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State of the Art:
Critical Developments & Trends in M&A

December 10, 2019

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Cautionary Tales from High Profile Delaware Cases

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Termination fee as exclusive remedy (*Genuine Parts Company v. Essendant Inc.*)

"Goodwill" covenants and bespoke versus boilerplate (*Dolan v. Altice USA, Inc.*)

Failure to extend drop-dead date: a costly oversight (*Vintage v. Rent-a-Center*)

Interaction between “no shop” clause and termination fee as exclusive remedy provision

- In Genuine Parts Company v. Essendant Inc., the merger agreement for a public company merger contained a typical “no shop” clause
  - Terminate discussions with existing bidders
  - Do not encourage or facilitate competing bids
  - Require a competing bidder to sign a comparable confidentiality agreement
  - Inform Buyer of any competing bids received
- In order for the termination fee to be Buyer’s exclusive remedy following the Target’s termination of the merger agreement to enter into an agreement with an alternate bidder, the termination fee was required to be paid in connection with a termination only in response to a competing transaction that did not arise from a material breach of the “no shop” clause

Interaction between "no shop" clause and termination fee as exclusive remedy provision (cont'd)

- Target accepted a competing bid and paid Buyer the termination fee, which the buyer accepted
- Buyer then sued for breach of the merger agreement based on alleged breaches of the "no shop" clause
- In ruling on a motion to dismiss, the Delaware Chancery Court held that the motion to dismiss must be denied

Interaction between “no shop” clause and termination fee as exclusive remedy provision (cont’d)

- The provision providing that the termination fee was the exclusive remedy required a termination by Target “in accordance with” and “pursuant to” its right to terminate the merger agreement for a superior proposal, which, in turn, depended on compliance with the “no shop” clause

- The court held that Buyer’s complaint pled facts which plausibly alleged a material breach of the “no shop” clause, which would mean that the termination fee was not the exclusive remedy

Interaction between “no shop” clause and termination fee as exclusive remedy provision (cont’d)

Target argued that Buyer’s acceptance of the termination fee precluded Buyer from seeking any other remedy

The court stated that, absent express and unconditional contractual language making receipt of the termination fee exclusive of other legal or equitable remedies, acceptance of the termination fee did not by itself foreclose Buyer’s right to sue Target for breach of contract

Genuine Parts Company v. Essendant Inc. – Key Takeaways

- Example of Delaware courts holding parties to the terms of their contractual bargains
- Need for focus on the interactions between the "no shop" clause, matching rights, termination provisions and break-up fee triggers
- Board of directors of the target should be briefed on how the provisions will work if a topping bid is received
- A buyer should scrutinize the target's actions leading up to and during a topping bid situation to preserve its ability to insist on strict compliance with the contractual language and protect the deal

Enforceability of "goodwill" covenants and bespoke versus boilerplate provisions

- In Dolan v. Altice USA, Inc., the merger agreement at issue included a provision requiring the buyer to operate the "News12" division of the target post-closing in accordance with a five-year business plan
  - The Dolans, the largest stockholders of the target prior to the deal, specifically negotiated for the covenant in exchange for including the "News12" division in the transaction
- After closing, the buyer took actions contrary to the business plan, including lay-offs
- The Dolans sued to obtain specific performance of the covenant requiring adherence to the business plan

Enforceability of "goodwill" covenants and bespoke versus boilerplate provisions (cont'd)

- The merger agreement included the following "boilerplate" provisions:
  - No survival of covenants except for specifically listed covenants, which did not include the "News12" covenant
  - No third-party beneficiaries except for specifically listed beneficiaries of certain covenants, which did not include the Dolans with respect to the "News12" covenant
- The buyer argued that the "News12" covenant was an aspirational covenant expressing goodwill and then-present intent and was not enforceable
- The Dolans argued that, notwithstanding the merger agreement's survival clause, the "News12" covenant, by its terms, extends post-closing, and if the Dolans were not deemed third-party beneficiaries, then there would be no one to enforce the covenant, rendering it surplusage

Enforceability of "goodwill" covenants and bespoke versus boilerplate provisions (cont'd)

- At the pleading stage, the Court of Chancery held that the merger agreement was "ambiguous" with respect to whether the parties intended that a post-closing covenant governing operation of the "News12" division would be enforceable post-closing by the Dolans, who were not parties to the merger agreement but had specifically negotiated for the covenant and allegedly had relied on it in determining to support the deal

Dolan v. Altice USA, Inc. – Key Takeaways

- Be careful in agreeing to aspirational or goodwill covenants
- Be careful in relying on boilerplate provisions that may conflict with bespoke provisions
- Non-parties to a merger agreement that disclaims third-party beneficiaries may nevertheless be able to enforce the merger agreement
- In drafting, be sure to check the survival provision and the third-party beneficiaries provision against each covenant in the agreement

Failure to extend drop-dead date: a costly oversight

- In *Vintage v. Rent-a-Center*, the proposed merger required approval from the FTC due to overlap of the parties' competing operations
- The merger agreement provided (a) for a drop-dead date of six months from signing, after which either party could terminate the agreement and (b) that either party could extend the drop-dead date for a three-month period, twice, by written notice to the other party prior to the then-effective drop-dead date if the FTC process was still ongoing
- When the drop-dead came and passed, and neither party elected to extend, Rent-a-Center sent notice of termination of Vintage
- It appears that Vintage simply forgot to send the notice of extension
- When Rent-a-Center terminated, Vintage became liable for payment of a reverse breakup fee
- Vintage sued, claiming that (a) the parties had effectively extended by virtue of their continuing to work diligently towards FTC approval and closing and (b) Rent-a-Center had engaged in fraud by acting as if it were willing to move forward when in fact it intended to terminate the agreement

Failure to extend drop-dead date: a costly oversight

- The Court of Chancery rejected both of Rent-a-Center's arguments, refusing to "fundamentally rewrite the bargain of the parties."

- The Court of Chancery noted that the drop-dead date provisions, including the methods to extend, had been heavily negotiated and were important bargained-for rights.

- The Court of Chancery rejected Vintage's arguments that:
  - Vintage's failure to provide notice timely was excused by the parties' conduct
  - Rent-a-Center breached its covenant to use commercially reasonable efforts to consummate the transaction by not reminding Vintage about the drop-dead date and not notifying Vintage of Rent-a-Center's intent not to extend
  - Rent-a-Center fraudulently induced Vintage into believing that Rent-a-Center still wanted to close the deal

Vintage v. Rent-a-Center – Key Takeaways

The Court of Chancery will enforce clear and unambiguous language in the bargained-for agreement and will not rescue a party from an unforced error

A party's covenant to exercise commercially reasonable efforts to consummate a transaction do not require such party to (a) remind its counterparty of the counterparty's contractual rights or (b) warn its counterparty of an intent to terminate the agreement

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Trends and Market Update for M&A Activity by Special Purpose Acquisition Companies

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Special Purpose Acquisition Company (SPAC)
Structure

- SPACs are newly formed shell companies, with no revenue or operating history, that raise proceeds in an IPO for the purpose of acquiring one or more operating businesses
- A sponsor team raises cash to acquire a private operating company
  - Normally, all cash raised in the IPO is placed in a trust account and is not released until SPAC completes a business combination or is returned to investors
  - In a concurrent private placement, sponsors invest an amount equal to the IPO expenses plus a specified amount to be held outside of the trust account for future expenses, in exchange for warrants or, sometimes, units
- SPAC raises capital by selling units composed of shares and warrants to investors in an IPO
- Capital raised from the public and capital contributed to SPAC by the Sponsor is held in a trust account to be used in connection with a business combination
- SPAC normally has 18-24 months to complete a business combination
  - If one does not occur, SPAC will liquidate and shareholders will receive their pro rata share of the amount in trust
  - Founders are not entitled to receive funds on such a dissolution in respect of their founders' shares
- SPACs have become another asset class for M&A transactions, and PE firms increasingly behind SPACs, including Goldman Sachs, TPG, The Gores Group, Riverstone Holdings, Apollo

SPAC Market Overview

- Investments in SPACs have grown substantially since the financial crisis.
- Following the pre-financial crisis peak in 2007 with $7.6 billion in SPAC IPOs in the second half of 2007 alone, SPAC IPOs have been on an upward trend since 2009 in both deal count and dollar amount raised.
  - In 2019, SPACs have raised $13.0 billion across 56 IPOs, with an average raise of $232 million.
  - This is an increase over 2018, which saw 46 SPACs go public, raising $10.7 billion in gross proceeds, with an average raise of $233.7 million. SPACs represented approximately 19% of all 2018 IPOs.
  - Compare this to 2013, when only 10 SPACs went public, raising $1.4 billion in gross proceeds at an average size of $144.7 million.
- 99 SPACs were active at the end of November 2019, with over $22.5 billion of funds in trust.
  - Because SPACs generally have a lifetime of 18 to 24 months and are required to effect business combinations with a value of at least 80% of the funds held in trust during that time period, current SPACs will seek to close $18 billion in business combinations over the next two years.

* Source: SPAC Research.

Trends in SPAC Transactions – Deal Certainty

- SPACs and SPAC targets are more focused than ever on ensuring certainty of closing.
- SPACs and their targets are less willing to rely on a "de-SPACing" marketing process between signing and closing to address the risk that a SPAC faces excess redemptions from its shareholders.
- Traditionally, SPACs have sought PIPE investments from third-party investors at signing (to be funded immediately prior to the closing of the business combination transaction) and to a lesser extent debt financing.
  - PIPE investment generally takes the form of unregistered common equity, subject to registration rights.
  - Proceeds used to, among other things, backstop redemptions, to pay cash merger consideration and transaction expenses, repay target indebtedness and/or fund post-closing working capital.
- More recently, SPACs have expanded their playbook to include:
  - Forward purchase agreements to purchase equity to the extent additional funds are required at closing.
  - Pre-negotiated shifts from cash consideration to equity consideration, sometimes contingent upon the drawdown of additional equity or debt financing or requiring the SPAC's founders to defer or cancel founder shares in connection with the change in consideration. These arrangements often are agreed at the LOI stage.
  - Agreements with third parties to purchase SPAC shares in the open market, coupled with an agreement not to redeem those shares and price protection on those shares borne by the post-combination entity.

Trends in SPAC Transactions – Importance of Due Diligence

- SPACs and their founders have to balance the time pressure associated with the SPAC's finite lifecycle and the need to complete an initial business combination with the time it takes to complete a complex M&A transaction, including the need to engage in robust legal, accounting, finance and tax due diligence.
- In June 2019, the SEC charged Ability Inc. (incl. two of its executives) with defrauding shareholders of Cambridge Capital Acquisition Corp., a SPAC which acquired Ability in December 2015.
  - Capital Acquisition Corp. would have liquidated absent an extension from its shareholders had the transaction not been approved and closed.
  - Ability allegedly lied about its business prospects, including the ownership of certain technology, and included misleading or incorrect statements in the SPAC's merger proxy.
  - Subsequent to the business combination, the company announced that it did not own the technology and had significantly lower financial performance than had been presented to the SPAC (i.e., realizing only $16.5m in revenue compared to $108m in forecasts provided to the SPAC).
  - The SEC alleged that Cambridge did not conduct independent due diligence on Ability.
  - Cambridge's CEO agreed to a settlement with the SEC, including a $100,000 civil penalty and a 12-month suspension, but bulk of recourse (including fraud charges) brought against the target's executives.

Trends in SPAC Transactions – Remedies Structures

- The *Ability* case highlights the need for SPACs to focus on due diligence and remedies structures.
- SPAC transactions historically have utilized a variety of remedies structures, including traditional indemnities, limited indemnities (e.g., capped at an amount in escrow or applying only to fundamental representations), and public company style, "no survival" transactions.
- A handful of recent transactions have used representations and warranties insurance. Benefits include:
  - Removes hurdle of negotiating indemnification structures, reducing timing to signing.
  - Target shareholders do not end up indemnifying themselves post-business combination, aligning incentives with the operating entity going forward.
  - SPACs are competing in auctions where use of insurance may be a prerequisite to a successful bid.
  - Provides some level of recourse for the SPAC's pre-existing shareholders and founders, and insurers pressure test the SPAC's due diligence process.
- Key difficulty is paying for the policy where the SPAC does not have sufficient working capital prior to the release of funds from trust. Some SPACs have provided that the target entity fronts the initial costs (e.g., insurer's due diligence costs), which are reimbursed by the SPAC at closing. Another alternative is to fund costs with a loan from the SPAC's sponsor.

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Recent CFIUS Developments

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Recent CFIUS Developments
Long History

- Defense Production Act of 1950
- Exon-Florio Amendment in 1988
- FINSA: Foreign Investment and National Security Act of 2007
- FIRRMA: Foreign Investment Risk Review Modernization Act of 2018
- Pilot Program: October 2018
- Proposed Regulations implementing FIRMMA published for comment in September 2019
  - While not yet adopted, they are consistent with, and would codify, the principals and definitions set forth in FIRRMA.
  - Final Regulations expected before February 13, 2020

Recent CFIUS Developments
Overview

Committee on **F**oreign **I**nvestment in the **U**nited **S**tates

C F I U S

Recent CFIUS Developments
Overview

Foreign Investor

- Covers all foreign buyers
  - Higher threat: in practice CFIUS give more critical review to China and Russia among others
  - Lower threat: list for certain types of investments to come in final regs
- Foreign vs Domestic
  - Up-the-chain analysis of control and influence
  - Highly fact dependent
- Foreign government has a substantial interest.
  - May require mandatory filing
  - Not just State Owned Enterprises and Sovereign Wealth Funds.

Investment Structure

- Control vs. Passive: Non-controlling investment can trigger CFIUS review under FIRRMA
- For TID targets (described at right), much broader array of investment structures are covered, including licenses, passive investments accompanied by technical information rights, board rights (including observers), or involvement in decision making
- Pure, non-convertible debt investments are outside of CFIUS jurisdiction

U.S. Target

- Critical Technology (T)
  - Controlled eExport
  - Emerging and foundational technologies – to be defined
- Critical Infrastructure (I)
  - Select functions tied to I companies e.g. telecom, utilities, energy, transportation
- Sensitive Personal Data (D)
  - Financial, geolocation, health and genetic information
  - Aggregated, anonymous or encrypted data is excluded if it can't be reversed
- Pilot program industries
  - 27 NAICS codes + Critical Technology = mandatory filing
- Real Estate in close proximity to military or infrastructure

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Attorney Client Privilege in M&A

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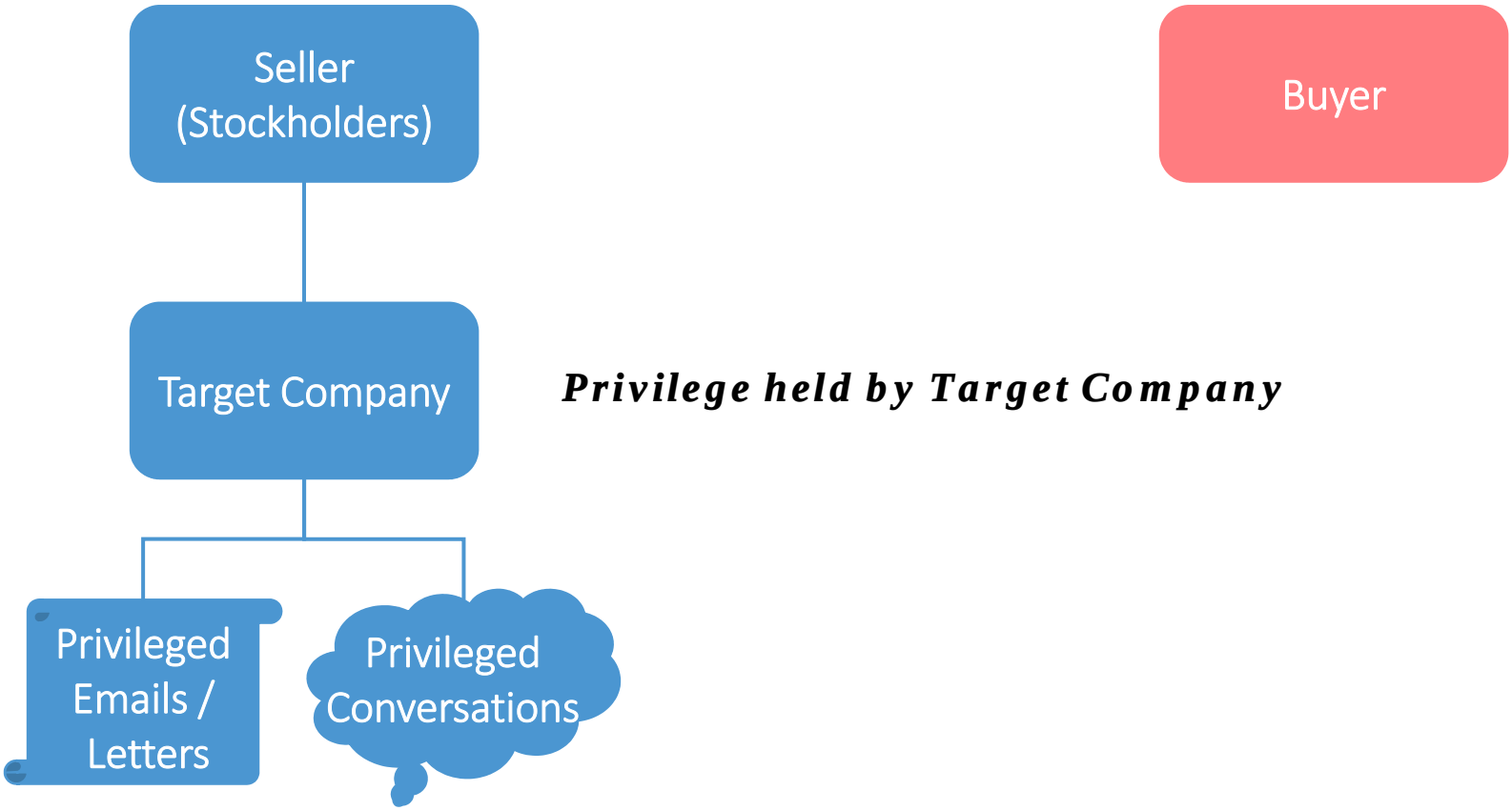
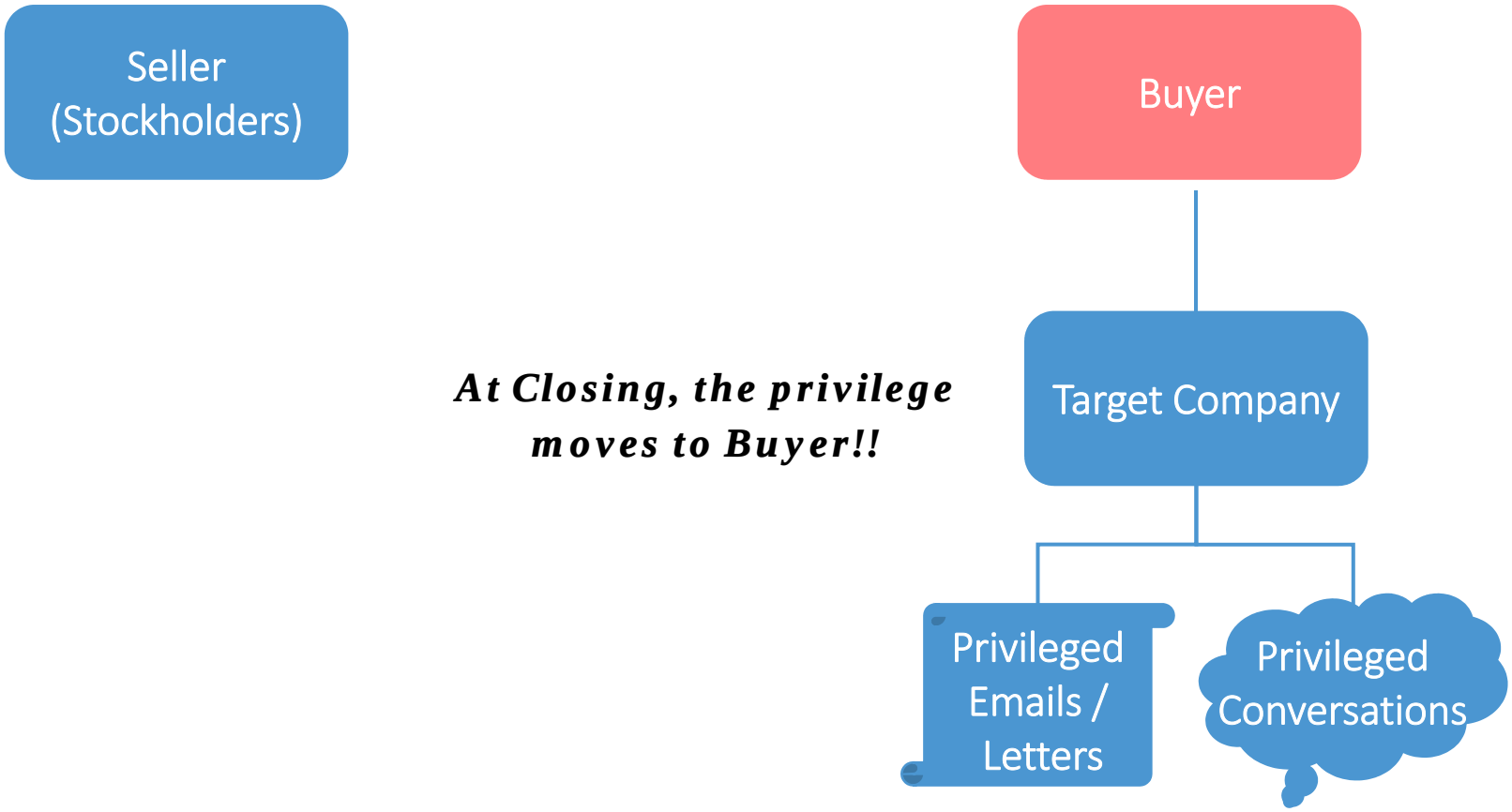
Attorney Client Privilege in M&A
Default Rule



Privilege held by Target Company

Attorney Client Privilege in M&A
Default Rule



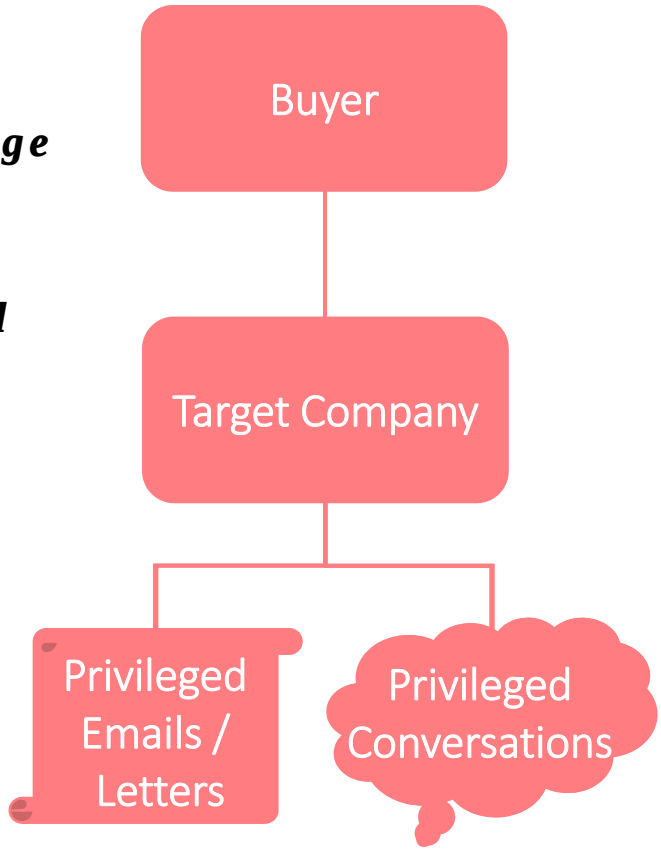
At Closing, the privilege moves to Buyer!!

Attorney Client Privilege in M&A
Default Rule

Seller (Stockholders)

At Closing, the privilege moves to Buyer!!

. . . and is controlled by Buyer in litigation against Seller.



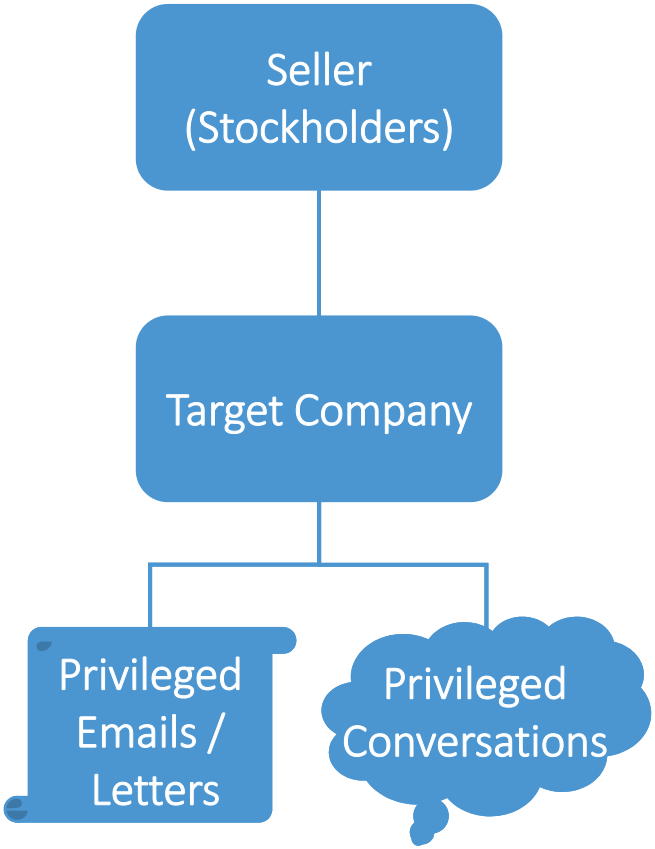
"Don't tell the Buyer about these minor diligence issues"

→ **Intentional breach**

"Don't tell Buyer about these major diligence issues"

→ **Fraud**

Attorney Client Privilege in M&A
Solution

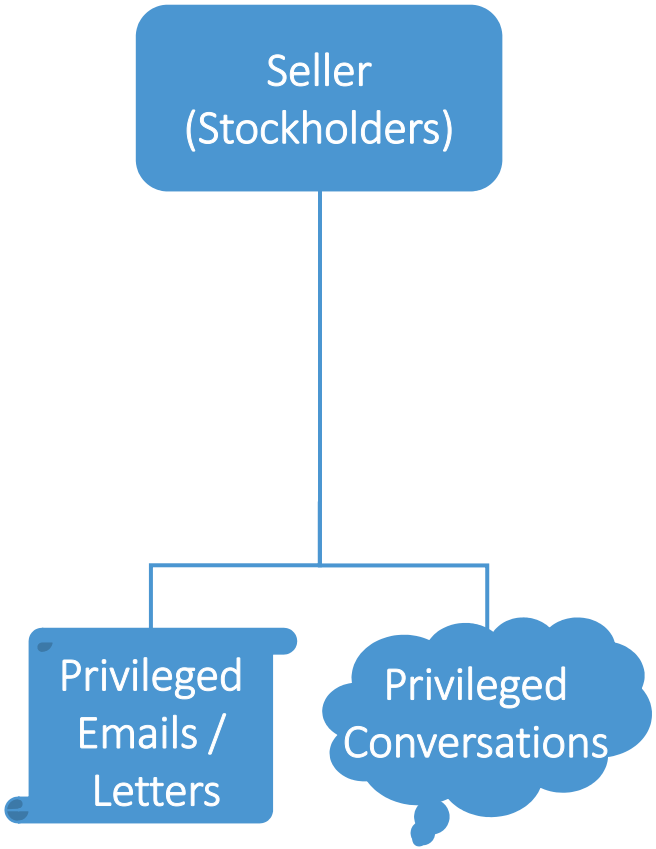


All privileged communications other than those carved out below

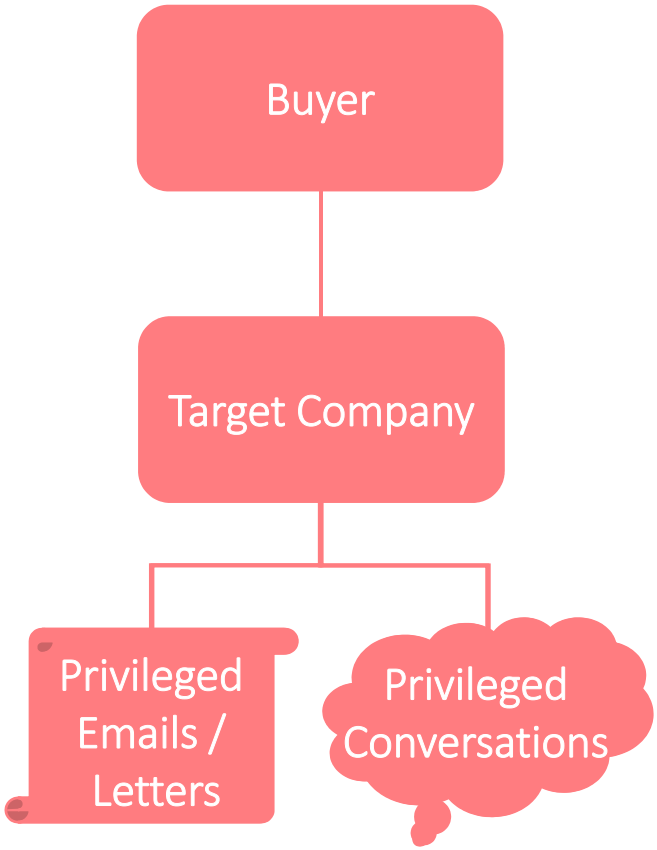
The solution is to split the privilege

Deal related communications used in litigation between Buyer and Seller

Attorney Client Privilege in M&A
Solution



Deal related communications used in litigation between Buyer and Seller



All other privileged communications

Attorney Client Privilege in M&A
Implementation

- Merger Agreement / Stock Purchase Agreement should say:
  - Certain privileged communications remain with Seller's representative
    - Deal related discussions only
    - Used in the context of litigation between Buyer and Seller
  - Disclosure to Buyer does not waive the privilege
- Buyer should also waive any conflicts for legal counsel to represent Sellers in post-Closing deal disputes
- Can also be implemented through pre-signing conflict waivers or engagement letters
  - Not as clear, because Buyer did not consent
  - Only effective between Target and Sellers - does not waive conflicts with Buyer to fully enable legal counsel to represent Sellers post-Closing
  - May need to be disclosed in the schedules as a waiver of rights out of the ordinary course
- References
  - *Shareholder Representative Services LLC v. RSI Holdco, LLC*, C.A. No. 2018-0517-KSJM (Del. Ch. May 29, 2019)
  - *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP*, 80 A.3d 155 (Del. Ch. 2013)

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Recent Delaware *Caremark*-Related Cases

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Recent Delaware *Caremark*-Related Cases

Caremark Claims

- Under Caremark, a board may have breached its duty of loyalty if either:
  - (i) the directors completely fail to implement any reporting or information system or controls, or
  - (ii) having implemented such a system or controls, consciously fail to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.
- This is a relatively high bar, but recent Delaware cases have withstood a motion to dismiss and the courts seem particularly concerned when the issues involve a failure of oversight with respect to regulatory and legal compliance as to a company's "critical product."
- Because this claim is a breach of a duty of loyalty instead of duty of care claim, directors may have personal liability.

Recent Delaware cases have permitted so-called *Caremark* claims to proceed beyond the pleadings stage.

Recent Delaware *Caremark*-Related Cases

Marchand v. Barnhill (Blue Bell)

- The case arose from a listeria outbreak in Blue Bell's manufacturing plants. As a result, three people died, and Blue Bell recalled all of its products, shut down production at its plants, and laid off one-third of its workers.
- Delaware Supreme Court overturned the Chancery Court and ruled that the plaintiff alleged particularized facts supporting a reasonable inference that the Blue Bell board "made no effort" to implement a board-level system to monitor the safety of the company's only product.
- Supreme Court considered: Blue Bell did not have a committee of the board focused on food safety; no regular processes or protocols existed that required management to update the board on food safety issues; there was no regular schedule for the Board to consider key safety food risks; in the lead-up to the listeria outbreak (when there were red and yellow flags), there was no mention in the Board minutes.
- This case proceeded upon the basis of a failure of the first prong of the Caremark test (failed to implement a monitoring program).

In re Clovis Oncology, Inc. Derivative Litigation

- The case arose out of the failure of a once-promising lung cancer treatment, which Clovis withdrew from FDA consideration in 2016 after disappointing clinical trials.
- The Delaware Chancery Court held that while there was a compliance system in place, the Board ignored multiple warning signs and red flags that management was inaccurately reporting the drug's efficacy before seeking confirmatory scans to corroborate the drug's cancer-fighting potency—violating both internal clinical trial protocols and associated FDA regulations.
- The Court noted that the "Board consciously ignored red flags that revealed a mission critical failure."

Recent Delaware *Caremark*-Related Cases

- Boards should identify critical risks to the company's business and operations and ensure there are appropriate board-level reporting systems for each critical risk.
  - Both Marchand and Clovis emphasize that when a company operates in an environment where externally imposed regulations govern its "mission critical" operations, the board's oversight function must be more rigorously exercised.
  - The board's consideration of those risks (and any yellow or red flags raised) should be carefully and thoroughly documented.
- The board should assess whether there are enough directors with the expertise to engage with management on these critical risks.
- The board should determine whether each critical risk can be managed by the board or an existing board committee, or if a new standing committee would aid the board in performing its oversight function.

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Antitrust Updates

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Antitrust Updates

- Both the DOJ and FTC have taken an interest in "killer" acquisitions—transactions where a nascent or upstart competitor is acquired by a larger incumbent.
  - DOJ sued to block Sabre's acquisition of Farelogix, an alleged upstart competitor in airline booking services.
  - In March 2018, the FTC filed a complaint to challenge CDK Global, Inc's acquisition of Auto/Mate, Inc. CDK ultimately abandoned the transaction.
  - Note: DOJ and FTC may challenge acquisitions that fall below the HSR threshold requiring a filing.
- In its press release regarding CDK, the FTC stated:

"The evidence indicated that Auto/Mate was also a threat to other incumbent DMS [dealership management system] providers, and, importantly, was poised to become an even more effective competitor in the near future. The Commission's action shows that it will block a proposed merger if a large, established firm seeks to eliminate competition from a small but significant and developing competitor that is delivering substantial competitive benefits in innovation, price, and quality."

Antitrust Updates

- State attorneys general have also stepped up enforcement into the tech sector and M&A transactions viewed as lessening competition.
  - Texas AG Ken Paxton, joined by nearly every state, has announced a probe into Google
  - Nine state AGs, led by New York, are also investigating Facebook.
  - ~12 state AGs and DC have sued to block the Sprint/T-Mobile proposed merger notwithstanding the DOJ having cleared the transaction and the FCC having voiced support for the transaction.
- Senator Warren has drafted proposed legislation entitled "Anti-Monopoly and Competition Restoration Act" which would (among other things) to essentially block strategic mergers.
- The bill would amend the Clayton Act to categorically ban what it calls "mega mergers" where either company has annual revenue of at least $40 billion; both companies have annual revenue of at least $15 billion each; the deal would result in the merged company having more than 45% of relevant market share as a seller or more than 25% as a buyer; or the deal would result in there being fewer than four remaining competitors with at least 10% market share.
- The bill would also give the FTC the ability to retroactively review and unwind any such mega merger dating back to 2000.

Changes in the administration or other political goals may impact antitrust enforcement actions.

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