target for even a temporary shortfall that occurs during the measuring period for the floating exchange ratio. To protect against having to issue a very high number of shares, agreements with floating exchange ratios frequently include a "collar" that places a cap on the number of shares to be issued and, at the same time, a floor on the number of shares that may be issued. Effectively, such agreements provide upper and lower market price limits within which the number of shares to be delivered will be adjusted. If market prices go outside the range, no further adjustments to the number of shares delivered to the target's shareholders will need to be made. The size of the range determines the degree of protection afforded to the acquiror, and correspondingly, the amount of the market risk borne by the target's shareholders. An acquiror would argue that the target's shareholders should bear some of the risk of a price decline, and the target would argue that its shareholders, if they are to bear some risk of a price decline, should receive the benefits from a price increase. Collars are typically, but not always, symmetrical in the level of price protection they provide to buyers and sellers.

The determination whether to negotiate for collar pricing or another price protection device depends on various factors, including:

- the parties' views on the potential impact from an accretion/dilution perspective of issuing additional shares and any potential timing consequences thereof (*i.e.*, if an increased share issuance would require a stockholder vote and delay closing);
- the overall prospects for share prices in the relevant industry;
- the relative size of the two companies;
- the parties' subjective market expectations over time; and
- the desirability or necessity of pegging the transaction price to a cash value.

Parties must also consider the anticipated effect on the acquiror's stock price of short selling by arbitrageurs once the transaction is announced. In some mergers, pricing formulas and collars are considered inadvisable due to the potential downward pressure on an acquiror's stock as a result of arbitrage trading.

3. Fixed Exchange Ratio within Price Collar

The fixed exchange ratio within a price collar is another formulation that may appeal to a target that is willing to accept some risk of a pre-closing market price decline in an acquiror's stock, but wishes to protect against declines beyond a certain point. In this formulation, the target's shareholders are entitled to receive a fixed number of shares of acquiror stock in exchange for each of their shares, and there is no adjustment in that number so long as the acquiror's stock is valued within a specified range during the valuation period (*e.g.*, 10% above or below the price on the date the parties agree to the exchange ratio). If, however, the acquiror's stock is valued outside that range during the valuation period, the number of shares to be delivered is adjusted accordingly (often to one of the endpoints of the range). Thus, for example, if the parties agree on a one-for-one exchange ratio and value the acquiror's stock at \$30 for purposes of the transaction, they might agree that price movements in the acquiror's stock between \$27 and \$33 would not result in any adjustments. If, however, the stock is valued at \$25 during the valuation period, the number of shares to be delivered in exchange for each target share would be 1.08, *i.e.*, a number of shares equal to \$27 (the low end of the collar) based on the \$25 valuation. Therefore, although the target's shareholders will not receive an increased number of shares because of the

drop in acquiror's stock price from \$30 to \$27, they will be compensated in additional acquiror shares by the drop in price from \$27 to \$25.

b. Walk-aways

Another, less common market-risk price protection is to include as a condition to closing the right for target to walk away from the merger if the price of the acquiror's stock falls below a certain level. For example, a fixed exchange ratio walk-away provision could permit termination of a merger agreement by the target if, at the time the transaction is to close, the acquiror's stock has decreased by 15%—a single trigger.

Some walk-away formulas provide for a double trigger, requiring not only an agreed-upon absolute percentage decline in the acquiror's stock price but also a specified absolute percentage decline in the acquiror's stock price relating to a defined peer group of selected companies during the pricing period. For example, the double-trigger walk-away may require that the acquiror's average stock price prior to closing fall (1) 15% or 20% from its price at the time of announcement and (2) 15% or 20% relative to a defined peer group of selected stocks. The double trigger essentially limits the walk-away right to market price declines specifically related to the acquiror, leaving target to bear the risk of price declines related to industry events. That is, the acquiror may argue that if its stock does no more than follow a general market trend, there should be no right on the part of the target to "walk." Walk-away rights are generally tested during a short trading period prior to closing and often include an option for an acquiror to elect to increase the exchange ratio to avoid triggering the target's walk-away right.

Walk-away rights can also be drafted for the benefit of an acquiror. An acquiror entering into a transaction with a floating exchange ratio, or with a fixed ratio within a price collar but without a cap on the number of shares it must issue, may negotiate for a termination right if its stock falls below a specified level, thus requiring it to issue more than a specified number of additional shares in order to provide the agreed consideration. In such a case, the target can be expected to negotiate for the right to waive the additional consideration on account of the acquiror's stock drop, so that the acquiror remains obligated to consummate the merger even if its walk-away right gets triggered.

Although walk-aways may appear desirable at first glance, they create additional risks that a transaction that is attractive from a business and strategic point of view will not be consummated due to temporary market fluctuations. Walk-aways can cause substantial difficulty in the planning for the post-merger combined company, since most walk-away rights relating to stock price declines are only triggered during a short

period immediately prior to closing. Moreover, the necessity for shareholder approval by both parties inherent in most stock-for-stock transactions provides a *de facto* walk-away right for price declines existing at the time of the vote, assuming, of course, that such declines are sufficiently large to defeat shareholder approval. Shareholder approval, often required for mergers, generally continues to be the most effective means of ensuring that the negotiated deal, including its price, remains in the best interests of each party's shareholders closer to closing. The benefits of a walk-away, and the related components of a floating exchange ratio or a price collar, must be weighed carefully against the potentially significant costs of transaction uncertainty and the risk of non-consummation after months of planning for the combined company.

c. Finding the Appropriate Pricing Structure for All-Stock Transactions

The pricing structure used in a particular all-stock transaction (and thus the allocation of market risk between an acquiror and a target and their respective shareholders) will depend on the characteristics of the transaction and the relative bargaining strength of the parties. A pricing structure used for one transaction may, for a variety of reasons, be entirely inappropriate for another. For instance, in a situation that is a pure sale, a target might legitimately request the inclusion of protective provisions such as a floating exchange ratio and/or a walk-away, especially if the target has other significant strategic opportunities. An acquiror may argue, of course, that the target should not be entitled to absolute protection (in the form of a walk-away) from general industry (compared to acquiror-specific) risks. A double-trigger walk-away can correct for general industry-wide events. At the other end of the spectrum, in an MOE or "partnership" type of transaction, claims on the part of a target for price protection, especially walk-aways, are less convincing. The argument against price protection is that, once the deal is signed, the target's shareholders are (and should be) participants in both the opportunities and the risks of the combined company. Moreover, in both MOEs and a true acquisition, the target can always find some comfort, albeit less direct, in respect of acquiror-specific price risk in the representations and warranties on the part of the acquiror relating to the nonoccurrence of material adverse changes and other matters (the accuracy of which will be a condition to closing).

Because of the length of time required to complete some strategic acquisitions subject to high levels of regulatory scrutiny, the management of, or protection against, market risk through various price-related provisions can assume particular significance during stock-for-stock transaction negotiations. Blind adherence to precedent without an analysis

of the particulars of the transaction at hand can be disastrous, as can careless experimentation. Transaction participants should carefully consider the many alternative pricing structures available in light of the parties' goals and the various risks involved. In all events, and consistent with their fiduciary duties, directors need to be fully informed as to how any price adjustments work, and understand the issues presented by such provisions.

3. Hybrid Transactions: Stock and Cash

In certain circumstances, the use of a mixture of stock and cash as consideration is appealing. Targets may find mixed consideration desirable because the cash component provides some downside protection to targets from a decline in the price of the acquiror's stock. In addition, depending on the allocation procedure employed (*e.g.*, whether each target shareholder is permitted to select his mix of consideration), both short- and long-term investors may be able to receive their preferred consideration in the form of all cash or all stock. Those who choose not to cash out may be able to retain the tax benefits of a tax-free exchange.

a. Possible Cash-Stock Combinations

There is a wide variety of potential pricing structures for a part-cash, part-stock transaction. Choosing the right pricing formula involves all of the complications raised in determining pricing formulas for an all-stock transaction (namely, the issues relating to fixed exchange ratios, floating exchange ratios, collars and walk-aways). In addition, if there is a formula for the cash component, it must be matched to the formula for the stock component. An important threshold issue is whether the parties intend for the values of the stock and cash components to remain equal as the price of the acquiror's shares fluctuates or whether there should be scenarios in which the values of the cash and stock components can diverge. This will be an important consideration in determining the proper allocation procedures for the cash and stock components.

The simplest formula in a part-cash, part-stock transaction is a fixed exchange ratio for the stock component linked with a fixed per-share cash amount for the cash component, with fixed percentages of the target's shares being converted into cash and stock, respectively. Because the value of the stock component of the transaction will vary with fluctuations in the acquiror's share price while the cash component remains fixed, it is important for the allocation procedures to be sensitive to the potential for significant oversubscriptions for stock, if the value of the acquiror's shares rises, and significant oversubscriptions for cash, if the value of the acquiror's shares declines. After all, at the time the target's shareholders make the decision to subscribe to a particular mix of consideration, they

will have more visibility into what the acquiror's stock price will be at closing than the transaction parties will have had at signing. Because using a fixed exchange ratio for the stock component and fixed per share cash amount for the cash component will often lead to differing consideration being paid to shareholders making one election or the other, in some instances, the parties may agree to track the blended value of the cash and stock consideration until closing and pay all stockholders the same blended per share value while still permitting target shareholders to make a cash or stock election. This structure has the benefit of treating all shareholders equally but runs the risk of requiring the acquiror to issue more shares or pay more cash than was initially contemplated at signing. Consequently, in order to mitigate this risk and preserve the tax-free treatment of the deal, parties typically will place limits on the aggregate amount of cash to be paid or number of shares to be issued.

A more common hybrid pricing mechanism is to link a floating exchange ratio pricing formula for the stock component with a fixed cash price. This formula has the advantage of equalizing the stock and cash values (generally based upon the average trading price for the acquiror's shares over a 10- to 30-day trading period prior to the effective date of the merger). This approach helps facilitate a cash election procedure by minimizing any economic differential pushing shareholders toward either the cash or stock consideration. However, issues may still arise in situations where the acquiror's shares trade outside the collar range established for the floating exchange ratio or where there is a last-minute run-up or decline in the price of the acquiror's stock.

While there can be a variety of business reasons for adjusting the aggregate limits on the percentage of target shares to be exchanged for cash versus stock consideration, historically the most common reason has been the desire to preserve the tax-free status of the transaction. As described in Section IV.A.1, a part-cash, part-stock merger (including a two-step transaction with a first-step tender or exchange offer followed by a back-end merger) generally can qualify as a tax-free reorganization only if at least a minimum portion of the total value of the consideration consists of acquiror stock. Historically, satisfaction of this requirement was, in all cases, determined by reference to the fair market value of the acquiror stock issued in the merger (*i.e.*, on the closing date). Accordingly, a part-cash, part-stock merger, particularly with a fixed or collared exchange ratio, that met this requirement when the merger agreement was signed could fail to qualify as a tax-free reorganization if the value of the acquiror's shares declined before the closing date. As described in Section IV.A.1.a, Treasury regulations issued in 2011 permit the parties, in circumstances where the consideration is "fixed" within the meaning of the regulations, to determine whether this requirement is met by reference

to the fair market value of the acquiror stock at signing rather than at closing. The regulations clarify that parties can rely on the signing date rule even if the acquisition agreement contemplates a stock/cash election as long as the aggregate mix of stock/cash consideration is fixed.

Adding an additional degree of complexity, hybrid cash-stock mergers may have formula-based walk-away rights. The walk-away formula can be quite complex, reflecting the specific concerns of the acquiror and the target.

Part-cash, part-stock transactions can also be structured to avoid triggering a vote by the acquiror's shareholders under stock exchange rules, by providing for a decrease in the stock portion of the consideration (and corresponding increase in the cash portion of the consideration) to the extent necessary to keep the number of shares issued below the relevant threshold (as was done in the Pfizer/Wyeth transaction, discussed in Section V.C).

In structuring a part-cash, part-stock pricing formula and allocating the cash and stock consideration pools, it is also important to consider how dissenting shares, employee stock options and other convertible securities will be treated. In addition, a board considering a proposal involving both cash and stock consideration should seek the advice of counsel with regard to whether the transaction may invoke enhanced scrutiny under *Revlon*.

b. Allocation and Oversubscription

A key issue in part-cash, part-stock transactions is choosing the best method of allocating the cash and stock components to satisfy divergent shareholder interests. The simplest allocation method is straight proration without target shareholder elections. In a straight proration, each of the target's shareholders receives a proportionate share of the aggregate pools of stock and cash consideration. Thus, in a transaction in which 50% of the consideration is being paid in stock and 50% of the consideration is being paid in cash, each target shareholder exchanges 50% of his shares for acquiror stock and 50% of his shares for cash. Shareholders who exchange their shares for a mixture of cash and stock generally will recognize gain, for federal income tax purposes, on the exchange to the extent of the lesser of (1) the gain on the exchange, measured as the difference between the fair market value of the stock and cash received over their tax basis in their shares, and (2) the amount of cash received. Thus, a principal drawback of straight proration is that the target's shareholders cannot choose their desired form of consideration and therefore all will likely recognize taxable gain.

Another approach is the use of a cash election merger. Cash election procedures provide the target's shareholders with the option of choosing between the cash and stock considerations. Such procedures allow the short-term investors to cash out of their positions while longer-term investors can exchange their shares in a tax-free exchange. Cash election procedures work best where the value of the cash and stock pools is equal and where there is a proportionate split between short- and long-term investors approximating the split between the available cash and stock consideration. Contractual provisions and related public disclosures concerning the election procedures must be drafted carefully to deal with the possibility that there may be significant oversubscriptions for one of the two types of consideration.

Of course, the easiest way of assuring simplicity in a cash election process is to provide for straight proration in the event of oversubscriptions for either the cash or the stock pool. This allocation method is still preferable to a straight proration without election procedures, because even if there is oversubscription, some shareholders will elect to receive the undersubscribed consideration and some shareholders will not return an election form and can be deemed to have elected to receive the undersubscribed consideration. Proration in this context, however, also has certain significant drawbacks. Few target shareholders will be fully satisfied because most will get a prorated portion of the undesired consideration and will also incur some taxation. Proration within the oversubscribed election pool will be most compelling when there is a significant difference between the value of the cash and stock consideration that is driving the oversubscriptions.

Another, albeit rarer, approach for handling oversubscriptions has been to select shareholders on a random or other equitable basis from those who have elected to receive the oversubscribed consideration until a sufficient number of shares are removed from the oversubscribed pool. The methods by which shareholders are selected for removal from the oversubscribed pool vary from a straight lottery to selection based on block size or time of election. Since proration is less problematic in the event of an oversubscription for cash, there is some precedent for using proration for cash oversubscriptions but a lottery selection process for stock oversubscriptions.

4. Valuing Stock Consideration in Acquisition Proposals

Even once the form of consideration is settled, targets are still confronted with the challenge of properly valuing the consideration offered in a proposed transaction. This valuation is a significant element in a board's decision whether to approve a particular transaction. Even with diligence, the evaluation of a stock merger, regardless of whether it

involves a sale of control, can be quite complex. Directors may properly weigh a number of issues beyond the headline per share payment when evaluating a proposed transaction.

a. Short- and Long-Term Values

Although current market value provides a ready first estimate of the value of a transaction to a company's shareholders, the Delaware Supreme Court in *QVC* and in other cases has stated that such valuation alone is not sufficient, and certainly not determinative of value.²⁶³ In the sale of control context, directors of a company have one primary objective: "to seek the transaction offering the best value reasonably available to the stockholders."²⁶⁴ This objective would ordinarily not be satisfied by looking only to the latest closing prices on the relevant stock exchange.

In fact, in *Trans Union*, a seminal Delaware Supreme Court decision on director responsibilities in selling a company, the Court criticized the directors for relying upon the market prices of the company's stock in assessing value. The Court held that using stock market trading prices as a basis for measuring a premium "was a clearly faulty, indeed fallacious, premise."²⁶⁵ Instead, the Court emphasized that the key issue must be the intrinsic value of the business, and that the value to be ascribed to a share interest in a business must reflect sound valuation information about the business. The same point was reiterated by the Delaware Supreme Court in its decision in *Time-Warner*, where the Court pointedly noted "that it is not a breach of faith for directors to determine that the present stock market price of shares is not representative of true value or that there may indeed be several market values for any corporation's stock."²⁶⁶

When valuing stock consideration, in addition to current stock prices, directors should also consider historical trading prices and financial indicators of future market performance. The result of such analyses may be that a target board values the stock consideration proposed by one bidder with a lower aggregate current market value more highly than that proposed by another bidder with a higher aggregate current market value. This is especially because in the context of competing bids, market prices may be a particularly confusing indicator. Once the offers are announced, the market may discount the securities of the higher bidder to reflect a likely victory and potential accompanying dilution, but it also may discount the securities of the lower bidder if that party is expected to raise its bid. These uncertainties, however, do not affect the validity of historical trading averages and other market comparisons which are not based on current stock prices. Of course, the target's shareholders may not

agree with the board in such a case and may reject the offer with the lower current market value.

Under either the *Revlon* standard or the traditional business judgment rule, the valuation task necessarily calls for the exercise of business judgment by directors. A board must not only look at financial valuations, but also must make judgments concerning the potential for success of the combined company. Due diligence by both parties to a stock-based merger is indispensable to informed decision-making, as is detailed analysis of pro forma financial information and contribution analyses. Directors of a company may need to consider such factors as past performance of the security being offered as consideration, management, cost savings and synergies, past record of successful integration in other mergers, franchise value, antitrust issues, earnings dilution and certainty of consummation. While predicting future stock prices is inherently speculative, a board can and should evaluate such information in the context of the historic business performance of the other party, the business rationale underlying the merger proposal and the future prospects for the combined company. To the extent competing bids are under review, directors should be careful to apply comparable evaluation criteria in an unbiased manner to avoid any suggestion that they have a conflict of interest pushing them to favor one bid over another or that they are not acting in good faith.

Absent a limited set of circumstances as defined under *Revlon*, directors are not required to restrict themselves to an immediate or short-term time frame. Instead, directors are entitled to select the transaction that they believe provides shareholders with the best long-term prospects for growth and value enhancement with the least amount of downside risk; directors thus have substantial discretion to exercise their judgment. In its *Time-Warner* decision, the Delaware Supreme Court stated that the directors' statutory mandate "includes a conferred authority to set a corporate course of action, including time frame, designed to enhance corporate profitability."²⁶⁷ In the same vein of judicial deference to director decision-making, *Time-Warner* likewise explained that even when a transaction is subject to enhanced scrutiny, a court should not be involved in "substituting its judgment as to what is a 'better' deal for that of a corporation's board of directors."²⁶⁸

b. Other Constituencies and Social Issues

In stock mergers not involving a change-of-control, Delaware directors may appropriately consider the effect of the transaction on non-shareholder constituencies. In seeking to achieve shareholder value, directors are permitted to take into account the impact of the prospective transaction on the company, its employees, its customers and the

community in which it operates.²⁶⁹ Some states outside Delaware, such as Illinois, Indiana, Minnesota, New Jersey, Maryland, Nevada, Ohio, Oregon and Pennsylvania, have adopted statutes known as “constituency statutes” specifically permitting boards to take into account such factors when making business decisions. Some of these statutes, such as those in Maryland and Oregon, only permit boards to consider the interests of other constituencies within the change-of-control context.²⁷⁰ The manner in which more broadly drafted constituency statutes interact with a board’s duties in a change-of-control context, and whether a target board can rely on such statutes to justify considering the interests of other constituencies instead of just maximum value to shareholders varies, state-by-state.²⁷¹ The economic terms of a proposed merger or acquisition transaction and the benefits that the transaction brings to shareholder interests will predominate in the directors’ inquiry. Nevertheless, “social issues”—concerns for the community and the combination’s impact on the continued viability of various operations—can play an important role in bringing two merger partners to the negotiating table and may be properly considered by directors in evaluating the strategic benefits of a potential merger or acquisition transaction not involving a change-of-control, at least insofar as they will promote future value.²⁷²

Consideration of employee and other constituent interests is also important in assuring a smooth transition period between the signing of a merger agreement and the closing of the transaction. It is important for the selling company to strive to preserve franchise value throughout the interim period, which may be more difficult in mergers that require a lengthy time period for consummation. Moreover, the impact of a proposed merger on a selling company’s franchise and local community interests can have a direct impact on the acquiror’s ability to obtain the requisite regulatory approvals.

5. Contingent Value Rights

a. Price Protection CVRs

Where target shareholders are particularly concerned about assessing the value of acquiror securities received as merger consideration, the parties can employ a contingent value right (“CVR”) to provide some assurance of that value over some post-closing period of time. This kind of CVR, often called a “price-protection” CVR, typically provides a payout equal to the amount (if any) by which the specified target price exceeds the actual price of the reference security at maturity. Unlike floating exchange ratios, which only provide value protection to target shareholders for the period between signing and closing, price-protection CVRs are more similar to put options and are issued at closing with maturities that usually range from one to three years.

For example, a price-protection CVR for a security that has a \$40 market value at the time of the closing of a transaction might provide that if, on the first anniversary of the closing, the average market price over the preceding one-month period is less than \$38, the CVR holder will be entitled to cash or acquiror securities with a fair market value to compensate for the difference between the then-average trading price and \$38. Price-protection CVRs may also include a floor price, which caps the potential payout under the CVR if the market value of the reference shares drops below the floor, functioning in the same manner as a collar or a cap in the case of a floating exchange ratio. For example, the previously described CVR might include a \$33 floor price, such that CVR holders would never be entitled to more than \$5 in price protection (the difference between the \$38 target price and the \$35 floor price), thereby limiting the financial or dilutive impact upon the acquiror at maturity of the CVR. Recently, Energy Transfer Equity, L.P.'s 2015 agreement to acquire the Williams Companies, Inc. for \$38 billion—the largest transaction to ever include a CVR—included a price protection CVR tied to the difference, if any, between the volume-weighted average trading price of Energy Transfer Equity common units and newly-issued Energy Transfer Corp. LP common shares over a 23-month period.

In most cases, CVRs are memorialized in a separate agreement, which usually calls for a trustee or rights agent to act on behalf of the holders. At maturity, CVRs may be payable in cash or acquiror securities or, in some cases, a combination of the two at the option of the acquiror. Acquirors may also negotiate for the option of extending the maturity of the CVRs, typically in exchange for an increase in the target price. In this way, an acquiror gives itself more time to achieve the target stock price, even at the cost of establishing a higher target stock price at the time of the transaction. Targets often require the acquiror to make CVRs transferrable (in which case the CVRs generally also have to be registered under the Securities Act)²⁷³ and, in some cases, to list them on a stock exchange.

b. Event-Driven CVRs

CVRs can also be used in other contexts, especially where the parties are unable to reach agreement as to the valuation of a specific asset, liability or contingency, including, for example, the outcome of a significant litigation, or the regulatory approval of a new drug of the target. A CVR of this type, often called an “event-driven” CVR, may be used to bridge a valuation gap between the two parties and to increase deal certainty by allowing the parties to close the deal without the contingency having been resolved. Event-driven CVRs typically provide holders with payments when certain events resolving the contingency occur, or when specific goals, usually related to the performance of the acquired business,

are met. For instance, Sanofi-Aventis SA's 2011 agreement to acquire Genzyme for \$20 billion provided for additional payments (up to an aggregate value of nearly \$4 billion) tied to six payment triggers, including the receipt of FDA approval for a particular drug, four product sales milestones and a production milestone.

Although both price-protection and event-driven CVRs can provide significant benefits in the structuring of a transaction, parties considering their use need to be aware of potential pitfalls. CVRs are highly structured instruments with many variables, and their negotiation and implementation can introduce significant additional complexity to a deal. While CVRs may be useful tools in bridging valuation gaps and overcoming disagreements, there is also a possibility that they create their own valuation issues and increase the potential for disputes during negotiations. Moreover, because CVRs remain outstanding and often impose restrictions on the actions of the acquiror long after closing, they may become the source of litigation, particularly where great care was not taken to anticipate potential misalignments between the interests of the acquiror and the CVR holders. Finally, CVRs are subject to a host of additional securities law, accounting and tax considerations, and parties contemplating their use should seek legal, financial, accounting and tax advice.

V.

Deal Protection and Deal Certainty

Merger agreements typically include a variety of provisions intended to balance each party's desire to preserve maximum flexibility to respond to future developments and to comply with its board's fiduciary duties, while ensuring that the other party remains obligated to consummate the transaction. The key provisions in this regard are "deal protection" devices intended to regulate interloper risk; closing conditions giving a party a right to walk away from a transaction without liability if a "material adverse effect" or "material adverse change" with respect to the other party occurs; and the remedies available in connection with a party's failure to comply with the agreement or otherwise close the transaction, including as a result of a failure to obtain the requisite financing or governmental approvals. These provisions can significantly influence whether an M&A transaction will be completed, renegotiated or abandoned in the face of post-signing changes in circumstances.

A. Deal Protection Devices

"Deal protection" devices—such as break-up fees, no-shop clauses, force-the-vote provisions and shareholder voting agreements—permit bidders "to protect themselves against being used as a stalking horse and [provide] consideration for making target-specific investments of time and resources in particular acquisitions."²⁷⁴ Targets often agree to such provisions in order to induce value-maximizing bids. Delaware courts have recognized that deal protection devices are permissible means of protecting a merger from third-party interference, where such provisions (viewed holistically) are reasonable under the circumstances.

Deal protection devices generally are reviewed under the enhanced scrutiny analysis set out in *Unocal* and *Revlon*.²⁷⁵ The reviewing court will examine closely the context of the board's decision to agree to the deal protections. As the Delaware Court of Chancery has stated, the reasonableness inquiry contemplated by *Unocal* and *Revlon* "does not presume that all business circumstances are identical or that there is any naturally occurring rate of deal protection, the deficit or excess of which will be less than economically optimal. Instead, that inquiry examines whether the board granting the deal protections had a reasonable basis to accede to the other side's demand for them in negotiations. In that inquiry, the court must attempt, as far as possible, to view the question from the perspective of the directors themselves, taking into account the real world risks and prospects confronting them when they agreed to the deal protections."²⁷⁶

1. Break-Up Fees

A common ingredient in the package of deal protection measures is a termination (or “break-up”) fee payable by the target in the event that the target terminates the merger agreement to accept a superior proposal, or in other specified circumstances generally involving the failure of the merger to occur as a result of a third-party bid. One rationale for break-up fees is to compensate a bidder whose definitive agreement to acquire the target is terminated for the risks and costs incurred in advancing the competitive bidding process and thereby incentivize potential bidders to undertake the cost of evaluating the target. Of course, termination fees, even more than other deal protection devices, impose an easily calculable cost on interlopers, and accordingly, may deter other potential acquirors from making an acquisition proposal after an agreement has been reached. An “excessive” break-up fee therefore will be viewed critically by courts.²⁷⁷

Break-up fees can be triggered by different events. A “naked no-vote” or “no-vote termination fee” is triggered if shareholders fail to approve the merger, whether or not another deal had been proposed or agreed to. As discussed further below, the size of a “naked no vote” break-up fee relative to the equity value of the target is typically lower than a break-up fee triggered in connection with an alternative offer. A break-up fee can also be triggered when a party terminates due to the other party’s board changing its recommendation in favor of the deal, or if a party enters into an alternative transaction during a “tail” period following termination for failure to obtain shareholder approval where an alternative acquisition proposal was made public prior to the shareholder vote.

In determining the reasonableness of a termination fee, courts do not rely on a set threshold percentage. Indeed, the question of whether equity value or enterprise value (*i.e.*, equity value plus net debt) should be used as the denominator in calculating the percentage size of the fee will depend on the circumstances. For example, enterprise value may be more appropriate where the company’s capital structure is highly leveraged,²⁷⁸ although in a recent case, a Delaware judge noted that Delaware law “has evolved by relating the break-up fee to equity value,” absent a “compelling reason” to deviate from that approach.²⁷⁹ Courts may also question what is the appropriate numerator for calculating the percentage of the fee. In the *Comverge* case in 2014, the Court of Chancery denied a motion to dismiss a claim based on the size of the termination fee where a topping bid would trigger the conversion into equity of notes that were issued at the time the merger agreement was executed. If the cost of buying the equity into which the bridging loan was converted was included as part of the fee, the percentage value of the fee would have been as high as 13%.²⁸⁰

The Delaware Court of Chancery has stated that there is no accepted “customary” level of break-up fees (or other deal protections), but rather that such fees (like all deal protections) should be considered contextually and cumulatively:

That analysis will, by necessity, require the Court to consider a number of factors, including without limitation: the overall size of the termination fee, as well as its percentage value; the benefit to shareholders, including a premium (if any) that directors seek to protect; the absolute size of the transaction, as well as the relative size of the partners to the merger; the degree to which a counterparty found such protections to be crucial to the deal, bearing in mind differences in bargaining power; and the preclusive or coercive power of *all* deal protections included in a transaction, taken as a whole. The inquiry, by its very nature fact intensive, cannot be reduced to a mathematical equation.²⁸¹

The Delaware Court of Chancery has provided useful guidance in considering the quantum of break-up fees, upholding termination fees that have approached, and in some cases exceeded, 4%. For example, in *Dollar Thrifty*, the Delaware Court of Chancery upheld a 3.9% termination fee and expense reimbursement, stating approvingly that the fee at best merely deterred “fractional topping” and actually encouraged an interloper to “dig deep and to put on the table a clearly better offer rather than to emerge with pennies more.”²⁸² In the *Topps* case, the Delaware Court of Chancery upheld a two-tiered termination fee of approximately 3% of equity value during the first 40 days, which went up to approximately 4.3% of equity value for termination after the 40-day period elapsed, albeit noting that it was “a bit high in percentage terms.”²⁸³ The Court of Chancery has also stated that a termination fee of 4.4% of equity value is “near the upper end of a ‘conventionally accepted’ range.”²⁸⁴ And in *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*,²⁸⁵ the Delaware Court of Chancery cast doubt upon the validity of a 6.3% termination fee (calculated based on the deal value to the seller’s shareholders), stating in *dicta* that the fee “certainly seems to stretch the definition of range of reasonableness and probably stretches the definition beyond its breaking point.”²⁸⁶

Illustrating that context matters, in the *Lear* case, the Delaware Court of Chancery upheld a “no-vote termination fee,” in which the potential acquiror had the right to receive \$25 million if shareholders failed to approve the merger, whether or not another deal had been proposed or agreed to.²⁸⁷ Lear’s board had agreed to sell the company to

Carl Icahn in an LBO. When faced with significant shareholder opposition to the transaction, Lear obtained a slightly higher price in exchange for a “naked” no-vote termination fee equal to 0.9% of the total deal value. The shareholders rejected the deal and the company paid the termination fee. The plaintiffs then challenged the no-vote fee. Even though the deal was a cash-out LBO that implicated *Revlon*, the *Lear* court upheld the fee, noting that the shareholders had in fact rejected the deal, that it was rational for Icahn to demand such a fee as additional compensation in the event of a no vote since he was effectively bidding against himself at that stage of the deal, and that Delaware courts have previously upheld no-vote termination fees of up to 1.4% of transaction value.²⁸⁸ No-vote termination fees are less customary than topping fees, and where they are included in transactions they typically are significantly lower than topping fees. In some cases, purchasers are entitled to expense reimbursement instead of a fee in the event of a no-vote.

2. “No-Shops,” “No Talks” and “Don’t Ask, Don’t Waive” Standstills

A “no-shop” provision in a merger agreement provides that a selling company will not encourage, seek, solicit, provide information to or negotiate with third-party bidders, but generally allows the seller to respond to unsolicited offers by supplying confidential information and to consider and negotiate with respect to certain competing bids.

The Delaware Court of Chancery has held that it is “critical” that bargained-for contractual provisions be enforced, including by post-closing damages remedies in appropriate cases.²⁸⁹ This principle also comes into play when a party claims that a target should be required to take actions in contravention of a buyer’s rights under a no-shop. In the 2014 *C&J Energy* case, the Delaware Supreme Court reversed the grant of a mandatory preliminary injunction that required the target company to shop itself in violation of a contractually bargained no-shop provision.²⁹⁰ The Court of Chancery had ruled that the board of the selling company had violated its duties under *Revlon* and enjoined the stockholder vote for 30 days while the selling company could undertake an active market check. The Supreme Court held that the judicial waiver of the no-shop clause was an error because the bidder was an “innocent third party” and, even on facts determined after trial, “a judicial decision holding a party to its contractual obligations while stripping it of bargained-for benefits should only be undertaken on the basis that the party ordered to perform was fairly required to do so, because it had, for example, aided and abetted a breach of fiduciary duty.”²⁹¹

On the other hand, Delaware courts will refuse to enforce no-shop provisions where there are “viable claims of aiding and abetting against

the holder of third party contract rights.”²⁹² In *In re Del Monte Foods Co. Shareholders Litigation*,²⁹³ the plaintiffs sought to enjoin the enforcement of a no-shop provision by a group of private equity buyers in its proposed \$5.3 billion cash acquisition of Del Monte. The merger agreement contained a number of deal protection measures, including a no-shop provision, a termination fee and matching right provisions. The no-shop provision prevented Del Monte from soliciting acquisition proposals once a 45-day go-shop period after the signing of the merger agreement had passed. In evaluating whether to enforce contract provisions, including no-shop provisions, in favor of an alleged aider and abettor of a breach of fiduciary, the Court of Chancery considered: “(1) whether the acquiror knew, or should have known, of the target board’s breach of fiduciary duty; (2) whether the . . . transaction remains pending or is already consummated at the time judicial intervention is sought; (3) whether the board’s violation of fiduciary duty relates to policy concerns that are especially significant; and (4) whether the acquiror’s reliance interest under the challenged agreement merits protection in the event the court were to declare the agreement enforceable.”²⁹⁴ In *Del Monte*, the Court ultimately determined that the factors weighed against enforcement of the no-shop and enjoined the parties from enforcing the provision.

In *QVC*, the Delaware Supreme Court expressed concern that the highly restrictive no-shop clause of the Viacom/Paramount merger agreement was interpreted by the board of Paramount to prevent directors from even learning of the terms and conditions of QVC’s offer, which was initially higher than Viacom’s offer by roughly \$1.2 billion.²⁹⁵ The Court concluded that the board invoked the clause to give directors an excuse to refuse to inform themselves about the facts concerning an apparently *bona fide* third-party topping bid, and therefore the directors’ process was not reasonable. And in *Phelps Dodge* in 1999, the Delaware Court of Chancery stated that “no talk” clauses that prohibit a board from familiarizing itself with potentially superior third-party bids were “troubling precisely because they prevent a board from meeting its duty to make an informed judgment with respect to even considering whether to negotiate with a third party.”²⁹⁶ Boards should therefore take care that a “no-shop” does not also function as a “no-talk”—*i.e.*, a clause that interferes with the board’s ongoing duty to familiarize itself with potentially superior bids made by third parties.

“Go-shop” provisions, discussed above in Section III.B.2, which allow the target company to actively solicit competing offers, are a variation on the typical no-shop clause. In addition to the general no-shop restrictions, go-shops provide a period after the merger agreement signing—usually 30 to 50 days—in which the target is permitted to

affirmatively solicit competing bids. The Court of Chancery has stated that the absence of a go-shop provision is not *per se* unreasonable.²⁹⁷

Targets will often require bidders to agree to a “standstill” that precludes the making of an offer. These provisions often include an anti-evasion clause that prohibits the potential bidder from requesting a waiver or taking actions that may make the bidder’s interest in the target public. Even private requests for a waiver have often been prohibited by standstill agreements because under certain circumstances, they can lead to disclosure on the part of the target, or simply a leak, thus giving the impression that the target is “in play.” The position that a target or bidder should take with respect to a provision prohibiting requests for waivers should be evaluated based on the particular circumstances in which the standstill is being negotiated.

In the 2012 *Genomics* case,²⁹⁸ Vice Chancellor Laster of the Court of Chancery enjoined a target company subject to *Revlon* from enforcing such a clause, which he referred to as a “Don’t Ask, Don’t Waive” provision. The Court did not object to the bidder being prohibited from publicly requesting a waiver of the standstill (which the Court understood would eviscerate the standstill the bidders had agreed to by putting the target “into play”), but held that directors have a continuing duty to be informed of all material facts, including whether a rejected bidder is willing to offer a higher price. The Court suggested that a “Don’t Ask, Don’t Waive” provision is analogous to the “no-talk” provision held invalid in *Phelps Dodge* and is therefore “impermissible because it has the same disabling effect as a no-talk clause, although on a bidder-specific basis.”²⁹⁹

Less than a month later, however, then-Chancellor Strine’s bench ruling in *In re Ancestry.com Inc. Shareholder Litigation*³⁰⁰ held that there is no *per se* rule against “Don’t Ask, Don’t Waive” standstill provisions, although he did express the view that they are “potent” provisions that must be used with caution. *Ancestry* recognized the valuable function that “Don’t Ask, Don’t Waive” standstill agreements can play in the process of selling a company as an “auction gavel” encouraging bidders to put their best offers on the table. But the Court also emphasized that “Don’t Ask, Don’t Waive” standstills will be subject to careful judicial review in the *Revlon* context. Then-Chancellor Strine’s ruling expressed the view that the directors of the selling company should be fully informed of the use and implications of the “Don’t Ask, Don’t Waive” standstill provision, and shareholders whose votes are sought for the transaction should be informed if bidders that participated in the auction are contractually prohibited from offering a topping bid. Boards that are considering the

use of these standstill provisions should ensure that their decision-making process is clearly documented.

In the *NetSpend* case,³⁰¹ the Court of Chancery again addressed the use of “Don’t Ask, Don’t Waive” standstill provisions. The seller had previously entered into “Don’t Ask, Don’t Waive” standstill agreements with two private equity firms, while the company was “not for sale.” The Court criticized the board’s decision to keep the provisions in place noting that the board had not “considered whether the standstill agreements should remain in place” and “blinded itself to any potential interest” from the private firms.³⁰²

The Court of Chancery has noted that “directors cannot willfully blind themselves to opportunities that are presented to them.”³⁰³ In considering the totality of the deal protection, the board should consider the effect of any “standstill provisions” included in confidentiality agreements signed with bidders, including the ability (or inability) of bidders to seek to have these restrictions waived.

3. Board Recommendations, Fiduciary Outs and “Force-the-Vote” Provisions

Public company merger agreements generally include provisions requiring the board of directors of the target (and, if the acquiror’s shareholders also will be voting on the transaction, the board of directors of the acquiror) to recommend that shareholders vote in favor of the merger agreement, except in specified circumstances. Merger agreements also often include provisions that permit a party to terminate the agreement to accept a superior proposal, subject to payment of a termination fee and other conditions—commonly known as a “fiduciary out.” The non-terminating party may be given the right to be notified of competing bids and a specified period of time in which to match them. The Delaware Court of Chancery has described non-solicitation clauses with fiduciary outs for superior proposals as “mild deal-protection devices.”³⁰⁴

One issue that is sometimes negotiated, given the reality that a negative board recommendation often is likely to lead to a negative shareholder vote, is whether the board may change its recommendation when the directors determine that their fiduciary duties so require, or can only do so in certain circumstances, such as in the context of a “superior proposal.” *Dicta* in Delaware cases raises the question whether a merger agreement provision precluding a change in recommendation except where a superior proposal has been made may be invalid, on the theory that directors’ fiduciary duties require the board to be able to change its recommendation for any reason.³⁰⁵ In the *Genomics* case, Vice Chancellor

Laster made clear his view that Delaware boards should retain the right to change their recommendation in compliance with their fiduciary duties, explaining that “[u]nlike in the no-shop and termination outs, fiduciary duty law in this context can’t be overridden by contract” because “it implicates duties to target stockholders to communicate truthfully.”³⁰⁶ Similarly, in *In re NYSE Euronext Shareholders Litigation*,³⁰⁷ then-Chancellor Strine in *dicta* expressed skepticism regarding provisions limiting a board’s ability to change its recommendation and described them as “contractual promises to lie in the future.” He also noted that although such provisions create litigation and deal risk, some companies accede to them in negotiations to gain a higher price.

Such criticism has also extended to provisions that delay the board’s ability to change a positive recommendation. Vice Chancellor Laster rhetorically asked in *Compellent*: “if stockholders are entitled to a current, candid, and accurate board recommendation, can a merger agreement contractually prevent the board from updating its recommendation for ‘at least four business days’ and potentially longer . . . ?”³⁰⁸

In some cases, practitioners have sought a middle course, drafting provisions that bar a change in recommendation unless there has been an “intervening event.” In any case, merger agreements often include termination rights for the buyer triggered upon a change in recommendation by the target board and fees payable upon such termination.

Under Section 146 of the DGCL, a Delaware corporation may, in a merger agreement, provide that the agreement be submitted to shareholders even if the board, having deemed the merger agreement advisable at the time of execution, subsequently changes its recommendation.³⁰⁹ This is referred to as a “force-the-vote” provision. Where a target does not have a fiduciary out giving the target board the right to terminate the agreement, a force-the-vote provision can be useful to an acquiror by enabling it to ensure that the target’s shareholders are given the opportunity to decide whether any competing offer is superior, and delaying execution of a competing transaction agreement until after that vote occurs.

4. Shareholder Commitments

In addition to other deal protections, an acquiror may also seek commitments from significant shareholders of the seller, whether members of management or otherwise, to support the transaction. Such commitments typically take the form of voting agreements entered into by stockholders concurrently with the merger or transaction agreement. The

visible, up-front support of major shareholders for a transaction can be a significant deterrent to third-party bids and may be critical in consummating the transaction.

In *Omnicare, Inc. v. NCS Healthcare, Inc.*,³¹⁰ the Delaware Supreme Court in 2003 enjoined a merger between Genesis Health Ventures and NCS Healthcare. The Court held that the approval by the NCS board of voting agreements that ensured shareholder approval of the proposed merger, together with approval of an agreement that included a “force-the-vote” provision without any ability of the board to terminate the merger agreement to accept a superior offer, precluded the directors from exercising their continuing obligation to discharge their fiduciary duties after the announcement of the merger agreement. The Court ruled that a merger agreement that leaves the board with no ability to prevent the submission of the merger to the target shareholders coupled with a majority-shareholder voting agreement is illegal *per se*—regardless of: (1) the unconflicted and fully informed view of the board that such an agreement is in the best interests of the shareholders, (2) the support by shareholders having a majority of the voting power and the largest economic interest and (3) the belief of both the board and the controlling shareholders that the inducement of a no-outs merger agreement was the best and only way to obtain the highest value for the shareholders.

The Court in *Omnicare* noted as a doctrinal matter that “deal protection devices” are subject to *Unocal* enhanced “reasonableness review” (rather than business judgment review) even in a stock-for-stock merger context. In holding that the devices agreed to by NCS’s board failed the second prong of the *Unocal* analysis, the Court determined that the deal protection devices were unreasonable because they were both coercive (*i.e.*, designed to coerce the consummation of the Genesis merger) and preclusive (*i.e.*, designed to preclude the consideration of any superior transaction). More particularly, the Court held that the “latitude” that a board has in either “maintaining or using [such] deal protection devices” depends *post hoc* on the degree of the benefit or detriment to the interests of the shareholders in the value or terms of the subsequent competing transaction. In that regard, the Court declared the deal protection devices “invalid” on the alternative ground that they “prevented” the board from discharging its “continuing” fiduciary responsibilities to the minority shareholders when a superior transaction appeared.

Under the Court’s ruling, no merger agreement that requires a shareholder vote can be truly “locked up,” even at the behest of controlling shareholders and seemingly even at the end of a diligent shopping/auction process. The ruling has made it more difficult for

majority shareholders to arrange the sale of subsidiaries or for majority-controlled companies to attract the highest and best offers from merger partners who may be reluctant to enter into a merger contract with a fiduciary out. As Chief Justice Veasey noted in his dissenting opinion, by “requiring that there must always be a fiduciary out, the universe of potential bidders who could reasonably be expected to benefit stockholders could shrink or disappear.”³¹¹ *Omnicare* remains controversial, and in 2011, the California Court of Appeal specifically declined to follow it.³¹²

Even in Delaware, the effect of *Omnicare* has been limited by subsequent decisions and practice developments. In a 2004 case, the Delaware Court of Chancery clarified the type of deal protection that an acquiror can seek from a controlling shareholder after *Omnicare*. In *Orman*, the Court upheld a voting agreement that required the controlling shareholder to vote for the proposed merger and against any alternative acquisition proposal for 18 months following the termination of the merger agreement.³¹³ The Court identified a number of factual differences from the circumstances presented in *Omnicare*: (1) the controlling shareholders in *Orman* bound themselves to support the merger only as shareholders, but did not restrict their right as members of the board to recommend that public shareholders reject the merger, (2) the *Orman* board negotiated an effective fiduciary out that would allow them to entertain *bona fide* superior offers, while no fiduciary out existed in *Omnicare*, and (3) the deal in *Orman* was expressly subject to approval of a majority of the minority shareholders, but was not in *Omnicare*. In sum, the Court concluded, the public shareholders in *Orman* were not coerced into voting for the merger for “some reason other than the merits of that transaction,” and the deal protection measures did not make the transaction a “*fait accompli*” or a “mathematical certainty” as they did in *Omnicare*. Accordingly, the voting arrangement survived the Court’s review under the *Unocal* standard. It should be noted that the “fiduciary out” in *Orman* was not a right to terminate the merger agreement to accept a superior proposal, but rather consisted of the board’s ability to withdraw its recommendation of the merger coupled with the shareholders’ ability to vote the transaction down. Similarly, in *NetSpend*, Vice Chancellor Glasscock held that “although the voting agreements appear to lock up approximately 40% of the stock in favor of the [proposed transaction], they are saved by the fiduciary-out clause. Specifically, the voting agreements terminate upon the Board’s termination of the Merger Agreement.”³¹⁴ The fiduciary-out in *NetSpend* permitted the Company to accept a more favorable acquisition proposal from a third party, subject to customary “no-shop” and termination fee provisions.

After *Omnicare*, practitioners also speculated whether the *Omnicare* analysis would apply only to mergers subject to a traditional vote at a shareholder meeting, or also to mergers approved by written consent of a holder or holders of a majority of shares shortly after signing a merger agreement. Although the Delaware Supreme Court has not ruled on this issue, in 2011 in *In re OPENLANE, Inc. Shareholders Litigation*, the Delaware Court of Chancery rejected an argument that a merger was an impermissible “*fait accompli*” simply because the merger, which did not include a fiduciary out, was approved by a majority of the stockholders by written consent the day after the merger agreement was signed.³¹⁵ The Court reasoned that the merger agreement did not “force[] a transaction on the shareholders,” who freely chose to submit their written consents, nor did it “deprive[] them of the right to receive alternative offers” because the board could have terminated the agreement without paying a termination fee if a majority of shareholders had not consented within 24 hours of signing.³¹⁶ *OPENLANE* adhered to *Omnicare* because shareholders could freely choose to give or withhold written consent to the transaction. Even so, a sign-and-consent structure can be analyzed under the *Revlon* standard, and boards should confirm that superior bids do not exist. Moreover, written consents may be disfavored where the acquiror intends to issue registered stock to the target’s shareholders because the SEC takes the view that a consent approving a merger constitutes a private offering of the acquiring company’s securities that precludes the acquiror from subsequently registering the offering on Form S-4. The staff takes the view that under such circumstances, offers and sales of the acquiror’s stock have already been made and completed privately, “and once begun privately, the transaction must end privately.”³¹⁷

5. Information Rights and Matching Rights

Information rights and matching rights provide bidders with an opportunity to learn more information about competitive bids and allow them to improve their offer. Specifically, information rights require a target to supply the initial bidder with information about subsequent bids in the event that a second bidder appears. The holders of such rights have an informational advantage because they can prepare counter-offers with knowledge about counter-bids. Matching rights give bidders an explicit right to match a competing offer before the target’s board can change its recommendation or terminate the agreement to accept that offer under the fiduciary out. Matching rights can take many forms, including “reset matching rights” whereby the initial bidder can match each competitive bid and “single-trigger matching rights” which allows the initial bidder to match only the first bid.

Information and matching rights have been criticized because such rights can deter subsequent bidders who do not wish to enter into a bidding contest. On the other hand, such rights can assist in initially bringing potential acquirors to the table. Because such rights reduce the uncertainty of consummating the transaction for the initial acquiror, a bidder might be more willing to make the initial investment to prepare an initial bid.

Delaware courts have routinely upheld matching rights, noting that “the presence of matching rights in the merger agreement do not act as a serious barrier to any bidder” willing to pay more than the merger consideration.³¹⁸ Delaware courts recognize that it might be reasonable for a board to grant matching rights if it is “necessary to successfully wring out a high-value bid.”³¹⁹ Matching rights have become nearly universal in transactions, appearing in over 99% of transactions with an equity value of \$100 million or more in 2014.³²⁰ Similarly, information rights have been routinely upheld by the Delaware Court of Chancery.³²¹

6. Other Deal Protection Devices

a. Issuance of Shares

Another mechanism available to transaction parties is the issuance of equity securities to the buyer prior to the record date for the merger vote, which increases the likelihood of shareholder approval of the merger. Although a transaction that involves the issuance of equity securities equal to or in excess of 20% of an issuer’s outstanding equity securities generally requires shareholder approval under NYSE and NASDAQ rules, an exception to the shareholder approval requirement may be granted by NYSE pursuant to NYSE Rule 312.05 when “the delay in securing stockholder approval would seriously jeopardize the financial viability of the enterprise.” NASDAQ has a similar exception to its shareholder approval policy. However, public disclosure of this extreme level of distress can have a number of negative consequences, including negative impact on customers and suppliers, and the possibility of triggering defaults under debt instruments and key contracts. Companies need to carefully assess these risks before invoking the “financial viability” exception to shareholder approval.

b. Loans and Convertible Loans

Some acquirors provide bridge loans or other commitments to financially distressed targets, which can have the effect of “locking-up” the transaction. For example, in *Genomics*,³²² the buyer provided \$30 million in bridge financing to a financially unstable target upon the signing of a merger agreement. In the event of a topping bid, the buyer

could convert the loan into shares, which, if fully drawn, represented approximately 22% of the then-outstanding stock of the target. In refusing to enjoin the transaction, Vice Chancellor Laster noted that the bridge loan “provided substantial benefit to [the target] in the form of much needed cash to get them through at least most of, and ideally all of, depending on how the future turns out, the transaction process and possibly a little bit beyond.”³²³ The Court of Chancery subsequently ruled in *Comverge* that a bridge loan made at the same time that a merger agreement was executed might be unreasonable because it could preclude a topping bid.³²⁴

c. Crown Jewels

The “crown-jewel” lock-up, in its classic form, is a device in which the target company grants the acquiror an option to purchase, or otherwise obtain the benefit of, key target assets in the event that the proposed merger does not close. This type of lock-up gives the acquiror assurance that even outside of a successful merger, it will nevertheless get key pieces of the target’s business. The device may also serve to deter competing bidders, since even with a superior topping bid, the competing bidders may not get the deal they are seeking (*i.e.*, at best they may get a deal without the crown jewels). Given their generally preclusive nature to other bids, crown-jewel lock-ups fell out of favor after *Revlon*, although at times, targets have granted options for legitimate business reasons.

For example, in JP Morgan’s 2008 acquisition of Bear Stearns during the financial crisis, JP Morgan received an option to purchase Bear Stearns’ headquarters for \$1.1 billion, which plaintiffs in the ensuing shareholder litigation claimed was a price well below the then-estimated value of the headquarters and amounted to a preclusive termination fee. The New York Supreme Court upheld the use of this option. Although a primary reason for doing so was that the record failed to substantiate plaintiffs’ claims that the headquarters option price was below fair value, the court further noted that “[t]he financial catastrophe confronting Bear Stearns, and the economy generally, justified the inclusion of the various merger protection provisions intended to increase the certainty of the consummation of the transaction with JPMorgan.”³²⁵

When carefully structured, the crown-jewel lock-up may serve as a useful deal protection device even outside of the circumstances presented by the 2008 financial crisis. For example, in 2012, in exchange for certain present and future cash payments, AuthenTec granted Apple an option to acquire a nonexclusive license to its sensor technology, separate and apart from the merger agreement between the two parties. In its proxy disclosure about this option, AuthenTec was careful to stress the reputational benefits of having public ties with Apple and the economic

benefits of the expected future cash stream from Apple. A Florida court denied a stockholder plaintiff's application to enjoin the transaction.³²⁶

Generally, having an independent business purpose for the separate crown-jewel arrangement will help the lock-up pass judicial muster. More recently, in the merger between NYSE Euronext and IntercontinentalExchange Inc. (ICE), ICE separately agreed with NYSE to act as the exclusive provider of certain clearing services for NYSE's European derivatives business for two years, whether or not the merger took place. The parties extensively detailed the business rationale for this agreement, mostly arising out of NYSE's need for clearing services regardless of whether the ICE merger was consummated. In evaluating that agreement under the *Unocal* standard, then-Chancellor Strine noted that there was "no evidence in the record that presents a barrier to any serious acquirer" and that a topping bidder could reach an economic solution with all parties concerned for a relatively small sum.³²⁷ In that regard, Delaware courts may take a close look at the preclusive effect of such side commercial arrangements on potential topping bidders in evaluating whether such agreements are an impermissible crown-jewel lock-up defense.

B. Material Adverse Effect Clauses

Virtually all domestic public company merger agreements allow the buyer to refuse to close if there has been a "material adverse effect" on or a "material adverse change" in the target company's business (although these provisions are less common in acquisition agreements involving European companies). This "MAE" or "MAC" clause is one of the principal mechanisms available to the parties to a transaction to allocate the risk of adverse events transpiring between signing and closing. In *IBP, Inc. v. Tyson Foods (In re IBP, Inc. Shareholders Litigation)*, the Delaware Court of Chancery provided important guidance on the use of these clauses.³²⁸ The Court placed the burden of proving a material adverse effect on the buyer and clarified that an MAE must be a long-term effect rather than a short-term failure to meet earnings targets: "[An MAE] provision is best read as a backstop protecting the acquiror from the occurrence of unknown events that substantially threaten the overall earnings potential of the target in a durationally-significant manner. A short-term hiccup in earnings should not suffice; rather the Material Adverse Effect should be material when viewed from the longer-term perspective of a reasonable acquiror."³²⁹ The *IBP* Court concluded that the acquiror had not met this standard and ordered it to complete the merger.

The *IBP* case is important not only for its explanation of the MAE concept but also because the Court ordered specific performance. The

Court found that New York law applied, requiring the party seeking specific performance to establish its entitlement to that remedy by the preponderance of the evidence (rather than, as in Delaware, by clear and convincing evidence). The Court held that IBP had met its burden, reasoning that the business combination between IBP and Tyson was a unique opportunity, that monetary damages would be difficult to calculate and “staggeringly large,” and that the remedy was practicable because the merger still made strategic sense.

While then-Vice Chancellor Strine decided the *IBP* case under New York law, Delaware courts have applied his analysis to merger agreements governed by Delaware law. In *Frontier Oil Corp. v. Holly Corp.* in 2005, Vice Chancellor Noble reiterated that the burden of proving an MAE, based on the “expectation of the parties, as reflected in the Merger Agreement and as informed by the case law,” fell on the party asserting it.³³⁰ The *Frontier* Court, like the *IBP* Court, refused to find an MAE, concluding that the existence of a potentially catastrophic lawsuit did not constitute an MAE where there was no evidence that the target was likely to lose the suit and where defense costs, while large and material to the buyer, did not rise to the level of an MAE in the context of the target’s enterprise value.³³¹

In *Hexion Specialty Chems., Inc. v. Huntsman Corp.*,³³² the Delaware Court of Chancery in 2008 reaffirmed that the acquiring company has a “heavy burden” in establishing an MAE and reminded acquirors that it “is not a coincidence” that “Delaware courts have never found a material adverse effect to have occurred in the context of a merger agreement.”³³³ The Court ruled that because the merger agreement contained a provision in which the target disclaimed that it was warranting the projections that had been submitted to the acquiror, the acquiror could not claim that the target’s failure to meet those projections by a wide margin should be considered in evaluating whether there had been an MAE.³³⁴ The Court concluded that the actual and expected performance of the target company could only be compared to the performance of the target company in the corresponding periods preceding the signing of the merger agreement. When measured against those historic results, the target company’s disappointing performance did not rise to the level of an MAE.

In addition to the difficulty in establishing that a “material adverse effect” has occurred, parties seeking to invoke MAE clauses have also had difficulty overcoming the long list of exceptions that a typical MAE clause contains. In *Genesco v. Finish Line*, the Tennessee Court of Chancery refused, in 2007, to excuse Finish Line’s and UBS’s performance because the cause of Genesco’s downturn, general economic or industry

conditions, had specifically been excluded from the definition of the MAE.³³⁵ Since *IBP v. Tyson*, public company targets have tended to negotiate long lists of factors—such as economic and industry developments (often to the extent they do not have a disproportionate impact on the adversely affected party)—that are excluded from the definition of MAE.

While no Delaware court has yet found an MAE to have occurred in a fully litigated case, an MAE clause is not illusory. Because the MAE provision allows an acquiror to refuse to close if there has been a material adverse effect on the target company's business, it can also serve as a lever for renegotiating a transaction. An acquiror claiming that a target MAE occurred can put the target company in the difficult position of either litigating to enforce the original transaction terms (running the risk that the alleged MAE is established) or accepting a reduced price and other terms. Following the dramatic market downturn at the height of the LBO boom in the summer of 2007, the MAE clauses in numerous merger agreements were implicated. Some of these transactions were renegotiated (e.g., the acquisition of Home Depot's supply unit by an investor group led by Bain Capital), others were terminated by mutual agreement of the parties (either with no strings attached, like the proposed merger between MGIC Investment Corp. and Radian Group Inc., or with an alternative arrangement such as the investment that KKR and Goldman Sachs made in Harman International when they terminated their agreement to take Harman private), and a few led to litigation, as described below.

C. Committed Deal Structures, Optionality and Remedies for Failure to Close

Traditionally, strategic buyers, with significant balance sheets, were expected to fully commit to the completion of a cash acquisition whereas financial sponsors, who often depended on borrowing a portion of the purchase price, negotiated for financing conditions that allowed the sponsor to exit the deal in the event that it was unable to obtain financing on the terms contemplated by the financing commitment papers executed at signing.

During the LBO boom of 2005–2007, however, sellers were able to negotiate purportedly seller-friendly provisions from financial buyers, including:

- *No Financing Condition.* The elimination of the financing condition left the buyer in breach in the event of a failure to obtain financing.

- *Reverse Termination Fee.* The reverse termination fee required the buyer to pay a fee in the event the buyer failed to close due to an inability to obtain financing (later expanded to a failure to close for any reason). The reverse termination fee often was the seller's sole remedy in the event of a failure to close.
- *Denial of Specific Performance.* The acquisition agreement would often provide that the seller could not obtain specific performance of the buyer's obligation to close, or could obtain such specific performance only in limited circumstances.
- *Limited Obligations of Financial Sponsor.* Because the buyer entity that actually signed the acquisition agreement with the target typically was a shell, the private equity fund would often sign a limited guarantee of the buyer's obligation to pay the reverse termination fee. In addition, the fund typically would sign an equity commitment letter in favor of the buyer to cover the equity portion of the purchase price. This letter usually provided that the funds would become due only if a closing occurred and sometimes, but not always, provided third-party beneficiary rights to the target company.

Although this structure was originally intended to increase deal certainty for sellers, the net effect of these features was to create a transaction structure that, depending on the specific terms of the documentation, could resemble an option to buy the target, permitting the buyer to walk away for a fixed cost (*i.e.*, the reverse termination fee).

The credit crunch and financial crisis that began in 2007 put the paradigmatic private equity structure to the test as buyers (and in some cases, lenders) decided to walk away from, or renegotiate, signed deals that had not yet closed. While many of the troubled deals were resolved consensually (including through price deductions and terminations) rather than through litigation, a number of situations were judicially resolved. For example, in *United Rentals, Inc. v. RAM Holdings, Inc.*,³³⁶ the Delaware Court of Chancery in 2007 respected provisions (albeit ambiguous ones) denying specific performance and giving the buyer the right to terminate the deal upon payment of the reverse termination fee; in *Alliance Data Systems Corp. v. Blackstone Capital Partners V L.P.*,³³⁷ the Court, in 2009, held that the shell companies formed by a financial sponsor to effect the merger did not have a contractual obligation to cause the sponsor, which was not a party to the merger agreement, to do anything to obtain a regulatory approval that was a condition to the shell companies' obligations to close the merger; and the same year in *James Cable, LLC v. Millennium Digital Media Systems, L.L.C.*,³³⁸ the Court

rejected claims, including for tortious interference, against a financial sponsor arising out of its portfolio company's alleged breach of an asset purchase agreement, where the sponsor was not a party to the agreement, did not enter into a written agreement to provide funding and did not make enforceable promises to help fund the transaction. The Court in *James Cable* reaffirmed the Delaware principle that companies affiliated through share ownership are shielded from tortious interference claims where their actions are "in furtherance of their shared legitimate business interests" unless the plaintiff offers specific allegations that the defendant was motivated by bad faith or a malicious purpose.

These market and judicial developments have influenced trends in transaction structuring in the post-crisis environment. For example, the less committed structures developed in the private equity arena were imported to some extent into several strategic transactions that occurred a number of years ago, such as the Mars/Wrigley, Pfizer/Wyeth and Hercules/Ashland deals. More recently, Berkshire Hathaway and 3G Capital's strategic acquisition of Heinz contained a reverse termination fee that allowed the buyers to walk away from the deal. Nonetheless, many strategic transactions continue to employ the traditional "full remedies" model, in which the seller is expressly granted the right to specific performance and there is no cap on damages against the buyer. On the other end of the spectrum is the "pure option" model, employed on rare occasions in financial sponsor transactions, in which the seller's right to specific performance is expressly denied and the seller's sole remedy for any and all breaches is payment of the reverse termination fee. Most private equity transactions today chart a middle course, in which a reverse termination fee is payable upon a financing failure, which also serves as the seller's sole remedy, and the seller retains a specific performance right to require the closing to occur (including the ability to compel a draw-down of the equity financing) if the debt financing is available. A further variation occasionally (but much more rarely now) seen in leveraged deals is a two-tiered reverse termination fee structure, in which a lower fee is payable for financing failures or non-willful breaches and a higher fee is payable when the financing is available or in the event of a willful breach.

Symmetry between target termination fees and reverse termination fees has become less common, with reverse termination fees often being higher. Although reverse termination fees now frequently range from 4% to 10% of transaction value, some have been higher, sometimes reaching well in excess of 10% of deal value, and in rare cases as high as the full equity commitment of the sponsor. In addition, the acquisition agreements governing many leveraged private equity transactions have obligated the buyers to use efforts to force lenders to fund committed financing, and in some cases specifically require the pursuit of litigation in furtherance of

this goal. Debt commitment letters, however, usually do not allow targets to seek specific performance directly against lenders or name targets as third-party beneficiaries. Lenders have in most cases sought to include provisions directly in acquisition agreements that limit or mitigate their own liability (commonly referred to as “Xerox provisions,” having been used in the Xerox/ACS transaction). These provisions vary, but generally include (1) limiting the target’s remedy to the payment of the reverse termination fee, (2) requiring that any action against the lenders be governed by New York law, (3) requiring that the buyer and seller waive any right to a jury trial in any action against the lenders, and (4) making the lender a third-party beneficiary of these provisions.

A recent innovation is a grace period that allows buyers to try to force the lenders to complete a financing. In the Berkshire Hathaway and 3G Capital acquisition of Heinz, the parties agreed to a provision (sometimes referred to as a “ketchup provision”) that provided that if the acquisition financing fell through, then the buyers would have four additional months to obtain financing before Heinz would be entitled to collect its reverse termination fee due to the buyer’s financing failure. Such provisions help mitigate the risk related to obtaining financing. Another innovation that has appeared in some deals (such as the acquisition of Tommy Hilfiger by Phillips Van Heusen) has been the introduction of a ticking fee concept, in which the purchase price increases by a stated amount for each day that the closing is delayed beyond a specified target date.

In addition to financing risk, reverse termination fees may also be used as a mechanism to allocate regulatory risk. In the proposed AT&T/T-Mobile transaction, the merger agreement required AT&T to pay Deutsche Telekom \$3 billion and transfer spectrum if the deal failed to win antitrust clearance. AT&T ultimately withdrew the deal amid regulatory opposition and paid Deutsche Telekom the termination fee. The \$3.5 billion Halliburton/Baker Hughes reverse termination fee is another such example.

Another important decision related to damages for failing to consummate a transaction is the U.S. Court of Appeals for the Second Circuit’s decision in *Consolidated Edison, Inc. v. Northeastern Utilities (Con Ed)*, which held that under New York law, lost shareholder premium could be collected neither by the selling company nor by its shareholders (due to lack of standing) as damages for the buyer’s alleged breach of an agreement that disclaimed third-party rights until after the “effective time” of the merger.³³⁹ Targets have, in some cases, sought to address *Con Ed*—which potentially could leave a target without an adequate remedy for a buyer’s breach where specific performance is precluded by the merger

agreement or otherwise unavailable—by including language in the merger agreement to the effect that damages for the buyer’s breach should be calculated based on shareholder loss, or by choosing Delaware law (under which the issue addressed in *Con Ed* has not yet been resolved) to govern the merger agreement.³⁴⁰

The *Hexion* decision discussed above in Part V.B addressed another issue that should be considered in negotiating contractual provisions relating to remedies, which is whether post-termination liability should be limited or eliminated for certain types of breaches. In *Hexion*, the Court interpreted a provision allowing uncapped damages in the case of a “knowing and intentional breach of any covenant” and liquidated damages of \$325 million in the event of other enumerated breaches. The Court held that “a ‘knowing and intentional’ breach, as used in the merger agreement, is the taking of a deliberate act, which act constitutes in and of itself a breach of the merger agreement, even if breaching was not the conscious object of the act.”³⁴¹ Whether and how a party should seek to define such limitations on liability is a question that should be considered in light of the particular circumstances.

As indicated by the variety of permutations that have been employed, negotiations of the deal certainty provisions in any particular transaction can proceed along a number of dimensions, including the amount of the reverse termination fee(s), if any, and the trigger(s) for payment; the breadth of any specific performance remedy; the types of breaches that could give rise to post-termination damages claims; the circumstances in which a cap on damages, if any, will apply; rights and remedies under ancillary documents such as equity commitment letters, limited guarantees and debt commitment letters; and expense reimbursement provisions. Transaction participants should be keenly aware of the impact and interrelation of these various components and carefully consider which package of deal certainty provisions is appropriate under the circumstances, based on factors such as whether the deal involves a strategic buyer or a financial sponsor; whether any debt financing will be required, and, if so, the extent of the leverage; the nature of any regulatory risk; the size of the transaction; and the relative bargaining power and sophistication of the parties.

VI.

Advance Takeover Preparedness and Hostile M&A

Advance takeover preparedness can improve a corporation's ability to deter coercive or inadequate bids or to secure a high premium in the event of a sale of control of the corporation. If gaps in a company's takeover defenses are found, the board must balance the desire to foreclose present vulnerabilities to unknown future threats against the risk of raising the company's profile with shareholder and governance activists. Companies should also consider contingency plans that can be adopted to deal with new threats.

Advance preparation for defending against a harmful takeover may also be critical to the success of a preferred transaction that the board has determined to be part of the company's long-term plan. As discussed in Section II, a decision to enter into a business combination transaction does not necessarily obligate a board to serve as auctioneer. In the case of a merger or acquisition not involving a change of control, the board may retain the protection of the business judgment rule in pursuing its corporate strategy.³⁴²

The Delaware Supreme Court's landmark *Time-Warner* decision illustrates the importance for a company that desires to maximize its ability to reject a hostile takeover bid to consider periodically its long-term business and acquisition strategies. In *Time-Warner*, both the Delaware Court of Chancery and the Delaware Supreme Court were influenced heavily by the documented history of Time's long-term business and acquisition strategies and Time's prior consideration and rejection of Paramount as a merger partner. *Time-Warner* shows that courts will respect and defer to a company's decision to reject a hostile bid and adhere to its long-term plans.

A. Rights Plans or "Poison Pills"

Rights plans, popularly known as "poison pills," are the most effective device for deterring abusive takeover tactics and inadequate bids by hostile bidders. Rights plans do not interfere with negotiated transactions, nor do they preclude unsolicited takeovers. The evidence is clear, however, that rights plans do have the desired effect of forcing a would-be acquiror to deal with a target's board. In this regard, rights plans ultimately may enable the board to extract a higher acquisition premium from an acquiror or deter inadequate offers. Economic studies have concluded that, as a general matter, takeover premiums are higher for

companies with rights plans in effect than for other companies and that a rights plan or similar protection increases a target's bargaining power. *See* Section VI.A.3. In addition, numerous studies have concluded that the negative impact, if any, of adoption of a rights plan on a company's stock price is not statistically significant.

The issuance of share purchase rights has no effect on the capital structure of the issuing company. If an acquiror takes action that triggers the rights, however, dramatic changes in the capital structure of the target company and/or the acquiror can result.

Rights plans have long been the subject of active discussion and debate, and they continue to contribute significantly to the structure and outcome of most major contests for corporate control. This debate has only increased, as many companies have allowed their rights plans to expire, have affirmatively terminated their rights plans, have modified their rights plans with watered-down protections, or have agreed not to implement rights plans going forward absent shareholder approval or ratification within some period of time, generally one year. In addition, ISS has policy guidelines providing that it would recommend an "against" or "withhold" vote for directors who: (i) adopt a rights plan with a "dead-hand" or "modified dead-hand feature," (ii) adopt a rights plan with a term of more than 12 months, or renew any existing rights plan (regardless of term), without shareholder approval, although a commitment to put a newly adopted rights plan to a binding shareholder vote within 12 months "may potentially offset an adverse vote recommendation," or (iii) make a material adverse change to an existing rights plan without shareholder approval. Directors who adopt a rights plan with a term of 12 months or less will be evaluated on a case-by-case basis, taking into account, among other things, how close the plan's adoption was to the date of the next shareholders meeting and the issuer's rationale. ISS also has a general policy of recommending votes in favor of shareholder proposals calling for companies to redeem their rights plans, to submit them to shareholder votes or to adopt a principle that any future rights plan would be put to a shareholder vote, subject to certain limited exceptions for companies with existing shareholder-approved rights plans and rights plans that will be put to a shareholder ratification vote within 12 months of adoption or expiry.

According to SharkRepellent, over 3,000 companies at one point had adopted rights plans, including over 60% of the S&P 500 companies. However, recent trends in shareholder activism, as well as the ability of a board to adopt a rights plan on short notice in response to a specific threat, have led to a marked decrease in the prevalence of these plans. Today, 367 U.S.-incorporated companies, including 4% of the S&P 500, have rights plans in effect. However, rights plans continue to be adopted by

small-cap companies that feel vulnerable to opportunistic hostile bids, companies responding to unsolicited approaches, including by stockholder activists, and, as noted below, companies putting in place so-called “Section 382” rights plans. In addition, many companies have an up-to-date rights plan “on the shelf,” which is ready to be quickly adopted if and when warranted.

Despite the decreased prevalence of long-term rights plans, we continue to believe that rights plans—or at least a board’s ability to adopt them rapidly when the need arises—remain a crucial component of an effective takeover defense and serve the best interests of shareholders. Accordingly, boards should generally endeavor to avoid situations that would lead to this ability being lost or significantly curtailed.

Rights plans may also be used to protect a corporation’s tax assets. Opportunistic investors who see attractive buying opportunities may present special risks to corporations with net operating losses (“NOLs”), “built-in” losses and other valuable tax assets. Accumulations of significant positions in such a corporation’s stock could result in an inadvertent “ownership change” (generally, a change in ownership by five-percent shareholders aggregating more than 50 percentage points in any three-year period) under Section 382 of the Internal Revenue Code. If a company experiences an ownership change, Section 382 will substantially limit the extent to which pre-change NOLs and “built-in” losses stemming from pre-change declines in value can be used to offset future taxable income. As with operating assets, boards of directors should evaluate the potential risks to these valuable tax assets and consider possible actions to protect them. In the last five years, 82 companies with significant tax assets have adopted rights plans designed to deter a Section 382 ownership change, according to SharkRepellent. Such rights plans typically incorporate a 4.9% threshold, deterring new shareholders from accumulating a stake of 5% or more, as well as deterring existing five-percent shareholders from increasing their stake in a way that could lead to a Section 382 ownership change. ISS recognizes the unique features of such a rights plan and will consider, on a case-by-case basis (despite the low threshold of such plans), management proposals to adopt them based on certain factors—including, among others, the threshold trigger, the value of the tax assets, other shareholder protection mechanisms and the company’s governance structure and responsiveness to shareholders. ISS also states that it will oppose any management proposal relating to a Section 382 pill if it has a term that would exceed the shorter of three years or the exhaustion of the NOLs.

A rights plan has also been used as a deal protection device following the signing of a friendly merger agreement. Rights plans in

such cases may help protect a deal against hostile overbids in the form of a tender offer and could deter activist shareholder efforts to accumulate large numbers of shares and vote down a proposed merger. In Apollo's 2014 acquisition of Chuck E. Cheese, Chuck E. Cheese adopted a poison pill that had a 10 percent trigger. If the board of Chuck E. Cheese waived, amended, or redeemed the rights plan, Apollo could terminate the deal and receive the termination fee.

Hedge funds and other shareholder activists have used equity swaps and other derivatives to acquire substantial economic interests in a company's shares without the voting or investment power required to have "beneficial ownership" for disclosure purposes under the federal securities laws. Rights plans can be drafted to cover equity swaps and other derivatives so as to limit the ability of hedge funds to use these devices to facilitate change-of-control efforts, although careful consideration should be given as to whether and how to draft a rights plan in this manner. One such rights plan was challenged in a Delaware court, although the case was settled with the company making clarifications to certain terms of the rights plan.

1. The Basic Design

The key feature of a rights plan is the "flip-in" provision of the rights, the effect of which, in specified circumstances, is to impose unacceptable levels of dilution on an acquiror. The risk of dilution, combined with the authority of a target's board to redeem the rights prior to a triggering event (generally an acquisition of between 10% and 20% of the target's stock), gives a potential acquiror a powerful incentive to negotiate with the target's board rather than proceeding unilaterally.

A rights plan should also provide that, once the triggering threshold is crossed, the target's board may exchange, in whole or in part, each right held by holders other than the acquiror for one share of the target's common stock. This provision avoids the expense of requiring rights holders to exercise their flip-in rights, eliminates any uncertainty as to whether individual holders will in fact exercise the rights and produce the intended dilution, and provides the board additional flexibility in responding to a triggering event. The exchange provision was used by the board of directors of Selectica when that pill was triggered by Trilogy in January 2009, and upheld by the Delaware Supreme Court in October 2010 in response to Trilogy's challenge of that pill.³⁴³ In cases where the acquiring person holds less than 50% of a target's stock, the dilution caused by implementation of the exchange feature is substantial and can be roughly comparable to the dilution caused by the flip-in provision, assuming all eligible rights holders exercise their rights.

Some companies have adopted rights plans that do not apply to a cash offer for all of the outstanding shares of the company. Recent versions of this exception have limited its scope to cash offers containing a specified premium over the market price of the target's stock. While a so-called "chewable pill" rights plan has some limited utility and may avoid a shareholder resolution attack, it is not effective in many situations and may create an artificial "target price" for a company that does not maximize shareholder value. As discussed in the next subsection, a recent trend by some companies is to adopt rights plans with bifurcated triggers (e.g., a higher trigger for Schedule 13G filers and a lower trigger for Schedule 13D filers) to allow their large, long-term institutional investors to continue to accumulate shares even during an activist situation, while placing a lower ceiling on potential "creeping control" by activists.

2. Basic Case Law Regarding Rights Plans

Rights plans, properly drafted to comply with state law and a company's charter, typically survive judicial challenge even under a *Unocal* analysis.³⁴⁴ Furthermore, courts have recognized rights plans as important tools available to boards to protect the interests of a corporation.³⁴⁵

One of the most debated issues concerning rights plans focuses on whether or not a board should be required to redeem the rights plan in response to a particular bid. In this respect, courts applying Delaware law have upheld, or refused to enjoin, determinations by boards not to redeem rights in response to two-tier offers, or inadequate 100% cash offers,³⁴⁶ as well as to protect an auction or permit a target to explore alternatives.³⁴⁷

In a landmark decision in February 2011 involving the broadest challenge to a poison pill in decades, the Delaware Court of Chancery reaffirmed the ability of a board of directors, acting in good faith and in accordance with their fiduciary duties, to maintain a poison pill in response to an inadequate all-cash, all-shares tender offer.³⁴⁸ The decision by then-Chancellor Chandler in *Airgas* reaffirmed the vitality of the pill and upheld the primacy of the board of directors in matters of corporate control, even after the target company with a staggered board had lost a proxy fight for one-third of the board. The decision reinforces that directors may act to protect the corporation, and all of its shareholders, against the threat of inadequate tender offers, including the special danger that arises when raiders induce large purchases of shares by arbitrageurs who are focused on a short-term trading profit, and are uninterested in building long-term shareholder value. Essentially, the Court held that a well-informed, independent board may keep the pill in place so long as it has a good faith and reasonable basis for believing the bid undervalues the shareholders' interest in the company. The Court stated that it is up to

directors, not raiders or short-term speculators, to decide whether a company should be sold. The board—and the Court’s—decisions were vindicated four years later, when, in 2015, Airgas agreed to be sold to Air Liquide at a price of \$143 per share, in cash, nearly 2.4 times Air Products’ original \$60 offer and more than double its final \$70 offer, in each case before considering the more than \$9 per share of dividends received by Airgas shareholders in the intervening years.

A second contested issue concerning rights plans is whether they may be adopted to prevent accumulations of ownership outside of the context of an outright bid for the company. On this point, the Delaware Court of Chancery has made it clear that the board may act in response to legitimate threats posed by large stockholders. For instance, the adoption of a rights plan to deter acquisitions of substantial stock positions was upheld by the Delaware Court of Chancery in the case involving Ronald Burkle’s acquisition of 17% of Barnes & Noble.³⁴⁹ Then-Vice Chancellor Strine held that the company’s adoption of a rights plan with a 20% threshold that grandfathered Burkle’s 29% stake was a “reasonable, non-preclusive action to ensure that an activist investor like [Burkle] did not amass, either singularly or in concert with another large stockholder, an effective control bloc that would allow it to make proposals under conditions in which it wielded great leverage to seek advantage for itself at the expense of other investors.”³⁵⁰ In the Barnes & Noble case, the Court upheld the rights plan’s prohibitions on “acting in concert” for purposes of a proxy contest and noted that the key question was whether the rights plan “fundamentally restricts” a successful proxy contest. In defining the behavior that might trigger a rights plan, the Court seemed to suggest that triggers should be based on the well-recognized definition of beneficial ownership in Section 13D of the Exchange Act. However, as previously noted, this is an unsettled point of law and, in appropriate circumstances, companies are well-advised to consider adopting rights plans that encompass aggregations of voting or economic interests through synthetic derivatives that decouple the traditional bundle of rights associated with outright common stock ownership.

Additionally, in 2014, the Delaware Court of Chancery upheld a rights plan adopted by the Sotheby’s board of directors in response to a rapid accumulation of its stock by Third Point and other short-term speculators. Notably, the rights plan adopted by the Sotheby’s board of directors had a two-tier trigger structure (setting a 20% trigger for 13G filers and a 10% trigger for 13D filers). After Sotheby’s refused Third Point’s request to waive the 10% trigger threshold during a proxy contest, Third Point sued the board of directors for breach of fiduciary duty, claiming that the “primary purpose” of the board’s refusal to waive the lower trigger was to prevent Third Point from prevailing in a proxy

context, that the rights plan was “disproportionate” to the threat that Third Point’s slate of nominees posed and that the rights plan was discriminatory because it was allegedly designed to favor the incumbent board. In *Third Point v. Ruprecht*, the Court of Chancery found sufficient evidence that the threat of “creeping control” posed by a hedge fund group led by Third Point created a legitimate, objectively reasonable threat and that the adoption of the rights plan was likely a proportionate response to collusive action by a group of hedge funds. In addition, the Court recognized that the board’s refusal to waive the lower trigger was reasonable because Third Point still posed a threat of negative control—a “situation[] in which a [stockholder] obtains an explicit veto right ... through a level of share ownership ... at a level that does not amount to majority control.” This decision reaffirms that a board may take action, including by adopting a rights plan, to defend the corporation against any reasonably perceived threat and the continued vitality of a rights plan in the face of evolving threats to corporate effectiveness.

Rights plans have also been upheld outside of the corporate control context. In *Selectica, Inc. v. Versata Enterprises, Inc.*, the Delaware Supreme Court rejected a *Unocal* challenge to the use of a “Section 382” rights plan with a 4.99% trigger designed to protect a company’s NOLs, even when the challenger had exceeded the threshold and suffered the pill’s dilutive effect.³⁵¹ Selectica never achieved an operating profit and had generated NOLs of approximately \$160 million. These NOLs could have substantial value in the event that the company became profitable, but under Section 382 of the Internal Revenue Code they can be adversely affected if the company experiences an “ownership change” of over 50% during a three-year period (measured by reference to holders of 5% or larger blocks). During 2008, the Selectica board considered and rejected several asset purchase and takeover proposals from Trilogy, a long-time corporate rival. After Trilogy then purchased some 6% of Selectica’s shares, Selectica reviewed its NOL status and learned that additional acquisitions of roughly 10% of the float by new and existing 5% holders would significantly impair the NOLs. The Selectica board responded by amending the company’s rights plan to lower the trigger from 15% to 4.99% (with a grandfather clause allowing pre-existing 5% holders to purchase another 0.5%). Shortly thereafter, Trilogy purposely broke through the NOL pill’s limit, with the stated rationale of “bring[ing] accountability” to the Selectica board and “expos[ing]” its “illegal behavior” in adopting the low-trigger NOL plan. The Selectica board triggered the pill’s exchange feature, doubling the number of outstanding shares held by holders other than Trilogy and diluting Trilogy from 6.7% to 3.3%. This marked the first intentional triggering of a flip-in rights plan, and the first exercise of the common stock-for-rights exchange provision in a rights plan by a board of directors. Selectica then adopted a

new rights plan with a 4.99% trigger to maintain the protection against additional purchases by Trilogy.

The Delaware Supreme Court in *Selectica* rejected Trilogy's challenge to the pill and the board's determination to utilize the pill's exchange feature.³⁵² First, the Court concluded that the board had reasonably identified the potential impairment of the NOLs as a threat to Selectica. Second, the Court held that the 4.99% rights plan was not preclusive. Explaining that a defensive measure cannot be preclusive unless it "render[s] a successful proxy contest realistically unattainable given the specific factual context," the Court credited expert testimony that challengers with under 6% ownership routinely ran successful proxy contests for micro-cap companies. The Court sharply rejected Trilogy's contention that Selectica's full battery of defenses was collectively preclusive, holding that "the combination of a classified board and a Rights Plan do[es] not constitute a preclusive defense." Finally, the Court held that the adoption, deployment and reloading of the 4.99% pill was a proportionate response to the threat posed to Selectica's tax assets by Trilogy's acquisitions.

3. "Dead Hand" Pills

When a board rejects an unsolicited bid, the tactic of choice for the bidder is often to combine a tender offer with a solicitation of proxies or consents to replace a target's board with directors committed to considering the dismantling of a rights plan to permit the tender offer to proceed. The speed with which this objective can be accomplished depends, in large part, upon the target's charter and bylaws and any other defenses that the target has in place. In Delaware, a bidder can act by written consent without a meeting of shareholders unless such action is prohibited in the certificate of incorporation, and can call a special meeting between annual meetings if permitted under a target's bylaws.

The holders of a majority of the shares can remove directors on a non-staggered board of a Delaware corporation with or without cause,³⁵³ while directors on a staggered board can only be removed for cause unless the certificate of incorporation provides otherwise.³⁵⁴

Thus, if a target's charter does not prohibit action by written consent and the target does not have a staggered board, a bidder for a Delaware corporation generally can launch a combined tender offer/consent solicitation and take over the target's board as soon as consents from the holders of more than 50% of the outstanding shares are obtained. Even if the target's charter prohibits action by written consent and precludes shareholders from calling a special meeting, a target without a staggered board can essentially be taken over in under a year by

launching a combined tender offer/proxy fight shortly before the deadline to run a proxy fight at the target's annual meeting. In contrast, a target with a staggered board may be able to resist a takeover unless a bidder successfully wages a proxy fight over two consecutive annual meetings—a point well-illustrated by Airgas' ultimately successful two-year takeover defense described in VI.A.2 above.

Some companies without staggered boards have adopted rights plans redeemable only by vote of the continuing directors on the board (*i.e.*, the incumbent directors or successors chosen by them)—a so-called “dead hand” pill. Variations of this concept come in a variety of forms, such as so-called “nonredemption” or “no hand” provisions, which typically provide that the board cannot redeem the rights plan once the continuing directors no longer constitute a majority of the board. This limitation on redemption may last for a limited period or for the remaining life of the rights plan. Another variant is the “limited duration” or “delayed redemption” dead hand pill, whereby the dead hand or no hand restriction's effectiveness is limited to a set period of time, typically starting after the continuing directors no longer constitute a majority of the board. The use of dead hand and no hand provisions was effectively foreclosed by Delaware case law over 15 years ago, although courts in Georgia and Pennsylvania have upheld their validity.³⁵⁵

B. Staggered Boards

Under Delaware law, directors on a staggered board can be removed only for cause, unless the certificate of incorporation provides otherwise.³⁵⁶ Hostile bidders can be expected to be creative in attempting to circumvent a staggered board provision and to find any hole in a target's defenses.

For example, Air Products tried to reduce the effectiveness of Airgas' staggered board in connection with its 2010 hostile bid. In addition to nominating a slate of three directors to be elected to the Airgas board at the Airgas annual meeting in September 2010, Air Products proposed a bylaw amendment that would accelerate the 2011 Airgas annual meeting to January 2011. Airgas' charter—like the charter provisions of a majority of major Delaware corporations with staggered boards—provided that directors will “be elected to hold office for a term expiring at the annual meeting of stockholders held in the third year following the year of their election.” The bylaw amendment was approved by Airgas shareholders, a substantial portion of which were arbitrageurs. While the Delaware Court of Chancery upheld the validity of the bylaw amendment, the Delaware Supreme Court unanimously reversed, finding that directors on staggered boards were elected to three-

year terms, and that the bylaw constituted a *de facto* removal of directors in a manner inconsistent with the Airgas charter.³⁵⁷

C. Other Defensive Charter and Bylaw Provisions

Defensive charter and bylaw provisions typically do not purport to, and will not, prevent a hostile acquisition. Rather, they provide some measure of protection against certain takeover tactics and allow a board additional negotiating leverage, as well as the opportunity to respond appropriately to proxy and consent solicitations. Defensive charter provisions include: (1) provisions that eliminate shareholder action by written consent or rights to call a special meeting; (2) provisions limiting the ability of shareholders to alter the size of a board; (3) “fair price” provisions (which require that shareholders receive equivalent consideration at both ends of a two-step bid, thus deterring coercive two-tier, front-end-loaded offers); and (4) “business combination” provisions (which commonly provide for supermajority voting in a wide range of business combinations not approved by the company’s continuing directors, if the transaction does not meet certain substantive requirements).

Because certain defenses (such as the elimination of the ability of shareholders to act by written consent) may only be implemented via the charter in the case of Delaware corporations and therefore require shareholder approval, and due to general institutional investor opposition to such provisions, few companies have put forth new proposals for such provisions in recent years. However, bylaws generally can be amended without shareholder approval and can be used to implement some of the structural defenses found in charters, although such defenses, if placed only in the bylaws, would be subject to further amendment by shareholders. Bylaws, as discussed in more detail below, often contain provisions in addition to those found in corporate charters, including: advance notice provisions relating to shareholder business and director nomination proposals, provisions that address the subject matters that may properly be brought before shareholder meetings and provisions establishing director eligibility standards. Bylaw provisions regarding the business to be conducted at, and the manner of presenting proposals for, annual and special meetings, as well as procedures for shareholder action by written consent (for companies that have not eliminated action by written consent in their charter), are helpful in protecting against an unexpected proxy or consent contest for control of the board of directors and can be adopted by a board without shareholder approval. Especially in light of the risks of shareholder activism, proxy fights and consent solicitations, state-of-the-art bylaw procedures can be extremely important. Such procedures help to ensure that boards have an appropriate

period of time to respond in an informed and meaningful manner to shareholder concerns and to prepare and clear any related proxy statement disclosure.

ISS has adopted voting guidelines to address bylaws adopted unilaterally without a shareholder vote. ISS will generally recommend that stockholders vote against or withhold votes from directors individually, committee members or the entire board if the board “amends the company’s bylaws or charter without shareholder approval in a manner that materially diminishes shareholders’ rights or that could adversely impact shareholders,” considering specified factors. Unless it is reversed or submitted to a binding shareholder vote, ISS will make voting recommendations on a case-by-case basis on director nominees in subsequent years, and will generally recommend voting against if the directors classified the board, adopted supermajority vote requirements to amend the bylaws or charter, or eliminated shareholders’ ability to amend bylaws.

Companies should review their bylaws on a regular basis to ensure that they are up to date and consistent with recent case law and SEC developments, and to determine whether modifications may be advisable. The most significant of these bylaw provisions are discussed in detail below.

1. Nominations and Shareholder Business

These bylaw provisions require shareholders to provide advance notice of business proposed to be brought before, and of nominations of directors to be made at, shareholder meetings, and have become common. These provisions generally set a date by which a shareholder must advise the corporation of the shareholder’s intent to seek to take action at a meeting (usually a minimum of 90 to 120 days in advance of the anniversary of the prior year’s meeting) and fix the contents of the notice, which can include information such as beneficial stock ownership and other information required by Regulation 14A of the federal proxy rules. Failure to deliver proper notice in a timely fashion usually results in exclusion of the proposal from shareholder consideration at the meeting. Bylaw provisions may also require nominees to respond to a questionnaire providing information about the candidate’s background and qualifications, address agreements the candidate may have with third parties as to voting or compensation in connection with the candidate’s service as a director, and address the nominee abiding by applicable confidentiality, governance, conflicts, stock ownership, trading and other policies of the company. In light of recent activity by hedge funds and others, companies may also decide to ask for disclosure of derivative and short positions, rather than limit such disclosure to the traditional category

of voting securities. The questionnaires are a useful way for boards of companies that have eligibility requirements for director nominations in their bylaws to have sufficient information to make ineligibility determinations where they are warranted.

Two 2008 Delaware Court of Chancery decisions have emphasized the need to review and update advance notice bylaw provisions. In March 2008, the Court held in *JANA Master Fund Ltd. v. CNET Networks, Inc.* that CNET's advance notice bylaw was applicable only to shareholder proposals made under Exchange Act Rule 14a-8 of the federal securities laws and not to the insurgent's proposed nomination of candidates for election to the CNET board.³⁵⁸ On a close reading of the bylaw—taking into account its precatory nature (the shareholder “may seek” to have an issue brought), the connection of its deadline to the filing of the proxy, and its grafting of Rule 14a-8's requirements onto the bylaw—the Court found that it was clearly designed to apply only to Rule 14a-8. In April 2008, the Court ruled in *Levitt Corp. v. Office Depot, Inc.* that a dissident shareholder was entitled to nominate director candidates from the floor of the annual meeting, despite the company's valid advance notice of business bylaw, because the company had brought the “business” of considering director candidates before the meeting by noticing the “election of directors” as an item of business.³⁵⁹ The *CNET* and *Levitt Corp.* cases indicate that the Court of Chancery views advance notice bylaws skeptically and may interpret them narrowly to require explicit reference to shareholder nominations before finding that any advance notice bylaw bars a dissident slate. Further, although the validity of advance notice bylaws has been established in many court decisions, such provisions are not immune from legal challenge. In 2012, for example, the Delaware Court of Chancery granted a motion to expedite a claim brought by Carl Icahn alleging that the directors of Amylin Pharmaceuticals had breached their fiduciary duties by enforcing the company's advance notice bylaw provision and refusing to grant Mr. Icahn a waiver to make a nomination following the company's rejection of a third-party merger proposal after the advance notice deadline.³⁶⁰ In December 2014, however, the Court of Chancery alleviated some of the concerns raised by the Amylin decision. The court clarified that, in order to enjoin enforcement of an advance notice provision, a plaintiff must allege “compelling facts” indicating that enforcement of the advance notice provision was inequitable (such as the board taking an action that resulted in a “radical” change between the advance notice deadline and the annual meeting).³⁶¹ Thus, while these cases do not call into question the permissibility or appropriateness of advance notice bylaws as to director nominations, shareholder business or other matters, they show that the applicability of such bylaws to *all* shareholder nominations and proposals should be made explicit and that enforcement of such bylaws should be equitable.

2. Dissident Director Conflict/Enrichment Schemes

Some companies have adopted or considered adopting bylaws designed to deter directors from taking special compensation from third parties, typically activist hedge funds, either by completely disqualifying such a director from serving or by requiring that all such arrangements be disclosed. These compensation schemes often entitle directors to large payments if the activist's goals are met within near-term deadlines. Such compensation schemes raise a host of issues because the directors' incentives may diverge from those of shareholders. These schemes also call into question whether the directors are able to satisfy their fiduciary duties to shareholders. Bylaw provisions can be formulated to prohibit qualification as a director if a candidate is a party to any such special compensation arrangement. Companies have the authority to adopt these provisions under DGCL § 141(b), which provides that "the certificate of incorporation or bylaws may prescribe other qualifications for directors." ISS has indicated, however, in a FAQ released in February 2015, that it would consider a board-adopted bylaw that disqualifies shareholders' nominees or directors who receive third-party compensation (as opposed to requiring mere disclosure of such arrangements) as "materially adverse to shareholders" and that such a bylaw would likely draw an ISS recommendation to vote against the board if adopted without shareholder approval. Where such qualification bylaws are put to a vote of shareholders, ISS had initially indicated open-mindedness as to whether they would recommend in favor of such a bylaw, but to date ISS has recommended against proposals seeking shareholder ratification of such bylaws. Nevertheless, a few companies have obtained shareholder support for such bylaws, even in the face of an adverse ISS recommendation. And, some companies—perhaps, in the spirit of compromise—have coupled a prohibition on such "golden leash" arrangements with adoption of a proxy access bylaw. Of the approximately 160 U.S. companies that have adopted proxy access bylaws, 25 companies reserve the right to exclude shareholder nominees that are party to or that may become party to any compensatory arrangements relating to their service as a director in such bylaw. Additionally, the Council of Institutional Investors has petitioned the SEC to issue regulatory guidance or new proxy rules requiring nominating shareholders to disclose the details and impact of compensation arrangements they may have with their director candidates.

3. Meetings

Provisions regarding the regulation of meetings play an important role in controlling the timing and frequency of meetings. If, as in Delaware, shareholders can be denied the right to call special meetings,³⁶² such a bylaw provision can delay potential proxy contests to the annual

meeting. Where state law does not so permit, corporations should also consider adopting bylaw provisions that regulate the ability of shareholders to call special meetings.

Many bylaws specify a particular date for an annual meeting. Such provisions should be amended to provide more flexibility and discretion to the board to set an annual meeting date. A board should be authorized to postpone previously scheduled annual meetings upon public notice given prior to the scheduled annual meeting date.

The chairman of the shareholder meeting should be specifically authorized to adjourn the meeting from time to time whether or not a quorum is present. Adjournments (and postponements) may help prevent premature consideration of a coercive or inadequate bid. The chairman of the meeting should also have express and full authority to control the meeting process, including the ability to require ballots by written consent, select inspectors of elections, and determine whether proposals and/or nominations were properly brought before the meeting.

As a matter of good planning, companies should also be alert to timing issues when undertaking friendly transactions. For instance, if a transaction is signed at a time of year near an upcoming annual meeting, management may consider putting the proposal to approve the merger on the agenda of the annual meeting rather than calling a special meeting. This, however, can be a trap for the unwary, as shareholder (and thus hostile bidder) access to the annual meeting agenda is often more liberal than to special meeting agendas, and, if an annual meeting must be significantly delayed past the one-year anniversary of the prior year's meeting (*e.g.*, due to an extended SEC comment process in connection with the merger proxy), under many standard notice bylaws, a later deadline for shareholder proposals may be triggered. Once triggered, this could enable a potential interloper to run a proxy contest or otherwise interfere with the shareholder vote. In many cases, the special meeting approach will be the right choice.

4. Vote Required

To approve a proposal, except for election of directors (which requires a plurality of the quorum if a company has not adopted a bylaw providing for majority voting), the required shareholder vote should not be less than a majority of the shares present and entitled to vote at the meeting (*i.e.*, abstentions should count as “no” votes for shareholder resolutions). For Delaware corporations, Section 216 of the DGCL dictates this result unless the charter or bylaws specify otherwise.³⁶³

5. Action by Written Consent

If the corporation's charter does not disallow action by shareholder consent in lieu of a meeting, the bylaws should establish procedures for specifying the record date for the consent process, for the inspection of consents and for the effective time of consents. Although Sections 213 and 228 of the DGCL contemplate such procedures, Delaware courts have closely reviewed these provisions to determine whether their real purpose is to delay and whether the procedures are unreasonable.³⁶⁴

6. Board-Adopted Bylaw Amendments

Although advance takeover preparedness is optimal, it is not always possible. Delaware courts have affirmed a board's ability to adopt reasonable bylaw amendments in response to a hostile offer, but such amendments may be subject to heightened scrutiny. A bylaw amendment made after announcement or knowledge of an unsolicited offer will be reviewed under the *Unocal* standard, and possibly under *Blasius Industries, Inc. v. Atlas Corp.*³⁶⁵ as discussed in Section II.B.2. The most common forms of such after-the-fact defensive bylaws change the date of a shareholder meeting in the face of a proxy contest or change the size of the board. In a series of decisions, the Delaware courts have generally accepted that boards can delay shareholder meetings (by bylaw amendment or adjournment) where there is "new information" or a change in position by the board.³⁶⁶

7. Forum Selection Provisions

In recent years, a number of companies have adopted forum selection provisions to help reign in the cost of multiform shareholder litigation. These forum selection provisions generally cover derivative lawsuits, actions asserting breaches of fiduciary duty, actions arising from the state of incorporation's business code, and actions asserting claims governed by the internal affairs doctrine.

In *Boilermakers Local 154 Retirement Fund v. Chevron Corp.*,³⁶⁷ a case of first impression, the Delaware Court of Chancery upheld the validity of forum selection bylaws as a matter of Delaware law. In that case, shareholders of Chevron and FedEx challenged: (1) whether bylaws could regulate the venue for shareholder corporate and derivative litigation as a matter of Delaware law; (2) whether the unilateral adoption of forum selection bylaws by a board of directors was a breach of the board's fiduciary duties; and (3) whether such bylaws could bind shareholders. The Court ultimately concluded that forum selection bylaws were facially valid under the DGCL and that a boards' unilateral adoption of bylaws did not render them contractually invalid. The Court noted that Section

109(b) of the DGCL permits the bylaws to “contain any provision, not inconsistent with law or with the certificate of incorporation, relating to the business of the corporation, the conduct of its affairs, and its rights or powers or the rights or powers of its stockholders, directors, officers or employees.”³⁶⁸ On the question of the board’s fiduciary duties, the Court held that “[j]ust as the board of Household was permitted to adopt the pill to address a future tender offer that might threaten the corporation’s best interests, so too do the boards of Chevron and FedEx have the statutory authority to adopt a bylaw to protect against what they claim is a threat to their corporations and stockholders, the potential for duplicative law suits in multiple jurisdictions over single events.”³⁶⁹ Finally, the Court held that the bylaws were valid as a matter of contract because investors knew when they bought stock of the corporation that the board could unilaterally adopt bylaws that were binding on shareholders.

In 2015, the Delaware General Assembly gave statutory backing to forum selection bylaws by adopting a new provision of the General Corporation Law, which allows a company, in its certificate of incorporation or bylaws, to provide that “any or all internal corporate claims shall be brought solely and exclusively in any or all of the courts in this State.”³⁷⁰ Notably, the new provision also provides that a forum selection bylaw may not divest stockholders of the right to bring suit in Delaware, thus overturning the result of *City of Providence v. First Citizens BancShares, Inc.*, where the Court of Chancery had ruled that a company could validly adopt a bylaw providing that all litigation must be brought in its non-Delaware headquarters state.³⁷¹ Jurisdictions outside Delaware are increasingly enforcing forum selection bylaws that provide that shareholder litigation must be conducted in Delaware.³⁷² The Court of Chancery, however, has consistently stated that it is reluctant to grant an anti-suit injunction against proceedings in a sister jurisdiction to uphold these bylaws, and instead still requires litigation filed outside of the contractually selected forum to be challenged in that jurisdiction.³⁷³

Although a growing number of companies are adopting forum selection bylaws, companies should also consider the risk of adverse recommendations from proxy advisory firms. ISS has stated that unilateral adoption by the board of an exclusive forum bylaw will be evaluated under ISS’ policy on unilateral bylaw and charter amendments. As discussed in Part VI.C, this policy focuses on whether such a bylaw “materially diminishes shareholder rights” or “could adversely impact shareholders.” Glass Lewis’ policy is to recommend voting against the chairman of the nominating and governance committee when a company adopts an exclusive forum provision without shareholder approval outside of a spin-off, merger or IPO.

8. Fee-Shifting Bylaws and Mandatory Arbitration Provisions

Although it is common in some jurisdictions outside the United States for the losing party to pay the prevailing party's attorney's fees and costs, under the majority rule in the U.S. each party must pay its own attorney's fees and costs, regardless of the outcome of the litigation. The Delaware Supreme Court in *ATP Tour, Inc. v. Deutscher Tennis Bund*, on a question of law certified to it from the District Court for the District of Delaware, held that a board-adopted fee-shifting bylaw that imposed the costs of litigation on a non-prevailing plaintiff in a private non-stock corporation is facially valid under Delaware law.³⁷⁴ In so ruling, the Delaware Supreme Court recognized that a "bylaw that allocates risk among parties in intra-corporate litigation" relates to the conduct of the affairs of the corporation.³⁷⁵ The Delaware Supreme Court cautioned that a fee-shifting bylaw enacted for an improper purpose would be invalid, even if the board had authority to adopt it in the first instance.

In response to the *ATP* case, the Delaware legislature adopted an amendment to the Delaware General Corporation Law providing that "[t]he certificate of incorporation may not contain any provision that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with an internal corporate claim."³⁷⁶ Although the statutory amendment bars fee-shifting provisions in stock corporations, it specifically does not apply to non-stock corporations, and thus leaves the holding of *ATP* intact.

Some bylaws and certificates of incorporation also include mandatory arbitration provisions requiring the resolution of any disputes, claims or controversies brought by shareholders in either a personal, class or derivative capacity to be resolved through binding and final arbitration. In *Corvex Management LP v. Commonwealth REIT*,³⁷⁷ a Maryland Court upheld the validity of such a provision. The Court rejected the plaintiffs' arguments that the bylaw was unenforceable because the shareholders had neither "assented" to the provision nor received consideration for its adoption. Instead the Court noted that the plaintiffs were sophisticated parties who had both constructive and actual knowledge of the clause, and therefore had assented to being bound by the provision. Companies considering adopting such provisions should take into account the fact that Maryland has not extended its ruling to unsophisticated shareholders and that other states, including Delaware, have not yet upheld the validity of mandatory arbitration provisions.

D. Change-of-Control Employment Arrangements

In order to attract and retain executives, most major companies have adopted executive compensation programs containing change-of-control protections for senior management. Change-of-control employment agreements or severance plans are not defensive devices intended to deter sales or mergers; rather they are intended to ensure that management teams are not deterred from engaging in corporate transactions that are in the best interests of shareholders on account of the potential adverse effects those transactions may have on management's post-transaction employment. A well-designed change-of-control employment agreement should neither incentivize nor disincentivize management from engaging in a transaction on the basis of personal circumstances.

Although there continues to be a great deal of scrutiny of executive compensation arrangements, appropriately structured change-of-control employment agreements are both legal and proper. Courts that have addressed the legality of change-of-control agreements and other benefit protections have almost universally found such arrangements to be enforceable and consistent with directors' fiduciary duties so long as such directors do not have a conflict of interest.³⁷⁸ A board's decision to adopt change-of-control provisions is usually analyzed under the business judgment rule.³⁷⁹ The scrutiny applied to such arrangements may be heightened if they are adopted during a pending or threatened takeover contest, thereby making careful planning in advance of a merger all the more important. Public companies that do not already maintain reasonable change-of-control protections for senior management should consider implementing them, and companies that already maintain such arrangements should monitor and periodically review them.

Over the years, a generally consistent form of change-of-control employment agreement or plan has emerged. Typically, the protections of the agreement or plan become effective only upon a change-of-control or in the event of a termination of employment in anticipation of a change-of-control. A protected period of two years following a change-of-control is fairly typical. If the executive's employment is terminated during the protected period by the employer without cause or by the executive following a specified adverse change in the terms of employment, the executive is entitled to severance benefits.

The severance benefits must be sufficient to ensure neutrality and retention, but not so high as to be excessive or to encourage the executive to seek a change-of-control when it is not in the best interests of the company and its shareholders. For the most senior executives at public companies, a multiple of an executive's annual compensation (*e.g.*, two or

three times) is the standard severance formula in most industries. “Compensation” for this purpose generally includes base salary and annual bonus (based on a fixed formula, usually related to the highest or average annual bonus over some period, or target bonus) and in some cases accruals under qualified and supplemental defined benefit pension plans. In addition, severance benefits typically include welfare benefit continuation during the severance period. In the change-of-control context, severance is customarily paid in a lump sum within a specified period of time following a qualifying termination, as opposed to installment payments, which prolong a potentially strained relationship between the executive and the former employer.

Many change-of-control agreements incorporate provisions to address the impact of the federal excise tax on excess parachute payments. The “golden parachute” tax rules subject “excess parachute payments” to a dual penalty: the imposition of a 20% excise tax upon the recipient and non-deductibility by the paying corporation. Excess parachute payments result if the aggregate payments received by certain executives of the company that are treated as “contingent” on a change-of-control equal or exceed three times the individual’s “base amount” (the average annual taxable compensation of the individual for the five or lesser number of years during which the employee was employed by the corporation preceding the year in which the change-of-control occurs). If the parachute payments to such an individual equal or exceed three times the “base amount,” the “excess parachute payments” generally equal the excess of the parachute payments over the employee’s base amount. Historically, many public companies have provided a “gross-up” for the golden parachute excise tax to their most senior executives. Recently, however, there has been increasing shareholder pressure against gross-ups, and they have become less common, particularly in new or modified agreements.

Companies should periodically analyze the impact the golden parachute excise tax would have in the event of a hypothetical change of control. The excise tax rules, for a variety of reasons, can produce arbitrary and counter-intuitive outcomes that punish long-serving employees in favor of new hires, punish promoted employees in favor of those who have not been promoted, punish employees who do not exercise options in favor of those who do, disadvantage employees who elect to defer compensation relative to those who do not and penalize companies and executives whose equity compensation programs include performance goals. Indeed, companies have historically implemented gross-ups because they are concerned that the vagaries of the excise tax would otherwise significantly reduce the benefits intended to be provided under the agreement and that such a reduction might undermine the shareholder-

driven goals of the agreement. As gross-ups become less prevalent, the importance of understanding the impact of the excise tax has increased, and companies and executives are more frequently considering excise tax impact and mitigation techniques in the context of compensation design.

In addition to individual change-of-control agreements, some companies have adopted so-called “tin parachutes” for less senior executives in order to formalize company policies regarding severance in the change-of-control context. Because of the number of employees involved, careful attention should be paid to the potential cost of such arrangements and their effect on potential transactions

Companies should also review the potential impact of a change-of-control on their stock-based compensation plans. Because a principal purpose of providing employees with equity incentives is to align their interests with those of the shareholders, plans should contain provisions for the acceleration of equity compensation awards upon a change-of-control (“single-trigger”) or upon a severance-qualifying termination event following a change-of-control (“double-trigger”). There has been a trend in recent years towards double-trigger vesting, although a significant minority of public companies still provide for single-trigger vesting.

Companies can expect increasing shareholder scrutiny of change-of-control employment arrangements, particularly in light of the nonbinding shareholder advisory votes on executive compensation in annual proxy statements and on golden parachute arrangements in transaction proxy statements that were mandated by Dodd-Frank in 2010. Heightened disclosure requirements regarding golden parachutes are triggered where shareholders are asked to approve an acquisition, merger, consolidation or proposed sale or other disposition of all or substantially all of the assets of a company. Furthermore, ISS and other shareholder advisory groups continue to criticize certain change-of-control practices such as excise tax gross-ups, single-trigger equity award vesting and post-retirement perks. Notwithstanding this increased scrutiny, companies should assess these and other executive compensation arrangements in light of company-specific needs, rather than broad policy mandates.

E. “Poison Puts”

Debt instruments may include provisions, sometimes known as “poison puts,” that allow debtholders to sell or “put” their bonds back to the issuing corporation at a predetermined price, typically at par or slightly above par value, if a defined “change of control” event occurs. Poison puts began to appear in bond indentures during the LBO boom of the 1980s in response to acquirors’ practice of levering up targets with new debt, which in turn led to ratings downgrades and a decline in the prices of

the targets' existing bonds. The inclusion of these protections, which generally cover mergers, asset sales and other change of control transactions, as well as changes in a majority of the board that is not approved by the existing directors (the latter being sometimes referred to as a "proxy put"), is generally bargained for by debtholders and therefore is assumed to lead to better terms (such as lower pricing) for the borrower.

In recent years, Delaware courts have addressed so-called proxy puts and, in so doing, have provided cautionary guidance on the effectiveness of poison puts in general. In 2009, in *San Antonio Fire & Police Pension Fund v. Amylin Pharmaceuticals, Inc.*, the Delaware Court of Chancery held that the board has the power, and so long as it is complying with the contractual implied duty of good faith and fair dealing to the debtholders also the right, to "approve" a dissident slate of director nominees for purposes of a proxy put in the company's bond indenture, even while the board is conducting a public campaign against them.³⁸⁰ Interpreting the terms of the indenture to preclude the board from "approving" the slate would have "an eviscerating effect on the stockholder franchise" and would "raise grave concerns" about the board's fiduciary duties in agreeing to such a provision.³⁸¹ The Court also clarified that the board is "under absolutely *no* obligation to consider the interests of the noteholders" in determining whether to approve the dissident slate.³⁸²

In its March 2013 decision in *Kallick v. SandRidge Energy Inc.*, the Court of Chancery cast further doubt on the effectiveness of proxy puts. *SandRidge* applied *Unocal*'s intermediate standard of review both to a board's decision to agree to poison put provisions in the first place and its subsequent conduct with respect to such clauses.³⁸³ Citing *Amylin*, then-Chancellor Strine held that a board must approve a dissident slate for purposes of a proxy put unless "the board determines that passing control to the slate would constitute a breach of the duty of loyalty, in particular, because the proposed slate poses a danger that the company would not honor its legal duty to repay its creditors." According to then-Chancellor Strine, a board may only decline to approve dissident nominees where the board can "identify that there is a specific and substantial risk to the corporation or its creditors posed by the rival slate" (such as by showing the nominees "lack the integrity, character, and basic competence to serve in office") or where the dissident slate has announced plans that might affect the company's ability to "repay its creditors." Thus, even though the board there believed itself to be better qualified and prepared to run the company than the dissident nominees, the Court enjoined the incumbent directors from opposing a control contest unless and until they approved their rivals for purposes of the put.

In 2014, the Court of Chancery, in *Pontiac General Employees Retirement v. Ballantine*, expressed further skepticism that proxy puts could be employed in a manner consistent with a board's fiduciary duties. In *Ballantine*, a company entered into restated credit and term loan agreement with a poison put. Two years later, an 11% stockholder, North Tide Capital, sent a critical letter to the board and threatened to wage a proxy fight, which was ultimately settled when the company agreed to nominate three North Tide candidates to the board.³⁸⁴ The board was then sued by stockholders who argued that the directors breached their fiduciary duties by approving a credit agreement with a poison put. Because the proxy fight with North Tide Capital had settled, the defendants argued that there was no present risk that the poison puts would trigger and that therefore the case was not ripe. Vice Chancellor Laster disagreed. He concluded that poison puts have a "deterrent effect," that "[a] truly effective deterrent is never triggered" and that "[i]f the deterrent is actually used, it has failed its purpose."³⁸⁵ Pointing to *Toll Brothers*, the Court noted that the put could have a chilling effect now and that there is no "requirement that an actual[] proxy contest be underway."³⁸⁶ The Court refused to dismiss the defendant directors from the case, and also ruled that the complaint had stated a claim against the lender on an aiding and abetting theory. In 2015, the Court went so far as to suggest that a proxy put might be so difficult to use that it was akin to a "toothless bulldog."³⁸⁷ When the case was later settled, the credit agreement was amended to eliminate the proxy put (without any payment to the lenders for agreeing to the amendment) and the company agreed to pay up to \$1.2 million in attorneys' fees.

Boards considering adoption of poison puts, and possibly other change of control agreements, should be aware that the adoption itself, as well as a board's decisions with respect to such instruments, may be challenged and reviewed by a skeptical court. Courts recognize, of course, that lenders may legitimately demand these positions and that companies may benefit from their use. But because courts may view poison puts as possibly having an entrenching effect in some circumstances, the board should weigh the potential effect of entrenchment against the needs of the lender and document carefully the process it followed. At least one board has heeded the warning—Morgans Hotels pre-approved the dissident nominees as continuing directors, so as not to trigger the change of control covenant in its notes.

F. Responding to an Unsolicited Offer—Preliminary Considerations

Takeover preparedness remains critical in today's M&A environment. Failure to prepare for a takeover attempt exposes potential

targets to pressure tactics and reduces the target's ability to control its own destiny. Further, while takeover defense is more art than science, there are some generally applicable principles to which companies should generally adhere.

1. Disclosure of Takeover Approaches and Preliminary Negotiations

When a takeover approach is made, keeping the situation private is generally preferable as it is much easier to defeat an unsolicited bid if it never becomes public. Once a takeover approach becomes public, a target company's options narrow dramatically because arbitrageurs and hedge funds often take positions in its stock, changing its shareholder base. These short-term investors' objectives will necessarily conflict with the company's pursuit of a standing, long-term plan and will most often pressure the board to accept a bid, with less regard to its adequacy than the board.

Because there are a limited number of ways to acquire control of a target without the support of its board—*i.e.*, through a tender offer, a stock purchase, or a combined tender offer and proxy contest—and each available hostile acquisition method is less preferable than a negotiated transaction, most initial takeover approaches are made privately and indicate a desire to agree to a friendly transaction. Acquirors generally begin their approach with either: (i) a “casual pass” where a member of the acquiror's management will contact a senior executive or director of the target and indicate the desire to discuss a transaction; or (ii) through a private bear-hug letter. Bear-hug letters come in various forms and levels of specificity but generally are viewed as a formal proposal to the target's management or board to engage in a transaction. While these private approaches give target boards time to consider the merits of a potential friendly transaction, they often put targets in the unenviable position of having to decide whether public disclosure is desirable or required. Determining if disclosure is required in response to a takeover approach or preliminary merger negotiations is a factually driven inquiry. The two guiding factors in this inquiry are: (i) whether information about the acquisition proposal is material and (ii) whether the target has a duty to disclose the approach.

The materiality of speculative events such as preliminary merger negotiations is determined based on the particular facts of each case by applying the Supreme Court's test in *Basic v. Levinson*³⁸⁸: whether, balancing the probability that the transaction will be completed and the magnitude of the transaction's effect on the issuer's securities, there is a substantial likelihood that the disclosure would be viewed by the reasonable investor as having significantly altered the total mix of

information. To assess probability, companies must look at the “indicia of interest in the transaction at the highest corporate levels” considering, among other things, board resolutions, instructions to investment bankers, and actual negotiations between the parties. The magnitude of the transaction on the issuer’s securities is determined by reference to the size of the two corporate entities and the potential premium over market value. However, “[n]o particular event or factor short of closing the transaction need be either necessary or sufficient by itself to render merger discussions material.”³⁸⁹

Even if preliminary merger negotiations are material, no disclosure is required absent an affirmative disclosure duty.³⁹⁰ A corporation is not required to disclose a fact merely because reasonable investors would very much like to know it.³⁹¹ However, an acquiror’s acquisition of a toehold position in the target’s stock or rumors regarding a potential transaction may occasionally lead to inquiries directed at the target. Consequently, disclosure duties most commonly arise in two situations: (i) when subsequent factual developments occur that make the issuer’s previous statements misleading or (ii) when leaks and market rumors are attributable to the issuer.

As a general matter, a company is not required to disclose approaches and negotiations in response to such inquiries.³⁹² However, if a target elects to speak publicly about mergers or acquisitions, it must speak truthfully and completely.³⁹³ Therefore, in most situations, the best response is a “no comment” posture. However, a “no comment” response may not be appropriate if the issuer had previously made a statement that has been rendered materially false or misleading as a result of subsequent events or if market rumors are attributable to issuer leaks.³⁹⁴

Similarly, a company cannot reply “no comment” in response to inquiries about unusual market activity or rumors if the leak is attributable to the company.³⁹⁵ However, if the leak is not attributable to the company, there is no duty to correct the market or verify the rumor.³⁹⁶ Market rumors and leaks are attributed to a company if it has “sufficiently entangled itself” with the disclosure of information giving rise to the rumor.³⁹⁷ In *State Teachers Retirement Board v. Fluor*,³⁹⁸ Fluor, a construction company, was awarded a \$1 billion contract to build a coal gasification plant in South Africa and, prior to it publicly disclosing award of the contract, its share price surged and daily trading volume increased threefold. Fluor received several inquiries from market analysts and reporters regarding rumors of the contract award but Fluor declined to comment due to contractual restrictions.³⁹⁹ The Second Circuit held that the company’s decision to not confirm the rumors could not give rise to liability because there was no indication that the leak was attributable to

the company or its employees.⁴⁰⁰ However, while courts have not required disclosure to combat rumors and leaks that are not attributable to the company, stock exchange rules, subject to certain exceptions, impose prompt disclosure duties to combat unusual market activity.⁴⁰¹

2. Other Considerations

In addition to keeping the situation private, all communications from and to an acquiror should be directed through the CEO unless otherwise decided by the board. Acquirors often will attempt to contact individual board members directly in order to undermine the target's ability to present a unified negotiating front or to learn information. Additionally, maintaining board unity is essential to producing the best outcome, whether the goal is independence or negotiating the best possible sale price. In this regard, the CEO should keep the board informed of developments, consult the board and solicit its advice. Honest and open debate should be encouraged, but kept within the boardroom.

During a takeover defense, every decision is tactical and must align with the target's defensive strategy. No conversation with a hostile bidder should be assumed to be off the record and any signs of encouragement, self-criticism or dissension within the board can be used against the company. Consequently, the board should carefully craft a formal response. Except in the case of a publicly disclosed tender offer, there is no period in which a company must respond to an offer. And, there is no duty to negotiate, even in the face of a premium bid, because no company is for sale from a legal perspective until the board determines that the company is for sale.

G. Defending Against an Unsolicited Offer

1. "Just Say No"

Unless the target has otherwise subjected itself to *Revlon* duties (e.g., by having previously agreed to enter into an acquisition involving a change-of-control, as in *QVC*), it seems clear that the target may, if it meets the relevant standard, "just say no" to an acquisition proposal.

Targets of unsolicited offers have been successful in rejecting such proposals in order to follow their own strategic plans. In response to a hostile bid by Moore, Wallace Computer Services relied on its rights plan and long-term strategy, rather than seeking a white knight, initiating a share repurchase program or electing another "active" response to Moore's offer. When Moore challenged the rights plan in Delaware federal district court, Wallace was able to satisfy the refusal to redeem the pill under the *Unocal* standard. Although 73% of Wallace's shareholders

tendered into Moore's offer, the Court found that the Wallace board had sustained its burden of demonstrating a "good faith belief, made after reasonable investigation, that the Moore offer posed a legally cognizable threat" to Wallace. The evidence showed that the favorable results from a recently adopted capital expenditure plan were "beginning to be translated into financial results, which even surpass management and financial analyst projections."⁴⁰² As the *Moore* decision illustrates, where the target of a hostile bid wishes to consider rejecting the bid and remaining independent, it is critical that the board follow the correct process and have the advice of an experienced investment banker and legal counsel.

Additionally, the ability of a board to reject an unsolicited offer by relying on its rights plan was reaffirmed in *Airgas*, as discussed in Sections II.B.2.a and VI.A.2. The *Airgas* board rejected a series of increasing tender offers from Air Products because it found the price to be inadequate, and the Delaware Court of Chancery upheld the primacy of the board's determination, even though *Airgas* had recently lost a proxy fight to Air Products for one-third of the company's staggered board.⁴⁰³

However, while a rights plan is the most useful tool for staving off a hostile bid, it is not necessary to successfully "just say no" in every situation. What is necessary in every case—and what a rights plan is designed to protect—is a thoughtful long-term plan that was developed by a board and management who long-term shareholders trust to deliver value. This proposition was on full display in Perrigo's recent successful defense of Mylan's \$35.6 billion takeover bid—the largest hostile takeover battle in history to ever go to the tender offer deadline.

In April 2015, Mylan made an exchange offer to acquire Perrigo (which had inverted from Michigan to Ireland). Perrigo's board rejected the bid because it undervalued the company. As an Irish company, Perrigo was prevented from adopting typical, U.S. style defenses, such as a rights plan, by a prohibition under the Irish Takeover Rules on the taking of "frustrating actions" in response to a bid. Consequently, Perrigo's best defense was to convince its shareholders that the value of a stand-alone Perrigo exceeded the value of a combined Mylan/Perrigo plus the offer's cash consideration and that the risk of owning Mylan shares—from a valuation and governance perspective—was significant. The saga took numerous twists and turns over the following seven months, including Teva Pharmaceuticals announcing its own bid for Mylan shortly after Mylan announced its offer for Perrigo, which Teva later withdrew in favor of an alternative deal after facing fierce resistance from Mylan; proceedings before courts and regulators on three continents; and extensive public relations campaigning and shareholder outreach.

During this time, Perrigo consistently emphasized its proven track record of delivering above market returns to shareholders, its consistently high trading multiple and its shareholder-focused corporate governance. These were contrasted with Mylan's relatively weaker historical performance and significant governance concerns, demonstrated by its use of extreme defenses—such as a self-perpetuating board structure and the issuance of a call option on 50% of Mylan's voting power to a Dutch trust—to fend off Teva's premium bid. Ultimately, more than 60% of Perrigo's shareholders rejected Mylan's bid, which resulted in the failure to satisfy the minimum tender condition and defeated the takeover attempt.

Along the way, much was discussed about whether merger arbitrageurs seeking short-term gains, who had acquired almost 25% of Perrigo's shares, would be able to deliver Perrigo into Mylan's hands. Much was also made of the fact that Perrigo did not agree to sell to a "white knight" or to do large acquisitions of its own, raising questions about whether a premium offer, even a questionable one, had put Perrigo on a "shot clock" to do the least bad deal that it could find. It did not. Perrigo's long-term shareholders accepted the judgment of the Perrigo board that Mylan's offer was too low to serve as a basis for discussions, rejecting the often-asserted notion that a board is obliged to negotiate with any bidder who offers a premium. The Perrigo situation shows that a target company can win a takeover battle and defeat short-term pressures by pursuing a shareholder-focused stand-alone strategy of value creation, especially where it fights for and wins the backing of its long-term shareholders.

2. White Knights and White Squires

A white knight transaction, namely a merger or acquisition transaction with a friendly acquiror, can be a successful strategy where the white knight transaction provides greater economic value to target company shareholders than the initial hostile offer. In some contexts, however, white knight transactions are more difficult to accomplish because of required regulatory approvals and related procedures. For example, in a banking or telecommunications acquisition, a white knight will require the same regulatory approvals as are required by the hostile acquiror and, to the extent that the white knight commences the approval process after the hostile acquiror does, the white knight will suffer a timing disadvantage. If a target has defended itself against the hostile acquiror by arguing that the deal is subject to antitrust risk, such arguments may be used against a proposed combination between the target and a white knight as well. Certain target companies may also be

constrained by a scarcity of available acquirors, depending upon applicable regulatory restrictions and antitrust considerations.

A recent situation involving Allergan reinforces the viability of a white knight strategy. In 2014, Pershing Square teamed up with Valeant and sought to carefully engineer a tender offer to avoid the securities laws designed to prevent secret accumulation of stock (although serious questions have been raised about the legality of their tactics).⁴⁰⁴ The pair formed a purchasing vehicle (funded primarily by Pershing Square) to purchase a large block in Allergan using stock options instead of shares of common stock. They also took advantage of the 10-day reporting window to acquire more stock until they nearly held 10% of the outstanding shares and then announced a proposed merger between Valeant and Allergan. Soon thereafter, Allergan's board adopted a rights plan and rejected Valeant's undervalued bid and cost-cutting strategy. Several months later Valeant launched an exchange offer for Allergan's shares that Allergan's board rejected as being a "grossly inadequate" offer. After several more months of public exchanges between Allergan and Pershing Square, Allergan announced that it would be acquired by Actavis at a much higher premium.

A white squire defense, which involves placing a block of voting stock in friendly hands, may be more quickly implemented. This defense has been successfully employed in a handful of instances, and the Delaware Court of Chancery has upheld the validity of this defense.⁴⁰⁵ Such sales to "friendly" parties should be carefully structured to avoid an unintended subsequent takeover bid by the former "friend." Voting and standstill agreements may be appropriate in this context.

3. Restructuring Defenses

Restructurings have been driven in part by the threat of hostile takeovers. The failure of a company's stock price to fully reflect the value of its various businesses has provided opportunities for acquirors to profit by acquiring a company, breaking it up, and selling the separate pieces for substantially more than was paid for the entire company. A primary goal of any restructuring is to cause the value of a company's various businesses to be better understood and, ultimately, to be better reflected in its stock price.

Like many forms of takeover defenses, a restructuring is best initiated well before a company is actually faced with a bid. In most cases, a restructuring will only be possible if there has been careful advance preparation by the company and its investment bankers and counsel. For example, arranging for a friendly buyer of a particular asset and restructuring a business to accommodate the loss of the asset are time-

consuming, costly and complicated endeavors and are difficult to effect in the midst of a takeover battle.

Nonetheless, restructuring defenses have been attempted or implemented in a number of prominent transactions. For example, during the course of BHP Billiton's effort to take over global mining giant Rio Tinto, Rio Tinto announced in late 2007 its decision to divest its aluminum products business (Alcan Engineered Products) and instead focus on its upstream mining businesses. BHP ultimately dropped its bid for Rio Tinto in November 2008, although it publicly attributed this decision to turmoil in the financial markets, uncertainty about the global economic outlook and regulatory concerns.

In addition to asset sales, a stock repurchase plan, such as that pursued by Unitrin in response to American General's unsolicited bid, may be an effective response to a takeover threat. Buybacks at or slightly above the current market price allow shareholders to lock in current market values and reduce a company's available cash, which may be critical to any leveraged acquisition bid. Companies may also initiate such buybacks when they choose not to pursue other publicly announced acquisitions in order to prevent a deterioration in the stock price and/or to reduce vulnerability to unsolicited offers. A principal benefit of stock buybacks is that they may be quickly implemented. Buybacks can be implemented through either a self-tender offer or an open market buyback program.

4. Making an Acquisition and the "Pac-Man" Defense

Companies can fend off a suitor by making an acquisition using either stock consideration or issuing new debt. Acquiring a new company through stock consideration has the effect of diluting the suitor's ownership interest if it has purchased a toehold in the target. An acquisition can also make the cost of a transaction significantly greater. In 2008, Anheuser-Busch considered acquiring Grupo Modelo so as to make the brewer too large for InBev to purchase the company. More recently, Jos. A. Bank agreed to buy retailer Eddie Bauer to make an acquisition by Men's Warehouse more difficult.

The "Pac-Man" defense involves a target company countering an unwanted tender offer by making its own tender offer for stock of the would-be acquiror.⁴⁰⁶ The Pac-Man defense recognizes that a transaction is appropriate while challenging which party should control the combined entity. This tactic first arose in the 1980s when Martin Marietta reversed a hostile takeover bid by Bendix and launched its own hostile bid for Bendix. Men's Warehouse also employed the Pac-Man defense in late

2013 to reverse an offer by Jos. A. Bank in a move that resulted in Men's Warehouse stitching up a deal to buy Jos. A. Bank in 2014.

5. Corporate Spin-Offs, Split-Offs and Split-Ups

Companies have used spin-offs, split-offs and similar transactions to enhance shareholder value and, in some cases, to frustrate hostile acquisition attempts. One means of focusing stock market attention on a company's underlying assets is to place desirable assets in a corporation and exchange shares of the new company for shares of the parent company (known as a "split-off"), which usually is done after issuing some shares of the new company in an initial public offering. Another method, known as "spin-off," is to distribute all of the shares of the new company to the parent company's shareholders as a dividend. The Court of Chancery has recently ruled that in a spin-off, barring exceptional circumstances, a company will be able to make a clean break between the two entities, and release liabilities between the entities.⁴⁰⁷ Another means of boosting the share price of a company is to "split up" (*i.e.*, to sell off businesses that no longer fit the company's strategic plans or split the company into logically separate units). In all of these cases, a company tries to focus the market's attention on its individual businesses which, viewed separately, may enjoy a higher market valuation than when viewed together.

In addition to potentially increasing target company valuations, spin-offs and similar structures may produce tax consequences that discourage takeover attempts for a limited period of time. Commercial Intertech used this defense to thwart an unsolicited offer by United Dominion. The spin-off of the profitable Cuno filtration business to CIC shareholders in effect created a "tax poison pill." Had United Dominion acquired either CIC or Cuno following the spin-off, the acquisition could have generated a prohibitive tax liability. A similar technique was employed by ITT in response to the hostile bid by Hilton.

6. Litigation Defenses

As shown by the litigation between Vulcan and Martin Marietta, a successful litigation strategy can delay, if not entirely eliminate, a hostile threat. As a remedy for Martin Marietta's breach of two binding confidentiality agreements, the Delaware Court of Chancery ordered that Martin Marietta be enjoined from prosecuting a proxy contest, making an exchange offer, or otherwise seeking to acquire Vulcan assets for a period of four months. In light of Vulcan's staggered board, the ruling had the practical effect of delaying Martin Marietta's ability to win a proxy fight (and thereby seating directors more likely to favor a combination of the two companies) by an entire year. While Delaware courts do not regularly

enjoin transactions, they are able and willing to do so when there is a clear record and a compelling legal theory to support such a decision.

The potential merit of a litigation defense was again shown in 2015 when a California court in *Depomed Inc. v. Horizon Pharma, PLC*⁴⁰⁸ preliminarily enjoined a hostile bidder on the ground that it misused information in violation of a confidentiality agreement, effectively ending the hostile takeover attempt, as discussed previously in III.A.1. Both of these cases illustrate that a company faced with a takeover threat should closely analyze its prior contractual dealings with the hostile acquiror and other entities and not shy away from using courts to enforce its rights.

VII.

Cross-Border Transactions

A. Overview

International capital flows, multinational enterprises and cross-border M&A activity have become ever-larger and more multifaceted parts of the global economy. Cross-border transactions reached \$1.57 trillion in 2015, the second highest volume ever and an increase of approximately 27% over 2014.⁴⁰⁹ Cross-border transactions accounted for 32.9% of 2015 global deal volume and included the three largest deals announced in 2015.⁴¹⁰ The activity featured a diverse variety of target countries and sources of acquisition capital, and was again strong across sectors, as healthcare, industrials, financials, energy and power, media and entertainment and consumer staples all experienced cross-border M&A volume greater than \$100 billion each.⁴¹¹

Cross-border M&A involving U.S. companies was approximately \$644 billion in 2015, 73% of which was in-bound to the United States.⁴¹² Emerging markets continue to drive a significant share of cross-border activity, as the volume of deals involving an emerging economy acquiror and a developed economy target grew 40% in 2015 (compared to 26.7% growth in 2014 and a decrease of 27.5% in 2013) and the volume of deals involving a developed economy acquiror and an emerging economy target grew 3%, slightly less than 2014 growth of 4.7%.⁴¹³

With the substantial increase in cross-border deal volume, regulatory issues also have risen in significance. In recent years, a number of significant cross-border deals, including several mega-deals, were not consummated or the consummation was delayed for regulatory reasons. For instance, the FTC brought an action to enjoin STERIS Corporation acquiring Synergy Health plc. Although the transaction parties ultimately won at trial, the parties had announced the deal on October 13, 2014, the FTC brought the case on June, 4, 2015, and the deal did not close until November 2, 2015. In addition, in December 2015, the Canadian Competition Commission brought an action before the Tribunal to block the Office Depot/Staples transaction. Non-consummated deals include the NYSE Euronext-Deutsche Börse business combination, AT&T's \$39 billion acquisition of T-Mobile USA from Deutsche Telekom, and AB Electrolux's acquisition of General Electric Company's appliance business. United Parcel Service's \$6.9 billion bid for TNT Express was withdrawn due to concerns from European antitrust regulators, and telecom providers TeliaSonera AB and Telenor Group abandoned their proposed combination to create Denmark's largest mobile phone operator,

citing as the cause the failure to reach an agreement with the European Commission on acceptable conditions.

Continuing a trend that began in 2014, hostile cross-border activity was abundant during 2015. Forty-five unsolicited or hostile cross-border bids, worth approximately \$237 billion, were launched during the year.⁴¹⁴ Major recent proposed unsolicited or hostile cross-border deals include, among others, Anheuser-Busch InBev's unsolicited but eventually agreed \$117 billion bid for SABMiller; Shire's hostile but ultimately friendly \$32 billion bid for Baxalta; the three-way battle among Perrigo, Mylan and Teva (ultimately resulting in Teva acquiring Allergan's generics business for \$40 billion and Perrigo and Mylan each remaining independent); Pfizer's abortive \$118 billion bid for AstraZeneca; Valeant Pharmaceuticals' unsuccessful attempt to buy Allergan for more than \$50 billion; AbbVie's unsolicited (and agreed but ultimately terminated) \$55 billion offer for Shire; BHP Billiton's ultimately withdrawn \$39 billion offer for Canada's Potash Corp.; and Sanofi-Aventis' unsolicited (and ultimately friendly and successful) offer for Genzyme.

Another trend that contributed to cross-border M&A activity in recent years is "inversion" transactions. In 2015, inversion transactions accounted for approximately 14% of cross-border activity, compared to approximately 66% in 2014.⁴¹⁵ In a typical inversion transaction, a publicly traded U.S. parent combines with a foreign company in a transaction in which the foreign merger party (or a newly formed foreign holding company) becomes the parent of the combined group (*i.e.*, the former U.S. parent becomes a wholly owned subsidiary of a foreign parent) and the shareholders of the foreign merger party own more than 20% of the resulting foreign parent.

B. Special Considerations in Cross-Border Deals

With advance planning and careful attention to the greater complexity and spectrum of issues that characterize cross-border M&A, such transactions can be accomplished in most circumstances without falling into the pitfalls and misunderstandings that have sometimes characterized cross-cultural business dealings. A number of important issues should be considered in advance of any cross-border acquisition or strategic investment, whether the target is within the U.S. or elsewhere.

1. Political and Regulatory Considerations

Even though non-U.S. investment in the U.S. remains generally well-received and rarely becomes a political issue, prospective non-U.S. acquirors of U.S. businesses or assets should undertake a comprehensive analysis of political and regulatory implications well in advance of making

an acquisition proposal, particularly if the target company operates in a sensitive industry or if the acquiror is controlled, sponsored or financed by a foreign governmental entity or organized in a jurisdiction where a high level of government involvement is generally understood to exist. Any weaknesses in the ability to clear regulatory hurdles could be used defensively by reluctant targets or offensively by competing bidders to frustrate or delay the completion of an acquisition.

In the U.S., many parties and stakeholders have potential leverage (economic, political, regulatory, public relations, *etc.*), and consequently it is important to develop a plan to address anticipated concerns that may be voiced by these stakeholders in response to the transaction. Moreover, it is essential that a comprehensive communications plan be in place prior to the announcement of a transaction so that all of the relevant constituencies can be targeted and addressed with the appropriate messages. It is often useful to involve local public relations firms in the planning process at an early stage. Planning for premature leaks is also critical. Similarly, potential regulatory hurdles require sophisticated advance planning. In addition to securities and antitrust regulations, acquisitions may be subject to review by the Committee on Foreign Investment in the United States (“CFIUS,” discussed below), and acquisitions in regulated industries (*e.g.*, energy, public utilities, gaming, insurance, telecommunications and media, financial institutions, transportation and defense contracting) may be subject to additional layers of regulatory approvals. Regulation in these areas is often complex, and political opponents, reluctant targets and competitors may seize on any perceived weaknesses in an acquiror’s ability to clear regulatory obstacles. Most obstacles to a cross-border deal are best addressed in partnership with local players (including, in particular, the target company’s management where appropriate) whose interests are aligned with those of the acquiror, as local support reduces the appearance of a foreign threat.

It is in most cases critical that the likely concerns of federal, state and local government agencies, employees, customers, suppliers, communities and other interested parties be thoroughly considered and, if possible, addressed prior to any acquisition or investment proposal becoming public. Flexibility in transaction structures, especially in strategic or politically sensitive situations, may be helpful in particular circumstances, such as no-governance or low-governance investments, minority positions or joint ventures, possibly with the right to increase to greater ownership or governance over time; when entering a non-domestic market, making an acquisition in partnership with a local company or management or in collaboration with a local source of financing or co-investor (such as a private equity firm); or utilizing a controlled or partly controlled local acquisition vehicle, possibly with a board of directors

having a substantial number of local citizens and a prominent local figure as a non-executive chairman. Use of preferred securities (rather than ordinary common stock) or structured debt securities should also be considered. While an acquisition of outright control of a target by a foreign entity in a sensitive industry may attract significant political attention and regulatory scrutiny, minority and non-controlling investments may be permitted (for example, CNOOC abandoned its attempt to acquire Unocal amid significant political controversy, but CNOOC's \$2.2 billion investment in oil and gas assets owned by Chesapeake Energy in 2010 was permitted by regulators).

In addition, local regulators and constituencies may seek to intervene in global transactions. Ostensibly modest social issues, such as the name of the continuing enterprise and its corporate seat, or the choice of the nominal acquiror in a merger, may affect the perspective of government and labor officials. Depending on the industry involved and the geographical distribution of the workforce, labor unions and “works councils” may be active and play a significant role in the current political environment, and as a result, demand concessions. In several recent transactions, the perspective of local constituencies influenced the transaction structure. For example, in its 2014 acquisition of Tim Hortons, Burger King agreed to list the new company on the Toronto Stock Exchange, reflecting the status of Tim Hortons as an iconic Canadian brand and local regulators' desire to maintain a Canadian listing. Similarly, in its attempted hostile acquisition of Perrigo, Mylan committed to list itself on the Tel Aviv Stock Exchange, regardless of the outcome of its offer, in part to portray a commitment to a long-term presence in Israel and appease Israeli securities regulators and Perrigo's Israeli shareholders. AB InBev also listed on the Johannesburg Stock Exchange in connection with its pending acquisition of SABMiller.

In the U.S., CFIUS is one of the key authorities to consider when seeking to clear U.S. acquisitions by non-U.S. acquirors. CFIUS is a multi-agency committee that reviews transactions for potential national security implications where non-U.S. acquirors could obtain “control” of a U.S. business or assets or transactions involving investments by non-U.S. governments or investments in U.S. critical infrastructure, technology or energy assets. In recent years, some high profile deals have failed due to CFIUS hurdles—including the January 2016 abandonment of GO Scale Capital's acquisition of an 80.1% interest in Philip's Lumileds Holding BV, and CFIUS's 2013 order that India-based Polaris Financial Technology divest its 85% ownership stake in U.S. company IdenTrust Inc., a provider of digital identification authentication services to banks and U.S. government agencies. However, many other transactions that have faced significant CFIUS review—such as the 2013 acquisition by

Wanxiang Group, China's biggest auto-parts maker, of most of the assets of U.S. battery-manufacturer A123 Systems Inc., and the 2013 acquisition by BGI-Shenzhen, a Chinese operator of genome sequencing centers, of Complete Genomics, Inc., a publicly traded U.S. life sciences company—have been able to achieve approval. It is often prudent to make a voluntary filing with CFIUS if control of a U.S. business is to be acquired by a non-U.S. acquiror and the likelihood of an investigation is reasonably high or if competing bidders are likely to take advantage of the uncertainty of a potential investigation. National security implications are not limited to defense sectors; critical infrastructure and industrial base assets and technology transfers can provide a basis for CFIUS interest. Any filing typically should be preceded by discussions with U.S. Treasury officials and other relevant agencies. In some cases, it may even be prudent to make the initial contact prior to the public announcement of the transaction. Given the higher volume of filings that have occurred in the last few years, such discussions can be instrumental in minimizing the review period. Nonetheless, in today's environment, in any transaction that may be of interest to CFIUS, the pre-filing consultation and review period is taking 75 days on average.

As a CFIUS review is only applicable when the foreign person is acquiring "control" over a "U.S." business (which can include the assets, intellectual property, or operations located in the U.S. of a non-U.S. business), such review may be avoided by structuring a transaction so that the investor is not acquiring "control." CFIUS regulations issued by the U.S. Department of the Treasury provide an exemption for non-U.S. investments of 10% or less in the voting securities of a U.S. business if made "solely for the purpose of passive investment," although this exclusion does not apply if the non-U.S. person intends to exercise control over the U.S. business or takes other actions inconsistent with passive intent. If the foreign acquiror's intent later changes, CFIUS may review the investment retroactively. Control status is fact-specific and subject to a number of guidelines, including with respect to implications of possession of a board seat or the exercise of pro rata voting rights, and whether the investor wields a degree of influence sufficient to determine, direct or decide "important" matters. Certain minority shareholder protections and negative rights may be held by non-U.S. investors without rendering such investors in control of an entity.

For acquisitions of control by U.S. or other acquirors of non-U.S. domiciled companies, similar provisions exist under the laws of other jurisdictions, including most notably in Canada, Australia and China as well as some European nations. Some countries that have traditionally been hospitable to off-shore investors have focused more attention recently on acquisitions by state-owned or state-connected enterprises.

For example, Canada's government initially blocked the \$5.2 billion bid by Malaysia's Petronas for Progress Energy Resources on the grounds that it would not create a net benefit for Canada before approving a revised bid, and CNOOC's \$15.1 billion acquisition of Canadian oil company Nexen was also subject to significant review by Canadian regulators. On the same day that the Canadian government approved the acquisitions of Progress Energy and Nexen, it announced changes to Canadian policy in reviewing investments in Canada by state-owned enterprises, which changes would increase the scrutiny applied to acquisitions by foreign-owned or influenced enterprises of control over Canadian enterprises, particularly in the oil-sands business, where such acquisitions would be approved only in exceptional circumstances. In 2013, the Australian Treasurer blocked the \$3.1 billion takeover bid of GrainCorp by the American-listed Archer Daniels Midland, after the Australian Foreign Investment Review Board could not reach a consensus on whether to allow the deal to proceed.

Besides the CFIUS filing, foreign investors have to keep in mind that the U.S. Department of Commerce, Bureau of Economic Analysis (BEA), has reinstated in March 2015 the mandatory filing of "BE-13" survey forms as to foreign direct investment in the U.S., including in respect of the acquisition of all or an interest in U.S. public or private companies, and of U.S. real estate, among other things. In particular, a report is required by the U.S. entity if (i) a foreign direct investment in the United States relationship is created or (ii) an existing U.S. affiliate of a foreign parent establishes a new U.S. legal entity, expands its U.S. operations, or acquires a U.S. business enterprise. Foreign direct investment is defined as the ownership or control, directly or indirectly, by one foreign person of 10% or more of the voting securities of an incorporated U.S. business enterprise, or an equivalent interest of an unincorporated U.S. business enterprise, including a branch. The form is to be submitted within 45 days of closing. The failure to report can be subject to a civil penalty of between \$2,500 and \$32,500. Willful failure to report can result in additional fines and potentially criminal penalties.

2. Integration Planning and Due Diligence

Integration planning and due diligence also warrant special attention in the cross-border context. Wholesale application of the acquiror's domestic due diligence standards to the target's jurisdiction can cause delay, wasted time and resources, or result in missing issues. Making due diligence requests that appear to the target as particularly unusual or unreasonable (a not uncommon occurrence in cross-border deals, where custom on the type and scope of diligence may vary) can easily cause a bidder to lose credibility. At the same time, missing a

significant local issue for lack of local knowledge can be highly problematic and costly. The \$10.3 billion acquisition of Autonomy by Hewlett-Packard and subsequent \$8.8 billion write-down, and the \$653 million acquisition of Zhengzhou Siwei Mechanical and Electrical Engineering by Caterpillar and subsequent \$580 million write-down, each underscore the importance of effective due diligence in the cross-border acquisition context.

Due diligence methods must take account of the target jurisdiction's legal regime and local norms, including what steps a publicly traded company can take with respect to disclosing material non-public information to potential bidders and implications for disclosure obligations. Many due diligence requests are best funneled through legal or financial intermediaries as opposed to being made directly to the target company. Due diligence with respect to risks related to the Foreign Corrupt Practices Act ("FCPA")—and understanding the U.S. Department of Justice's guidance for minimizing the risk of inheriting FCPA liability—is critical for U.S. buyers acquiring a company with non-U.S. business activities; even acquisitions of foreign companies that do business in the U.S. may be scrutinized with respect to FCPA compliance. Diligence relating to compliance with the sanction regulations overseen by the Treasury Department's Office of Foreign Asset Control can also be important for U.S. entities acquiring non-U.S. businesses.

Careful attention must also be paid to foreign operations of domestic companies, including joint ventures with foreign parties. The importance of this issue was dramatically illustrated in the failed attempt by Apollo Tyre, an Indian company, to acquire Cooper Tire and Rubber, which is a U.S.-based company with a significant joint venture in China. During the pendency of the deal, the Chinese minority partner locked Cooper out of the Chinese factory and made demands about a higher price and the potential clash between Indian and Chinese culture at the plant, contributing in part to the termination of the merger agreement with Apollo.

Cross-border deals sometimes fail due to poor post-acquisition integration where multiple cultures, languages, historic business methods and distance may create friction. If possible, the executives and consultants who will be responsible for integration should be involved in the early stages of the deal so that they can help formulate and "own" the plans that they will be expected to execute. Too often, a separation between the deal team and the integration/execution teams invites slippage in execution of a plan that in hindsight is labeled by the new team as unrealistic or overly ambitious. However, integration planning needs to be carefully phased-in, as implementation cannot occur prior to the time most

regulatory approvals are obtained and merging parties must exercise care not to engage in conduct that antitrust agencies perceive as a premature transfer of beneficial ownership or conspiracy in restraint of trade. Investigations into potential “gun-jumping” present costly and delaying distractions during substantive merger review.

3. Competition Review and Action

Cross-border M&A activity is subject to careful review by competition authorities, and parties should prepare for multi-jurisdictional review and notifications. Nearly 100 jurisdictions have pre-merger notification regimes, and the list continues to grow; multinational transactions (including minority investments) may require over a dozen notifications. For example, the Dell/EMC transaction required approval from approximately 20 jurisdictions, while the Siemens/Dresser-Rand transaction required filings in almost a dozen countries. In recent years, the FTC, DOJ and the European Commission have not been hesitant to challenge and block cross-border mergers and other cross-border transactions, even, in rare cases, post-consummation. Notably, United Parcel Service’s \$6.9 billion bid for TNT Express was withdrawn in 2013 due to concerns of European antitrust regulators, and in early 2012 the European Commission blocked the proposed merger of NYSE Euronext and Deutsche Börse.

Competition authorities (particularly those in the U.S., Europe and Canada) often, though not always, coordinate their investigations of significant transactions. To the extent that a non-U.S. acquirer directly or indirectly competes or holds an interest in a company that competes in the same industry as the target company, antitrust concerns may arise either at the federal agency- or state attorneys general-level in the U.S., as well as in the home country. Although less typical, concerns can also arise if the foreign acquirer of a U.S. target participates in a market either upstream or downstream of the target. Competition analyses will need to consider variations in market conditions and competition law across relevant jurisdictions. How conglomerate relationships are treated (and views as to required relief) is one area of meaningful variation among competition authorities.

China also now has a robust pre-merger notification system and has been active in its review and enforcement activities. In June 2014, the Anti-Monopoly Bureau of the Ministry of Commerce in China (“MOFCOM”) issued a decision prohibiting the formation of the P3 Network, a long-term container shipping alliance among A.P. Møller-Maersk, Mediterranean Shipping Company and CMA CGM, which are Danish, Swiss and French companies, respectively. In the seven years since the adoption of a pre-merger notification law in China, MOFCOM

had previously imposed restrictive conditions in 27 cases and rejected only one transaction (Coca-Cola's proposed acquisition of China Huiyuan Juice Group, a leading Chinese juice maker back in 2009). Transactions upon which MOFCOM imposed restrictions included Google's \$12.5 billion acquisition of Motorola Mobility (conditioned on Google's commitment to keep the Android operating system free for five years), and United Technologies' acquisition of Goodrich (conditioned on a divestiture). China's antitrust laws require that MOFCOM review any acquisition where aggregate global sales of all parties exceed \$1.5 billion and sales in China for each of at least two parties exceed \$62 million. This low threshold for Chinese sales puts many U.S. or European deals squarely within MOFCOM's jurisdiction. China's laws also give MOFCOM broad latitude in selecting remedies and the timing of review. The review clock in China only starts ticking after MOFCOM accepts the filing, which can take weeks or months at MOFCOM's discretion. The review process itself can take a long time (longer than most jurisdictions). For example, FedEx's ongoing acquisition of TNT Express, which was announced in April of 2015, received clearance from U.S., EU and Brazilian regulatory authorities by early February in 2016, yet, as of mid-March 2016, the deal is still under ongoing review in China.

Additionally, India's merger control regime, which came into force in 2011 with the creation of the Competition Commission of India ("CCI"), and is now in full swing. Since then, the CCI has received 250 notices of a combination of enterprises and approved 234 of them without modification, two involved modifications and the remainder were still being reviewed as of the reporting year-end (May 2015). According to the CCI's last annual report, it has not prohibited any transaction. An extensive amount of information about the parties and the transaction is required to be included in the notification, and India is one of very few jurisdictions that require notification to be filed within 30 days of either the boards of directors' approval of the combination or the execution of any binding documents related to the combination. The CCI has 30 to 210 days from the date of filing to issue a decision but the clock stops whenever the CCI issues a request for supplemental information. Parties should expect at least one or two supplemental requests for information to stop the clock. Consequently, the review period will generally be at least two to three months and depending upon the complexity of the matter can be longer.

4. Deal Techniques and Cross-Border Practice

Understanding the custom and practice of M&A in the jurisdiction of the target is essential. Successful execution is more art than science, and will benefit from early involvement by experienced local advisors.

For example, understanding when to respect—and when to challenge—a target’s sale “process” may be critical. Knowing how and at what price level to enter the discussions will often determine the success or failure of a proposal. In some situations it is prudent to start with an offer on the low side, while in other situations offering a full price at the outset may be essential to achieving a negotiated deal and discouraging competitors, including those who might raise political or regulatory issues. In strategically or politically sensitive transactions, hostile maneuvers may be imprudent; in other cases, unsolicited pressure may be the only way to force a transaction. Similarly, understanding in advance the roles of arbitrageurs, hedge funds, institutional investors, private equity funds, proxy voting advisors and other important market players in the target’s market—and their likely views of the anticipated acquisition attempt as well as when they appear and disappear from the scene—can be pivotal to the outcome of the contemplated transaction.

Where the target is a U.S. public company, the customs and formalities surrounding board of director participation in the M&A process, including the participation of legal and financial advisors, the provision of customary fairness opinions, and the inquiry and analysis surrounding the activities of the board and the financial advisors, can be unfamiliar and potentially confusing to non-U.S. transaction participants and can lead to misunderstandings that threaten to upset delicate transaction negotiations. Non-U.S. participants need to be well-advised as to the role of U.S. public company boards and the legal, regulatory and litigation framework and risks that can constrain or prescribe board action. In particular, the litigation framework—which, as discussed in Part I.B.5, has recently been shifting—should be kept in mind as shareholder litigation often accompanies M&A transactions involving U.S. public companies. The acquiror, its directors, shareholders and offshore reporters and regulators should be conditioned in advance (to the extent possible) to expect litigation and not to necessarily view it as a sign of trouble. The litigation risk and the other factors mentioned above can impact both tactics and timing of M&A processes and the nature of communications with the target company. Additionally, local takeover regulations often differ from those in the acquiror’s home jurisdiction. For example, the mandatory offer concept common in Europe, India and other countries—in which an acquisition of a certain percentage of securities requires the bidder to make an offer for either the balance of the outstanding shares or for an additional percentage—is very different from U.S. practice. Permissible deal protection structures, pricing requirements and defensive measures available to targets also differ. Sensitivity also must be given to the contours of the target board’s fiduciary duties and decision-making obligations in home jurisdictions, particularly with respect to

consideration of stakeholder interests other than those of shareholders and nonfinancial criteria.

This multifaceted overlay of foreign takeover laws and the legal and tactical considerations they present can be particularly complex when a bid for a non-U.S. company may be unwelcome. Careful planning and coordination with foreign counsel are critical in hostile and unsolicited transactions, on both the bidder and target sides. For example, Italy's "passivity" rule that limits defensive measures a target can take without shareholder approval is suspended unless the hostile bidder is itself subject to equivalent rules. A French company's organizational documents can provide for a similar rule, and as of April, 2016, France's Florange Law will make it the default that a French company's long-term shareholders are granted double voting rights, which would reduce the influence of toehold acquisitions or merger arbitrageurs. Dutch law and practice allow for the target's use of an independent "foundation" or *stichting* to at least temporarily defend against hostile offers. The foundation, which is controlled by independent directors appointed by the target and has a broad defensive mandate, is issued high-vote preferred shares at a nominal cost, which allow it to control the voting outcome of any matter put to target shareholders. The recent three-way battle among Mylan, Perrigo and Teva illustrates how the applicable takeover regime can have significant impact. Perrigo (which had inverted from Michigan to Ireland) was subject to the "frustrating action" rule and other Irish Takeover Rules, which made it more difficult to defend against Mylan's hostile bid—though Perrigo ultimately succeeded in convincing shareholders not to accept the bid. By contrast, Mylan (which had inverted from Pennsylvania to the Netherlands) used a potent combination of takeover defenses facilitated by Dutch law and its own governance documents, including the use of a foundation, to take a resist-at-all-costs approach to Teva's bid.

In many ways, the acquisition financing markets in 2015 experienced a continuation of trends that began in 2014, with increasing volatility constraining the availability and increasing the cost of committed acquisition financing for leveraged issuers and for transactions with long closing periods. Given this environment, in the context of cross-border transactions, potential acquirors should consider whether this volatility has created inefficiencies and opportunities in different geographic credit markets such that financing is cheaper or otherwise available on more favorable terms in one local market as opposed to another; how committed acquisition financing is required to be under local regulation (*e.g.*, the "funds certain" requirement in certain European jurisdictions) and whether a transaction with a financing contingency or other non-certain funds structure might be feasible; whether to explore

alternative, non-traditional financing sources and structures, including seller paper; whether there are transaction structures that can minimize refinancing requirements; and how comfortable the target will feel with the terms and conditions of the financing. Under U.S. law, unlike the laws of some other jurisdictions, non-U.S. acquirors are not prohibited from borrowing from U.S. lenders, and they generally may use the assets of U.S. targets as collateral (although there are some important limitations on using stock of U.S. targets as collateral).

As the U.S. continues to be a popular destination for restructuring of multinational corporations, including those with few assets or operations in the country, firms evaluating a potential acquisition of a distressed U.S. target should consider the full array of tools that may be available. This might include acquisition of the target's fulcrum debt securities that are expected to become the equity through an out-of-court restructuring or plan of reorganization, acting as a plan investor or sponsor in connection with a plan, backstopping a plan-related rights offering, or participating as a bidder in a court-supervised "Section 363" auction process, among others. Transaction certainty is of critical importance to success in a "Section 363" sale process or confirmation of a Chapter 11 plan, and non-U.S. participants accordingly need to plan carefully for transaction structures that will result in a relatively level playing field with U.S. participants. Acquirors also need to consider the differing interests and sometimes conflicting agendas of the various constituencies, including bank lenders, bondholders, distressed-focused hedge funds and holders of structured debt securities and credit default protection.

Disclosure obligations may also vary across jurisdictions. How and when an acquiror's interest in the target is publicly disclosed should be carefully controlled to the extent possible, keeping in mind the various ownership thresholds or other triggers for mandatory disclosure under the law of the jurisdiction of the company being acquired. Treatment of derivative securities and other pecuniary interests in a target other than equity holdings also vary by jurisdiction and have received heightened regulatory focus in recent periods.

5. U.S. Cross-Border Securities Regulation

U.S. securities regulations apply to acquisitions and other business combination activities involving non-U.S. companies with U.S. security holders unless bidders can avoid a jurisdictional nexus with the U.S. and exclude U.S. security holders. Where a transaction cannot escape U.S. securities regulations in this manner, exemptive relief may be available. Under the current two-tiered exemptive regime, relief from certain U.S. regulatory obligations is available for tender offers that qualify for one of two exemptions—the "Tier I" exemption where U.S. security holders

comprise less than 10% of a security subject to a tender offer, and the “Tier II” exemption, where the U.S. shareholder base does not exceed 40%. Tier I transactions are exempt from almost all of the disclosure, filing and procedural requirements of the U.S. federal tender offer rules, and securities issued in Tier I exchange offers, business combination transactions and rights offerings need not be registered under the Securities Act. Tier II provides narrow relief from specified U.S. tender offer rules that often conflict with non-U.S. law and market practice (such as with respect to prompt payment, withdrawal rights, subsequent offering periods, extension of offers, notice of extension and certain equal treatment requirements) but does not exempt the transaction from most of the procedural, disclosure, filing and registration obligations applicable to U.S. transactions or from the registration obligations of the Securities Act. Non-U.S. transactions where U.S. ownership in the target company exceeds 40% are subject to U.S. regulation as if the transaction were entirely domestic.

Several of the revisions to the U.S. cross-border securities regulatory regime enacted in 2008 have provided U.S. and non-U.S. bidders with somewhat enhanced flexibility and certainty in structuring deals for non-U.S. targets, even if the amendments did not fundamentally alter the nature or scope of the existing regulations, nor, in some respects, go far enough in enacting reforms.⁴¹⁶ The 2008 revisions also codified relief in several areas of frequent conflict and inconsistency between U.S. and non-U.S. regulations and market practice.

Significantly, neither Tier I nor Tier II exemptive relief limits the potential exposure of non-U.S. issuers—in nearly all cases already subject to regulation in their home jurisdiction—to liability under the antifraud, anti-manipulation and civil liability provisions of the U.S. federal securities laws in connection with transactions with U.S. entanglements. Both this risk and a desire to avoid the demands of U.S. regulation have persuaded many international issuers and bidders to avoid U.S. markets and exclude U.S. investors from significant corporate transactions. Notably, the exclusionary techniques that have developed for avoiding applicability of U.S. securities regulation are often simply not available to non-U.S. purchasers who buy shares through, for example, open market purchases. It may be impossible when transacting on non-U.S. exchanges to exclude U.S. sellers, and hence this inability to exclude U.S. sellers may render problematic any attempts to structure around U.S. laws. As was seen in the Endesa/E.ON/Acciona matter, such uncertainty—and the potential for ensuing litigation—can be exploited to gain tactical advantage in a takeover battle.

Also notable is the U.S. Supreme Court's landmark decision in *Morrison v. National Australia Bank Ltd.*, in which the Court sharply limited the extraterritorial reach of U.S. securities laws, particularly Section 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5.⁴¹⁷ The decision overturned 40 years of lower-court precedent. The decision and its progeny have eradicated billions of dollars in potential liability for foreign securities issuers and curtailed, if not eliminated, a burgeoning species of securities litigation that had been known as “foreign-squared” and “foreign-cubed” class actions.

C. Deal Consideration and Transaction Structures

While cash remains the predominant (although not exclusive) form of consideration in cross-border deals, non-cash structures are not uncommon, offering target shareholders the opportunity to participate in the resulting global enterprise. Where target shareholders will obtain a continuing interest in the acquiring corporation, expect heightened focus on the corporate governance and other ownership and structural arrangements of the acquiror in addition to business prospects. Pricing structures must be sensitive to exchange rate and currency risk as well as volatility in international markets. Alternatives to all-cash structures include non-cash currencies such as depositary receipts, “global shares” and straight common equity, as well as preferred securities and structured debt.

Transaction structure may affect the ability to achieve synergies, influence actual or perceived deal certainty and influence market perception. Structures should facilitate, rather than hinder, efforts to combine the operations of the two companies so as to achieve greater synergy, promote unified management and realize economies of scale. The importance of simplicity in a deal structure should not be underestimated—simple deal structures are more easily understood by market players and can facilitate the ultimate success of a transaction.

One of the core challenges of cross-border deals using acquiror stock is the potential “flowback” of liquidity in the acquiror's stock to the acquiror's home market. This exodus of shares, prompted by factors ranging from shareholder taxation (*e.g.*, withholding taxes or loss of imputation credits), index inclusion of the issuer or target equity, available liquidity in the newly issued shares and shareholder discomfort with non-local securities, to legal or contractual requirements that certain institutional investors not hold shares issued by a non-local entity or listed on a non-local exchange, can put pressure on the acquiror's stock price. It may also threaten exemptions from registration requirements that apply to offerings outside the home country of the acquiror.

U.S. and foreign tax issues will, of course, also influence deal structure. In structuring a cross-border deal, the parties will attempt to maximize tax efficiency from a transactional and ongoing perspective, both at the entity and at the shareholder level. Transactions involving a U.S. target corporation generally will be tax-free to its U.S. shareholders only if, in addition to satisfying the generally applicable rules regarding reorganizations or Section 351 exchanges, they satisfy additional requirements under Section 367(a) of the Internal Revenue Code and related Treasury Regulations (which require, among other things, that the value of the foreign merger party be at least equal to the value of the domestic merger party). In addition, cross-border transactions in which shareholders of the U.S. merger party receive equity in the combined foreign group need to be analyzed under Section 7874 of the Internal Revenue Code, which relates to “inversions.”

1. All-Cash

All-cash transactions are easy for all constituencies to understand and do not present flowback concerns. The cash used in the transaction frequently must be financed through equity or debt issuances that will require careful coordination with the M&A transaction. Where cash constitutes all or part of the acquisition currency, appropriate currency hedging should be considered, given the time necessary to complete a cross-border transaction. In addition, parties should be cognizant of financial assistance rules in certain non-U.S. jurisdictions that may limit the ability to use debt financing for an acquisition.

2. Equity Consideration

U.S. securities and corporate governance rules can be problematic for non-U.S. acquirors who will be issuing securities that will become publicly traded in the U.S. as a result of an acquisition. SEC rules, the Sarbanes-Oxley and Dodd-Frank Acts and stock exchange requirements should be evaluated to ensure compatibility with home country rules and to be certain that the non-U.S. acquiror will be able to comply. Rules relating to director independence, internal control reports, and loans to officers and directors, among others, can frequently raise issues for non-U.S. companies listing in the U.S. Similar considerations must be addressed for U.S. acquirors seeking to acquire non-U.S. targets. Structures involving the issuance of non-voting stock or other special securities of a non-U.S. acquiror may serve to mitigate some of the issues raised by U.S. corporate governance concerns. Governance practices can be particularly relevant when equity consideration is used in a hostile acquisition. For example, in Mylan’s hostile cash and stock offer for Perrigo, Mylan’s shareholder-unfriendly governance regime, which was permissible in the Netherlands, was a sticking point for many Perrigo

investors, and was a significant driver in Mylan's inability to generate sufficient support for its offer among Perrigo shareholders.

3. Stock and Depositary Receipts

All-stock transactions provide a straightforward structure for a cross-border transaction but may be susceptible to flowback. A depositary receipt approach carries many of the same advantages as an all-stock transaction but may mitigate flowback, as local institutional investors may be willing to hold the depositary receipts instead of the underlying non-local shares, easing the rate at which shares are sold back into the acquiror's home country market. However, in the typical depositary receipt program, the depositary receipt holders are free to surrender their receipts to the depositary in exchange for the underlying shares. Once the underlying shares are received, the non-U.S. shareholder is free to trade them back into the acquiror's home market.

4. "Dual Pillar" Structures

A more complex structure for a cross-border combination is known as the dual listed company ("DLC") structure. In a DLC structure, each of the publicly traded parent corporations retains its separate corporate existence and stock exchange listing. Management integration typically is achieved through overlapping boards of directors. Broadly speaking, DLC structures can be divided into two categories: "downstream" DLCs and "synthetic" DLCs. In a downstream DLC, the merged businesses are combined under one or more holding companies that are jointly owned by the two publicly traded parent companies. In a synthetic DLC, the merged businesses typically are not jointly owned, and economic integration is achieved solely through contractual "equalization" arrangements.

Examples of downstream DLC structures include ABB Asea Brown Boveri and Reed-Elsevier. Royal Dutch/Shell, which had utilized such a structure for several decades, restructured into a single holding company a number of years ago. Examples of synthetic DLCs include RTZ-CRA and BHP-Billiton.

Because DLC structures raise novel and complex tax, accounting, governance and other issues as applied to the U.S., to date, these structures have not been successfully employed in cross-border combinations involving a U.S. parent corporation.

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¹ 2015 Annual PE Exits & Company Inventory Report, PITCHBOOK 4 (Feb. 17, 2016), <http://pitchbook.com/news/reports/2015-annual-pe-exits-company-inventory-report>.

² *Id.* at 7.

³ *Id.* at 9. Percentage change was calculated from data provided.

⁴ Annual Fundraising Report 2015, PRIVATE EQUITY INTERNATIONAL (January 2016)

⁵ 2015 Annual PE & VC Fundraising & Capital Overhang Report, PITCHBOOK 4 (Feb. 23, 2016), <http://pitchbook.com/news/reports/2015-annual-global-pe-vc-league-tables-report>

⁶ *Id.* at 9.

⁷ See, e.g., Dawn Lim, *Calpers Asks for Disclosure on Fees Charged to Portfolio Companies*, WALL ST. J. (August 18, 2015), <http://blogs.wsj.com/privateequity/2015/08/18/calpers-asks-for-disclosure-on-fees-charged-to-portfolio-companies>.

⁸ See Matthew D. Cain & Steven Davidoff Solomon, *A Great Game: The Dynamics of State Competition and Litigation*, 100 IOWA L. REV. 465, 476 (2015); Matthew D. Cain & Steven Davidoff Solomon, *Takeover Litigation in 2014* (2015), available at <http://ssrn.com/abstract=2567902>.

⁹ See Cain & Davidoff, *Takeover Litigation in 2014*, *supra* note 8, at 2.

¹⁰ *Id.* at 477-78.

¹¹ E.g., *In re Trulia, Inc. S'holder Litig.*, 129 A.3d 884 (Del. Ch. 2016); *City Trading Fund v. Nye*, 46 Misc. 3d 1206(A) (N.Y. Sup. Ct. 2015).

¹² *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013).

¹³ DEL. CODE ANN. tit. 8, § 115.

¹⁴ See Cain & Davidoff, *Takeover Litigation in 2014*, *supra* note 8, at 3; Alison Frankel, *Forum Selection Clauses Are Killing Multiforum M&A litigation*, REUTERS, Jun.

24, 2014, available at <http://blogs.reuters.com/alison-frankel/2014/06/24/forum-selection-clauses-are-killing-multiforum-ma-litigation/>.

¹⁵ DEL. CODE ANN. tit. 8, § 102(f).

¹⁶ E.g., *Merion Capital LP v. BMC Software, Inc.*, C.A. No. 8900-VCG, 2015 WL 6164771 (Del. Ch. Oct. 21, 2015); *Huff Fund Inv. P'ship v. CKx*, No. 6844-VCG, 2013 WL 5878807 (Del. Ch. Nov. 1, 2013), *aff'd*, 2015 WL 631586 (Del. Feb. 12, 2015).

¹⁷ E.g., *LongPath Capital, LLC v. Ramtron Int'l Corp.*, 2015 WL 4540443 (Del. Ch. June 30, 2015).

¹⁸ *In re Ancestry.com, Inc.*, 2015 WL 66825 (Del. Ch. Jan. 5, 2015); *Merion Capital LP*, C.A. No. 8900-VCG, 2015 WL 6164771. .

¹⁹ Transactions abandoned in 2015 due to antitrust opposition include General Electric's bid for Electrolux which was abandoned after five months of litigation in July of 2015; Comcast's proposed acquisition of Time Warner Cable that was abandoned in April 2015 over 15 months after proposal of the acquisition; the proposed merger between Applied Materials and Tokyo Electron, also abandoned in April 2015; and the proposed merger between Chicken of the Sea and Bumble Bee Foods.

²⁰ *Smith v. Van Gorkom (Trans Union)*, 488 A.2d 858, 874 (Del. 1985) (holding that in the context of a proposed merger, directors must inform themselves of all "information . . . reasonably available to [them] and relevant to their decision" to recommend the merger); *see also Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) ("[U]nder the business judgment rule director liability is predicated upon concepts of gross negligence.").

²¹ DEL. CODE ANN. tit. 8, § 141(e) (West 2015).

²² *See supra* note 18; *see also* Accounting and Auditing Enforcement SEC Release No. 34-1763, Litigation Release No. 18104 (Apr. 24, 2003) (describing enforcement action against, *inter alia*, a member of the company's audit committee for violation of antifraud provisions of the securities laws by "ignoring clear warning signs that financial improprieties were ongoing at the company," among other reasons). In a 2004 decision that departs from prior law and the scope of which remains uncertain, the Delaware Court of Chancery suggested that a director's specialized knowledge may be one factor taken into account in determining whether he satisfied the duty of care. *In re Emerging Commc'ns, Inc. S'holders Litig.*, C.A. No. 16415, 2004 WL 1305745 (Del. Ch. June 4, 2004). *But see In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 128 n.63 (Del. Ch. 2009) (explaining that "[d]irectors with special expertise are not held to a

higher standard of care in the oversight context simply because of their status as an expert.”).

²³ See *Paramount Commc’ns, Inc. v. Time Inc. (Time-Warner)*, 571 A.2d 1140, 1153-54 (Del. 1990).

²⁴ *RBC Capital Mkts., LLC v. Jervis*, 129 A.3d 816, 865 n.191 (Del. 2015).

²⁵ Under Del. Code Ann. tit. 8, section 102(b)(7), a Delaware corporation may in its certificate of incorporation either limit or eliminate entirely the personal liability of a director to the corporation or its shareholders for monetary damages for breach of fiduciary duty, but such provisions may not eliminate or limit the liability of a director for, among other things, (1) breach of the director’s duty of loyalty to the corporation and its shareholders or (2) acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law. Many Delaware corporations have either eliminated or limited director liability to the extent permitted by law. The Delaware Supreme Court has ruled that the typical Delaware corporation charter provision exculpating directors from monetary damages in certain cases applies to claims relating to disclosure issues in general and protects directors from monetary liability for good faith omissions. See *Arnold v. Soc’y for Sav. Bancorp, Inc.*, 650 A.2d 1270 (Del. 1994). Similar provisions have been adopted in most states. The limitation on personal liability does not affect the availability of injunctive relief.

²⁶ An ancillary of the duty of loyalty is the corporate opportunity doctrine. Generally, a director may not appropriate an opportunity belonging to the corporation for himself. See *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939); see also *Broz v. Cellular Info. Sys., Inc.*, 673 A.2d 148, 155-57 (Del. 1996) (stating that a director “may not take a business opportunity for his own if: (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation’s line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the [director] will thereby be placed in a position inimicable to his duties to the corporation” but that a director “may take a corporate opportunity if: (1) the opportunity is presented to the director...in his individual and not his corporate capacity; (2) the opportunity is not essential to the corporation; (3) the corporation holds no interest or expectancy in the opportunity; and (4) the director or officer has not wrongfully employed the resources of the corporation in pursuing or exploiting the opportunity”).

²⁷ See, e.g., *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987); *In re PNB Holding Co. S’holders Litig.*, C.A. No. 28-N, 2006 WL 2403999 (Del. Ch. Aug. 18, 2006) (reviewing under the entire fairness standard a transaction in which most public shareholders were cashed out but some shareholders, including the directors, continued as shareholders of the recapitalized company); *Blasius Indus., Inc. v. Atlas*

Corp., 564 A.2d 651 (Del. Ch. 1988) (holding that actions by the board after a consent solicitation had begun which were designed to thwart the dissident shareholder's goal of obtaining majority representation on the board, violated the board's fiduciary duty); *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 111 (Del. Ch. 1986) (“[W]here a self-interested corporate fiduciary has set the terms of a transaction and caused its effectuation, it will be required to establish the entire fairness of the transaction to a reviewing court's satisfaction.”).

²⁸ *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

²⁹ *Id.*

³⁰ *In re Walt Disney Co. Derivative Litig.*, 906 A.2d 27, 67 (Del. 2006).

³¹ *In re Cornerstone Therapeutics Inc. S'holder Litig.*, 115 A.3d 1173 (Del. 2015).

³² *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 235 (Del. 2009).

³³ *See Chen v. Howard-Anderson*, 87 A.3d 648, 680-85 (Del. Ch. 2014) (interpreting *Lyondell* to address only one theory of bad faith and noting that *Lyondell* did not foreclose possibility of bad-faith claims premised on improper motives of fiduciaries).

³⁴ *Lyondell*, 970 A.2d at 243.

³⁵ *Id.* at 244; *see also In re Answers Corp. S'holders Litig.*, C.A. No. 6170-VCN, 2014 WL 448427 (Del. Ch. Feb. 3, 2014); *Wayne Cnty. Emps.' Ret. Sys. v. Corti*, C.A. No. 3534-CC, 2009 WL 2219260, at *14 (Del. Ch. July 24, 2009); *In re NYMEX S'holder Litig.*, C.A. Nos. 3621-VCN, 3835-VCN, 2009 WL 3206051, at *7 (Del. Ch. Sept. 30, 2009); *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 654-55 (Del. Ch. 2008) (“Courts should...be extremely chary about labeling what they perceive as deficiencies in the deliberations of an independent board majority over a discrete transaction as not merely negligence or even gross negligence, but as involving bad faith. In the transactional context, a very extreme set of facts would seem to be required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties.”).

³⁶ J. Travis Laster, *Revlon Is a Standard of Review: Why It's True and What It Means*, 19 FORDHAM J. CORP. & FIN. L. 5, 26-27 (2013) (discussing the distinction between standards of conduct and standards of review).

³⁷ *Panter v. Marshall Field & Co.*, 646 F.2d 271, 293-95 (7th Cir. 1981); *Treadway Cos. v. Care Corp.*, 638 F.2d 357, 382-83 (2d Cir. 1980); *Johnson v. Trueblood*, 629

F.2d 287, 292-93 (3d Cir. 1980); *Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334, 1341 (Del. 1987); *Cede & Co. v. Technicolor, Inc. (Technicolor I)*, 634 A.2d 345, 360-61 (Del. 1993); *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984); *Aronson v. Lewis*, 473 A.2d 805, 811-12 (Del. 1984).

³⁸ *In re Goldman Sachs Grp., Inc. S'holder Litig.*, C.A. No. 5215-VCG, 2011 WL 4826104, at *23 (Del. Ch. Oct. 12, 2011) (quoting *In re Citigroup Inc. S'holder Derivative Litig.*, 964 A.2d 106, 139 (Del. Ch. 2009)).

³⁹ DEL. CODE ANN. tit. 8, § 141(a) (West 2011).

⁴⁰ *See, e.g., Aronson*, 473 A.2d at 812-13 & n.6.

⁴¹ *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1373 (Del. 1995).

⁴² *In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d 604, 615 (Del. Ch. 2005).

⁴³ *E.g., Orman v. Cullman*, 794 A.2d 5, 20 (Del. Ch. 2002).

⁴⁴ *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946 (Del. 1985).

⁴⁵ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986).

⁴⁶ *Reis v. Hazelett Strip-Casting Corp.*, 28 A.3d 442, 457 (Del. Ch. 2011).

⁴⁷ *RBC Capital Mkts., LLC v. Jervis*, 129 A.3d 816, 857 (Del. 2015).

⁴⁸ *Corwin v. KKR Fin. Holdings, LLC*, 125 A.3d 304, 312 (Del. 2015).

⁴⁹ *See e.g., Id.* at 308-14; *But cf. Id.* at 311 n.20 (declining to rule on the continued vitality of *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59 (Del. 1995), in which the court did not apply the business judgment rule to the Santa Fe board's decision to adopt defensive measures to ward off a hostile approach from Union Pacific, on the ground that "the stockholders of Santa Fe merely voted in favor of the merger [with Burlington] and not the defensive measures").

⁵⁰ *See, e.g., Paramount Commc'ns Inc. v. QVC Network Inc. (QVC)*, 637 A.2d 34, 45 (Del. 1994); *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279 (Del. 1989). Two subsequent Delaware Supreme Court decisions confirm that board actions subject to review under *Unocal* in the context of an active takeover defense will in other circumstances need to satisfy only the standard business judgment analysis. In *Williams v. Geier*, 671 A.2d 1368 (Del. 1996), the Delaware Supreme Court reiterated that adoption of a defensive measure approved by shareholder vote would not be subjected to *Unocal* scrutiny since it would not constitute unilateral board action. In *Kahn ex rel.*

DeKalb Genetics Corp. v. Roberts, 679 A.2d 460 (Del. 1996), the Delaware Supreme Court refused to apply *Unocal*'s enhanced scrutiny to a share repurchase program, because that program was not initiated in response to any perceived threat.

⁵¹ *Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361, 1361 (Del. 1995).

⁵² The Unitrin board also claimed that American General's offer created a risk of an antitrust violation. The Court preliminarily rejected the theory of an "antitrust threat" as relevant to the first part of the *Unocal* analysis, stating that either the Federal Trade Commission would block the transaction (in which case no defensive device is necessary) or it would not (in which case there is no antitrust threat). *Am. Gen. Corp. v. Unitrin, Inc.*, C.A. Nos. 13656, 13699, 1994 WL 698483, at *12 (Del. Ch. Oct. 14, 1994), *rev'd and remanded*, 651 A.2d 1361 (Del. 1995).

⁵³ The Delaware Court of Chancery's decision in *Santa Fe*, which concluded that the adoption of a "discriminatory" rights plan to defend against a third-party unsolicited, all-cash all-shares offer was a reasonable measure under *Unocal*, again recognizes the board's discretion in preserving a strategic plan. *In re Santa Fe Pac. Corp. S'holder Litig.*, C.A. No. 13587, 1995 WL 334258, at *9-10 (Del. Ch. May 31, 1995), *rev'd on other grounds*, 669 A.2d 59, 71-72 (Del. 1995).

⁵⁴ *See Chesapeake Corp. v. Shore*, 771 A.2d 293 (Del. Ch. 2000).

⁵⁵ *Id.* at 331.

⁵⁶ *Id.* at 344.

⁵⁷ *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011).

⁵⁸ *Id.* at 129.

⁵⁹ *Id.*

⁶⁰ *Ace Ltd. v. Capital Re Corp.*, 747 A.2d 95, 108 (Del. Ch. 1999); *see also Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, C.A. No. 17398, 1999 WL 1054255, at *2 (Del. Ch. Sept. 27, 1999); *La. Mun. Police Emps.' Ret. Sys. v. Crawford*, 918 A.2d 1172, 1181 n.10 (Del. Ch. 2007) ("Nor may plaintiffs rely upon some naturally-occurring rate or combination of deal protection measures, the existence of which will invoke the judicial blue pencil. Rather, plaintiffs must specifically demonstrate how a given set of deal protections operate in an unreasonable, preclusive, or coercive manner, under the standards of this Court's *Unocal* jurisprudence, to inequitably harm shareholders.").

⁶¹ *Crawford*, 918 A.2d at 1181 n.10.

⁶² *Blasius Indus. Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

⁶³ *MM Cos., v. Liquid Audio, Inc.*, 813 A.2d 1118, 1130 (Del. 2003).

⁶⁴ *Id.*

⁶⁵ *Id.* at 1120.

⁶⁶ *Id.* at 1132.

⁶⁷ *Mercier v. Inter-Tel (Delaware), Inc.*, 929 A.2d 786, 808-09 (Del. Ch. 2007).

⁶⁸ *Id.* at 819.

⁶⁹ On a motion for preliminary injunction, Vice Chancellor Parsons “conclude[d] that Plaintiffs are likely to succeed on their argument that the approximately 50% cash and 50% stock consideration here triggers *Revlon*.” *In re Smurfit-Stone Container Corp. S’holder Litig.*, C.A. No. 6164-VCP, 2011 WL 2028076, at *16 (Del. Ch. May 24, 2011).

⁷⁰ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d, 173 182 (Del. 1986).

⁷¹ *Paramount Commc’ns Inc. v. QVC Network Inc. (QVC)*, 637 A.2d 34, 46 (Del. 1994) (citation omitted).

⁷² *Barkan v. Amsted Indus., Inc.*, 567 A. 2d 1279, 1286 (Del. 1989).

⁷³ *QVC*, 637 A.2d at 45.

⁷⁴ *C&J Energy Servs., Inc. v. City of Miami Gen. Emps.’ & Sanitation Emps.’ Ret. Trust*, 107 A.3d 1049, 1053 (Del. 2014).

⁷⁵ *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 242 (Del. 2009).

⁷⁶ *Id.*

⁷⁷ See *Gantler v. Stephens*, 965 A.2d 695 (Del. 2009) (*Unocal* review not required where the plaintiff challenged the board’s decision to reject the offers of three suitors and pursue a recapitalization instead); *TW Servs., Inc. v. SWT Acquisition Corp.*, C.A. Nos. 10427, 10298, 1989 WL 20290 (Del. Ch. Mar. 2, 1989) (*Revlon* not triggered by an unsolicited offer to negotiate a friendly deal).

⁷⁸ *Paramount Commc’ns, Inc. v. Time Inc. (Time-Warner)*, 571 A.2d 1140 (Del. 1989).

⁷⁹ *Paramount Commc'ns Inc. v. QVC Network Inc. (QVC)*, 637 A.2d 34 (Del. 1994).

⁸⁰ Transactions in which a controller cashes or squeezes out the minority are often subject to entire fairness review, discussed *infra* Section II.C.

⁸¹ *In re Synthes, Inc. S'holder Litig.*, 50 A.3d 1022, 1047–48 (Del. Ch. 2012); *In re NCS Healthcare, Inc., S'holders Litig.*, 825 A.2d 240, 254–55 (Del. Ch. 2002) (“The situation presented on this motion does not involve a change of control. On the contrary, this case can be seen as the obverse of a typical *Revlon* case. Before the transaction . . . is completed, [the seller] remains controlled by the [controlling stockholder]. The record shows that, as a result of the proposed [] merger, [the seller’s] stockholders will become stockholders in a company that has no controlling stockholder or group. Instead, they will be stockholders in a company subject to an open and fluid market for control.”), *rev'd on other grounds sub nom. Omnicare, Inc. v. NCS Healthcare, Inc.*, 822 A.2d 397 (Del. 2002).

⁸² *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59 (Del. 1995).

⁸³ *In re Smurfit-Stone Container Corp. S'holder Litig.*, C.A. No. 6164-VCP, 2011 WL 2028076, at *15 (Del. Ch. May 24, 2011).

⁸⁴ *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 241 (Del. 2009).

⁸⁵ *In re Rural Metro Corp. S'holders Litig.*, 88 A.3d 54, 89-96 (Del. Ch. 2014), *aff'd sub nom. RBC Capital Mkts., LLC v. Jervis*, 129 A.3d 816 (Del. 2015).

⁸⁶ *Paramount Commc'ns Inc. v. QVC Network Inc. (QVC)*, 637 A.2d 34, 44 (Del. 1994).

⁸⁷ *Golden Cycle, LLC v. Allan*, C.A. No. 16301, 1998 WL 892631, at *16 (Del. Ch. Dec. 10, 1998); *accord In re MONY Grp. Inc. S'holder Litig.*, 852 A.2d 9, 15 (Del. Ch. 2004).

⁸⁸ *In re Dollar Thrifty S'holder Litig.*, 14 A.3d 573 (Del. Ch. 2010).

⁸⁹ *Id.* at 595-96.

⁹⁰ *Id.* at 578.

⁹¹ *In re Family Dollar Stores, Inc. Stockholder Litig.*, C.A. No. 9985-CB, 2014 WL 7246436 (Del. Ch. Dec. 19, 2014).

⁹² *Id.* at 16.

⁹³ *C&J Energy Servs., Inc. v. City of Miami Gen. Emps.’ & Sanitation Emps.’ Ret. Trust*, 107 A.3d 1049, 1053 (Del. 2014).

⁹⁴ *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1286 (Del. 1989); *Barkan v. Amsted Indus., Inc.*, C.A. No. 9212, slip op. at 13 (Del. Ch. Sept. 21, 1990).

⁹⁵ *Macmillan*, 559 A.2d at 1287.

⁹⁶ *Id.* (citations omitted).

⁹⁷ *In re Toys “R” Us, Inc. S’holder Litig.*, 877 A.2d 975 (Del. Ch. 2005).

⁹⁸ *In re Topps Co. S’holders Litig.*, 926 A.2d 58 (Del. Ch. 2007).

⁹⁹ *In re Smurfit-Stone Container Corp. S’holder Litig.*, C.A. No. 6164-VCP, 2011 WL 2028076, at *17, *18, *22 (Del. Ch. May 24, 2011).

¹⁰⁰ *In re Plains Exploration & Prod. Co. Stockholder Litig.*, C.A. No. 8090-VCN, 2013 WL 1909124, at *5 (Del. Ch. May 9, 2013).

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ *Barkan v. Amsted Indus., Inc.*, 567 A. 2d 1279, 1287 (Del. 1989) (citations omitted). Similarly, with respect to auctions, Delaware law “does not require that whenever a corporation is to be sold for cash an auction be held, it does require . . . at the least that directors take reasonable steps designed to assure that they have probed for alternatives and have a reasonable basis to conclude that the choice that they make is the best available alternative.” *Braunschweiger v. Am. Home Shield Corp.*, C.A. No. 10755, 1989 WL 128571, at *1008-09 (Del. Ch. Oct. 26, 1989) (citation omitted).

¹⁰⁴ *In re Netsmart Techs., Inc. S’holders Litig.*, 924 A.2d 171 (Del. Ch. 2007); *see also* Transcript of Oral Argument at 14, 20, *Forgo v. Health Grades, Inc.*, C.A. No. 5716-VCS (Del. Ch. Sept. 3, 2010) (criticizing the target’s board for failing to “sift through possible . . . buyers and make a judgment about whether there might be someone who would be interested” and create “any record that it really segmented the market or considered whether there was a likely buyer”).

¹⁰⁵ *Netsmart*, 924 A.2d at 198-99.

¹⁰⁶ *Koehler v. NetSpend Holdings Inc.*, C.A. No. 8373-VCG, 2013 WL 2181518 (Del. Ch. May 21, 2013).

107 *Id.* at *23.

108 *RBC Capital Mkts., LLC v. Jervis*, 129 A.3d 816 (Del. 2015).

109 *Id.* at 830-31.

110 *In re Rural Metro Corp. S’holders Litig.*, 88 A.3d 54, 94 (Del. Ch. 2014), *aff’d sub nom. RBC Capital Mkts.*, 129 A.3d 816.

111 *In re Rural/Metro Corp. S’holders Litig.*, 102 A.3d 205, 224 (Del. Ch. 2014), *aff’d sub nom. RBC Capital Mkts.*, 129 A.3d 816.

112 *RBC Capital Mkts.*, 129 A.3d at 860.

113 *In re Del Monte Foods Co. S’holders Litig.*, 25 A.3d 813 (Del. Ch. 2011).

114 *Id.* at 822.

115 *Id.* at 836.

116 *See Paramount Commc’ns, Inc. v. Time Inc. (Time-Warner)*, 571 A.2d 1140, 1154 (Del. 1990); *accord In re Santa Fe Pac. Corp. S’holder Litig.*, C.A. No. 13587, 1995 WL 334258, at *8 (Del. Ch. May 31, 1995) (holding that although a “bidding contest” did occur, *Revlon* duties not triggered where board did not initiate bidding and sought strategic stock-for-stock merger), *aff’d in part, rev’d in part*, 669 A.2d 59 (Del. 1995).

117 *Time-Warner*, 571 A.2d at 1150 (emphasis in original); *see also id.* at 1154 (“The fiduciary duty to manage a corporate enterprise includes the selection of a time frame for achievement of corporate goals.”); *accord Arnold*, 650 A.2d at 1289-90.

118 *Time-Warner*, 571 A.2d at 1153.

119 *Compare Gilbert v. El Paso Co.*, 575 A.2d 1131, 1143-44 (Del. 1990) (holding that because all of the board’s actions were in response to an unsolicited tender offer seeking control of company, *Unocal* standard applied throughout), *with Santa Fe*, 1995 WL 334258, at *9 n.7 (holding that the board’s decision to enter into original stock-for-stock merger was subject to business judgment review, but altered transaction in response to unsolicited third-party offer must be subjected to enhanced scrutiny under *Unocal*), *aff’d in part, rev’d in part*, 669 A.2d 59 (Del. 1995); *Time-Warner*, 571 A.2d at 1151 n.14 (holding that original plan of merger entered into as part of corporate strategy subject to business judgment rule, while later actions in response to hostile tender offer are subject to enhanced *Unocal* standard).

¹²⁰ *Encite LLC v. Soni*, C.A. No. 2476-VCG, 2011 WL 5920896, at *20 (Del. Ch. Nov. 28, 2011) (internal quotation marks omitted).

¹²¹ *In re Tyson Foods, Inc.*, 919 A.2d 563, 596 (Del. Ch. 2007).

¹²² *N.J. Carpenters Pension Fund v. infoGROUP, Inc.*, C.A. No. 5334-VCN, 2011 WL 4825888, at *11 (Del. Ch. Oct. 6, 2011).

¹²³ *Americas Mining Corp. v. Theriault*, 51 A.3d 1213, 1240 (Del. 2012).

¹²⁴ *See, e.g., Ivanhoe Partners v. Newmont Mining Corp.*, 535 A.2d 1334 (Del. 1987).

¹²⁵ *See, e.g., O'Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 913 (Del. Ch. 1999).

¹²⁶ *See, e.g., Harbor Fin. Partners v. Huizenga*, 751 A.2d 879 (Del. Ch. 1999).

¹²⁷ *See, e.g., Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997).

¹²⁸ *Cinerama, Inc. v. Technicolor, Inc. (Technicolor II)*, 663 A.2d 1134, 1153 (Del. Ch. 1994) (emphasis in original), *aff'd*, *Cinerama, Inc. v. Technicolor, Inc. (Technicolor III)*, 663 A.2d 1156 (Del. 1995). Separate from the question whether the interest of a director in a transaction may trigger entire fairness review, is the question of the applicability of the statutory “safe harbor” protecting a transaction from being void solely by reason of such interest or because of the participation of the interested director in board action. DGCL Section 144(a) provides that a director’s self-interest or participation in board action will not void a transaction or contract if (1) the director discloses, or the board is otherwise aware of, the material facts of the director’s interest and a majority of disinterested directors approves the action; (2) a majority of shareholders similarly aware of the director’s interest approves the action; or (3) the transaction or contract is fair to the corporation as of the time it was authorized, approved or ratified by the board or the shareholders. Del. Code Ann. tit. 8, § 144(a) (West 2011).

¹²⁹ *See In re John Q. Hammons Hotels Inc. S’holder Litig.*, C.A. No. 758-CC, 2011 WL 227634, at *12 (Del. Ch. Jan. 14, 2011) (holding, in cases involving third-party mergers where the controller and unaffiliated stockholders may be competing for consideration, “business judgment would be the applicable standard of review if the transaction were (1) recommended by a disinterested and independent special committee, and (2) approved by stockholders in a non-waivable vote of the majority of all the minority stockholders.”); *Americas Mining Corp. v. Theriault*, 51 A.3d 1213, 1240 (Del. 2012) (holding, in mergers where the controller stands on both sides, “the defendants may shift the burden of persuasion by one of two means: first, they may show that the

transaction was approved by a well-functioning committee of independent directors; or second, they may show that the transaction was approved by an informed vote of a majority of the minority shareholders.”)

¹³⁰ *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 645 (Del. 2014).

¹³¹ *Id.* at 646.

¹³² Tr. of Oral Arg. and Court’s Ruling, *Swomley v. Schlecht*, C.A. No. 9355-VCL (Del. Ch. Aug. 27, 2014).

¹³³ *Id.* at 73.

¹³⁴ *Swomley v. Schlecht*, 128A.3d 992 (TABLE), (Del. 2015).

¹³⁵ *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983); *accord Kahn v. Lynch Commc’n Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994) (quoting *Weinberger*, 457 A.2d at 711).

¹³⁶ *In re John Q. Hammons Hotels Inc. S’holder Litig.*, C.A. No. 758-CC, 2009 WL 3165613, at *13 (Del. Ch. Oct. 2, 2009) (internal quotations and citations omitted).

¹³⁷ *Cinerama, Inc. v. Technicolor, Inc. (Technicolor II)*, 663 A.2d 1134, 1143 (Del. Ch. 1994).

¹³⁸ *See Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997); *Kahn v. Lynch Commc’n Sys.*, 638 A.2d 1110 (Del. 1994); *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929 (Del. 1985).

¹³⁹ *Lynch*, 638 A.2d 1110.

¹⁴⁰ *Ams. Mining Corp. v. Theriault*, 51 A.3d 1213, 1243 (Del. 2012).

¹⁴¹ *Id.* at 1244.

¹⁴² *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 639, 642 (Del. 2014).

¹⁴³ *See, e.g., Gesoff v. IIC Indus. Inc.*, 902 A.2d 1130 (Del. Ch. 2006) (criticizing a special committee that did not bargain effectively, had limited authority, and was advised by legal and financial advisors selected by the controlling shareholder); *In re Tele-Commc’ns, Inc. S’holders Litig. (TCI)*, C.A. No. 16470, 2005 WL 3642727 (Del. Ch. Jan. 10, 2006); *In re Emerging Commc’ns, Inc. S’holders Litig.*, C.A. No. 16415, 2004 WL 1305745 (Del. Ch. June 4, 2004) (criticizing a special committee that never met to consider the transaction together).

- ¹⁴⁴ *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304, 307 (Del. 2015).
- ¹⁴⁵ *In re Sea-Land Corp. S'holders Litig.*, C.A. No. 8453, 1988 WL 49126, at *3 (Del. Ch. May 13, 1988).
- ¹⁴⁶ *In re W. Nat'l Corp. S'holders Litig.*, C.A. No. 15927, 2000 WL 710192 (Del. Ch. May 22, 2000).
- ¹⁴⁷ *Williamson v. Cox Commc'ns, Inc.*, C.A. No. 1663-N, 2006 WL 1586375 (Del. Ch. June 5, 2006).
- ¹⁴⁸ *In re KKR Fin. Holdings LLC S'holder Litig.*, 101 A.3d 980, 993 (Del. 2014), *aff'd*, *Corwin*, 125 A.3d 304.
- ¹⁴⁹ *Del. Cty. Emps.' Ret. Sys. v. Sanchez*, 124 A.3d 1017, 1019 (Del. 2015).
- ¹⁵⁰ *See Orman v. Cullman*, C.A. No. 18039, 2004 WL 2348395, at *5 (Del. Ch. Oct. 20, 2004).
- ¹⁵¹ *Cf. Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997) (reversing trial court's decision to place burden of proving unfairness on plaintiffs in part on the Delaware Supreme Court's finding that three members of the special committee had previous affiliations with the buyer and received financial compensation or influential positions from the buyer).
- ¹⁵² *In re Emerging Commc'ns, Inc. S'holders Litig.*, C.A. No. 16415, 2004 WL 1305745 (Del. Ch. June 4, 2004).
- ¹⁵³ *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879 (Del. Ch. 1999); *see also Mizel v. Connelly*, C.A. No. 16638, 1999 WL 550369, at *4 (Del. Ch. Aug. 2, 1999) (stating that close familial ties should "go a long (if not the whole) way toward creating a reasonable doubt" as to independence).
- ¹⁵⁴ *Sanchez*, 124 A.3d at 1019.
- ¹⁵⁵ *See also In re J.P. Morgan Chase & Co. S'holder Litig.*, 906 A.2d 808 (Del. Ch. 2005) (dismissing plaintiffs' claims that the acquiror "overpaid" for the target because claims were derivative and therefore could not survive if a majority of the acquiror's board was independent, and concluding that the overwhelming majority of directors were in fact independent, despite directors' various business relationships with the acquiror and (in some cases) leadership positions held by directors of charitable institutions which were alleged to be major recipients of the acquiror's corporate giving), *aff'd*, 906 A.2d 766 (Del. 2006).

¹⁵⁶ *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310 (Del. Ch. 2010), *aff'd*, 15 A.3d 218 (Del. 2011).

¹⁵⁷ *See Citron v. Fairchild Camera & Instrument Corp.*, 569 A.2d 53 (Del. 1989).

¹⁵⁸ *In re KKR Fin. Holdings LLC S'holder Litig.*, 101 A.3d 980, 997 (Del. Ch. 2014).

¹⁵⁹ *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 639, 649 (Del. 2014).

¹⁶⁰ *Id.* at 648 n.26.

¹⁶¹ *Beam ex. rel Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1049-50 (Del. 2004).

¹⁶² *Id.* at 1049-52.

¹⁶³ *In re Plains Exploration & Prod. Co. Stockholder Litig.*, C.A. No. 8090-VCN, 2013 WL 1909124, at *5 (Del. Ch. May 9, 2013) (quoting *Gesoff v. IIC Indus., Inc.*, 902 A.2d 1130, 1145 (Del. Ch. 2006)).

¹⁶⁴ *See Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994).

¹⁶⁵ *See, e.g., Cede & Co. v. Technicolor, Inc. (Technicolor I)*, 634 A.2d 345 (Del. 1993).

¹⁶⁶ *In re Digex, Inc. S'holders Litig.*, 789 A.2d 1176 (Del. Ch. 2000).

¹⁶⁷ *McMullin v. Beran*, 765 A.2d 910 (Del. 2000).

¹⁶⁸ In *In re CompuCom Sys., Inc. Shareholders Litigation*, C.A. No. 499-N, 2005 WL 2481325 (Del. Ch. Sept. 29, 2005), the Delaware Court of Chancery affirmed that the mere presence of a controlling shareholder in the context of a sale to an unaffiliated third party, conducted by an independent special committee after an 18-month search for a buyer, did not give rise to a claim by plaintiffs upon which relief could be granted.

¹⁶⁹ *Rabkin v. Olin Corp.*, C.A. No. 7547, 1990 WL 47648, at *6 (Del. Ch. Apr. 17, 1990), *aff'd*, 586 A.2d 1202 (Del. 1990); *accord Kahn v. Dairy Mart Convenience Stores, Inc.*, C.A. No. 12489, 1996 WL 159628, at *6 (Del. Ch. Mar. 29, 1996).

¹⁷⁰ *Cf. Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1118-21 (Del. 1994) (reversing trial court's finding that the special committee acted at arm's length in negotiation with controlling shareholder). To avoid the burden of proving entire fairness, interested directors must inform a special committee of (1) material transaction terms; (2) material facts relating to the use or value of the assets in question, including "hidden

value”; and (3) material facts relating to the value of the assets to third parties, such as forthcoming changes in technology or legal regulation. On the other hand, interested directors need not disclose the reservation price they have assigned to assets nor their plans regarding the use of sale proceeds. Such information, though material, is protected by a “negotiation privilege.” *Kahn v. Tremont Corp.*, C.A. No. 12339, 1996 WL 145452, at *15-16 (Del. Ch. Mar. 21, 1996), *rev’d and remanded*, 694 A.2d 422 (Del. 1997); *see also Hollinger Int’l, Inc. v. Black*, 844 A.2d 1022 (Del. Ch. 2004) (placing equitable limitations on statutory and common law powers normally enjoyed by controlling shareholder), *aff’d*, 872 A.2d 559 (Del. 2005).

¹⁷¹ *Lynch*, 638 A.2d 1110.

¹⁷² *See Gesoff v. IIC Indus. Inc.*, 902 A.2d 1146, 1150 (Del. Ch. 2006).

¹⁷³ *In re S. Peru Copper Corp. S’holder Derivative Litig.*, 30 A.3d 60 (Del. Ch. 2011), *revised and superseded*, 52 A.3d 761 (Del. Ch. 2011).

¹⁷⁴ *Id.* at 97-98.

¹⁷⁵ *See Ams. Mining Corp. v. Theriault*, 51 A.3d 1213 (Del. 2012).

¹⁷⁶ *See La. Mun. Police Emps’. Ret. Sys. v. Fertitta*, C.A. No. 4339-VCL, 2009 WL 2263406, at *8 n.34 (Del. Ch. July 28, 2009).

¹⁷⁷ *Kahn v. Lynch Commc’n Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994).

¹⁷⁸ *See, e.g., In re Rural Metro Corp. S’holders Litig.*, 88 A.3d 54, 90 (Del. Ch. 2014).

¹⁷⁹ *See, e.g., In re El Paso Pipeline Partners, L.P. Derivative Litig.*, C.A. No. 7141-VCL, 2015 WL 1815846 (Del. Ch. Apr. 20, 2015).

¹⁸⁰ *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1279-80 (Del. 1989).

¹⁸¹ *In re Tele-Commc’ns, Inc. S’holders Litig. (TCI)*, C.A. No. 16470, 2005 WL 3642727, at *10 (Del. Ch. Jan. 10, 2006).

¹⁸² *Gesoff v. IIC Indus. Inc.*, 902 A.2d 1150 (Del. Ch. 2006).

¹⁸³ *In re Emerging Commc’ns, Inc. S’holders Litig.*, C.A. No. 16415, 2004 WL 1305745, at *32 (Del. Ch. June 4, 2004).

¹⁸⁴ *See, e.g., RBC Capital Mkts., LLC v. Jervis*, 129 A.3d 816, 864 (Del. 2015).

185 *TCI*, 2005 WL 3642727.

186 *In re Trados Inc. S'holder Litig.*, 73 A.3d 17 (Del. Ch. 2013). However, the mere fact that directors own shares of common stock but not preferred stock, in and of itself, does not necessarily deprive them of the protections of the business judgment rule with respect to a decision of how to allocate merger consideration amongst common and preferred shareholders. *See LC Capital Master Fund, Ltd. v. James*, 990 A.2d 435 (Del. Ch. 2010).

187 *In re John Q. Hammons Hotels Inc. S'holder Litig.*, C.A. No. 758-CC, 2009 WL 3165613, at *12, *18 (Del. Ch. 2009); *see also In re John Q. Hammons Hotels Inc. S'holder Litig.*, 2011 WL 227634 (Del. Ch. Jan. 14, 2011).

188 *John Q. Hammons*, 2009 WL 3165613, at *12, *18.

189 *Id.* at *12.

190 *Id.*

191 In reaching its decision, the Court noted that the members of the special committee were “highly qualified” and had “extensive experience,” “understood their authority and duty to reject any offer that was not fair to the unaffiliated stockholders” and were “thorough, deliberate, and negotiated at arm’s length with [multiple bidders] over a nine month period to achieve the best deal available for the minority stockholders.” *John Q. Hammons*, 2011 WL 227634, at *2.

192 *In re Delphi Fin. Grp. S'holder Litig.*, C.A. No. 7144-VCG, 2012 WL 729232 (Del. Ch. Mar. 6, 2012).

193 *Id.* at *6.

194 *Id.* at *7.

195 *Id.*

196 *Id.* at *19, *21.

197 *Id.* at *16.

198 *Martin Marietta Materials, Inc. v. Vulcan Materials Co.*, 56 A.3d 1072 (Del. Ch. 2012), *aff'd*, 68 A.3d 1208 (Del. 2012).

199 *Depomed Inc. v. Horizon Pharma, PLC*, Nos. 1-15-CV-283834, 1-15-CV-283835 (Cal. Sup. Ct. Nov. 19, 2015).

200 *Id.* at 2-3.

201 Bid procedure letters sent on behalf of a selling company to potential bidders in an auction context can serve a similar function, and should similarly include language making absolutely clear that the target company has no legal, fiduciary or other duty to any bidder with respect to the manner in which it conducts the auction. Bid procedure letters should also include an express disclaimer to the effect that the bidder is not relying on any express or implied representation concerning the manner in which the auction will be conducted.

202 *PharmAthene, Inc. v. SIGA Techs., Inc.*, C.A. No. 2627-VCP, 2010 WL 4813553, at *7 (Del. Ch. Nov. 23, 2010) (citing *Hindes v. Wilmington Poetry Soc’y*, 138 A.2d 501, 502-04 (Del. Ch. 1958)).

203 Transcript of Oral Argument, *Global Asset Capital, LLC v. Rubicon US Reit, Inc.*, C.A. No. 5071-VCL (Del. Ch. Nov. 16, 2009).

204 *SIGA Techs., Inc. v. PharmAthene, Inc.*, 67 A.3d 330, 336 (Del. 2013).

205 *Id.* at 346.

206 *Id.* at 334.

207 *Siga Techs., Inc. v. PharmAthene, Inc.*, No. 2627-VCP, 2015 WL 9591986, at *4 (Del. 2015).

208 *Ev3, Inc. v. Lesh*, 114 A.3d 527 (Del. 2014).

209 *Id.* at 529.

210 *Id.* at 530.

211 *C&J Energy Servs., Inc. v. City of Miami Gen. Emps.’ & Sanitation Emps.’ Ret. Trust*, 107 A.3d 1049, 1067 (Del. 2014) (quoting *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1286 (Del. 1989)); *Paramount Commc’ns Inc. v. QVC Network Inc. (QVC)*, 637 A.2d 34, 44 (Del. 1994).

212 *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 242 (Del. 2009).

213 *In re Netsmart Techs., Inc. S’holders Litig.*, 924 A.2d 171, 192 (Del. Ch. 2007).

214 *In re Fort Howard Corp. S’holders Litig.*, C.A. No. 9991, 1988 WL 83147, 14 DEL. J. CORP. L. 699, 722 (Del. Ch. Aug. 8, 1988).

- ²¹⁵ See, e.g., *In re MONY Grp. Inc. S'holder Litig.*, 852 A.2d 9 (Del. Ch. 2004) (denying shareholder plaintiffs' request for injunctive relief based upon allegations that the MONY board of directors, having decided to put the company up for sale, failed to fulfill their fiduciary duties by foregoing an auction in favor of entering into a merger agreement with a single bidder and allowing for a post-signing market check).
- ²¹⁶ *In re Topps Co. S'holders Litig.*, 926 A.2d 58, 86 (Del. Ch. 2007).
- ²¹⁷ *Id.* at 86-87; see also *In re Lear Corp. S'holder Litig.*, 926 A.2d 94, 119-20 (Del. Ch. 2007).
- ²¹⁸ *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813 (Del. Ch. 2011).
- ²¹⁹ *In re Fort Howard Corp. S'holders Litig.*, CIV. A. No. 9991, 1988 WL 83147, (Del. Ch. Aug. 8, 1988); see *C&J Energy Servs., Inc. v. City of Miami Gen. Emps.' Ret. Trust*, 107 A.3d 1049, 1070 (Del. 2014) (“In prior cases like *In re Fort Howard Corporation Shareholders Litigation*, this sort of passive market check was deemed sufficient to satisfy *Revlon*.”).
- ²²⁰ *Fort Howard*, 1988 WL 83147, at *12.
- ²²¹ *In re Smurfit-Stone Container Corp. S'holder Litig.*, C.A. No. 6164-VCP, 2011 WL 2028076, at *19 n.133 (Del. Ch. May 24, 2011).
- ²²² *Id.* at *5 (citing *In re Pennaco Energy, Inc.*, 787 A.2d 691, 707 (Del. Ch. 2001)).
- ²²³ *Koehler v. NetSpend Holdings Inc.*, C.A. No. 8373-VCG, 2013 WL 2181518 (Del. Ch. May 21, 2013).
- ²²⁴ *Id.* at *19.
- ²²⁵ *Id.* at *20.
- ²²⁶ *Cinerama, Inc. v. Technicolor, Inc. (Technicolor II)*, 663 A.2d 1134, 1142 (Del. Ch. 1994).
- ²²⁷ 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. (forthcoming May 2015).
- ²²⁸ See, e.g., *Smith v. Van Gorkom (Trans Union)*, 488 A.2d 858, 876-77 (Del. 1985).
- ²²⁹ See *Steinhardt, et al. v. Occam Networks, Inc., et al.*, C.A. No. 5878-VCL, at 15 (Del. Ch. Jan. 24, 2011) (ordering disclosure concerning, among other things, “what

appear to be longitudinal changes from previous Jefferies' books that resulted in the final book making the deal look better than it would have been had the same metrics been used that were used in prior books.”).

²³⁰ See Self-Regulatory Organizations, SEC Release No. 34-56645, 91 SEC Docket 2216 (Oct. 11, 2007).

²³¹ See FINRA Manual, FINRA Rule 5150.

²³² *In re Tele-Comm'ns, Inc. S'holders Litig. (TCI)*, C.A. No. 16470, 2005 WL 3642727, at *10 (Del. Ch. Jan. 10, 2006).

²³³ *In re Toys “R” Us, Inc. S'holder Litig.*, 877 A.2d 975, 1005 (Del. Ch. 2005).

²³⁴ See *In re Atheros Commc'ns, Inc. S'holders Litig.*, C.A. No. 6124-VCN, 2011 WL 864928 (Del. Ch. Mar. 4, 2011) (concluding that a fee arrangement in which the ratio of contingent to non-contingent compensation was 50:1 must be disclosed).

²³⁵ *La. Mun. Police Emps.' Ret. Sys. v. Crawford*, 918 A.2d 1172 (Del. Ch. 2007).

²³⁶ *Atheros*, 2011 WL 864928, at *8.

²³⁷ *In re Del Monte Foods Co. S'holders Litig.*, 25 A.3d 813 (Del. Ch. 2011).

²³⁸ *Id.* at 835 (internal quotations and citations omitted).

²³⁹ *Id.* at 834.

²⁴⁰ *In re Rural Metro Corporation Stockholders Litig.*, 88 A.3d 54 (Del. Ch. 2014).

²⁴¹ *Id.* at 100.

²⁴² *Id.*

²⁴³ *RBC Capital Mkts., LLC v. Jervis*, 129 A.3d 816 (Del. 2015).

²⁴⁴ *Id.* at 865.

²⁴⁵ *Id.* at 855 n.129.

²⁴⁶ See, e.g., *In re Zale Corp. S'holders Litig.*, No. 9388-VCP, 2015 WL 6551418 (Del. Ch. Oct. 29, 2015).

²⁴⁷ See, e.g., *In re El Paso Corp. S'holder Litig.*, 41 A.3d 432 (Del. Ch. 2012).

²⁴⁸ *In re Tele-Comm's, Inc. S'holders Litig.*, C.A. No. 16470, 2005 WL 3642727 (Del. Ch. Jan. 10, 2006); *see also Levco Alternative Fund Ltd. v. Reader's Digest Ass'n, Inc.*, 2002 WL 1859064 (Del. Aug. 13, 2002).

²⁴⁹ *See In re Netsmart Techs., Inc. S'holders Litig.*, 924 A.2d 171, 177 (Del. Ch. 2007); *see also Maric Capital Master Fund, Ltd. v. PLATO Learning, Inc.*, 11 A.3d 1175, 1178 (Del. Ch. 2010) (“[I]n my view, management’s best estimate of the future cash flow of a corporation that is proposed to be sold in a cash merger is clearly material information.”).

²⁵⁰ *In re 3Com S'holders Litig.*, C.A. No. 5067-CC, 2009 WL 5173804, at *3 (Del. Ch. Dec. 18, 2009) (holding that plaintiffs have failed to show how disclosure of full projections, instead of the summary provided by the financial advisors, would have altered the “total mix of available information”); *see also In re CheckFree Corp. S'holders Litig.*, C.A. No. 3193-CC, 2007 WL 3262188 (Del. Ch. Nov. 1, 2007).

²⁵¹ *See David P. Simonetti Rollover IRA v. Margolis*, C.A. No. 3694-VCN, 2008 WL 5048692, at *10 (Del. Ch. June 27, 2008) (explaining that “Delaware law requires that directors disclose the substance of the investment banker’s work, which usually depends in part upon management’s best estimates,” and holding that a proxy statement that discloses projections that “reflected management’s best estimates at the time” instead of “lower-probability projections” meets the requirement to disclose projections that “would have been considered material by the reasonable stockholder”).

²⁵² *In re Micromet, Inc. S'holders Litig.*, C.A. No. 7197-VCP, 2012 WL 681785, at *13 (Del. Ch. Feb. 29, 2012) (quoting *Globis Partners, L.P. v. Plumtree Software, Inc.*, C.A. No. 1577-VCP, 2007 WL 4292024 (Del. Ch. Nov. 30, 2007)) (holding that there is no legal requirement to disclose projections that present “overly optimistic ‘what-ifs’”).

²⁵³ Transcript of Oral Argument on Plaintiffs' Motion For Preliminary Injunction and Rulings of the Court, *In re BEA Sys., Inc. S'holder Litig.*, C.A. No. 3298-VCL (Del. Ch. Mar. 26, 2008).

²⁵⁴ *Id.* at 94.

²⁵⁵ *See, e.g.*, DEL. CODE ANN. tit. 8, § 251(h) and § 253 (West 2010).

²⁵⁶ *In re Siliconix Inc. S'holders Litig.*, C.A. No. 18700, 2001 WL 716787 (Del. Ch. June 19, 2001).

²⁵⁷ *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242, 243 (Del. 2001).

²⁵⁸ *In re CNX Gas Corp. S'holders Litig.*, 4 A.3d 397 (Del. Ch. 2010).

²⁵⁹ *Id.* at 412-14.

²⁶⁰ *See* DEL. CODE ANN. tit. 8, § 251(h) (West 2013).

²⁶¹ *See, e.g., Olson v. ev3, Inc.*, C.A. No. 5583-VCL, 2011 WL 704409 (Del. Ch. Feb. 21, 2011); *In re Cogent, Inc. S'holder Litig.*, 7 A.3d 487 (Del. Ch. 2010).

²⁶² Companies considering cross-border transactions may also need to consider the impact of different currencies on the pricing structure. Currency risk raises similar issues to those found in market risk and can amplify the market volatility factor inherent in all-stock transactions. *See* Section VII.D.

²⁶³ *See, e.g., Smith v. Van Gorkom (Trans Union)*, 488 A.2d 858, 875 (Del. 1985).

²⁶⁴ *Paramount Commc'ns Inc. v. QVC Network Inc. (QVC)*, 637 A.2d 34, 43 (Del. 1994).

²⁶⁵ *Trans Union*, 488 A.2d at 876 (pointing to evidence that members of Trans Union's Board "knew that the market had consistently undervalued the worth of Trans Union's stock, despite steady increases in the Company's operating income in the seven years preceding the merger").

²⁶⁶ *Paramount Commc'ns, Inc. v. Time Inc. (Time-Warner)*, 571 A.2d 1140, 1150 n.12 (Del. 1990).

²⁶⁷ *Id.* at 1150.

²⁶⁸ *Id.* at 1153.

²⁶⁹ *E.g., id.*

²⁷⁰ MD. CODE CORPS. & ASS'NS §2-104(9) (2013) (permitting corporations to adopt a charter provision that allows the board of directors "in considering a potential acquisition of control of the corporation, to consider the effect of the potential acquisition of control on" among, other constituencies, employees, suppliers, customers, creditors, and communities in which the corporation's offices are located); OR. REV. STAT. §60.357 (1989) (permitting directors to consider the social, legal and economic effects on constituencies other than shareholders "[w]hen evaluating any offer of another party to make a tender or exchange offer for any equity security of the corporation, or any proposal to merge or consolidate the corporation . . . or to purchase or otherwise acquire all or substantially all the properties and assets of the corporation").

²⁷¹ *See, e.g., Norfolk S. Corp., et al. v. Conrail Inc., et al.*, C.A. No. 96-CV-7167 (E.D. Pa. Nov. 19, 1996) (concluding that Pennsylvania's constituency statute "provides

that in considering the best interests of the corporation or the effects of any action, the directors are not required to consider the interests of any group, obviously including shareholders, as a dominant or controlling factor... ”); *Georgia-Pacific Corp. v. Great N. Nekoosa Corp.*, 727 F.Supp. 31, 33 (D. Me.1989) (justifying use of a poison pill in response to a cash tender offer partly on the basis of Maine’s other constituency statute).

²⁷² See *Unocal Corp. v. Mesa Petrol. Co.*, 493 A.2d 946 (Del. 1985); *Mills Acquisition Co. v. Macmillan, Inc.*, C.A. No. 10168, 1988 WL 108332 (Del. Ch. Oct. 18, 1988), *rev’d on other grounds*, 559 A.2d 1261. In the *Macmillan* case, the Delaware Supreme Court noted that it was legitimate for a board to consider the “effect on the various constituencies” of a corporation, the companies’ long-term strategic plans and “any special factors bearing on stockholder and public interests” in reviewing merger offers. *Macmillan*, 559 A.2d at 1285 n.35.

²⁷³ See *Minnesota Mining and Manufacturing Co.*, SEC No-Action Letter, 1988 WL 234978 (Oct. 13, 1988) (indicating that the following factors will be considered by the SEC to conclude that a CVR is not a security: (1) the CVR to be granted to the selling shareholders are an integral part of the consideration to be received in the proposed merger; (2) the holders of the CVR will have no rights common to stockholders such as voting and dividend rights, nor will they bear a stated rate of interest; (3) the CVRs will not be assignable or transferable except by operation of law; and (4) the CVRs will not be represented by any form of certificate or instrument).

²⁷⁴ *NACCO Indus., Inc. v. Applicia Inc.*, 997 A.2d 1, 19 (Del. Ch. 2009).

²⁷⁵ *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Unocal*, 493 A.2d 946; *see also* Section II.B.2.

²⁷⁶ *In re Toys “R” Us, Inc. S’holder Litig.*, 877 A.2d 975, 1016 (Del. Ch. 2005).

²⁷⁷ *Id.* at 1021.

²⁷⁸ See, e.g., *In re Cogent, Inc. S’holder Litig.*, 7 A.3d 487, 503-04 (Del. Ch. 2010) (citing *In re Lear Corp. S’holder Litig.*, 926 A.2d 94, 120 (Del. Ch. 2007)) (observing that the decision whether to view a termination fee’s preclusive effect in terms of equity value or enterprise value will depend on the factual circumstances existing in a given case).

²⁷⁹ *In re Answers Corp. S’holders Litig.*, C.A. No 6170-VCN, 2011 WL 1366780, at *4 n.52 (Del. Ch. Apr. 11, 2011).

²⁸⁰ *In re Comverge, Inc. S’holders Litig.*, Consol. C.A. No. 7368-VCP, 2014 WL 6686570, at *15-17 (Del. Ch. Nov. 25, 2014).

²⁸¹ *La. Mun. Police Emps.’ Ret. Sys. v. Crawford*, 918 A.2d 1172, 1181 n.10 (Del. Ch. 2007).

²⁸² *In re Dollar Thrifty S’holder Litig.*, 14 A.3d 573, 575 (Del. Ch. 2010).

²⁸³ *In re The Topps Co. S’holders Litig.*, 926 A.2d 58, 86 (Del. Ch. 2007).

²⁸⁴ *Answers*, 2011 WL 1366780 at *4 n.52; *see also id.* at *9 (noting that, in the context of a relatively small transaction, a “somewhat higher than midpoint on the ‘range’ is not atypical”).

²⁸⁵ *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, C.A. No. 17398, 1999 WL 1054255 (Del. Ch. Sept. 27, 1999).

²⁸⁶ *Id.* at *5.

²⁸⁷ *In re Lear Corp. S’holder Litig.*, 926 A.2d 94 (Del. Ch. 2007).

²⁸⁸ *See H.F. Ahmanson & Co. v. Great W. Fin. Corp.*, C.A. No. 15650, 1997 WL 305824 (Del. Ch. June 3, 1997).

²⁸⁹ *NACCO Indus., Inc. v. Applicia Inc.*, 997 A.2d 1, 19 (Del. Ch. 2009).

²⁹⁰ *C&J Energy Servs., Inc. v. City of Miami Gen. Emps.’ Ret. Trust*, 107 A.3d 1049 (Del. 2014).

²⁹¹ *Id.* at 1054, 1072.

²⁹² *Id.* at 1072 n.110 (quoting *OTK Assocs. LLC v. Friedman*, 85 A.3d 696, 720 n.2 (Del. Ch. 2014)).

²⁹³ *In re Del Monte Foods Co. S’holders Litig.*, 25 A.3d 813 (Del. Ch. 2011).

²⁹⁴ *Id.* at 841 (quoting *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 105-106 (Del. Ch. 1999)).

²⁹⁵ *Paramount Commc’ns Inc. v. QVC Network Inc. (QVC)*, 637 A.2d 34, 47-48 (Del. 1994).

²⁹⁶ *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, C.A. No. 17398, 1999 WL 1054255, at *1 (Del. Ch. Sept. 27, 1999).

²⁹⁷ *Koehler v. NetSpend Holdings Inc.*, C.A. No. 8373-VCG, 2013 WL 2181518, at *18 (Del. Ch. May 21, 2013) (“It is not per se unreasonable for a board to forgo a go-

shop where it makes an informed decision that such forbearance is part of a process designed to maximize price.”). Go-shop provisions were found in 11% of deals between public targets and strategic acquirors in 2013, up from 6% in 2012 and 4% in 2011. AM. BAR ASS’N, 2014 STRATEGIC BUYER/PUBLIC TARGET M&A DEAL POINTS STUDY 48 (2015).

²⁹⁸ Transcript of Telephonic Oral Argument and Ruling of the Court, *In re Complete Genomics, Inc. S’holder Litig. (Genomics II)*, C.A. No. 7888-VCL (Del. Ch. Nov. 27, 2012).

²⁹⁹ *Id.* at 18.

³⁰⁰ Transcript of Ruling of the Court, *In re Ancestry.com Inc. S’holder Litig.*, C.A. No. 7988-CS (Del. Ch. Dec. 17, 2012).

³⁰¹ *Koehler*, 2013 WL 2181518 .

³⁰² *Id.* at *19.

³⁰³ *Cirrus Holding Co. Ltd. v. Cirrus Indus.*, 794 A.2d 1191, 1207 (Del. Ch. 2001).

³⁰⁴ *Koehler*, 2013 WL 2181518, at *14.

³⁰⁵ *See Frontier Oil Corp. v. Holly Corp.*, C.A. No. 20502, 2005 WL 1039027, at *27 (Del. Ch. Apr. 29, 2005) (“The Merger Agreement, of course, was not an ordinary contract. Before the Merger could occur, the shareholders of Holly had to approve it. The directors of Holly were under continuing fiduciary duties to the shareholders to evaluate the proposed transaction. The Merger Agreement accommodated those duties by allowing, under certain circumstances, the board of directors to withdraw or change its recommendation to the shareholders that they vote for the Merger.”).

³⁰⁶ Transcript of Telephonic Ruling of the Court at 18, *In re Complete Genomics, Inc. S’holder Litig. (Genomics I)*, C.A. No. 7888-VCL (Del. Ch. Nov. 9, 2012).

³⁰⁷ Transcript of Oral Argument at 133, *In re NYSE Euronext S’holders Litig.*, C.A. 8136-CS (Del. Ch. May 10, 2013).

³⁰⁸ *In re Compellent Techs., Inc. S’holder Litig.*, C.A. 6084-VCL, 2011 WL 6382523, at *13 (Del. Ch. Dec. 9, 2011).

³⁰⁹ *See* DEL. CODE ANN. tit. 8, § 146 (West 2011).

³¹⁰ *Omnicare v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

311 *Id.* at 946.

312 *See Monty v. Leis*, 123 Cal. Rptr. 3d 641, 646 (Ct. App. 2011) (quoting *In re Toys “R” Us, Inc. S’holder Litig.*, 877 A.2d 975, 1016 n.68 (Del. Ch. 2005), for the proposition that *Omnicare* “‘represents . . . an aberrational departure from [the] long accepted principle’ that what matters is whether the board acted reasonably in light of all the circumstances”).

313 *See Orman v. Cullman*, C.A. No. 18039, 2004 WL 2348395 (Del. Ch. Oct. 20, 2004); *see also Majority Shareholders’ Voting Agreement Not Impermissible Lock-Up, Del. Court Says*, 7 M&A L. REP. 863 (Nov. 8, 2004).

314 *Koehler v. NetSpend Holdings Inc.*, C.A. No. 8373-VCG, 2013 WL 2181518, at *17 (Del. Ch. May 21, 2013).

315 *In re OPENLANE, Inc. S’holders Litig.*, C.A. No. 6849-VCN, 2011 WL 4599662 (Del. Ch. Sept. 30, 2011); *see also Optima Int’l of Miami, Inc. v. WCI Steel, Inc.*, C.A. No. 3833-VCL, 2008 WL 3822429 (Del. Ch. June 17, 2008) (distinguishing *Omnicare* and rejecting an argument that a shareholder written consent, which was received within a day of the target board’s approval of the merger agreement, was impermissible under the *Omnicare* analysis).

316 *OPENLANE*, 2011 WL 4599662, at *10.

317 *See SEC Compliance and Disclosure Interpretation, Securities Act Section 239.13* (Nov. 26, 2008), *available at* <https://www.sec.gov/divisions/corpfin/guidance/sasinterp.htm>.

318 *In re Toys “R” Us, Inc. S’holder Litig.*, 877 A.2d 975, 980 (Del. Ch. 2005).

319 *Id.* at 1018.

320 PRACTICAL LAW COMPANY, DEAL PROTECTIONS AND REMEDIES: A COMPARATIVE ANALYSIS OF 2014 PUBLIC MERGER AGREEMENTS, 16 (2014).

321 *In re BioClinica, Inc. S’holder Litig.*, C.A. No. 8272-VCG, 2013 WL 5631233, at *8 (Del. Ch. Oct. 16, 2013).

322 Transcript of Telephonic Ruling of the Court, *In re Complete Genomics, Inc. S’holder Litig. (Genomics I)*, C.A. No. 7888-VCL (Del. Ch. Nov. 9, 2012); Transcript of Telephonic Oral Argument and Ruling of the Court, *In re Complete Genomics, Inc. S’holder Litig. (Genomics II)*, C.A. No. 7888-VCL (Del. Ch. Nov. 27, 2012).

323 Transcript of Telephonic Ruling of the Court at 16, *Genomics I*, C.A. No. 7888-VCL.

324 *In re Comverge, Inc. S'holders Litig.*, Consol. C.A. No. 7368-VCP, 2014 WL 6686570, at *15-17 (Del. Ch. Nov. 25, 2014).

325 *In re Bear Stearns Litig.*, 870 N.Y.S.2d 709, 734-35 (N.Y. Sup. Ct. 2008).

326 *Brown v. Authentec, Inc.*, Case No. 05-2012-CA-57589 (Fla. Cir. Ct. Sept. 18, 2012), *aff'd*, 109 So. 3d 219 (Fla. Dist. Ct. App. 2013) (table).

327 Transcript of Oral Argument on Plaintiffs' Motion for a Preliminary Injunction and Rulings of the Court at 106, *In re NYSE Euronext S'holders Litig.*, C.A. 8136-CS (Del. Ch. May 10, 2013).

328 *IBP, Inc. v. Tyson Foods, Inc.*, 789 A.2d 14 (Del. Ch. 2001).

329 *Id.* at 68 (footnote omitted). In *Ameristar Casinos, Inc. v. Resorts Int'l Holdings, LLC*, the Court accepted the premise, although did not decide, that an MAE had occurred where there was a 248% increase in the property tax assessment on the target asset, which translated to a tax liability of \$18 million per year for an asset generating \$30 million per year in net income. *Ameristar Casinos, Inc. v. Resorts Int'l Holdings, LLC*, C.A. No. 3685-VCS, 2010 WL 1875631 (Del. Ch. May 11, 2010).

330 *Frontier Oil Corp. v. Holly Corp.*, C.A. No. 20502, 2005 WL 1039027, at *35 (Del. Ch. Apr. 29, 2005).

331 The Court specifically noted that “[i]n the context of [a merger agreement], the concept of ‘Material Adverse Effect’ and ‘material’ are analytically distinct, even though their application may be influenced by the same factors.” *Id.* at *38.

332 *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008).

333 *Id.* at 738.

334 *Id.* at 740.

335 *Genesco, Inc. v. The Finish Line, Inc.*, No. 07-2137-II(III), 2007 WL 4698244 (Tenn. Ch. Dec. 27, 2007).

336 *United Rentals, Inc. v. RAM Holdings, Inc.*, 937 A.2d 810 (Del. Ch. 2007).

337 *Alliance Data Sys. Corp. v. Blackstone Capital Partners V L.P.*, 963 A.2d 746 (Del. Ch.), *aff'd*, 976 A.2d 170 (Del. 2009) (table).

³³⁸ *James Cable, LLC v. Millennium Dig. Media Sys., L.L.C.*, C.A. No. 3637-VCL, 2009 WL 1638634 (Del. Ch. June 11, 2009).

³³⁹ *Consol. Edison, Inc. v. Ne. Utils.*, 426 F.3d 524 (2d Cir. 2005).

³⁴⁰ For a discussion of sample contract language, see Ryan Thomas & Russell Stair, *Revisiting Consolidated Edison—A Second Look at the Case That Has Many Questioning Traditional Assumptions Regarding the Availability of Shareholder Damages in Public Company Mergers*, 64 BUS. LAW. 329, 349-57 (2009). Cf. *Amirsaleh v. Bd. of Trade*, C.A. No. 2822-CC, 2008 WL 4182998 (Del. Ch. Sept. 11, 2008) (holding that stockholder who received late election form had standing to sue for his preferred form of consideration after the merger was consummated).

³⁴¹ *Hexion Specialty Chems., Inc. v. Huntsman Corp.*, 965 A.2d 715, 748 (Del. Ch. 2008).

³⁴² *See Paramount Commc'ns, Inc. v. Time Inc. (Time-Warner)*, 571 A.2d 1140 (Del. 1990).

³⁴³ *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586 (Del. 2010).

³⁴⁴ *See, e.g., Moran v. Household Int'l, Inc.*, 500 A.2d 1346, 1346 (Del. 1985); *Leonard Loventhal Account v. Hilton Hotels Corp.*, C.A. No. 17803, 2000 WL 1528909 (Del. Ch. Oct. 10, 2000), *aff'd*, 780 A.2d 245 (Del. 2001).

³⁴⁵ *See Hollinger Int'l, Inc. v. Black*, 844 A.2d 1022, 1085-88 (Del. Ch. 2004) (upholding the adoption of a rights plan in the context of a company's ongoing process of exploring strategic alternatives, where the court found that the controlling shareholder seeking to sell its control bloc had breached fiduciary duties and contractual obligations to the company, such that the normal power of a majority shareholder to sell its stock without sharing the opportunity with minority holders could not be used to further these breaches).

³⁴⁶ *See Desert Partners, L.P. v. USG Corp.*, 686 F. Supp. 1289 (N.D. Ill. 1988); *BNS Inc. v. Koppers Co.*, 683 F. Supp. 458, 474-75 (D. Del. 1988); *Moore Corp. v. Wallace Computer Servs. Inc.*, 907 F. Supp. 1545 (D. Del. 1995); *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011).

³⁴⁷ *CRTF Corp. v. Federated Dep't Stores, Inc.*, 683 F. Supp. 422, 438-42 (S.D.N.Y. 1988) (refusing to enjoin discriminatory application of rights plan during auction); *MAI Basic Four, Inc. v. Prime Computer, Inc.*, C.A. No. 10428, 1988 WL 140221 (Del. Ch. Dec. 20, 1988); *In re Holly Farms Corp. S'holders Litig.*, C.A. No. 10350, 1988 WL 143010 (Del. Ch. Dec. 30, 1988).

348 *Airgas*, 16 A.3d 48.

349 *Yucaipa Am. Alliance Fund II, L.P. v. Riggio*, 1 A.3d 310 (Del. Ch. 2010); *see also In re Bioclinica, Inc. S'holder Litig.*, C.A. 8272-VCG, 2013 WL 673736 (Del. Ch. Feb. 25, 2013).

350 *Yucaipa*, 1 A.3d at 350.

351 *Versata Enters., Inc. v. Selectica, Inc.*, 5 A.3d 586, 586 (Del. 2010).

352 *Id.*

353 In a recent transcript ruling, the Court of Chancery invalidated charter and bylaw provisions providing that directors of a company without a staggered board and cumulative voting could only be removed for cause. The stockholder plaintiffs argued—and the court agreed—that under §141(k) of the DGCL, stockholders have the right to remove directors without cause unless the company has a staggered board or cumulative voting. *In re Vaalco Energy S'holder Litig.*, Cons. C.A. No. 11775-VCL (Dec. 21, 2015).

354 DEL. CODE ANN. tit. 8, § 141(k) (West 2011).

355 In the case of *Quickturn Design Sys., Inc. v. Shapiro*, the Delaware Supreme Court ruled that dead hand and no hand provisions—even of limited duration—are invalid. *See Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998). The Court held that the dead hand feature of the rights plan, which barred a newly elected board from redeeming the pill for six months, ran afoul of Section 141(a) of the DGCL, which empowers the board with the statutory authority to manage the corporation. The Court also criticized dead hand provisions because they would prevent a newly elected board “from completely discharging its fundamental management duties to the corporation and its stockholders for six months” by restricting the board’s power to negotiate a sale of the corporation. *Id.* at 1291 (emphasis omitted). The reasoning behind the *Quickturn* holding, together with that of the 1998 decision in *Carmody v. Toll Bros.* (which dealt with a pure dead hand pill rather than a no hand pill), leaves little room for dead hand provisions of any type in Delaware. *Carmody v. Toll Bros. Inc.*, 723 A.2d 1180 (Del. Ch. 1998). In contrast to Delaware, courts in both Georgia and Pennsylvania have upheld the validity of dead hand and no hand provisions. *See Invacare Corp. v. Healthdyne Techs. Inc.*, 968 F. Supp. 1578 (N.D. Ga. 1997); *AMP Inc. v. Allied Signal Inc.*, C.A. Nos. 98-4405, 98-4058, 98-4109, 1998 WL 778348 (E.D. Pa. Oct. 8, 1998), *partial summary judgment granted*, 1998 WL 967579 (E.D. Pa. Nov. 18, 1998), *rev'd and remanded*, 168 F.3d 649 (3d Cir. 1999).

356 *See* DEL. CODE ANN. tit. 8, § 141(k)(1) (West 2011).

- 357 *Airgas, Inc. v. Air Prods. & Chems., Inc.*, 8 A.3d 1182, 1185 (Del. 2010).
- 358 *JANA Master Fund, Ltd. v. CNET Networks, Inc.*, 954 A.2d 335 (Del. Ch. 2008).
- 359 *Levitt Corp. v. Office Depot, Inc.*, C.A. No. 3622-VCN, 2008 WL 1724244 (Del. Ch. Apr. 14, 2008).
- 360 *Icahn Partners LP v. Amylin Pharm., Inc.*, No. 7404-VCN, 2012 WL 1526814 (Del. Ch. Apr. 20, 2012).
- 361 *AB Value Partners, LP v. Kreisler Mfg. Corp.*, No. 70434-VCP, 2014 WL 7150465, at *5 (Del. Ch. Dec. 16, 2014).
- 362 *See* DEL. CODE ANN. tit. 8, § 211(d) (West 2011).
- 363 *See Licht v. Storage Tech. Corp.*, C.A. No. 524-N, 2005 WL 1252355 (Del. Ch. May 13, 2005) (holding that, as a default matter, when the shareholders of a corporation vote on matters other than the election of directors (and barring the application of a more specific voting standard under another Delaware statute), abstentions are properly counted as negative votes).
- 364 *See, e.g., Allen v. Prime Computer, Inc.*, 540 A.2d 417 (Del. 1988); *Edelman v. Authorized Distribution Network, Inc.*, C.A. No. 11104, 1989 WL 133625 (Del. Ch. Nov. 3, 1989); *Nomad Acquisition Corp. v. Damon Corp.*, C.A. Nos. 10173, 10189, 1988 WL 383667 (Del. Ch. Sept. 20, 1988).
- 365 *Blasius Indus. Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).
- 366 *See, e.g., Kidsco Inc. v. Dinsmore*, 674 A.2d 483 (Del. Ch.), *aff'd*, 670 A.2d 1338 (Del. 1995); *Stahl v. Apple Bancorp, Inc.*, C.A. No. 11510, 1990 WL 114222 (Del. Ch. Aug. 9, 1990).
- 367 *Boilermakers Local 154 Ret. Fund v. Chevron Corp.*, 73 A.3d 934 (Del. Ch. 2013).
- 368 *Id.* at 950.
- 369 *Id.* at 953 (referring to *Moran v. Household Int'l*, 500 A.2d 1346 (Del. 1985)).
- 370 DEL. CODE ANN. tit. 8, § 211.
- 371 *City of Providence v. First Citizens BancShares, Inc.*, 99 A.3d 229 (Del. Ch. 2014).

³⁷² E.g., *In re CytRX Corp. S'holder Derivative Litig.*, No. CV-14-6414, 2015 WL 9871275 (C.D. Cal. Oct. 30, 2015); *Brewerton v. Oplink Commc'ns, Inc.*, No. RG14-750111 (Cal. Super. Ct. Dec. 14, 2014); *Groen v. Safeway, Inc.*, No. RG14-716651, 2014 WL 3405752 (Cal. Super. Ct. May 14, 2014); *Miller v. Beam, Inc.*, No. 2014 CH 00932, 2014 WL 2727089 (Ill. Ch. Ct. Mar. 5, 2014); *Genoud v. Edgen Grp., Inc.*, No. 625,244, 2014 WL 2782221 (La. Dist. Ct. Jan. 17, 2014); *Collins v. Santoro*, No. 154140/2014, 2014 WL 5872604 (N.Y. Sup. Ct. Nov. 10, 2014); *HEMG Inc. v. Aspen Univ.*, C.A. No. 650457/13, 2013 WL 5958388 (N.Y. Sup. Ct. Nov. 14, 2013); *North v. McNamara*, 47 F. Supp. 3d 635 (S.D. Ohio 2014); *Roberts v. TriQuint Semiconductor, Inc.*, 358 Or. 413, 415 (2015); see also *City of Providence v. First Citizens BancShares*, 99 A.3d 229 (Del. Ch. 2014) (enforcing a North Carolina forum-selection bylaw).

³⁷³ Order, *Centene Corp. v. Elstein*, C.A. No. 11589-VCL (Del. Ch. Oct. 8, 2015); Tr. of Rulings of the Ct., *Edgen Grp. Inc. v. Genoud*, C.A. No. 9055-VCL (Del. Ch. Nov. 5, 2013).

³⁷⁴ *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014).

³⁷⁵ *Id.* at 558.

³⁷⁶ DEL. CODE ANN. tit. 8, § 102(f).

³⁷⁷ *Corvex Mgmt. LP v. Common Wealth REIT*, Case No. 24-C-13-001111, 2013 WL 1915769 (Md. Cir. Ct. May 8, 2013).

³⁷⁸ See, e.g., *Moore Corp. v. Wallace Computer Servs. Inc.*, 907 F. Supp. 1545 (D. Del. 1995) ; *Buckhorn, Inc. v. Ropak Corp.*, 656 F. Supp. 209 (S.D. Ohio 1987), *aff'd*, 815 F.2d 76 (6th Cir. 1987).

³⁷⁹ See, e.g., *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342 (Del. Ch. 1998), *aff'd in part, rev'd in part sub nom. Brehm v. Eisner*, 746 A.2d 244 (Del. 2000); *Grimes v. Donald*, 673 A.2d 1207 (Del. 1996) ; *Worth v. Huntington Bancshares, Inc.*, 540 N.E.2d 249 (Ohio 1989).

³⁸⁰ *San Antonio Fire & Police Pension Fund v. Amylin Pharm., Inc.*, 983 A.2d 304 (Del. Ch. 2009), *aff'd*, 981 A.2d 1173 (Del. 2009).

³⁸¹ *Id.* at 315.

³⁸² *Id.* at 316 n.37.

³⁸³ *Kallick v. SandRidge Energy, Inc.*, 68 A.3d 242 (Del. Ch. 2013).

384 Transcript of Oral Argument on Defendants' Motions to Dismiss and Rulings of
the Court, *Pontiac Gen. Emps. Ret. Sys. v. Ballantine*, No. 9789-VCL (Del. Ch. Oct. 14,
2014) at 70.

385 *Id.* at 73.

386 *Id.* at 74; *see Carmody v. Toll Bros., Inc.*, 723 A.2d 1180 (Del. Ch. 1998).

387 Tr. of Bench Ruling at 8, *Fire & Police Pension Fund, San Antonio v. Stanzone*,
C.A. No. 10078-VCG (Del. Ch. Feb. 25, 2015).

388 *Basic v. Levinson*, 485 U.S. 224, 239 (1988); *see also, TSC Industries, Inc. v.*
Northway, Inc., 426 U.S. 438, 439 (setting forth the basic test for materiality under the
securities laws).

389 *Basic*, 485 U.S. at 239-41.

390 Targets only must disclose a potential transaction if (i) such disclosure is
affirmatively required by SEC rules, (ii) the target or a corporate insider desires to trade
on the basis of material non-public information (the “disclose or abstain rule”), or (iii)
disclosure is required to make prior statements not misleading. *Vladmir v. Bioenvision*
Inc., 606 F. Supp.2d at 484; *SEC v. Texas Gulf Sulphur*, 401 F.2d 833, 848 (2d Cir.
1968); *see also* Exchange Act Rule 14e-3 (prohibiting trading in the context of tender
offers on the basis of material non-public information). Disclosure is only required by
SEC rules in limited situations and Item 1.01 of Form 8-K does not require disclosure of
mergers until a formal agreement is signed. Further, the SEC staff takes the position that
although Item 303 of Regulation S-K could be read to require companies to address
pending talks as “likely to have material effects on future financial condition or results of
operations,” where disclosure is not otherwise required, a company’s management’s
discussion and analysis need not contain a discussion of the impact of negotiations where
inclusion of such information would jeopardize the completion of the transaction.
Management’s Discussion and Analysis of Financial Condition and Results of
Operations; Certain Investment Company Disclosures, SEC Release No. 33-6835 (May
18, 1989); 17 C.F.R. §229.303.

391 “The duty of a corporation and its officers to disclose is limited. To that end, a
corporation is not required to disclose a fact merely because a reasonable investor would
very much like to know that fact. Rather an omission is actionable under the securities
laws only when the corporation is subject to a duty to disclose the omitted facts.”
Vladmir, 606 F. Supp.2d at 484 (S.D. N.Y. 2009) (quoting *In re Time Warner Sec. Litig.*,
9 F.3d 259, 267 (2d Cir. 1993); *see also, Basic*, 485 U.S. at 239 n. 17 (1988).

³⁹² However, the NYSE takes the position that “[n]egotiations leading to mergers and acquisitions . . . are the type of developments where the risk of untimely and inadvertent disclosure of corporate plans are most likely to occur. . . . If unusual market activity should arise, the company should be prepared to make an immediate public announcement of the matter. . . . A sound corporate disclosure policy is essential to the maintenance of a fair and orderly securities market. It should minimize the occasions where the [NYSE] finds it necessary to temporarily halt trading in a security due to information leaks or rumors in connection with significant corporate transactions.” *NYSE Listed Company Manual*, Rule 202.01. Similarly, Nasdaq imposes a duty on listed companies to promptly disclose, except in unusual circumstances, any material information which would reasonably be expected to affect the value of their securities or influence investors’ decisions. *Nasdaq Stock Market Rules*, Rule 5250(b)(1). Nasdaq defines unusual circumstances as, among other things, “where it is possible to maintain confidentiality of those events and immediate public disclosure would prejudice the ability of the Company to pursue its legitimate corporate objectives.” *Nasdaq Stock Market Rules*, Rule IM 5250-1.

³⁹³ See, e.g., *In re MCI Worldcom, Inc. Sec. Litig.*, 93 F. Supp.2d 276, 280 (E.D.N.Y. 2000) (concluding that a disclosure duty arose only after the company affirmatively denied merger negotiations); *In re Columbia Sec. Litig.*, 747 F.Supp. 237, 243 (S.D.N.Y. 1990) (concluding that the plaintiff sufficiently pled that affirmative denial of merger negotiations during ongoing merger negotiations was materially misleading).

³⁹⁴ *In the Matter of Carnation Company*, SEC Release No. 34-22214 (July 8, 1985).

³⁹⁵ *Eisenstadt v. Centel Corp.*, 113 F.3d 738, 744 (7th Cir. 1997) (“Obviously a corporation has no duty to correct rumors planted by third parties.”); *Carnation Company*, SEC Release No. 34-22214. Additionally, there may be a duty to make corrective disclosure where there is evidence that market rumors stem from trading by insiders in the company’s shares. *In re Sharon Steel*, SEC Release No. 34-18271 (Nov. 19, 1981).

³⁹⁶ *State Teachers Ret. Bd. v. Fluor*, 654 F.2d 843, 850 (2d Cir. 1981); see also, *Eisenstadt*, 113 F.3d at 744; *In re Time Warner Inc. Sec. Litig.*, 9 F.3d 259, 265 (2d Cir. 1993); *Holstein v. Armstrong*, 751 F. Supp. 746, 747 (N.D. Ill. 1990).

³⁹⁷ The test of whether a leak or rumor is attributable to an issuer mirrors the test for whether a company is liable for analyst statements and forecasts—that is, whether the company has “sufficiently entangled” itself with the disclosure of information giving rise to the rumor. “Sufficient entanglement” can occur either explicitly by leaking information or implicitly if the company reviews information and represents that it is accurate or comports with the company’s views. *Elkind v. Liggett & Myers, Inc.*, 653 F.2d 156, 162-63 (2d Cir. 1980).

398 *Fluor*, 652 F.2d 843.

399 *Id.* at 846-49.

400 *Id.* at 851.

401 For example, Nasdaq notes that “Whenever unusual market activity takes place in a Nasdaq Company's securities, the Company normally should determine whether there is material information or news which should be disclosed. If rumors or unusual market activity indicate that information on impending developments has become known to the investing public, or if information from a source other than the Company becomes known to the investing public, a clear public announcement may be required as to the state of negotiations or development of Company plans. Such an announcement may be required, even though the Company may not have previously been advised of such information or the matter has not yet been presented to the Company’s Board of Directors for consideration. In certain circumstances, it may also be appropriate to publicly deny false or inaccurate rumors, which are likely to have, or have had, an effect on the trading in its securities or would likely have an influence on investment decisions.” *Nasdaq Stock Market Rule*, Rule IM 5250-1. See also *supra* note 392.

402 *Moore Corp. v. Wallace Computer Servs. Inc.*, 907 F. Supp. 1545, 1558, 1560 (D. Del. 1995).

403 *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48 (Del. Ch. 2011).

404 See *Allergan, Inc. v. Valeant Pharm. Int’l Inc.*, No. SACV 14–1214 DOC(ANx), 2014 WL 5604539 (C.D. Cal. Nov. 4, 2014).

405 The technique of a white squire defense combined with a self-tender offer at market or a slight premium to market was used defensively by Diamond Shamrock and Phillips-Van Heusen in 1987. In neither of those instances, however, did the would-be acquiror challenge the defense. In 1989, the Delaware Court of Chancery upheld the issuance of convertible preferred stock by Polaroid Corporation to Corporate Partners in the face of an all-cash, all-shares tender offer, marks the most significant legal test of the white squire defense. See *Shamrock Holdings, Inc. v. Polaroid Corp.*, 559 A.2d 278 (Del. Ch. 1989). The Polaroid decision confirmed the prevailing line of cases upholding the issuance of stock to a white squire as a defensive measure when the result was not to consolidate voting control in management or employee hands.

406 *Moran v. Household Int’l, Inc.*, 500 A.2d 1346, 1350 n.6 (Del. 1985).

407 *In re AbbVie S’holder Derivative Litig.*, Cons. C.A. No. 9983-VCG, 2015 WL 4464505 (Del. Ch. July 21, 2015).

⁴⁰⁸ *Depomed Inc. v. Horizon Pharma, PLC*, Nos. 1-15-CV-283834, 1-15-CV-283835 (Cal. Sup. Ct. Nov. 19, 2015).

⁴⁰⁹ THOMSON REUTERS, MERGERS & ACQUISITIONS REVIEW, FULL YEAR 2015, *available at* http://dmi.thomsonreuters.com/Content/Files/4Q2015_Global_MandA_Legal_Advisory_Review.pdf.

⁴¹⁰ *Id.*

⁴¹¹ INT’L INST. FOR THE STUDY OF CROSS-BORDER INVESTMENT AND M&A, XBMA ANNUAL REVIEW 2015 (Raaj Narayan & Francis Stapleton, eds., 2016) (2016), *available at* <http://xbma.org/StatisticalReviews.aspx>.

⁴¹² THOMSON REUTERS DATABASE, SPECIAL MERGER SECTORS CUSTOM SEARCH, accessed on January 25, 2016.

⁴¹³ XBMA ANNUAL REVIEW 2015.

⁴¹⁴ THOMSON REUTERS DATABASE, SPECIAL MERGER SECTORS CUSTOM SEARCH, accessed on January 25, 2016.

⁴¹⁵ Julia Chariell and Tiffany Young, *US Federal Budget Dashboard: State of the Union 2016*, BLOOMBERG INTELLIGENCE (January 12, 2016); Richard Summerfield, *Cross-Border M&A Boom*, FINANCIER WORLDWIDE, Dec. 2014, *available at* http://www.financierworldwide.com/cross-border-ma-boom/#.VOzPpEfF_zg.

⁴¹⁶ *See* Wachtell, Lipton, Rosen & Katz, Comment Letter to SEC (July 24, 2008), *available at* <http://www.sec.gov/comments/s7-10-08/s71008-28.pdf> (commenting that the SEC’s proposed revisions, which ultimately were adopted substantially as proposed with a few notable exceptions, should be revised to enact comprehensive reform, such as using U.S. trading volume—and not beneficial ownership—as the relevant criterion for determining the level of exemption; providing Tier I-style exemptive relief to Section 13(d) regulation under the Williams Act; and eliminating the use of “unconventional tender offer” analysis in foreign transactions).

⁴¹⁷ *Morrison v. Nat’l Australia Bank Ltd.*, 561 U.S. 247 (2010).

WACHTELL, LIPTON, ROSEN & KATZ

SPIN-OFF GUIDE

2016

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I.

Overview

A spin-off involves the separation of a company's businesses through the creation of one or more separate, publicly traded companies. Spin-offs have been popular because many investors, boards and managers believe that certain businesses may command higher valuations if owned and managed separately, rather than as part of the same enterprise. An added benefit is that a spin-off can often be accomplished in a manner that is tax-free to both the existing public company (referred to as the parent) and its shareholders. Moreover, in recent years, companies have been able to tap the debt markets to lock in low borrowing costs for the business being separated and monetize a portion of its value. For example, in connection with its \$55 billion spin-off from Abbott Laboratories in 2012, AbbVie conducted a \$14.7 billion bond offering, which at the time was the largest ever investment-grade corporate bond deal in the United States, at a weighted average interest rate of approximately two percent. Other notable recent spin-offs include Penn National Gaming's spin-off of its real estate assets into the first-ever casino REIT, Energizer's spin-off of its household products business, Gannett's spin-off of its publishing business, DuPont's spin-off of its performance chemicals business, eBay's spin-off of PayPal, Baxter's spin-off of its biopharmaceuticals business, HP's separation of its PC and printer business and its enterprise business, W.R. Grace's separation of its construction products and packaging technologies businesses and its catalyst technologies and engineered materials businesses, and Yum Brands' planned spin-off of its China business. The volume of spin-offs in 2015 was a record-setting \$257 billion.

The process of completing a spin-off is complex and requires consideration of a myriad of financial, capital markets, legal, tax and other factors. The issues that arise in an individual situation depend largely on the business goals of the separation transaction, the degree to which the businesses were integrated before the transaction, the extent of the continuing relationships between the businesses after the transaction, and the structure of the transaction. For example, if the businesses were tightly integrated before the transaction or are expected to have significant business relationships following the transaction, it will take more time and effort to allocate assets and liabilities, identify personnel that will be transferred, separate employee benefits plans, obtain consents relating to contracts and other rights, and document ongoing arrangements for shared services (*e.g.*, legal, finance, human resources and information technology) and continuing supply, intellectual property sharing and other commercial or operating agreements. If the parent is expected to own a substantial portion of the

spin-off company after the closing, careful planning is also required with respect to the composition of the new company's board, independent director approval of related-party transactions, handling of corporate opportunities and other matters. In addition to these separation-related issues, spin-offs raise various issues associated with taking a company public, such as drafting and filing the initial disclosure documents, applying for listing on a stock exchange, implementing internal controls and managing ongoing reporting obligations and public investor relations.

This guide is intended to help navigate the spin-off process, from the preliminary phases through completion of the transaction. Part II of this guide describes some of the initial planning considerations relating to spin-offs, and includes a discussion of the principal reasons for spin-offs and a comparison to other separation transactions. Part III examines a broad array of general corporate separation issues that may arise in a spin-off. Part IV discusses the transaction agreements commonly executed to implement a spin-off and govern the post-spin relationship between the parent and the spin-off company. Part V identifies the principal securities law matters. Part VI examines certain tax issues, which are critical given the tax-sensitive nature of separation transactions. Finally, Part VII reviews stock exchange listing and trading considerations. A sample illustrative timetable for a spin-off (that is not preceded by an initial public offering) is attached as Annex A. A discussion of post-spin limitations on strategic transactions is attached as Annex B.

II.

Initial Planning Considerations

A. Reasons for Spin-Offs

There are several drivers of spin-off activity. The principal reasons often cited by companies for pursuing spin-offs include the following:

- *Enhanced business focus.* A spin-off will allow each business to focus on its own strategic and operational plans without diverting human and financial resources from the other business.
- *Business-appropriate capital structure.* A spin-off will enable each business to pursue the capital structure that is most appropriate for its business and strategy. Each business may have different capital requirements that may not be optimally addressed with a single capital structure.
- *Distinct investment identity.* A spin-off will create distinct and targeted investment opportunities in each business. A more “pure-play” company may be considered more transparent and attractive to investors focused on a particular sector or growth strategy, thereby counteracting the “conglomerate discount” and enhancing the value of the business.
- *Effectiveness of equity-based compensation.* A spin-off will increase the effectiveness of the equity-based compensation programs of both businesses by tying the value of the equity compensation awarded to employees, officers and directors more directly to the performance of the business for which these individuals provide services.
- *Use of equity as acquisition currency.* By creating a separately publicly traded stock for part of the parent company’s businesses, a spin-off will enhance the ability of both the parent and the spun-off business to effect acquisitions using its stock as consideration.

Shareholder activism is another and more recent potential driver of spin-off activity. Shareholder activists have become an increasingly powerful force in the corporate landscape, and many activists agitate for “value maximizing” activity, including spin-offs. Activists are often a catalyst for spin-off activity, and the rise in shareholder activism may explain some of the increase in spin-off

activity. For example, Trian Fund Management ran a proxy fight for board representation at DuPont in 2015 and campaigned for a spin-off of DuPont's agriculture, health and industrial biosciences businesses. Although Trian did not win board representation, DuPont several months later agreed to merge with The Dow Chemical Company, which had also faced pressure from activist Third Point, and the two agreed that post-merger, they would separate into three new companies—an agricultural chemicals company, a material sciences company and a specialty products company.

Although spin-offs often have advantages, they also may involve a variety of disadvantages, including:

- the potential loss of both revenue and cost synergies due to the separation of the parent's businesses;
- disruptions to the business as a result of the spin-off;
- separation costs;
- reduced size and diversification, which could potentially result in greater cash flow volatility and reduced access to capital markets, and which may affect the company's credit rating;
- the potential reduction of equity research coverage and investor focus if the separated companies are too small;
- the possibility of short-term stock price volatility as the market adjusts to the distinct investment identities of the separated companies;
- potential stock market index exclusion depending on the size or nature of the companies; and
- the possible increased susceptibility to unsolicited takeover activity (given that the businesses of each of the two post-spin companies will be less diversified and smaller than the combined predecessor company).

B. Separation Transaction Structures

It is common for a company in the initial planning phases to consider other types of separation transactions in addition to a spin-off. Separation transactions can be divided into two categories: (1) a sale to a third party of the

business being separated and (2) a sale or distribution of the stock in a new public company holding the business being separated. The decision as to which type of separation transaction to pursue depends on a variety of factors. A sale to a third party can often generate the largest amount of cash proceeds to the parent. However, a sale or distribution of the stock in a new public company can often result in greater value to the parent's shareholders because (1) the public market may place a higher value on the business than a third party and (2) a distribution of stock in a new public company to the parent's shareholders can be accomplished in a manner that is tax-free to both the parent and its shareholders. By contrast, a sale for cash would be a taxable transaction, and, as compared to a spin-off, there is a greater risk that a sale to a third party may not be consummated. Also, the parent can generally determine the terms and timing of a spin-off, but a sale to a third party requires due diligence by the buyer and the negotiation and execution of a definitive agreement with respect to price, timing and other terms, and the closing of such a sale will also typically be subject to various conditions, including, for example, regulatory approvals. Depending on the nature and size of the business to be separated, there could be a relatively small universe of buyers that may be interested in and able to acquire the business. Purchase agreements with third parties also often include various representations and warranties about the target business, supported by post-closing indemnities. In a spin-off, on the other hand, the business usually is transferred to the spin-off company on an "as-is, where-is" basis.

Within the category of transactions involving the sale or distribution of the stock of a new public company, a variety of structures can be employed to accomplish different financial and legal objectives, including those summarized below.

1. 100% Spin-Off

In a typical 100% spin-off, all of the shares of the spin-off company are distributed to the shareholders of the parent as a dividend. This results in a full separation of the two entities in a single transaction. Examples of 100% spin-offs include Expedia's spin-off of TripAdvisor, Motorola's spin-off of Motorola Mobility Holdings, ITT's simultaneous spin-offs of Exelis and Xylem, IAC/InterActiveCorp's simultaneous spin-offs of Ticketmaster, HSN, Tree.com and Interval Leisure Group, ConocoPhillips's spin-off of Phillips 66, Covidien plc's spin-off of Mallinckrodt plc, Sears Holdings Corporation's spin-off of Lands' End Inc., Edgewell Personal Care Company's spin-off of Energizer Holdings, eBay's spin-off of PayPal and W.R. Grace's spin-off of GCP Applied Technologies.

There are other corporate mechanics available for accomplishing a spin-off. For example, in 2005, IAC/InterActiveCorp (“IAC”) spun off Expedia through a charter amendment that reclassified each share of IAC common stock into a share of IAC common stock and a fraction of a share of mandatory exchangeable preferred stock that automatically exchanged into a share of Expedia common stock immediately following the reclassification. Because this structure involves a charter amendment, it requires a vote of the parent’s shareholders. By contrast, a spin-off accomplished through a dividend usually does not require a shareholder vote under the law of most jurisdictions.

2. Partial Spin-Off

In some cases, the parent may distribute fewer than all of the shares of the spin-off company. Typically, the parent would not intend to retain the remaining shares long-term, but rather would use them to generate cash proceeds or to retire existing debt of the parent, as discussed below under “General Separation Issues—Capital Structure Considerations.” However, as described below under “Tax Issues,” in order for a spin-off to be tax-free, the parent must generally distribute “control” (*i.e.*, at least 80% of the voting power of all of the shares and at least 80% of any non-voting shares) of the spin-off company and must establish to the satisfaction of the Internal Revenue Service that it has a valid business purpose for retaining any shares of the spin-off company. In addition, the parent must dispose of the retained shares of the spin-off company within five years following the spin-off for the transaction to be tax-free. Examples of this type of transaction include Valero’s spin-off of Corner Store Holdings, Ralcorp’s spin-off of Post Holdings, Cardinal Health’s spin-off of CareFusion and SUPERVALU’s planned spin-off of its Save-a-Lot discount grocery business.

3. IPO Plus Spin-Off / The “Up-C” Structure

A parent may structure a separation transaction through an initial public offering of a portion of the common stock of the subsidiary to be separated followed by a distribution of the subsidiary’s common stock to shareholders of the parent. In the IPO, the subsidiary would sell a portion of its shares to the public in an underwritten offering, with the proceeds either retained by the subsidiary or distributed to the parent. An IPO allows the formation of a natural investor base for the subsidiary in advance of distributing the remainder of the parent’s stake in the subsidiary to the parent’s shareholders.

Creating an investor base in advance of a spin-off may be helpful because the shareholders of the parent on the record date for the spin-off dividend may or may not wish to hold shares of the spin-off company. An IPO also allows for a

trading market and market valuation of the spin-off company to be established before the distribution of the spin-off company stock to the parent's shareholders.

For the subsequent spin-off to qualify as tax-free, the parent must generally retain at least 80% of the shares of the subsidiary after the IPO, because the tax rules require the parent to distribute "control" (generally, 80% of the voting stock and 80% of each non-voting class of stock) of the subsidiary. An IPO followed by the distribution of the offering proceeds to the parent is generally tax-free to the corporations involved if the amount of cash distributed is less than the parent's basis in the stock of the subsidiary and certain other requirements are met. If the distribution of proceeds exceeds the parent's aggregate tax basis in the stock of the subsidiary, the excess would generally be includible in income of the parent either when the distribution occurs or when the parent divests the subsidiary.

Issuing low-vote stock to the public may preserve the ability to spin off the subsidiary in a subsequent step if the parent wants more than 20% of the value of the stock of the subsidiary to be issued to the public. However, the IRS no longer issues rulings regarding the tax consequences of a spin-off in which such a high-vote/low-vote structure is put into place in anticipation of the spin-off. Accordingly, under current IRS practice, any such spin-off would have to be done on the basis of an opinion of counsel, rather than an IRS private letter ruling.

If the parent desires to sell to the public more than 20% of the stock of the subsidiary while preserving the ability to spin-off its remaining interest in the subsidiary subsequently in a tax-free manner, an alternative to the traditional high-vote/low-vote structure is to structure the subsidiary as an "Up-C." An Up-C structure generally has the following characteristics:

- the business to be separated is contributed to an operating company that is a limited liability company or limited partnership and is treated as a partnership for tax purposes;
- the public purchases low-vote stock in a newly formed corporation that holds a minority economic interest in the operating company and a majority of the vote and control over the operating company; and
- the parent holds both non-economic high-vote stock in the newly formed corporation giving it control over the corporation and at least a 50% direct economic interest in the operating company.

When the parent subsequently spins off its remaining interest after the IPO, the operating company merges with the corporation.

The Up-C structure allows the parent to sell up to 50% of the economics of the business being separated and, until it spins off the remaining interest, receive cash distributions from the operating company on a tax-efficient basis. Distributions can be received on a tax-efficient basis because the operating company is a partnership for tax purposes rather than a non-consolidated corporate subsidiary. The main downside of the structure is that the parent may pay tax on the upfront proceeds from the IPO of the corporation. As with the traditional high-vote/low-vote structure, the IRS no longer rules on spin-offs of corporations that have issued low-vote (or high-vote) stock in anticipation of the spin-off.

Some companies determine not to pursue a carve-out IPO because of the additional costs (such as underwriting fees), complications and uncertainty involved in an IPO. The timing of an IPO will depend in large part on equity market conditions, which could significantly delay the completion of the transaction. An IPO also raises governance issues because the parent continues to control the subsidiary between the time of the carve-out IPO and the later spin-off, resulting in fiduciary duties to the subsidiary's public shareholders.

Examples of carve-out IPOs followed by spin-offs are the Sunoco/SunCoke Energy, Motorola/Freescale Semiconductor and GE/Synchrony Financial transactions.

4. IPO Plus Split-Off / "Cash-Rich" Split-Off

In a split-off, the parent makes an offer to its shareholders to exchange their parent stock in exchange for all or a portion of the shares of the spin-off subsidiary. It is equivalent to a share buyback of the parent's stock using stock in a subsidiary as the consideration instead of cash. A split-off is typically done after the spin-off company has been taken public as a result of an IPO so that the established trading value of the spin-off company's shares can be used in pricing the split-off exchange ratio. In a split-off, the parent typically offers to purchase the parent stock at a premium relative to the trading price of the spin-off company's shares. Because the parent's shareholders elect whether to participate in a split-off, ownership of the spin-off company following the transaction generally is not proportionate (unlike a spin-off, in which shareholders receive a proportionate number of shares of the spin-off company), and the transaction must be registered under the U.S. Securities Act of 1933 (the "Securities Act") because it involves an investment decision by the parent's shareholders. A split-off is also

an issuer tender offer under the U.S. Securities Exchange Act of 1934 (the “Exchange Act”), and, therefore, the parent must comply with the tender offer rules. Examples of split-offs include MetLife’s split-off of its 52% stake in Reinsurance Group of America, CBS’s split-off of its CBS Outdoor Americas business and Pfizer’s split-off of Zoetis.

A split-off can also be used to reacquire stock, generally from a large stockholder, in a transaction that is referred to as a “cash-rich split-off.” In this type of transaction, the parent company creates a new subsidiary and contributes an “active trade or business” (*i.e.*, an operating business that the parent has owned and operated for five years or more) to that subsidiary as well as cash. Assuming other tax requirements are satisfied, such as having a five-year active trade or business and a valid business purpose for the transaction, the parent can then exchange stock in the new subsidiary for the parent’s stock held by the large stockholder in a transaction that is tax-free. However, tax-free treatment will not apply if either the parent or the subsidiary own investment assets (generally, cash or other liquid or inactive assets) whose fair market value constitutes two-thirds or more of the fair market value of all the assets of the parent or the subsidiary, respectively, immediately after the distribution. Moreover, the IRS will no longer issue rulings as to the tax-free treatment of certain “cash-rich split-offs” (or spin-offs) where a very large percentage of the asset value of the parent or the subsidiary consists of investment assets, as described in more detail in Part VI.A.2. below.

5. Sponsored Spin-Offs

A spin-off also can be combined with a significant investment transaction in a so-called “sponsored spin-off.” In this type of transaction, the parent distributes the shares of the subsidiary in a tax-free spin-off concurrently with the acquisition by a sponsor of up to 49.9% of either the parent or the spin-off company. The sponsor’s investment allows the parent to raise proceeds in the spin-off without having first to go through the IPO process, and can help demonstrate the value of the target business to the market. Sponsored spin-offs raise a number of complex issues, including those related to valuation, capital structure and governance.

6. Spin-Offs Combined with M&A Transactions

A spin-off can also be used in combination with a concurrent M&A transaction, although there are limitations on the type of such transactions that can be accomplished in a tax-free manner, as described in more detail in Part VI.B below. For example, “Morris Trusts” and “Reverse Morris Trusts” effectively

allow the parent to transfer a business to a third party in a transaction involving stock consideration in a manner that is tax-free to the parent if certain requirements are met. In a traditional Morris Trust, all of the parent's assets other than those that will be combined with the third party are spun off or split off into a new public company and then the parent merges with the third party. In a Reverse Morris Trust, all assets to be combined with the third party are spun off or split off into a new public company and then the new company merges with the third party.

In order to be tax-free, the Morris Trust and Reverse Morris Trust structures generally require, among other things, that the merger partner be smaller than the business to be combined with the merger partner (*i.e.*, that the shareholders of the parent own a majority of the stock of the combined entity). One advantage of a Reverse Morris Trust structure over a Morris Trust structure is that a Reverse Morris Trust generally does not require approval by the parent shareholders for the spin-off or merger. In a Reverse Morris Trust transaction, the spin-off company is combining with the merger partner, and the parent entity approves this combination at the time when the parent entity is the sole shareholder of the spin-off company. By contrast, a Morris Trust transaction often requires approval by the parent's shareholders because the merging party (*i.e.*, the parent) is already a public company at the time that the merger is submitted for approval by the parent's shareholders. Recent examples of Reverse Morris Trust transactions include MeadWestvaco's 2012 spin-off of its consumer and office products business and merger of such business with ACCO Brands, PPG Industries' 2013 split-off of its commodity chemicals business and merger of such business with Georgia Gulf (since renamed Axiall Corporation), Dow Chemical's spin-off of its chlor-alkali business and merger of such business with Olin Corp and P&G's planned spin-off of certain beauty products and merger of that business with Coty. An example of a spin-off combined with a concurrent M&A transaction is Atlas Energy, L.P.'s taxable spin-off of its exploration and production business and merger of the remaining midstream business with Targa Resources Corp. A simultaneous spin-off and M&A transaction involves additional complexity because each transaction will typically be conditioned on the completion of the other. In addition, the acquiror and target will often engage in extensive negotiations of the key spin-off agreements prior to entering into the merger agreement so that both parties have a clear understanding of which assets and liabilities will be spun off and which will be retained.

In some cases, a spin-off may come after the closing of a M&A transaction. This approach allows parties to reap the benefits of a combination while also signaling to the market an intent to rationalize the portfolio of the combined company in the future. Examples of spin-offs that will follow a merger

include Johnson Controls' planned spin-off its automotive business, which is expected to occur after the closing of Johnson Controls' planned merger with Tyco International; WestRock's planned spin-off of its specialty chemicals business, which MeadWestvaco announced prior to merging with Rock-Tenn Company to form WestRock; and DuPont and Dow's planned merger and subsequent split-up into three separate companies. In addition, in the press release announcing Pfizer and Allergan's agreement to combine, the parties noted that the transaction preserves the opportunity for a potential future separation of the combined company's innovative and established businesses. In such transactions, if the "active trade or business" to be relied upon by either the parent or the spin-off company was conducted only by the legal target in the merger, the spin-off may not qualify for tax-free treatment if it occurs within five years of the merger.

Part VI.B below provides an overview of the tax considerations relevant to post-spin acquisitions, and a more detailed explanation is attached as Annex B.

7. REIT Separation Transactions

Many companies have made substantial real estate investments in connection with their businesses. While real estate holdings give a company control over assets that can be critical from an operational perspective, they also tie up capital and may require significant management attention. One potential means of unlocking the value of a company's real estate is to split the company into an operating company and a separate real estate investment trust ("REIT") that owns the company's real estate. Long-term leases and other contractual relationships can be established between the two companies to ensure the operating business's ability to continue to use the real estate assets on satisfactory terms. Separation transactions involving REITs can be complex, given the rules that an entity must comply with in order to be treated as a REIT. Among other things, the REIT must have no earnings and profits from the pre-REIT period. Congress recently amended Section 355 of the Internal Revenue Code to provide that a spin-off in which only one of the spun-off company or the remaining company is a REIT cannot qualify for tax-free treatment, although a transaction where a REIT spins off another REIT or a REIT spins off a taxable REIT subsidiary may still qualify as tax-free. Examples of recent REIT separation transactions include CBS's IPO of its CBS Outdoor Americas business, Simon Property's spin-off of its strip center business and smaller enclosed malls into a REIT, Penn National Gaming's spin-off of its real estate assets into the first-ever casino REIT, and Ventas's spin-off of most of its post-acute/skilled nursing facility portfolio into a REIT.

C. Internal Process Considerations

In planning for a spin-off, it is important to understand the role of the various internal constituencies that will be involved. Some aspects of the spin-off are, in practice, often largely determined by the board and management of the parent—such as the basic decision as to which business(es) will be spun off, as well as the selection of the spin-off company’s directors. Other aspects of the spin-off may appropriately involve more input from the future directors and management of the spin-off company, such as the terms of its corporate documents (*e.g.*, committee charters, governance guidelines, insider trading policies, codes of ethics and the like). Even on matters such as these, companies often decide to generally follow a “clone and go” approach by establishing a presumption in favor of using the parent’s documents as models to simplify the already complex process of turning one public company into two (or more).

In some cases a company may choose to allow managers of the business to be spun off to take a more active role in planning for the spin-off, such as where the spun-off business and the remaining business are of relatively equal size and have historically been managed independently. However, companies should recognize that these managers may begin to view themselves in a quasi-adversarial position to the parent, as they begin to focus on positioning the business to be spun off in the most advantageous manner. In some cases, the question arises whether management of the business to be spun off should have separate legal representation in connection with negotiating the terms of the spin-off, either initially or when the process is closer to completion. Separate legal representation before completion of the spin-off generally is inappropriate as it would unnecessarily exacerbate internal divisions and is inconsistent with the notion that it is the duty of the parent’s board to establish the terms of the separation in a manner that serves the best interests of the parent shareholders (who, of course, will also be the initial shareholders of the spin-off company). Moreover, as to those matters that will not affect the parent following the spin-off (such as the spin-off company’s compensation policies), the spin-off company will be able to make whatever changes it desires following the spin-off, lessening the need for internal negotiations over these topics in connection with the spin-off.

The approach to be taken in any particular spin-off on matters such as these should be considered with appropriate thoughtfulness and sensitivity, balancing respect for the role of the future directors and officers of the company being spun off with the fundamental premise that the responsibility for the spin-off rests with the parent’s board and management.

III.

General Separation Issues

A. Identification and Grouping of Businesses

An initial step for a spin-off is to determine exactly what is to be spun off. In the case of a subsidiary that has historically operated as a standalone business, this may be a relatively simple process because the business to be spun off will already be reasonably well defined. Even in that context, however, it may be necessary to add or remove operations from the subsidiary before the separation occurs. In addition, as discussed below, there may be important ongoing business relationships to be formalized between the parent and the company to be spun off and common support functions that will have to be divided, replicated or provided on an interim or transitional basis before the company to be spun off will be ready to operate as a standalone, publicly traded company. Tax restrictions must be taken into account in structuring any such ongoing business relationships, as discussed below.

In the case of a spin-off of a division or portion of a business that has been operated through legal entities that also have operations that will remain with the parent, the corporate separation issues are far more complex because the assets and operations to be held by the spin-off company must be identified and intercompany transfers will need to be effected. These transfers often raise complex corporate and tax structuring issues, including determining the optimal corporate mechanic for effecting each transfer (contribution, sale of assets, internal spin-off, etc.), the order and timing of various steps, required governmental and third-party consents, and many other issues that typically arise in connection with internal restructurings. Particularly where international operations are involved, such pre-spin internal reorganization plans can involve a large number of steps, and careful planning is required to effect the internal reorganization in a tax-efficient manner. It usually will be preferable to complete the internal restructuring steps later in the process, to minimize the risk that transactions may need to be unwound in the unlikely event that the spin-off were abandoned or modified, though in some cases the need to complete a financing in advance of the spin-off may require that the restructuring be completed earlier. In any event, the restructuring should commence sufficiently early to ensure its completion before the spin-off occurs. As discussed below in “Transaction Agreements,” separation and distribution agreements typically include provisions addressing the possibility that some transfers may not be completed by the time of the spin-off.

A spin-off will also be more complicated if the spun-off business does not have substantially the same assets, business and operations as one or more of the parent's financial segments. In such cases, it will usually require significantly more time to prepare the financial statements and MD&A for the spun-off business that are required to be included in the Form 10 registration statement. Furthermore, a spin-off company that does not track one of the parent's financial reporting segments will not be eligible to use Form S-3 for at least 12 months after the date the spin-off company's Form 10 registration statement becomes effective, and affiliates of the spin-off company—including its directors and policymaking executive officers at the time of the spin-off distribution—will not be eligible to use Rule 144 for sales of that company's securities until 90 days after the date of effectiveness.

B. Capital Structure Considerations

One of the key steps in preparing for a spin-off is to determine the capital structure of the parent and the spin-off company after the spin-off, as well as the steps required to implement the desired capital structure. A company engaging in a spin-off will generally want to reallocate its existing cash and debt between itself and the spin-off company, as well as potentially raise additional cash or repay some of its debt.

There are a variety of techniques that can be used to implement the desired capital structure, and the optimal strategy is often driven by tax considerations and the terms of the company's existing debt. A common strategy is for the spin-off company to issue new debt in exchange for cash before the spin-off and distribute such cash to the parent, which the parent may then use to retire its existing debt. The distribution of cash from the spin-off company to the parent can be effected, for example, by having the spin-off company make a cash distribution to the parent, redeem some of its own shares held by the parent in exchange for cash, pay off an intercompany payable owed to the parent, or pay cash to acquire assets from the parent. To retain favorable tax treatment, the proceeds of certain distributions made by the spin-off company to its parent must be further transferred by the parent to its shareholders or creditors. As an alternative, the spin-off company may assume some of the parent's indebtedness. However, the assumption of debt may be restricted by the parent's existing debt agreements. Each of these strategies raises complex tax issues, including potentially triggering gain recognition to the parent to the extent the payment or assumption of indebtedness exceeds the parent's basis in the spin-off company's stock or assets.

A parent may, however, be able to extract value from the spin-off company in excess of the parent's basis in the spin-off company's stock without recognizing gain for U.S. federal income tax purposes. The techniques for doing so involve the parent's use of debt or equity of the spin-off company to retire the parent's indebtedness. While the variations are plentiful, the parent's use of the spin-off company's equity for this purpose is often called a "debt-for-equity exchange," and the parent's use of the spin-off company's debt for this purpose is often called a "debt-for-debt exchange." In one variation, the parent distributes to its shareholders less than 100% of the stock of the spin-off company at the same time as it closes a debt-for-debt exchange, and then completes a debt-for-equity exchange at a later date. Another technique involves a spin-off of 100% of the stock of the spin-off company to the parent's shareholders with a simultaneous debt-for-debt exchange, but without a subsequent debt-for-equity exchange. As discussed below, the IRS's current practice is that it will not issue private rulings on the tax treatment of debt-for-debt or debt-for-equity exchanges in connection with spin-offs where the parent's debt that is exchanged for either debt or equity of the spin-off company was issued in anticipation of the spin-off. The inability to obtain a ruling where the parent debt is newly issued reduces the attractiveness of this monetization technique. However, companies may also undertake debt-for-debt or debt-for-equity exchanges using historical parent debt, and the IRS has not announced any changes in its ruling practice with respect to such exchanges. Yet another structure is an IPO through a debt-for-equity exchange, followed by a subsequent distribution of the parent's remaining shares in the spin-off company.

Spin-offs often require a significant array of related financing transactions—the incurrence of new term debt (in the form of a credit facility or notes) by the spin-off company, often used to fund a distribution to the parent in connection with the spin-off, the entry into a revolving credit facility or other line of credit by the spin-off company to fund future liquidity needs and, in some circumstances, the amendment or refinancing of debt of the parent in order to avoid defaults or in connection with the right-sizing of the now-smaller parent's capital structure.

One significant complicating factor is that the parent and/or the spin-off company may have different creditworthiness and business plans than, and will have (sometimes significantly) smaller assets and earnings than, the pre-spin parent. As a result, the terms (including pricing, financial and operating covenants and required guarantees and collateral support) of the credit documents of the parent and spin-off company can be dramatically different than those of the pre-spin parent, particularly if the parent is an investment grade issuer and the spin-off company will not be; therefore, such transactions can require a significant amount of new drafting, negotiation and disclosure. As a result of these

considerations, the negotiation and execution of spin-off related financing can take substantially more time than corporate officers may have been accustomed to spending on similar transactions in the past.

Due to the factors discussed above, as well as the recent instability in the financing markets, it is important that early in the spin-off planning process, companies begin to identify the optimal financing structure for each of the parent and the spin-off company, begin to consider ideal terms of their debt instruments, initiate discussions with potential financing sources and rating agencies and begin to consider the timing of the financing transactions in relation to the anticipated effective date of the spin-off (especially in light of then-prevailing market conditions). Indeed, the financing considerations should play a critical role in the determination of the structure for the spin-off itself, as the size of the spin-off company and the parent and their capital structures and creditworthiness (including whether or not they will receive investment-grade ratings) can dramatically affect their cost of capital and the terms of their debt.

And, because the spin-off company's new debt documents are likely to govern its activities for an extended period, companies should also consider involving the spin-off company's future treasury and financial officers in the negotiations of the spin-off company's debt agreements, even if doing so might require identification of such officers earlier than might otherwise be planned.

In some cases, existing debt may logically "belong" with, or may be explicitly associated with, a specific business, such as debt used to fund the activities of a finance subsidiary or secured by assets used in a specific business. If the entity to be spun off has operated as a standalone subsidiary, an appropriate level of debt may already exist at the subsidiary level. In other cases, the parent debt may need to be allocated based on the desired balance of the capital structures of the businesses to be separated, as well as tax considerations.

From a diligence perspective, existing debt needs to be reviewed to determine the limitations on assumption of the debt by each of the businesses, as well as the contours of any covenants that may limit the parent's ability to spin off major portions of its business, such as restrictions on dividends or ability to dispose of "all or substantially all" of the parent's assets, or financial maintenance tests. In some cases it may be appropriate to seek consents with respect to debt covenants. To the extent that covenants in the parent's existing debt prevent the desired allocation of debt among the various businesses, it may be possible to incur new debt at the level of the spin-off company and dividend the proceeds up to the parent (which proceeds may in turn be used to repay the parent's existing debt).

Finally, the need for new financing in connection with a spin-off has the potential to introduce conditionality and risk into the execution of the spin-off transaction. If market conditions or other circumstances prevent the issuance of the required debt, then the spin-off could be delayed or even abandoned. Issuers can mitigate these risks in a number of ways, including by obtaining financing commitments (the conditionality of which will need to be negotiated) during the spin-off planning process or by issuing debt or entering loan documents substantially in advance of completing the spin-off. These approaches often come with their own risks, costs and considerations, which should be evaluated and discussed at the outset of the spin-off planning process.

C. Allocation of Other Liabilities

Allocation of liabilities other than debt, including contingent liabilities, also requires an analysis of the liabilities that logically belong with each business, as well as legacy liabilities that may be unrelated to any of the parent's current businesses. Additional consideration may also need to be given to general corporate liabilities or other shared liabilities that do not relate specifically to the parent or the spin-off company, such as shareholder litigation. In some cases, the applicable liabilities may already reside in the appropriate legal entity. In other cases, the liabilities may need to be assumed by other entities. Typically, liability allocations are reinforced through indemnities from one business to the other in the separation and distribution agreement or other transaction documents. In addition, the parent and the spin-off company often will release each other from various liabilities. The Delaware Court of Chancery has confirmed that such customary mutual releases are presumptively appropriate and enforceable.

D. Solvency and Surplus

Care must be taken in allocating debt and liabilities in the spin-off context to ensure that the spin-off company (and the parent) are financially viable and that any solvency risks relating to either entity have been considered. In allocating debt and other liabilities and ensuring financial viability, consideration will also need to be given to the allocation of cash, cash equivalents and financial instruments such as derivatives.

Spin-offs typically involve the payment of at least one dividend—the distribution of the stock of the spin-off company to the parent's shareholders—and often involve others, including in the form of a payment of cash from the spin-off company to the parent before the spin-off or even the declaration before the spin-off of a cash dividend payable by the spin-off company to its shareholders after the completion of the spin-off. Under both state fraudulent

conveyance law and the federal bankruptcy code, dividends are subject to subsequent attack and recoupment by the payor or its creditors if a court later determines that the payor was insolvent at the time it made the distribution. In order to mitigate this risk, companies may seek solvency opinions from valuation firms with respect to either or both of the parent and the spin-off company. Although these opinions are not necessarily dispositive in a subsequent litigation about the payor's insolvency, they can be helpful in establishing solvency (along with the far more important factor of contemporaneous market pricing data for the stock and debt of the payor, among other things) and demonstrate that the board of directors was focused on the issue. Whether the receipt of such an opinion is worth the costs ultimately depends on the specific facts, including the creditworthiness of the payor after giving effect to the spin-off.

Under the corporate law of most jurisdictions, a company may make a distribution to its shareholders only out of surplus or earnings (and only to the extent the company is not insolvent and would not be rendered insolvent by payment of the distribution). Appreciation in the value of assets, though possibly not reflected in book value, as well as contingent liabilities that may not be reflected on the balance sheet, should be taken into account in determining whether sufficient surplus exists. As with the solvency analysis, the company's board of directors could rely on expert opinions, if appropriate (in addition to the company's management), to determine the availability of surplus. The laws of some states also provide a safe harbor for directors who rely on the company's financial statements to determine that the company has sufficient surplus to make the distribution.

E. Governance Considerations

1. Duties of the Parent Board

Under Delaware law, the parent board's decision to effect a spin-off typically will be protected by the business judgment rule. Under the business judgment rule, the court will defer to the substance of the directors' decision and will not invalidate the decision, will not examine its reasonableness, and will not substitute its views for those of the board if the latter's decision can be attributed to any rational business purpose. To be entitled to the protections of the business judgment rule, the directors must satisfy the familiar duties of loyalty and care and must act in good faith. In satisfying their duty of care, directors are entitled to rely on advice from management, financial advisers, legal counsel and other experts. In addition, many companies' charters provide for exculpation of directors for breaches of duty of care to the full extent permitted by Delaware law.

The directors of the parent do not owe fiduciary duties to the spin-off company. Nor does the parent or its board owe fiduciary duties to prospective shareholders of the spin-off company in their capacity as shareholders of the spin-off company, even after the parent declares its intention to spin off the subsidiary. In structuring a spin-off transaction, directors of a solvent corporation owe their duties to the shareholders of the pre-spin company and may structure the transaction in a fashion that maximizes value for those shareholders. There is no duty of “fairness” as between the parent and the spin-off company. Accordingly, the parent board can make unilateral decisions as to the allocation of assets and liabilities between the parent and the spin-off company, subject to insolvency and tax considerations, before the spin-off is completed.

2. Corporate and Governance Structuring of the Spin-Off Company

Because a spin-off company is typically a wholly owned subsidiary or is created as a wholly owned subsidiary of the parent, its corporate structure, charter and bylaws can be established by the parent without holding a vote of public shareholders. The parent will need to select the jurisdiction of incorporation of the spin-off company, draft its constitutive documents such as its charter and bylaws, and determine the size and composition of the board of directors, as well as board compensation and the structure of board committees and whether to provide for “proxy access.” Identification and recruitment of the spin-off company’s directors can be a lengthy process to which ample time should be afforded.

The parent will also need to decide whether members of the parent’s board will be moved to (or sit concurrently on) the board of the spin-off company. It is possible for a parent and the spin-off company to have overlapping directors, although any overlap in directors between the parent and the spin-off company generally is limited to a minority of each board in order to preserve the tax-free nature of the spin-off. All other facts and circumstances should also be considered in determining the impact of overlapping directors on the tax treatment of the spin-off. If the parent decides to have overlapping directors with a spin-off company, it should consider the possibility that conflicts may arise between it and the spin-off company that may make it appropriate for any such overlapping directors to recuse themselves from deliberations at each company’s board. It is important to consider whether the parent and the spin-off company could become competitors of each other in the future because Section 8 of the Clayton Antitrust Act of 1914 (the “Clayton Act”) prohibits any person from serving as a director or officer of two or more competing corporations unless the sales of competing products or services of the two companies are less than certain *de minimis*

thresholds. Finally, one should be mindful that, although Institutional Shareholder Services (“ISS”) and Glass Lewis do not have a stated view or policy on overlapping boards, they have policies on overboarding generally. Currently, ISS recommends voting against or withholding votes from individual directors who sit on more than six public company boards or are CEOs of public companies who sit on the boards of more than two public companies besides their own (in which case ISS will withhold only at those outside boards). Starting in 2017, ISS will recommend voting against or withholding votes from individual directors who sit on more than five public company boards. ISS also recently considered, but did not implement, a limit of one outside public company directorship (as opposed to two) for CEOs, and an alternate limit of four total for non-CEOs, and it may revisit these policies in the future. Glass Lewis recommends a vote against a director who is on an “excessive” number of boards. This typically means a vote against a director who serves as an executive officer of any public company while serving on more than two other public company boards and any other director who serves on more than six public company boards. Like ISS, Glass Lewis will not recommend voting against a director at the company where he or she serves as an executive officer, but will recommend against at the other public companies where he or she serves on the board.

Often, the full slates of individuals who will serve as directors and executive officers of the spin-off company following completion of the spin-off are not formally appointed until relatively late in the process, although they may have been identified earlier on. Prior to that time, the spin-off company’s directors and officers typically will primarily consist of a small number of personnel of the parent company, which facilitates obtaining the necessary approvals and signing documents on behalf of the spin-off company.

3. Takeover Defenses

The takeover defense profile of the spin-off company should be carefully considered. In many spin-offs and IPOs, the spin-off company has more antitakeover provisions in its charter and bylaws than the parent. Some companies conclude that it is preferable for the newly public company to have antitakeover provisions from the outset, as the new company’s board could always seek to eliminate them later, whereas a decision to add antitakeover provisions made when the company is already public will likely face resistance from proxy advisory services such as ISS and governance activists. Such resistance could, in the case of protections (such as classified boards) that can be implemented only with shareholder approval, make it very difficult to adopt such protections following the spin-off or IPO. In addition, the spin-off company could be more vulnerable to hostile takeovers than the previously combined

company because it has a smaller market capitalization, particularly in the period immediately following the spin-off, during which the stock price of the spin-off company may experience relatively high volatility.

A key antitakeover provision included in the charters of many spin-off companies is a classified board structure. A classified board is one of the most effective defenses available in the event of hostile attempts to acquire board control, because it provides the board with time to adequately consider a bid. Because only one-third of the board is up for election in any given year, a hostile acquiror or shareholder activist who runs a proxy fight to replace board members with its nominees would need to obtain shareholder support in two election years to replace a majority of the board members. With a classified board, directors will be under less pressure to make decisions that maximize the short-term interests of activist shareholders at the expense of the long-term interests of the company. Another advantage of having a classified board is that it enables the company to require that directors may only be removed for cause. By contrast, if the board is not classified, then Delaware law requires that shareholders have the right to remove directors with or without cause. It should be noted, however, that shareholder activists are critical of classified boards and have submitted de-classification proposals to numerous companies.

Other takeover defenses include: no right for shareholders to call a special meeting; no right for shareholders to act by written consent; blank check preferred stock authorization; inclusion of “fair price” provisions; advance notice provisions for shareholders seeking to make director nominations or otherwise bring business before a shareholders’ meeting; limitation on shareholders’ ability to amend bylaws; no exemption from state antitakeover statutes; and requirements that a supermajority of shareholders approve business combination transactions or changes to the company’s anti-takeover defenses. In the case of a spin-off preceded by an equity carve-out, the charter may specify that some antitakeover provisions come into effect only upon the complete spin-off of the subsidiary.

Generally, newly spun-off companies tend not to adopt shareholder rights plans upon the spin-off. Rather, as has been the trend in recent years with established public companies, a newly public company often will keep a rights plan “on the shelf” and ready for deployment if and when needed.

Recently, governance advisors have increased their focus on newly public companies. ISS issued voting guidelines under which it generally will make adverse recommendations for directors at the first shareholder meeting of a newly public company if that company has bylaw or charter provisions that are “materially adverse to shareholder rights.” In making its assessment, ISS will

consider the level of impairment of shareholders' rights caused by the provision, the rationale for adopting the provision, the impact of the provision on the ability to change the company's governance structure in the future, the ability to hold directors accountable through annual elections and whether the company has made a public commitment to put the provision to a shareholder vote within three years of the date of the IPO. Unless an adverse provision is reversed or submitted to a vote of public shareholders, ISS will make voting recommendations on a case-by-case basis on director nominees in subsequent years. Glass Lewis' guidelines provide for a one-year grace period for companies that have recently completed an IPO in which Glass Lewis refrains from issuing voting recommendations on the basis of corporate governance best practices, except in egregious cases. However, Glass Lewis will consider recommending to vote against the members of the board who served when an antitakeover provision such as a shareholder rights plan or a classified board was adopted if the board (i) did not also commit to submit such provision to a shareholder vote within 12 months of the IPO or (ii) did not provide a sound rationale for adopting such provision. In addition, the Council of Institutional Investors issued a draft statement laying out investor expectations as to various governance features of newly public companies.

In addition, shareholder activists have pressured companies to remove, or agree not to include, several antitakeover defenses in spin-off companies' governance documents. After DuPont announced that its performance chemicals spin-off company, Chemours, would have a classified board and several other customary antitakeover protections for a spin-off or IPO company, Trian Fund Management criticized the DuPont board and subsequently launched a proxy fight. DuPont later revised Chemours' governance so that the classified board would be subjected to approval by the Chemours shareholders at the first annual meeting of Chemours stockholders. Carl Icahn has also entered into agreements with eBay, Manitowoc and Gannett that require their respective spin-off companies to, for a period of time after the spin-off, have an annually elected board, permit shareholders to call special meetings, and refrain from adopting a shareholder rights plan with a threshold below approximately 20% or a duration of more than a specified number of days without stockholder ratification.

Notwithstanding these developments, companies considering a spin-off or IPO should, as always, focus on how to structure the governance of the new company in a manner that maximizes long-term value creation. But they also should understand the governance landscape and the implications of their choices as they chart a course for the enterprises they are creating.

Spin-off companies incorporated in Delaware have also increasingly adopted charter or bylaw provisions requiring shareholders to bring suit in Delaware, in keeping with the general trend towards adoption of such exclusive forum provisions. Following the Delaware Court of Chancery's June 2013 decision upholding board-adopted exclusive forum bylaws, such provisions have become increasingly common. Courts throughout the country—including courts in New York, Texas, Illinois, Ohio, Louisiana and California—have enforced exclusive forum bylaws and dismissed or stayed litigation filed in violation thereof. Over 1,170 companies have now adopted exclusive forum bylaws or charter provisions. These provisions are not self-executing—if a plaintiff sues a company in a jurisdiction other than that which is stated in such company's organizational documents as the exclusive forum for adjudicating such a dispute, the company will need to litigate to enforce its forum selection provision.

Proxy advisory firms have generally been skeptical of exclusive forum provisions, although their policies and practices have been changing since the Delaware Court of Chancery's decision. ISS has stated that unilateral adoption by the board of an exclusive forum bylaw will be evaluated under ISS' policy on unilateral bylaw and charter amendments. As discussed above, in the context of a newly public company, this policy focuses on whether such a bylaw is “materially adverse to shareholder rights.” Glass Lewis has stated that it will weigh the presence of an exclusive forum provision in a newly public company's bylaws in conjunction with other provisions that it believes will unduly limit shareholder rights such as supermajority vote requirements, a classified board or a fee-shifting bylaw.

Some companies undergoing separation transactions have considered providing for mandatory arbitration in the newly public company's organizational documents, which would require shareholders with claims against the company to participate in mandatory confidential arbitration. Such provisions may encounter resistance, however, as evidenced by the Carlyle Group's 2012 attempt to include such a governance provision in its organizational documents in connection with its IPO. Carlyle ultimately determined not to include this provision in the face of opposition by investors, lawmakers and the Securities and Exchange Commission.

4. Governance Following a Carve-Out IPO

In a carve-out IPO, the parent may continue to own at least a majority of the outstanding shares of the issuer. Ongoing board representation for the parent is appropriate in this context, but must be carefully calibrated to protect minority public shareholders and to comply with the requirements of the Clayton Act and the Sherman Antitrust Act (the “Sherman Act”), as discussed further below under

“Antitrust.” In the case of a company listed on the New York Stock Exchange (the “NYSE”), the issuer would be a “controlled company” under NYSE rules for so long as the parent owns at least a majority of the issuer after the IPO and thus would be exempt from the NYSE requirement that a majority of its directors be independent. However, the spin-off company would not be exempt from the NYSE requirement that its audit committee be comprised exclusively of independent directors within one year of the date the registration statement becomes effective. One alternative with respect to board composition would be for the parent and subsidiary to agree (1) that the subsidiary will nominate a slate of directors including a percentage of parent designees based upon the percentage of common stock owned by the parent and (2) to cause a percentage of the subsidiary board to be composed of independent directors.

An additional consideration in forming the board of directors in a carve-out IPO is the duty of loyalty, which requires all directors to act in what they reasonably believe to be the best interests of the company and all of its shareholders. Although Delaware law permits a corporation, in its charter, to eliminate director liability for monetary damages for certain breaches of fiduciary duty, director liability arising from a breach of the duty of loyalty may not be so eliminated. Courts usually examine a board of directors’ decisions under the business judgment rule, but, where an inherent conflict situation arises, such as where directors are on both sides of a transaction, directors’ decisions are not entitled to the protections of the business judgment rule. In such conflict situations, directors are required to demonstrate the “entire fairness” of the transaction. A parent company that continues to control its former subsidiary likewise owes fiduciary duties to the former subsidiary’s public shareholders. In addition, persons who are both directors or officers of the parent and directors of the former subsidiary owe the same duties to both corporations. Such dual roles may create conflicts which require overlapping directors to abstain from participation in specific situations.

One mechanism for reducing the legal issues raised by conflict transactions when directors are on both sides of a transaction is for independent directors to ratify material transactions between the parent and subsidiary, a mechanism that should be utilized for ongoing transactions between the parent and its former subsidiary following an IPO. This ratification mechanism, if properly applied, would generally shift the burden of proof regarding the fairness of such transactions from the former parent and the interested directors to the challenging public shareholder.

An additional issue arising out of the duty of loyalty is the “corporate opportunity” doctrine. Under this doctrine, a director or controlling stockholder

may not appropriate a business opportunity that rightfully belongs to the corporation. While there is no bright-line test for determining which opportunities “belong” to a majority-owned subsidiary and which to its controlling stockholder, courts may consider a number of factors, including how closely the opportunity ties to their respective lines of business, the subsidiary’s expectancy in the opportunity and the capacity in which the opportunity comes to the parent or subsidiary.

Under Delaware law, a corporation’s charter may contain provisions modifying its fiduciaries’ obligations regarding corporate opportunities. For example, the subsidiary’s charter could contain provisions eliminating liability on the part of the parent (as controlling stockholder) to the subsidiary or its shareholders for a breach of fiduciary duty for taking any business opportunity for itself or for failing to present the corporate opportunity to the subsidiary. In addition, the subsidiary’s charter may contain provisions setting forth a procedure for allocating business opportunities between the parent and the subsidiary that are offered to persons who are directors, officers or employees of both parent and subsidiary.

F. Management and Employee Matters

1. Composition of Management

In the case of a subsidiary that has historically operated as a standalone entity, composition of management will likely be reasonably straightforward. Even in such a case, however, the successful transition from a subsidiary to a separate publicly traded company may necessitate new or additional managers, and compensation programs and levels will need to be evaluated in the context of new peer companies. In spin-offs of divisions that have not been operated on a standalone basis, composition of management may pose more complicated decisions, especially where existing managers have responsibilities that overlap between businesses to be spun off and businesses to be retained, or have experience in and are valuable to both sides of the business. The needs of each business, as well as the desires of the individual managers, are important considerations in determining who is allocated to which business. Where managers have roles at both the parent and the spun-off subsidiary following the spin-off transaction, care should be taken to comply with the requirements of the Clayton and Sherman Acts, as discussed further below under “Antitrust,” and to address potential areas of conflict.

2. Allocation of Other Employees and Employee Benefits

Most employees, other than senior management, will likely logically “belong” with one of the businesses. The issues inherent in separating the employee population are primarily legal, such as the division of pension plans and related assets, the division of other benefit plans and related assets, the treatment of stock options and other equity-based awards, the impact of any union contracts (including restrictions on the allocation of employees, benefits and benefit plan assets) and, for international operations, works’ council or other employee consultation requirements.

The spin-off company must also determine the compensation arrangements and employee benefit plans it will have after it becomes a separate company. If employees of the spin-off company or the parent participate in bonus or other performance-based arrangements that use consolidated parent performance targets and the transaction occurs other than at the end of a performance year, adjustments to those targets may be necessary to reflect the spin-off. And if employees of the spin-off company participate in parent employee benefit plans (medical, 401(k), nonqualified deferred compensation, etc.), the spin-off company generally will create its own plans to provide those benefits at the closing of the transaction. Those plans may also assume liabilities related to the spin-off company’s employees from the related parent plans, as well as any associated assets.

3. Adjustments to Equity-Based Compensation Awards

The parent’s equity compensation plans, as well as individual award agreements, should be reviewed to determine whether adjustments to equity-based compensation awards granted thereunder are required or permitted in connection with a spin-off. Subject to any restrictions in such adjustment provisions, there are two principal methodologies for adjusting equity-based compensation awards of the parent in connection with a spin-off:

- *Concentration Method.* The parent awards held by specified employees (typically, employees who will be primarily dedicated to the spin-off company) are converted into awards of the spin-off company, while the parent awards held by all other employees continue to be awards based on parent equity and are adjusted to reflect the decrease in value of parent equity upon the spin-off.
- *Basket Method.* All parent awards (regardless of employee) are converted into two awards: (1) an adjusted parent award and (2) a

spin-off company award. This method is sometimes referred to as the “shareholder method,” because the treatment closely mirrors the treatment of shares generally, or as the “bifurcated method.”

The basket method is often chosen in recognition of the contributions by equity award holders to the value of both companies and to make sure that employees reap the benefit of the value that they have helped create, regardless of which company they work for post-spin. In addition, this method is chosen to ensure that holders are treated like stockholders who receive shares in both companies. The concentration method is typically selected to ensure that employees are incentivized to maximize the value of the company for which they perform services. The concentration method also gives rise to fewer complications from an accounting, securities law, and tax perspective than does the basket method.

Method of Adjustment. Equity award adjustments in spin-offs generally aim to preserve the economic characteristics of the pre-spin-off award, with the value of the shares subject to the post-spin-off award (or awards) generally equivalent to the value of the shares subject to the pre-spin-off award, based on the relative values of parent equity immediately prior to the spin-off and parent and/or spin-off company equity, as applicable, immediately after the spin-off. For options to purchase parent shares, both the number of parent shares underlying the award and the exercise price must be adjusted. For tax reasons, regardless of the method chosen, the adjustment of parent options should preserve the aggregate spread of the options immediately prior to the spin-off. Although it may be possible to change the ratio of exercise price to equity price immediately prior to the spin-off, typically that ratio is preserved in the adjusted awards.

Overhang/Dilution. Companies should consult their financial advisers regarding the effect of a spin-off on the overhang and dilution of each of the parent and the spin-off company.

Accounting Charge. The adjustment of parent awards may result in an accounting charge regardless of the method of adjustment used. As a general rule, (1) the excess, if any, of the fair value of the adjusted awards over the fair value of the awards prior to adjustment is taken as a one-time accounting expense in connection with the adjustment, and (2) unaccrued accounting expense will continue to accrue over the remaining vesting period of the award. More significantly, further charges could be required if the parent’s equity plans do not require (as opposed to making optional) anti-dilution adjustments to awards in connection with the spin-off. Companies should consult their auditors for advice on the accounting effects of the adjustment of equity awards.

Blackout Periods. In connection with the adjustment of the parent awards to reflect a spin-off, the parent will typically impose a blackout period on option exercises and the settlement of other awards in equity for some period prior to the spin-off date and thereafter to give time to implement the spin-off adjustments. The parent should notify its award holders of this fact as far as practicable in advance of the commencement of the blackout period.

G. Consent Requirements

To the extent the spin-off company has not operated as a standalone entity, the separation may require the assignment of assets, interests in joint ventures or other partnerships, contracts and other rights, including leases, guarantees, and letters of credit, into separate corporate entities. Material agreements must be reviewed to determine assignability and the degree to which consents to assignment will be required, or new agreements with counterparties will need to be entered into by both the parent and the spin-off company. Agreements must also be reviewed to ensure that there are no provisions that would be unacceptable following a spin-off or sale (*e.g.*, provisions that require sharing of business plans with the entity to be spun off). Government contracts, both domestic and foreign, require particular attention for any novation rights and security clearance issues in connection with a proposed assignment or change of control or if the spin-off company will be organized in a jurisdiction outside of the United States. Companies should also analyze whether any domestic or foreign governmental consents will be required in connection with the separation of the businesses to be spun off and the ability to obtain such consents before the date of the spin-off.

H. Antitrust

Any IPO or spin-off involving overlapping ownership structures raises potential U.S. antitrust issues and should be analyzed from this perspective. These issues could arise under Section 1 of the Sherman Act (which prohibits concerted action among competitors) and Section 8 of the Clayton Act (which prohibits interlocking directors and/or officers in many competing corporations). In general, no filing under the Hart-Scott-Rodino Antitrust Improvements Act is required for a spin-off so long as the interests in the subsidiary are distributed *pro rata* to the parent's stockholders. Depending on the distribution of businesses and assets and the relationship of the two companies post-spin, however, antitrust questions could arise regarding non-compete agreements, transition services agreements, supply arrangements and interlocking directorates.

I. Intellectual Property

If the business to be separated relies on intellectual property rights (*e.g.*, patents) held by or licensed to the parent, this intellectual property may need to be allocated to or shared among the appropriate businesses. This may raise the consent issues discussed above, but with even more complexity if the parent is a licensee or if both companies need to share the intellectual property. Tax considerations also play a role if the parent and the spin-off company intend to enter into cross-licenses to allow each company to use intellectual property allocated to the other. In addition, consideration may need to be given to the use of trademarks and trade names by the businesses to be separated. If trade names or marks are licensed by one entity to another, the licensing party must have some ability to control the use of the mark and the quality of the products or services to be sold or offered under the mark.

J. Related-Party Arrangements

Related-party transactions will have to be described in the securities filings required in connection with the spin-off. Following the separation and the listing of the spin-off company, the NYSE rules recommend that an audit committee or other independent body of the board approve all new related-party transactions. The SEC defines a related-party transaction as any transaction in which the company was or is to be a participant and the amount involved exceeds \$120,000, and in which any related person had or will have a direct or indirect material interest. The definition of “related person” includes, among other things, any person who is the beneficial owner of more than five percent of the company’s voting securities. In addition, the spin-off company’s process for the review, approval or ratification of such related-party transactions will have to be described in securities filings on an ongoing basis.

K. Initial Disclosure of the Spin-Off

Consideration of the timing of a spin-off should take into account necessary financing activities, any planned stock repurchases and other disclosure issues. Absent these or similar circumstances, no public disclosure issue should arise until, at the earliest, the company’s board of directors has determined to proceed with pursuing a separation transaction or spin-off. Early discussion with the board of directors may be desirable. Preliminary consideration by the board does not mandate public disclosure, and the timing of disclosure is not generally dictated by legal strategy. Before disclosing an intended spin-off, companies should complete enough preliminary work to be confident that, once the anticipated spin-off has been announced, it can be completed; therefore, the

company should have a general understanding of the expected costs of implementing the transaction and the likely time frame and confirm that there are no “show-stoppers” that would prevent completion of the transaction. While “no comment” is generally the best strategy in the event of rumors, such a situation would have to be evaluated based on all factors existing at the time. In addition, the seriousness of consideration of the potential transaction, and the likelihood of its occurrence, need to be monitored in the context of any proposed purchases or sales of stock by executives having knowledge of the potential transaction.

A spin-off is typically preceded by an announcement that the parent plans to pursue a separation of a business. This announcement does not preclude other alternatives that may arise, including retaining or selling the business if warranted by the circumstances. For example, McGraw-Hill initially announced that it intended to spin off its education business and even filed a Form 10 registration statement before selling the business to affiliates of Apollo Global Management. Likewise, FMC Corporation initially announced a plan to spin off its mineral businesses and then subsequently sold the alkali portion of that business in an auction to Tronox and retained the lithium portion.

L. Shareholder Vote

Under the law of most jurisdictions, a shareholder vote is required for the “sale or other disposition of all or substantially all” of a company’s assets. In Delaware, the shareholder vote requirement is triggered if the corporation wishes to “sell, lease or exchange all or substantially all of its property and assets.” Because a spin-off is effected by means of a dividend of shares of the spin-off company (as opposed to a sale of assets), there is law supporting the proposition that a spin-off does not constitute a sale, lease or exchange within the meaning of the Delaware statute and, therefore, stockholder approval is generally not required. Consistent with this analysis, stockholder approval has not been sought in significant spin-offs by Delaware companies. In other jurisdictions, however, such as New York, the analogous statutes governing sales or transfers of substantially all of a company’s assets potentially apply to spin-offs, and, accordingly, careful consideration should be given as to whether a shareholder vote is required.

IV.

Transaction Agreements

A. Generally

A parent typically enters into a number of agreements with the spin-off company to implement the spin-off and establish a framework for their relationship following completion of the spin-off. Typically, these include a separation and distribution agreement, a transition services agreement, an employee matters agreement and a tax matters agreement. In some cases, certain of these agreements may be combined (*e.g.*, employee matters may be addressed in the separation and distribution agreement), or alternatively may appear in separate agreements. For example, if one company will rely on the other company for the supply of services, systems, raw materials, equipment, etc., on a commercial basis, they may enter into separate commercial agreements governing those relationships. Companies also may enter into patent, trademark and other intellectual property license agreements. The terms of any intercompany arrangements, particularly any long-term arrangements, must be carefully structured and reviewed to ensure that they will not jeopardize the tax-free nature of the spin-off. Generally, long-term or commercial arrangements between the companies must be at arm's-length terms, including arm's-length pricing.

SEC rules require that forms of the material transaction agreements be filed as exhibits to the Form 10 registration statement, and as exhibits to the spin-off company's periodic reports following completion of the spin-off. The SEC may also require that schedules and other attachments to these agreements be filed, depending on the nature of the agreement and the information included in the attachments. Companies should be cognizant of the potential for public disclosure in determining the form and content of the agreements (including deciding whether to move provisions out of the separation and distribution agreement into a separate agreement) as well as their schedules, and consideration should be given as to whether and when confidential treatment should be sought with respect to any information in the agreements or schedules that the SEC may require to be filed.

B. Separation and Distribution Agreement

The separation and distribution agreement sets forth the agreements between the parent and the spin-off company regarding the principal corporate transactions required to effect the separation and other agreements governing the

relationship between the parties. The separation and distribution agreement identifies assets to be transferred, liabilities to be assumed and contracts to be assigned to each of the spin-off company and the parent in implementing the separation, and it provides for when and how these transfers, assumptions and assignments will occur.

Generally, the asset and liability transfer provisions are structured similarly to those in an asset purchase agreement for a divestiture transaction. The agreement will define transferred assets, assumed liabilities, excluded assets and retained liabilities, in each case through a combination of categorical descriptions of the relevant assets and liabilities (*e.g.*, “all liabilities primarily related to [the spun-off business],”) and references to schedules (such as lists of real properties, patents, etc.). In drafting the categorical descriptions, decisions will need to be made as to the breadth of the defined categories (*e.g.*, “primarily related,” “exclusively related” or “to the extent related”). The agreement will also typically reference the pro forma balance sheet of the spin-off company in defining its assets and liabilities. It is generally preferable to specifically list the relevant assets and liabilities in schedules to the agreement, unless doing so is unduly cumbersome or they clearly fall within the enumerated categories. In some cases, a separation and distribution agreement may include a working capital or other balance sheet adjustment, which may be similar to those that are included in private M&A agreements, or may be more customized depending on the nature of the spun-off business and the desired capital allocation approach.

As noted above, a separation and distribution agreement typically provides for the business to be transferred on an “as is, where is” basis—*i.e.*, without any representations as to financial statements, undisclosed liabilities, litigation or other matters that typically are addressed in representations and warranties in a purchase agreement with a third party. The separation and distribution agreement usually will provide for cross-indemnities designed to place financial responsibility for the obligations and liabilities of the spin-off business with the spin-off company and financial responsibility for the obligations and liabilities of the parent’s remaining business with the parent, among other indemnities. In general, each party to the separation and distribution agreement assumes liability for all pending, threatened and unasserted legal matters related to its own business or its assumed or retained liabilities. Some companies may also choose to split any liability for shared or corporate legal matters that cannot be easily allocated to one business.

Similar to purchase agreements for a carve-out divestiture, separation and distribution agreements generally include provisions intended to account for the possibility that assets, liabilities, contracts, permits or other items contemplated to

be transferred cannot be transferred at the closing due to the failure to obtain required consents or approvals or to make required notifications or, in some cases, delayed regulatory approval. To this end, separation and distribution agreements typically include provisions intended to transfer the benefits and burdens of the relevant items to the applicable party until the consent, approval or notification (or regulatory approval) has been made or obtained, with legal title to follow when the transfer is completed. These provisions also typically impose obligations to continue to use efforts to complete such transfers.

The separation and distribution agreement also governs the rights and obligations of the parent and the spin-off company regarding the distribution of the spin-off company's shares and sets out the conditions to the distribution. Usually, the conditions to the distribution include, at a minimum: effectiveness of the Form 10 registration statement and delivery (by mailing or electronically) of the related information statement to stockholders; approval of the shares of the spin-off company's common stock for listing on the applicable stock exchange; receipt of an opinion of tax counsel as to the tax treatment of the spin-off (if it is intended to be tax-free); absence of injunctions prohibiting the spin-off; and a "catch-all" condition that there has been no adverse event that, in the judgment of the parent's board of directors, makes it inadvisable to complete the spin-off. Other conditions that are sometimes included are completion of the internal restructuring plan (if any), receipt of a private letter ruling from the IRS as to the tax treatment of specific issues in the spin-off, delivery of solvency/surplus opinions and completion of the distribution of financing proceeds obtained by the spin-off company, if applicable.

The separation and distribution agreement also generally outlines obligations with respect to retention of information and confidentiality and describes the circumstances under which the parent and spin-off company are obligated to provide each other with access to information. The agreement also often deals with insurance matters, including allocation among the parties of rights and obligations under existing insurance policies or captive insurance arrangements with respect to various claims or occurrences and procedures for the administration of insured claims.

As a result of the conditions to the distribution, as well as typically broad termination and amendment rights in favor of the parent, the parent will often retain great contractual freedom to modify, delay or abandon the transaction until it is completed. Moreover, in some cases, the separation and distribution agreement (and other transaction agreements) are not even entered into until very late in the process. However, significant deviation from publicly announced plans may be viewed unfavorably by the markets.

Spin-off transaction agreements sometimes provide for arbitration of disputes, though the appropriate dispute resolution mechanism should be considered in light of the particular facts and circumstances and preferences of the company.

C. Transition Services Agreement

The transition services agreement typically will cover services that are shared by the businesses to be separated, such as legal, payroll, accounting, information technology or benefits, which may have to be continued on an interim or transitional basis after the separation of the businesses. In some cases, only one party provides the services (*e.g.*, from the parent to the spin-off company), whereas in other cases both parties provide services to each other. Pricing of these services as well as the period of time over which they will be provided will need to be considered from both a business and tax perspective.

In order to preserve the tax-free nature of a spin-off, transition services agreements covering administrative and other support services should generally have terms of no longer than 12 to 24 months. The parties may often provide these services under such short-term transition services agreements on a cost or cost-plus basis, although the tax implications of the terms of such agreements will need to be considered in light of all the facts and circumstances. As described above, services that the parties will provide on a long-term basis or that are operational or commercial (and not administrative) in nature should be provided on arm's-length terms, including arm's-length (rather than cost or cost-plus) pricing.

As in a sale transaction, the body of the transition services agreement typically addresses matters such as service standards, termination and renewal rights, liability limitations and indemnification, while the scope and duration of the services are described in schedules.

D. Tax Matters Agreement

In connection with the separation, parties generally enter into a tax matters agreement that governs the rights, responsibilities and obligations of the parent and spin-off company after the spin-off with respect to taxes, including taxes, if any, imposed on the spin-off or related transactions (such as any internal transactions undertaken in anticipation of the distribution).

The tax matters agreement allocates tax liabilities between the parent and the spin-off company. One way to do so is on a pre- and post-closing basis (*i.e.*,

the parent is responsible for all taxes related to the period before closing, and the spin-off company is responsible for all taxes in respect of the spun-off entities related to the period after closing). A second approach is more complex. It allocates liabilities based on a “line-of-business” split (*i.e.*, the parent is responsible for all taxes in respect of the businesses it retains and the spin-off company is responsible for all taxes in respect of the spun-off business, regardless of the time period to which such taxes relate). A third approach is to let taxes “lie where they fall” under the law (*i.e.*, the legal entity on which the tax is imposed under the law is also responsible for the tax as between the parties). Often, a tax matters agreement will adopt different approaches for different types of taxes. For example, federal income taxes might be allocated on a pre-closing/post-closing basis, while sales taxes might be allocated based on a line-of-business split and transfer taxes based on a legal entity approach.

The tax matters agreement also assigns responsibilities for tax compliance matters, such as the filing of returns, payment of taxes due, retention of records and conduct of audits, examinations or similar proceedings. In addition, the tax matters agreement provides for cooperation and information sharing with respect to tax matters.

In order to protect the tax-free nature of the spin-off or related transactions, the tax matters agreement often contains restrictions on the spin-off company’s ability to take actions for the two-year period following the spin-off without obtaining either the parent’s consent or an IRS ruling or an opinion of counsel that the action will not affect the tax treatment of the spin-off or related transactions. Such restrictions typically include restrictions on any transaction that would result in a significant change in ownership of the spin-off company (whether via a merger of the spin-off company or otherwise), a liquidation of the spin-off company, a sale of a substantial portion of the spin-off company’s assets, and certain repurchases of the stock of the spin-off company. Moreover, the tax matters agreement generally will provide that the spin-off company is responsible for any taxes imposed on the parent as a result of the failure of the spin-off or related transactions to qualify as tax-free under applicable tax law if such failure is attributable to certain actions taken by the spin-off company or its shareholders, regardless of whether the parent consents to such actions or a ruling or opinion is obtained permitting such actions.

E. Employee Matters Agreement

The parent and the spin-off company generally will enter into an employee matters agreement in connection with the separation to allocate liabilities and responsibilities relating to employment matters, employee compensation and

benefits plans and programs, and other related matters. The employee matters agreement typically specifies the method of adjustment of equity compensation awards (see discussion in Part III.F.3 above), and addresses any assumption by the spin-off company of any employee benefit plans or of employment or similar agreements between the parent and members of the spin-off company's management team, as well as any other assets and liabilities under parent employee benefit plans that are being shifted to the spin-off company.

V.

Securities Law Matters

A. Principal Securities Law Filings

The primary disclosure document in connection with a spin-off that is not preceded by an IPO is a registration statement on Form 10 filed by the spin-off company. The Form 10 registration statement registers the class of shares being distributed under the Exchange Act. The Form 10 contains an information statement that is disseminated to all parent shareholders and provides disclosure with respect to the spin-off company similar to disclosure that would appear in an IPO prospectus. The Form 10 is typically given a full review by the SEC, which may take several months to complete. Although this review process may result in substantial revisions, the Form 10 becomes a public document upon its initial filing. The initial Form 10 also must include audited financial statements of the spin-off company, including two years of balance sheets, three years of income statements, three years of cash flows and three years of statements of shareholder equity, as well as unaudited stub period financials for interim quarters, if applicable, and five years of selected financial data. (The requirements for an “emerging growth company” are different, as discussed in Part V.C below.) Therefore, if the spin-off company does not already have audited financial statements, audit work should commence on preparing carve-out financials in sufficient time to be completed for the initial Form 10 filing.

If the spin-off company will have significant equity investees or has recently acquired significant businesses, the Form 10 may also need to include separate audited historical financial statements of these entities. Planning for the spin-off should include sufficient lead time to perform these audits and, if required, obtain the consent of the equity investee to publicly disclose its financial information in the Form 10.

The following outlines the primary sections of a typical information statement:

- Questions and Answers about the Separation
- Information Statement Summary
- Summary Historical and Unaudited Pro Forma
- Combined Financial Data
- Risk Factors

Cautionary Statement Concerning Forward-Looking
Statements
Dividends
Capitalization
Unaudited Pro Forma Condensed Combined
Financial Statements
Selected Historical Combined Financial Data
Business
Management's Discussion and Analysis of
Financial Condition and Results of Operations
Management
Compensation Discussion and Analysis
Executive Compensation
Certain Relationships and Related-Person
Transactions
Security Ownership of Certain Beneficial Owners
and Management
The Separation
Relationship with Parent Following the Separation
Material U.S. Federal Income Tax Consequences
Description of Material Indebtedness
Description of the Spin-off Company's Capital
Stock
Audited Historical Financial Statements (including
accountants' audit opinion)

The exhibits to be filed with the Form 10 typically include the following:

Charter
Bylaws
Financing agreements
Material contracts (whether relating to the spin-off,
intercompany arrangements, or the business of the
company to be spun off)
Benefit plans, arrangements and contracts
List of subsidiaries

If the forms of transaction agreements and organizational documents of the spin-off company have not yet been completed by the time of the initial filing, they may be excluded from the initial filing. Likewise, the initial Form 10 filing need not identify initial directors and officers or set out the proposed dividend policy, capital structure or description of indebtedness. But, if the company plans

to go to market with a bond offering, all material information will need to be disclosed in the offering memorandum or prospectus, even if the offering occurs in advance of the effectiveness of the Form 10. It is advisable to file the initial Form 10 sufficiently in advance of the bond offering to have time to go through at least one round of SEC comments on the Form 10 before completing the offering memorandum or prospectus.

Registration of the dividend of the spin-off shares under the Securities Act is generally not required. The Staff of the SEC issued Legal Bulletin No. 4 in 1997 to address common securities law issues relating to spin-offs. The Staff specified five conditions that must be met to avoid registration under the Securities Act in a spin-off not preceded by an IPO:

- the parent stockholders do not provide consideration for the spun-off shares;
- the spin-off is made *pro rata* to parent's stockholders;
- the parent provides adequate information about the spin-off and the subsidiary to its stockholders and the trading markets through a document such as a Form 10 information statement;
- the parent has a valid business purpose for the spin-off; and
- if the parent spins off "restricted securities," it has held those securities for at least two years (although this requirement does not apply where the parent forms the subsidiary being spun off, rather than acquiring the business from a third party).

In the case of a spin-off that is preceded by an IPO, the initial offering must be registered under the Securities Act, generally on Form S-1. The Form S-1 will contain disclosure similar to that described above for a Form 10 and is typically subject to a similar full review by the SEC. The Form S-1 will also typically include the same exhibits as a Form 10 as well as accountant consents and a legal opinion as to the shares being registered. The company also will need to file a registration statement on Form 8-A before the IPO to register the class of shares being sold under the Exchange Act, which typically simply incorporates by reference the relevant information and exhibits from the Form S-1.

Where a spin-off follows a prior IPO, a full Form 10 filing is not required because the company is already subject to Exchange Act reporting obligations. Instead, upon distribution of the remaining shares in the spin-off company held by

the parent, the parent only needs to provide more limited information about the spin-off to its shareholders, such as the tax consequences of the spin-off and treatment of fractional shares, and this document is not typically subject to SEC review. If a company disposes of its remaining shares in the spin-off company by means of a split-off, then the split-off exchange offer must be registered under the Securities Act, generally on Form S-4. The exchange offer also will be subject to the tender offer rules, which require that the parent file a Schedule TO.

The spin-off company will be primarily liable for any violations of the securities laws in connection with an IPO. If the parent is a selling stockholder in the IPO, it may also be primarily liable for violations of the securities laws. Moreover, if the parent is not a selling stockholder, it may still be secondarily liable for primary violations of the securities laws under the theory of “controlling person liability.” Generally, a Form S-1 is subject to more stringent liability standards than a Form 10.

B. Eligibility of Subsidiary to Use Form S-3

A spin-off company may desire access to the public equity and/or debt markets soon after the spin-off is consummated, for example, to refinance short-term debt allocated to it. One of the eligibility requirements to use Form S-3, which reduces the time and expense needed to register securities, is that the issuer has timely filed Exchange Act reports for at least 12 months. The SEC Staff stated in Staff Legal Bulletin No. 4 that a spin-off company may inherit its former parent’s Exchange Act reporting history for purposes of becoming eligible to use Form S-3 at the consummation of the spin-off if:

- it was eligible to use Form 10 in the spin-off under the conditions described above;
- the parent is current in its Exchange Act reporting; and
- the spin-off company will have substantially the same assets, business and operations as a separate segment in the parent’s financial reporting for at least 12 months before the spin-off.

C. Emerging Growth Company Status

If the spin-off company qualifies as an “emerging growth company” under the JOBS Act, it will be able to take advantage of certain provisions of the JOBS Act that reduce the burden of being a public company. For example, the spin-off company will only need to include three (instead of five) years of selected

financial information in any Exchange Act registration statement or periodic report, need not include an auditor's attestation on the effectiveness of internal controls over financial reporting in its Form 10-K and may provide more limited executive compensation disclosure in the Form 10 and periodic and other reports. Emerging growth companies may also elect to opt out of the requirement to comply with new or revised accounting policies until they are also applied to private companies, and are exempt from rules on rotation of accountants.

A spin-off company can qualify as an emerging growth company if it had less than \$1 billion in total annual gross revenues during the most recently completed fiscal year. Once qualified as an emerging growth company, the spin-off company will retain the status until the earliest of: the last day of the fiscal year during which the company had total annual gross revenues of \$1 billion or more; the date on which the company has, during the prior three-year period, issued more than \$1 billion of non-convertible debt; the date on which the company is deemed to be a "large accelerated filer" under the Exchange Act; and the last day of the fiscal year following the fifth anniversary of the company's first registered sale of common equity pursuant to an effective registration statement under the Securities Act.

D. Other SEC Filings

The spin-off company also typically files one or more Forms S-8 to register the issuance of equity under its employee benefit plans. If any former parent employees (excluding persons who become employees of the spun-off company and its subsidiaries) will hold equity awards with respect to the spun-off company's securities, then the spun-off company will probably need to file a Form S-1 or, if eligible, a Form S-3. The spin-off company typically would file such a required Form S-1 immediately after the information statement is finalized (or, if eligible, would file a Form S-3 on the distribution date). If the spin-off company files a Form S-1, the SEC typically would not comment on the filing extensively because the disclosures in the Form S-1 would largely correspond to disclosures contained in the Form 10 information statement.

In addition, the directors and executive officers and significant stockholders of the spin-off company will need to make Section 16 filings such as Forms 3 and 4. The parent, as sole stockholder, and the spin-off company's directors and executive officers serving on the day the SEC declares the Form 10 effective, must each file a Form 3 no later than the close of business that day. Directors and officers appointed after the Form 10 is effective need to file a Form 3 within ten business days of their appointment. The parent will also need to file a Form 4 reflecting its disposition of the spin-off company's stock in the spin-off

distribution. Although the SEC has issued no-action letters indicating that directors and officers generally need not file a Form 4 to reflect the *pro rata* adjustment of their equity-based compensation into awards of parent and spin-off company stock, the company and its advisers should analyze carefully the terms of directors' and officers' existing awards and the adjustment formulas to determine whether those individuals must file Forms 4.

The parent company will typically file a Form 8-K when the parent board of directors declares the spin-off dividend. Upon completion of the spin-off, the spin-off company typically files a Form 8-K reporting its entry into material definitive agreements with the parent, changes in board and executive officer composition, amendments to its organizational documents and any press release issued by the spin-off company to announce its entry into the public markets. Similarly, the parent typically files a Form 8-K reporting completion of the transaction. If the spin-off constitutes a disposition of a significant amount of assets within the meaning of Form 8-K Item 2.01, the parent will need to file pro forma financial information reflecting such disposition on Form 8-K within four business days of the closing of the spin-off.

E. Obligations Upon Effectiveness of the Registration Statement

Once the SEC declares the spin-off company's Form 10 effective—or, if the spin-off will be preceded by an IPO, once the Form 8-A is effective—the company will be subject to the Exchange Act's periodic reporting requirements, including the requirement to file current reports on Form 8-K to report material events (subject to limited exemptions prior to the completion of the spin-off). The spin-off company will also need to file an annual report on Form 10-K for the fiscal year in which the registration statement became effective, even if the deadline under the Exchange Act to file a Form 10-K for that fiscal year occurs before the completion of the spin-off. Moreover, following the effectiveness of the applicable registration statement, the spin-off company will be subject to the Exchange Act's proxy, insider reporting and short-swing profit liability provisions, and will be subject to the Sarbanes-Oxley Act, including provisions related to loans to executive officers and directors (which, in the case of an IPO, actually become effective upon filing of the Form S-1, and not only at effectiveness), director independence, and attorney "reporting up." Companies should consider the timing of actions undertaken in connection with the separation in light of these requirements.

A newly public company does not become subject to certain requirements relating to management's annual report on internal controls over financial reporting and the required auditor's attestation in a Form 10-K until the second

annual report that it is required to file with the SEC. However, if a newly formed public company seeks to use and is deemed eligible to use Form S-3 on the basis of another entity's reporting history as described in Part V.B, then the newly public company would be considered an accelerated filer and therefore required to comply with these requirements in the first annual report that it files.

Establishing the necessary internal controls over financial reporting, as well as disclosure controls and procedures more broadly, is a complex process that involves substantial planning and coordination among internal financial reporting and legal personnel, the board of directors (particularly the audit committee) and outside auditors. In some cases, the newly public company may need to upgrade its systems in connection with its separation, including purchasing computer hardware infrastructure, implementing additional financial and management controls, reporting systems and procedures and hiring additional accounting, finance and information technology staff. Moreover, the newly public company may be reliant on its former parent for services relating to some of its internal controls over financial reporting. Careful consideration will need to be given to these issues in order for the company to meet its obligations with respect to internal controls.

Following approval for listing on an exchange (which will occur before the commencement of "when issued" trading in the spin-off company's stock), the spin-off company will also be required to comply with the relevant exchange's quantitative and qualitative criteria for continued listing, including substantive corporate governance requirements. For example, even though the spin-off company will still be a wholly owned subsidiary of the parent, as of the listing date, the spin-off company must (1) have at least one independent director, (2) at least one independent member on its audit committee and (3) identify all of the directors to be appointed to the spin-off company's board and its audit, compensation and nominating committees as of the spin-off date.

As of the time of the spin-off, the spin-off company must have (1) at least three members on its audit committee, one of whom must be independent, (2) a compensation committee and nominating committee, each of which must include at least one independent director, (3) audit, compensation and nominating committee charters posted on its website and (4) corporate governance guidelines and code of business conduct and ethics guidelines posted to its website. The NYSE has a phase-in rule that does not require a majority of the spin-off company's board to be independent until one year after the listing date, and other phase-in rules regarding the independence of the spin-off company's audit committee and compensation committee.

F. Investor Relations Activities

In connection with a spin-off, it is often desirable to try to educate the investment community with respect to the company. Key time periods for approaches to the investment community should be identified and guidelines should be provided to assure compliance with securities law requirements. In the case of a spin-off preceded by an IPO, the blackout and waiting period requirements of a registered public offering will restrict the companies' activities in this area but Regulation FD will not be applicable to disclosures made in connection with the registered offering. A spin-off does not involve similar blackout and waiting period requirements, but the general antifraud provisions of the securities laws will still apply. In addition, Regulation FD will apply to disclosures that constitute material nonpublic information regarding the parent in connection with a spin-off. Discussions with investors and analysts should be consistent with the publicly available information contained in the Form 10. Decisions will also need to be made as to the desirability and scope of "road show" activity (including the scope of investment banker assistance on the road show).

VI.

Tax Issues

A. Generally

1. Requirements for Tax-Free Treatment

In order for a spin-off to qualify as tax-free to both the parent and its shareholders for U.S. federal income tax purposes, it must qualify under Section 355 of the Internal Revenue Code. Section 355 aims to provide tax-free treatment to transactions that separate two operating businesses and not to transactions that resemble either (1) distributions of cash or other liquid assets or (2) corporate-level sales. This Part VI.A.1. discusses requirements under Section 355 that are intended to bolster the first goal, while Part VI.B below describes Section 355 requirements relating to the second goal.

Under Section 355, the parent must distribute “control” of the spin-off company (generally, stock representing 80% of the voting power and 80% of each non-voting class of stock) and must establish that any retention of stock or securities is not pursuant to a tax avoidance plan. In the spin-off, the parent can distribute stock or stock and securities of the spin-off company, and the distributees can be shareholders or shareholders and security holders. In addition, the parent and the spin-off company must each satisfy a five-year active trade or business test (*i.e.*, immediately after the spin-off, each of the parent and the spin-off company must be engaged in an “active trade or business” that was actively conducted throughout the five-year period before the spin-off, with certain exceptions).

Further, the spin-off must be carried out for one or more corporate business purposes and not be used principally as a “device” for the distribution of the earnings and profits of the parent, the spin-off company, or both. Whether the spin-off is a “device” turns on whether the spin-off encompasses planned sales or exchanges of stock of the parent or spin-off company, or other transactions the effect of which would be to permit the distribution of corporate earnings without a dividend tax. This standard as to sales and exchanges may, in some cases, involve seeking representations by greater than five percent holders to the effect that such sales, exchanges or other distributions are not planned. In addition, certain repurchases of the stock of the parent company or spin-off company following the spin-off may implicate the “device” requirement. However, IRS ruling guidelines with respect to share repurchases are quite liberal, and generally, the repurchases will not be viewed as causing the distribution to be considered a

“device” if (1) the repurchases are supported by a sufficient business purpose, (2) the repurchased shares are widely held, (3) the purchases are made in the open market, and (4) there is no plan for the aggregate amount of repurchased shares to exceed 20% of the parent’s or the spin-off company’s outstanding shares.

The “business purpose” standard requires that a real and substantial non-tax purpose germane to the business of the parent, the spin-off company or both in fact motivated, in whole or substantial part, the spin-off. A shareholder purpose, such as increasing shareholder value, will not in and of itself suffice, although the IRS has held in published advice that a spin-off motivated by the desire to increase the stock price satisfies the business purpose requirement where that stock will be used to make acquisitions or compensate management. If more than one spin-off is to occur, each spin-off must be supported by its own business purposes.

Business purposes that can support a spin-off include demonstrably improving intended access to capital markets for the parent or the new company (including enhancement of an initial carve-out IPO), allowing the parent or the new company to have a “single line of business” or a higher value public stock needed to make desired acquisitions, allowing the parent or the new company to have a “single line of business” or a higher value public stock to attract or retain employees, improving credit terms or enhancing “fit and focus.”

In some cases, a parent corporation having significant tax attributes, such as net operating losses or capital losses, may want a distribution to be partially taxable to the parent corporation in order to “refresh” these attributes in the form of amortizable tax basis in the hands of the spin-off company. In some cases, it may be possible to trigger gain at the corporate level while preserving tax-free treatment to shareholders. For example, if the spin-off company distributes cash to the parent corporation in excess of basis, the transaction is generally partially taxable to the parent. As well, the IRS has ruled on “busted 351” structures in which the taxpayer has been able to choose the assets with respect to which gain will be recognized.

2. Procedural Considerations

A company planning a spin-off must determine whether to proceed solely on the basis of an opinion of tax counsel or whether to seek a private letter ruling from the IRS. A private letter ruling provides a high degree of assurance as to the tax results of the issues ruled upon, which may include aspects of internal restructuring steps that precede a spin-off or split-off.

Depending on the complexity of the transaction structure, the preparation of a ruling request could take several weeks or months, as the ruling request includes detailed information regarding the entities and businesses involved. Typically, seeking IRS rulings as to numerous internal pre-spin restructuring steps slows the process of preparing the ruling request and obtaining the ruling once the request has been submitted as compared with seeking only rulings on the spin-off itself. The IRS will generally grant a request for expedited handling for rulings pursuant to Section 355. If expedited handling is granted, IRS guidelines state that a ruling will typically be issued within ten weeks of submitting the ruling request. However, depending on the complexity of the request, the process of obtaining a ruling may take approximately six months, regardless of whether expedited handling has been requested. Typically, supplemental submissions in addition to the initial submission of the ruling request are required, both to respond to questions and issues raised by the IRS and to update the IRS with respect to the status of the relevant transactions and any changes in the transaction structure.

The IRS has strict and sometimes unpredictable ruling guidelines. There is generally no assurance that a favorable ruling can be obtained, although a pre-submission conference with the IRS, as well as discussions with the IRS while the ruling request is pending, provide feedback. The IRS has over time limited the scope of spin-off related private letter rulings that it will grant. The IRS will no longer rule broadly on whether a transaction as a whole satisfies the requirements for tax-free treatment, but instead will only rule on “significant issues” embedded in the transaction. Furthermore, the IRS will not rule on whether the “device” and “business purpose” requirements have been satisfied or whether the spin-off is part of a “plan” that includes a post-spin acquisition, as described in Part VI.B below and Part II.B above. Moreover, the IRS will no longer issue private rulings with respect to certain structures that had previously been utilized regularly in spin-off transactions, including debt-for-debt or debt-for-equity exchanges where the parent’s debt is issued in anticipation of the spin-off and certain high-vote/low-vote structures at the company to be spun off. Similarly, absent unique and compelling reasons, the IRS will no longer issue rulings as to the tax-free treatment of a spin-off if the fair market value of the gross assets of the “active trade or business” on which either company is relying is less than five percent of the total fair market value of the gross assets of the company.

Furthermore, the IRS will no longer issue rulings as to the tax-free treatment of certain “cash-rich” spin-offs (or split-offs), where a very large percentage of the asset value of the parent or the spin-off company consists of investment assets (*i.e.*, cash or other liquid or inactive assets, for this purpose, including a non-controlling stake in another publicly traded entity). Specifically,

the IRS will not rule if (1) the value of the investment assets held by either the parent or the subsidiary is at least two-thirds of the value of its total gross assets, (2) the value of the active trade or business of either company is less than 10% of the value of its investment assets, and (3) the ratio of the value of investment assets to non-investment assets of either company is at least three times such ratio of the other. This appeared to lead Yahoo! to abandon its planned tax-free spin-off of a company that would hold its stake in Alibaba.

In connection with obtaining an IRS ruling, the parent will be required to make certain representations with respect to the transaction under penalties of perjury. An opinion of tax counsel will similarly rely upon representations made by an officer of each of the parent and the company to be spun off.

B. Spin-Offs Followed by Acquisitions

As described above in Part VI.A, certain requirements for tax-free treatment under Section 355 are intended to avoid providing preferential tax treatment to transactions that resemble corporate-level sales. Under current law, a spin-off coupled with a tax-free or taxable acquisition will cause the parent to be taxed on any corporate-level gain in the spin-off company's stock if, as part of the plan (or series of related transactions) encompassing the spin-off, one or more persons acquires a 50% or greater interest in the parent or the spin-off company. Acquisitions occurring either within the two years before or within the two years after the spin-off are presumed to be part of a plan or series of related transactions with the spin-off. IRS regulations include facts and circumstances tests and safe-harbors for determining whether an acquisition and spin-off are part of a plan or series of related transactions.

A detailed explanation of the tax considerations relevant to post-spin acquisitions is attached as Annex B. Generally, where there have been no "substantial negotiations" with respect to the acquisition of the parent or the spin-off company or a "similar acquisition" within two years prior to the spin-off, an acquisition of the parent or the spin-off company for acquiror stock after the spin-off will not jeopardize the tax-free nature of the spin-off. Substantial negotiations generally require discussions of significant economic terms. In general, an actual acquisition is "similar" to another potential acquisition if the actual acquisition effects a direct or indirect combination of all or a significant portion of the same business assets as the potential acquisition would have.

Post-spin equity transactions that are part of the plan remain viable where the historic shareholders of the parent retain a greater than 50% interest (by vote and value) in the parent and the spin-off company after the merger transaction.

Thus, a spin-off followed by a merger with a smaller company is feasible even if it is part of a plan or series of related transactions with the spin-off and has been the format of a number of significant recent transactions, as discussed in Part II.B. Where the merger partner is larger than the parent or spin-off company to be acquired, it may be possible to have the merger partner borrow funds to redeem or otherwise shrink its capitalization prior to the merger transaction.

Because post-spin transactions can cause the spin-off to become taxable to the parent corporation (and potentially its shareholders), it is not uncommon for tax matters agreements to impose restrictions with respect to such transactions and to allocate any corporate tax liability resulting from the spin-off to the corporation the acquisition of whose stock after the spin-off triggered the tax, as described above in Part IV.D.

VII.

Listing and Trading Considerations

A. Stock Exchange Listing

The parent and the company to be spun off will need to decide on which exchange(s) the spin-off company's stock will be listed after the spin-off. A listing application with the exchange(s) chosen should then be filed shortly after the initial filing of the Form 10 with the SEC (or the Form S-1, in the case of a spin-off preceded by an IPO). Approval for listing upon notice of issuance should be obtained before the spin-off (or, if applicable, before closing the public offering) and will typically be a condition of closing. A certification of approval for listing is typically filed by the stock exchange with the SEC in connection with the spin-off company's request for the accelerated effectiveness of the registration statement.

B. "When-Issued" Trading

Typically, a company will seek to smooth the transition to post-spin trading of the shares of the parent and the spin-off company by establishing multiple trading markets during the period beginning approximately two days before the record date for the spin-off and continuing through the date of the spin-off. At the parent level, this involves two markets in shares of parent common stock: a "regular-way" market and an "ex-distribution" market. The parent shares that trade on the "regular-way" market trade with an entitlement to the shares of the subsidiary to be distributed in the spin-off. The parent shares that trade on the "ex-distribution" market trade without an entitlement to shares of the subsidiary to be distributed in the spin-off.

During this same period, there is a "when-issued" market in the shares of the subsidiary to be distributed in the spin-off. "When-issued" trading refers to a sale or purchase made conditionally because the security has been authorized but not yet issued. The "when-issued" trading market is a market for the shares of the spin-off company, which allows parent shareholders to trade their entitlement to shares of the spin-off company without shares of the parent. "When-issued" trading with respect to the shares of the spin-off company ends on the last trading day before the distribution, and "regular-way" trading begins the next trading day.

If the spin-off is conditioned on another transaction that is itself conditioned on an event outside the parties' control, such as a merger or other M&A transaction that requires shareholder or regulatory approval, then the stock

exchange generally will not allow “when-issued” trading to begin until after the required approval has been obtained.

C. The Distribution Ratio

The distribution ratio is the number of shares of the spin-off company to be distributed in respect of each share of parent common stock in the spin-off. The distribution ratio is determined by the parent’s board of directors, in consultation with management and its financial advisor, and is typically based on the target share price for the spin-off company.

D. Reverse Stock Splits

If the subsidiary being spun off comprises a significant portion of the value of the parent, the spin-off likely will result in a substantial decrease in the stock price of the former parent. A parent may implement a reverse stock split to move the per-share trading price of its stock back towards the pre-spin level. A reverse stock split is commonly effected by a series of amendments to the parent’s certificate of incorporation, which, depending on state law, typically require a shareholder vote.

ILLUSTRATIVE SAMPLE TIMETABLE FOR A SPIN-OFF¹Times and Actions

<i>Period/Event</i>	<i>Action</i>
Initial Consideration of Potential Transaction	Establish team consisting of key personnel from the parent (“Parent”) and, if appropriate, the spin-off company (“Spinco”) to review and resolve principal issues.
[minimum of one month before Initial Approval Board Meeting]	<p>Review separation-related issues, including:</p> <ul style="list-style-type: none"> – identification of assets to be spun off; – determination of capital structure, liquidity requirements and availability of financing, particularly with respect to any new financing arrangements to be entered into in connection with the spin-off (<i>e.g.</i>, to pay a pre-spin dividend to Parent); – allocation of debt and other liabilities; – corporate structure, including the Spinco jurisdiction of incorporation; – consent requirements, including with respect to Parent and Spinco material contracts and financing arrangements; – solvency of Parent and Spinco following the spin-off (including whether to seek a third-party solvency opinion) and evaluation of contingent liabilities; – availability of surplus for spin-off distribution under applicable law; – identification of Spinco senior management; – board size and composition (including search process for director candidates); – if relevant, evaluate interlocks among Parent and Spinco directors and officers; – employee and management compensation issues, including treatment of benefit plans and employment arrangements; – identification of necessary intercompany arrangements post-

¹ This illustrative timetable is for a spin-off that is not preceded by an IPO.

Period/Event

Action

- spin (*e.g.*, shared services, technology sharing, intellectual property licenses and commercial arrangements);
- determination of whether tax opinion or a combination of tax opinion and IRS ruling will be relied upon (and initial preparation of ruling request);
 - determination of internal tax and corporate restructuring to effect separation in most tax-efficient manner;
 - determination of any required regulatory filings;
 - initial preparation of securities law filings; and
 - corporate name for each entity and right to use Parent name.

Determine what historical financial statements and pro forma financial statements will be required for Form 10 purposes and commence preparation. In any event, prepare standalone financial statements for Spinco and Parent (including allocation of existing goodwill and identification of reserves and transaction costs).

Consider projected dividend levels for Spinco, if any.

Develop public and investor relations plan, including plan for presentations to:

- institutional investors;
- existing lenders;
- rating agencies;
- employees;
- customers and suppliers; and
- governmental and regulatory bodies.

Develop a strategy for communicating with Spinco employees regarding future benefits arrangements and Parent regarding effects of spin-off on remaining Parent employees.

Prepare board information package, draft board resolutions, management presentations and information concerning contingent liabilities.

<i>Period/Event</i>	<i>Action</i>
Board Meeting for Initial Approval	<p>Parent Board meeting to discuss and give preliminary approval of spin-off, subject to final board approval, and authorize Parent management to proceed with preparation therefor. Board meeting to include presentations from Parent management (including with respect to pro forma financial statements and adequacy of surplus), internal and/or outside counsel, and, if desirable, solvency expert and financial advisor.</p> <p>Notify Parent stock exchanges and issue Parent press release.</p> <p>File Form 8-K for Parent.</p>
Weeks 1–2 After Board Meeting	<p>Consider commencing public investor relations plan.</p> <p>Continue preparation of information statement and Form 10.</p> <p>Continue preparation of financial statements and MD&A for Form 10 purposes. Consider impact of spin-off on Parent financial statements.</p> <p>Commence drafting separation and distribution agreement, employee matters agreement, tax matters agreement, transition services agreement and other agreements concerning the relationship between Parent and Spinco, if applicable, such as intellectual property arrangements (the “Spin-off Documents”).</p> <p>Determine projected dividend levels for Spinco.</p> <p>Determine on which exchange(s) Spinco will be listed.</p> <p>Prepare and distribute questionnaire to directors and officers of Spinco, if determined.</p> <p>Survey of regulatory filings and approvals. Retain local counsel where necessary.</p> <p>Reserve Spinco name in proposed state of incorporation and elsewhere as necessary, as well as stock exchange ticker symbol.</p>

<i>Period/Event</i>	<i>Action</i>
	<p>Parent and Spinco to review any required new lending relationships for Spinco and general liquidity requirements.</p> <p>Commence process of seeking any required third-party consents.</p> <p>Preliminary contact with rating agencies.</p>
Weeks 3–4 After Board Meeting	<p>Distribute drafts of the separation and distribution agreement and any other Spin-off Documents that will need to be considered by larger groups. Certain agreements that will involve smaller working teams may proceed on separate tracks.</p> <p>Distribute drafts of historical financial statements and MD&A, if practicable.</p> <p>Begin preparing organizational documents and corporate documents for Spinco. Charter and bylaws take precedence as they ultimately will need to be filed with the Form 10; committee charters, policies, etc., can proceed on a separate track.</p> <p>Begin preparation of resolutions for Parent, Spinco and subsidiary boards of directors authorizing transfers of assets and related matters.</p>

<i>Period/Event</i>	<i>Action</i>
Weeks 5–9 After Board Meeting	<p>Drafting sessions for information statement and Form 10.</p> <p>Finalize financial statements and MD&A for Form 10 purposes.</p> <p>Finalize ruling request and file with IRS if ruling is to be sought.</p> <p>Continue drafting Spin-off Documents.</p> <p>Determine the treatment of any tax-qualified retirement plans.</p> <p>Begin drafting employee benefit and equity plans for Spinco.</p> <p>Consider blue sky issues.</p> <p>File Form 10 with the SEC.</p> <p>Issue press release regarding filing, if desired.</p>
Weeks 10–13 After Board Meeting	<p>Receive and respond to SEC comments.</p> <p>Continue drafting Spin-off Documents. File forms of material agreements, when ready, as exhibits to the Form 10.</p> <p>Finalize employee benefit and equity plans for Spinco.</p> <p>Begin confidential discussions with applicable stock exchange regarding listing application process and draft preliminary listing application(s) and other documents relating to exchange listing.</p> <p>Obtain third-party consents and state and foreign regulatory approvals.</p> <p>Negotiate bank and/or other credit facilities with lenders.</p> <p>Engage and negotiate agreements with distribution agent for the spin-off and transfer agent for Spinco stock post-spin.</p>

<i>Period/Event</i>	<i>Action</i>
Weeks 14–18 After Board Meeting	<p>Receive and respond to additional SEC comments.</p> <p>Finalize Spin-off Documents. File forms of documents as exhibits to the Form 10.</p> <p>File preliminary listing application(s) with applicable exchanges.</p> <p>Prepare registration statements for employee equity plans of Spinco.</p> <p>Parent and Spinco boards of directors or authorized committees meet to approve the following (to the extent not previously approved):</p> <ul style="list-style-type: none"> – elect Spinco directors and officers; – approve Spinco charter and bylaws and adopt any related board or shareholder resolutions; – authorize transfers of assets and liabilities, if necessary; – approve form of separation and distribution agreement and other Spin-off Documents; – ratify Form 10; authorize execution and delivery of the other securities law-related documentation; appoint attorney-in-fact to sign the registration statements required for Spinco employee benefit plans; and authorize other customary securities law matters relating to the spin-off; – approve form and authorize execution and delivery of various agreements concerning credit lines and debt agreements, if applicable; – appoint transfer agent and registrar acceptable to applicable stock exchanges on which listing will be made; – authorize compliance with blue sky laws as required and adopt resolutions concerning blue sky authorities; – authorize listing of Spinco common stock; – authorize name changes and filings to effectuate them; – approve employee benefits, stock option and other incentive compensation and benefit plans of Spinco; and – authorize all steps previously taken and the taking of all further

<i>Period/Event</i>	<i>Action</i>
	<p>steps in connection with the spin-off.</p> <p>Spinco executes agreements with transfer agent and registrar in form satisfactory to the securities exchanges on which Spinco is intending to list.</p> <p>Establish eligibility of Spinco common stock with DTC.</p>
Weeks 19–25 After Board Meeting	<p>Receive and respond to additional SEC comments. Clear all outstanding comments and submit request for acceleration of Form 10 effectiveness.</p> <p>Receive notice of approval for listing from securities exchanges.</p> <p>Form 10 declared effective by the SEC.</p> <p>File blank Form 3s for Parent (as stockholder of Spinco) and current executive officers and directors of Spinco on day the Form 10 is declared effective.</p> <p>File Form 8-K and issue press release for Parent as to effectiveness.</p> <p>File registration statement(s) regarding Spinco employee equity plans.</p> <p>Continue investor relations plan with respect to the spin-off.</p> <p>Finalize Spinco’s bank and other credit facilities.</p> <p>Receive solvency opinion with respect to solvency of Spinco following the spin-off. Solvency firm may give a bring-down opinion at closing.</p> <p>Parent board of directors acts to:</p> <ul style="list-style-type: none"> – authorize distribution of Spinco common stock to Parent shareholders, distribution ratio and method of handling fractional shares;

<i>Period/Event</i>	<i>Action</i>
	<ul style="list-style-type: none"> – set record and distribution dates for stock dividend effecting spin-off and declare spin-off dividend; – appoint distribution agent; – designate an officer or committee of Parent with power to approve all matters in connection with the proposed distribution, if desired; and – receive updated reports from experts if needed. <p>Give notice of record and distribution dates to transfer agent and distribution agent.</p> <p>Print and mail final information statement to Parent stockholders, or post information statement online and mail notice of availability to Parent stockholders.</p> <p>File any necessary name changes in appropriate states.</p>
Weeks 26–29 After Board Meeting	<p>Receive opinion of tax counsel and, if applicable, IRS ruling.</p> <p>“When-issued” trading market commences two days before record date of the distribution and continues until the distribution date.</p> <p>Distribution date and closing of spin-off.</p> <p>Parent and Spinco execute Spin-off Documents.</p> <p>Issue Parent and Spinco press releases and file Parent and Spinco Forms 8-K regarding closing. (Spinco 8-K typically includes executed versions of the material Spin-off Documents.)</p> <p>Notify distribution agent and other required parties of closing.</p> <p>Distribute stock of Spinco to Parent shareholders and implement approved mechanism for handling fractional shares on distribution date.</p> <p>File Form 3 for executive officers and directors of Spinco appointed at the closing of the spin-off. File Form 4 for Parent</p>

Period/Event

Action

reflecting disposition of Spinco stock in the distribution.

File final securities exchange listing applications, if required by exchange.

ANNEX B

POST-SPIN LIMITATIONS ON STRATEGIC TRANSACTIONS

As described in Part VI.B above, when a parent spins off a subsidiary in a tax-free transaction, the tax rules impose certain restrictions on subsequent acquisitions of the parent or the spin-off company. The following chart summarizes these restrictions and is followed by additional explanation and discussion. The summary chart is for ease of reference only and should be read in conjunction with the discussion that follows it.

Circumstances	Acquisition of 50% or more of the parent or the spin-off company in stock transaction	Acquisition of 50% or more of the parent or the spin-off company in cash transaction
No agreement or “substantial negotiations” with respect to acquisition or a “similar acquisition” (see below) within two years prior to completion of spin-off	No post-spin waiting period	Facts and circumstances test as to whether spin is a “device” to distribute earnings (see below)
Spin-off motivated by valid business purpose, and no agreement or “substantial negotiations” with respect to acquisition or a “similar acquisition” within one year prior to completion of spin-off	Six-month post-spin waiting period	Six-month post-spin waiting period, plus facts and circumstances test (see above)
Substantial negotiations within one year prior to spin-off, but no agreement, understanding or arrangement concerning the acquisition or a “similar acquisition” at the time of the spin-off	One-year post-spin waiting period	One-year post-spin waiting period, plus facts and circumstances test (see above)

“Substantial negotiations” generally require discussions of significant economic terms (*e.g.*, price or exchange ratios).

In general, an actual acquisition is “similar” to another potential acquisition if the actual acquisition effects a direct or indirect combination of all or a significant portion of the same business assets as the potential acquisition would have.

Under the “device” rules, a spin-off is taxable at the corporate level and at the shareholder level if the spin-off is principally a device for the distribution of earnings and profits (*i.e.*, if the spin-off is principally a means to get cash to shareholders at capital gains rates). The “device” rules are discussed below.

Discussion

I. Section 355(e) Rules

Under the “anti-Morris Trust” rules of Section 355(e) of the Internal Revenue Code, a spin-off is taxable at the corporate level (although not at the shareholder level) if the spin-off is part of a “plan” that includes the acquisition of 50% of the vote or value of the parent or the spin-off company.

- Under the statute, a spin-off and an acquisition of stock are presumed to be part of a plan if the acquisition occurs within two years before or after the spin-off.
- Under regulations, an acquisition of the parent or the spin-off company within two years after the spin-off will not be deemed to be part of a plan if:
 - There was no agreement, understanding, arrangement, or “substantial negotiations” regarding the acquisition or a “similar acquisition” **within the two-year period ending on the date of the completion of the spin-off; OR**
 - The spin-off was motivated in whole or substantial part by a corporate business purpose other than to facilitate an acquisition of, or issuance of stock by, the acquired company (the parent or the spin-off company), and there was no agreement, understanding, arrangement, or “substantial negotiations” regarding the acquisition or a “similar

acquisition” during the period that **begins one year before the spin-off and ends six months after the completion of the spin-off**; OR

- There was no agreement, understanding or arrangement concerning the acquisition or a “similar acquisition” **at the time of the spin-off** AND there was no agreement, understanding, arrangement, or “substantial negotiations” regarding the acquisition or a “similar acquisition” **within one year after the completion of the spin-off**.

II. “Device” Rules

Under the “device” rules, a spin-off is taxable at the corporate level and at the shareholder level if the spin-off is principally a device for the distribution of earnings and profits (*i.e.*, if the spin-off is principally a means to get cash to shareholders at capital gains rates).

- A sale or exchange of stock of the parent or the spin-off company following a spin-off is evidence of device, except in the case of an exchange pursuant to an all-stock acquisition. Thus, the “device” rules come into play in the context of a spin-off followed by a cash acquisition (or an acquisition for cash and stock). Generally, the shorter the period between the spin-off and the sale, the stronger the evidence of device.
- A post-spin sale or exchange that was discussed by the buyer and the seller before the spin-off and was reasonably to be anticipated by both parties will ordinarily be considered “substantial” evidence of device.
- Absence of accumulated earnings and profits is evidence of non-device.