GIBSON DUNN
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NO-SHOPS & FIDUCIARY OUTS: A SURVEY OF 2012 PUBLIC MERGER AGREEMENTS

One of the fundamental tenets of corporate law is that boards of directors owe fiduciary duties to the corporation and its stockholders. In the context of a sale of the corporation, these duties may require a board of directors to pursue multiple transactions in an effort to ensure that the corporation's stockholders receive the highest price reasonably available for their shares. However, once a merger agreement has been signed, the board of directors of the target corporation typically becomes subject to contractual commitments not to pursue alternative transactions and to recommend the transaction to its stockholders. The potential tension between a board's fiduciary duties to obtain the highest price reasonably available when it is in "Revlon" mode and its commitments in the merger agreement is implicated when an event occurs after the signing of the merger agreement—such as the receipt of a competing acquisition proposal—that would normally require a board, in satisfying its fiduciary duties, to change direction and withdraw its recommendation of the transaction.

Fiduciary out provisions in a merger agreement aim to reconcile the tension between a board's continuing fiduciary duties, on the one hand, and the binding no-shop covenants of the merger agreement, on the other hand. Because this need to protect a target corporation board's ability to exercise its fiduciary duties is in opposition to a buyer's desire for deal certainty, fiduciary out provisions can become some of the most hotly negotiated provisions of a merger agreement. Nevertheless, the resulting compromises often fall within a known universe of options.

In this article, we examine many of the provisions at the center of such negotiations. We have compiled data relating to a target's ability to negotiate with an alternative bidder, the requirements to be met before a target board can change its recommendation, each party's ability to terminate a merger agreement in connection with the fiduciary out provisions, and the consequences of such a termination. Our data pool consists of 59 merger agreements filed with the Securities and Exchange Commission during 2012 reflecting transactions with an equity value of $1 billion or more.

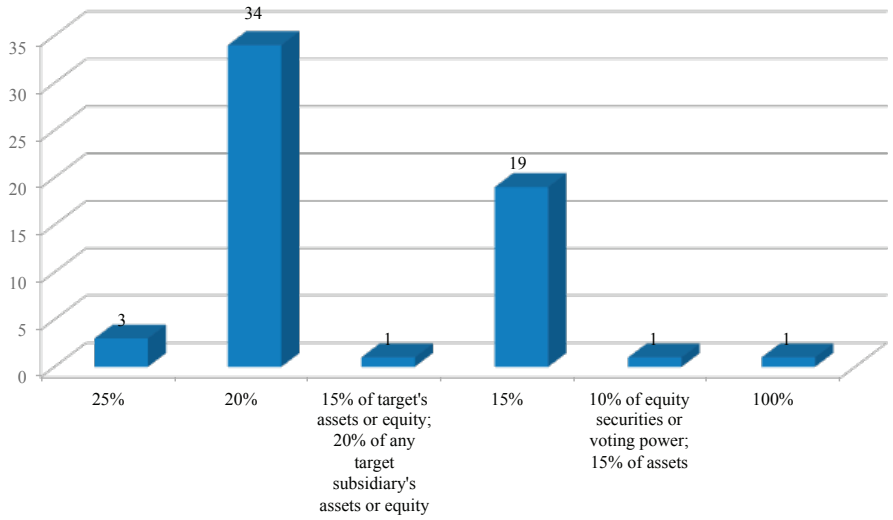
WHAT'S INSIDE

Target's Ability to Negotiate with an Alternative Bidder

Virtually every public merger agreement includes covenants, often referred to as "no-shop covenants," restricting the target's ability to negotiate with an alternative bidder. Sometimes the no-shop covenants take effect immediately upon signing the merger agreement, while other times they spring into effect after a period of time during which the target is permitted to actively solicit competing offers.[1]

Typically, the no-shop covenants require the target to terminate any existing negotiations with respect to "acquisition proposals" and not to initiate, solicit or otherwise facilitate any new negotiations with respect to an "acquisition proposal." Because the no-shop covenants do not apply to all transactions—only acquisition proposals—the definition of "acquisition proposal" is a key point of negotiation. As shown in chart 1 below, typically an "acquisition proposal" is defined as a transaction involving at least 15% or 20% of the target's equity or assets.

Chart 1: Trigger for "Acquisition Proposal"



Determinations Regarding Fiduciary Duties

No-shop covenants are rarely absolute. That is, notwithstanding the no-shop covenants, a target will almost always be permitted to engage in negotiations with respect to an acquisition proposal if certain requirements are satisfied. In some merger agreements, one of those requirements is that the target's board of directors determines that its fiduciary duties necessitate engaging in such negotiations. However, not all merger agreements contain this requirement—as shown in chart 2 below, approximately 32% of the merger agreements we reviewed did not include such a requirement—and those that do contain this requirement are not uniform in their formulation of the determination to be made by the target's board of directors. For example, a more buyer-friendly formulation may require

1 For the purposes of this article, we have not examined provisions that permit the target to actively solicit competing offers, often referred to as "go-shop provisions." However, we note that only eight agreements (or 13.5%) of the agreements we reviewed included go-shop provisions.

PRE-SIGNING PUBLIC M&A CHECKLIST FOR IN-HOUSE COUNSEL

When a public M&A deal commences, in-house counsel often face the daunting task of coordinating various work streams involving both outside counsel and company personnel while juggling responsibility for spotting legal issues and managing communications. Below is a checklist to assist in-house counsel of public companies when they become engaged in an M&A transaction:

1. NON-DISCLOSURE AGREEMENT

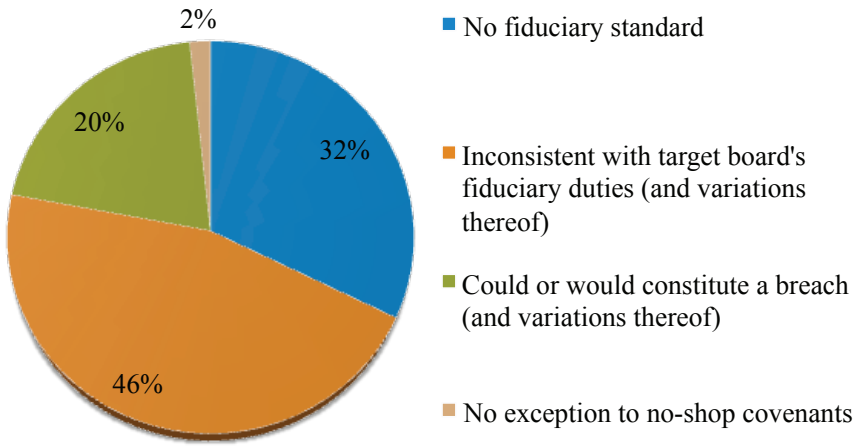
- Enter into non-disclosure agreement: When parties first engage in merger talks they should execute a confidentiality or non-disclosure agreement.
- Negotiate sensitive provisions: Special attention should be paid to whether it is appropriate to include "standstill" provisions restricting the potential buyer from acquiring the target's securities.

2. BOARD UPDATES

- Gauge initial interest: In connection with a change of control or material M&A transaction, management should consult with the board to gauge the directors' initial reaction to the proposed transaction and, if the transaction appears to be viable, should schedule a special board meeting to discuss whether or not to proceed.

that the target's board determine that not engaging in negotiations "would be a breach of its fiduciary duties," whereas a more seller-friendly formulation may require a determination that not engaging in negotiations "would be reasonably likely to be inconsistent with its fiduciary duties." Chart 2 below sets forth some of the more common formulations and their prevalence in the precedent we reviewed.

Chart 2: Fiduciary Determination Required Before Target Can Engage in Negotiations with Alternative Bidder



Entering into an Acceptable Confidentiality Agreement

Another requirement that a target typically must satisfy before it can engage in negotiations with respect to an acquisition proposal is to enter into a confidentiality agreement with the alternative bidder. Of course, this raises the issue of what provisions, if any, must be included in that confidentiality agreement. Merger agreements vary widely in their answer to this question. Many require that the confidentiality agreement be "no less favorable" or "no less favorable in any material respect" to the target than the target's existing confidentiality agreement with the buyer, whereas others require that the confidentiality agreement be "no less favorable in the aggregate" or "customary" for a transaction of this nature. Chart 3 below shows some of the more common formulations and the prevalence of those formulations in the precedent we reviewed.

Many of these definitions regarding what is an acceptable confidentiality agreement between a target and an alternative bidder speak to the confidentiality agreement as a whole but fail to address specific provisions. As a result, whether or not a particular provision is required may not be entirely clear. For example, consider whether the confidentiality agreement must include a standstill provision—that is, a provision in which the alternative bidder agrees to restrictions on its ownership of the target's securities and its conduct with respect to the target. If the alternative bidder's confidentiality agreement must be no less favorable to the target than the target's existing confidentiality agreement with the buyer,

- Regular updates: Throughout the negotiation process, management should keep the board regularly informed of material developments, and the board should actively oversee the process.

3. FINANCIAL ADVISOR

- Engage financial advisor: Once the potential target's board has decided to pursue a possible transaction, it should engage a financial advisor or investment bank to assist with the process. A financial advisor can serve as a liaison for negotiating purposes and assist the board in evaluating the financial terms of the transaction. Recent Delaware cases have highlighted the problems associated with conflicts of interest of financial advisors. The company should pose questions to financial advisor candidates to solicit information regarding conflicts, such as the financial advisor's relationship with potential transaction counterparties, so that the board can assess the financial advisor's independence.

4. CONFLICTS

- Evaluate potential conflicts: The board should evaluate whether the transaction poses any potential conflicts involving members of the board or management. Potential conflicts can arise in a variety of situations, including due to management's participation in the transaction.

- Consider need to form a special committee: In the event potential conflicts arise, consideration should be given to whether it is appropriate to form a special board committee of

and the buyer's confidentiality agreement contains a standstill provision, then the answer is most likely yes. But what if the alternative bidder's confidentiality agreement must be "customary" or "not materially less favorable"? Or the buyer's confidentiality agreement does not include a standstill? In these cases, the answer may be ambiguous. Therefore, a practitioner should take care to identify any particular provisions, such as standstill provisions, where its client would be well served to have certainty regarding whether such provisions must be part of a confidentiality agreement with an alternative bidder. As shown in chart 3 below, a number of merger agreements address specific provisions, such as standstill and exclusivity provisions, when defining the requirements of an acceptable confidentiality agreement.

Chart 3: Definition of Acceptable Confidentiality Agreement

Standard	Number (Percentage)
"No less favorable" to the target or "not less restrictive"	31 (52.5%)
"Customary"	13 (22%)
Must permit target to comply with the merger agreement	12 (20.3%)
Does not have to restrict alternative buyer from making an unsolicited bid	10 (17%)
Standstill explicitly required	9 (15.3%)
"No less favorable in any material respect"	7 (11.9%)
"No less favorable in the aggregate"	6 (11.3%)
Cannot provide for exclusivity	3 (5%)
"Substantially similar"	3 (5%)
Standstill provision may be less favorable but, if so, such provision in the buyer's agreement is deemed amended or shall be amended to include such less favorable provision	2 (3.4%)
"No less favorable in any substantive respect"	2 (3.4%)
"Not materially less favorable" to the target	1 (1.7%)
"Not materially less restrictive in the aggregate"	1 (1.7%)
Standstill provisions not taken into account for purposes of determining whether agreement is acceptable	1 (1.7%)
If less favorable terms, company must offer to amend the buyer's agreement	1 (1.7%)

Waiver of Standstill Provisions

We addressed above standstill provisions as they relate to the target entering into new confidentiality agreements with alternative bidders. But what about standstill provisions with potential alternative bidders that the target had in place prior to signing the merger agreement? After execution of the merger agreement, can the target waive these provisions in hopes that an alternative bidder will offer a better deal, or must the standstill provisions stay in place?

As shown in chart 4 below, many merger agreements—including approximately 37% of the agreements we reviewed—are silent on this point, meaning targets in those deals are left to interpret whether the general language of the no-shop covenants regarding the non-solicitation of alternative proposals prohibits a waiver of existing standstill provisions.

In a number of other deals, the parties opted for certainty. As shown in chart 4 below, in almost all of these deals the parties included language expressly prohibiting the target from waiving existing standstill provisions. The Delaware

disinterested directors to negotiate the transaction and should engage a separate financial and legal advisor to assist in the process.

5. CONFIDENTIALITY

- Form an internal working group: To avoid premature disclosure of the potential transaction, companies should usually restrict the number of individuals within and outside the company who know about transaction.

6. TRADING IN COMPANY SECURITIES

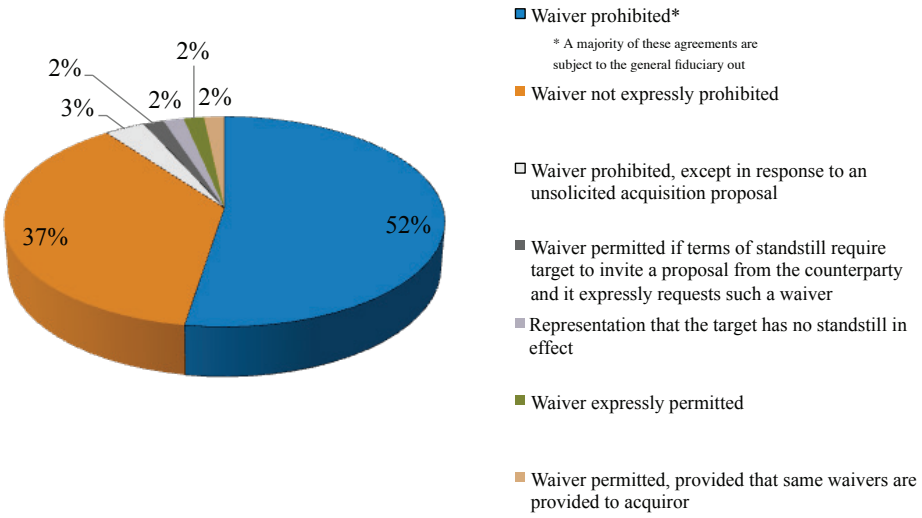
- Impose restrictions on trading: Companies should also consider imposing a "blackout" on insiders' transactions while the transaction is being negotiated. In-house counsel will need to consider the impact of closing the trading window for all employees or just for the internal working group with knowledge of the transaction. Consideration should be given to the fact that following the public announcement of a transaction, pre-announcement trading in the companies' securities may be scrutinized by stock exchanges, the Financial Industry Regulatory Authority and the Securities and Exchange Commission. The company should also assess with counsel the need to suspend any ongoing share buyback program.

7. PUBLIC DISCLOSURE

- Design a plan to respond to inquiries: Although federal securities laws generally do not require disclosure of preliminary M&A negotiations, a company should

Court of Chancery has recently focused on the intersection of "don't ask/don't waive" standstill provisions with the fiduciary out provisions of merger agreements and have questioned the efficacy of fiduciary out provisions in certain circumstances when "don't ask/don't waive" standstill provisions are in place with potential alternative bidders. While the rulings have made clear that Delaware has determined that such "don't ask/don't waive" provisions are not per se invalid, the rulings do raise a number of questions regarding the permissibility of prohibiting the target from waiving existing standstill provisions combined with a no-shop covenant. For a more detailed discussion regarding this issue, see *In re Ancestry.com: Has Delaware Weakened the Use of Standstills in Auctions?* below.

Chart 4: Right to Waive Standstill Provisions



Changes in the Target Board's Recommendation

Aside from the no-shop covenants, the buyer will include covenants in the merger agreement that require the target's board of directors to recommend that the target's stockholders vote in favor of, or tender into in the case of a two-step transaction, the buyer's deal and prohibit the target's board of directors from changing this recommendation. Faced with these restrictions, the target will attempt to preserve the flexibility of its board of directors to satisfy its fiduciary duties. Because a change of recommendation by the target's board of directors is detrimental to the buyer's deal, many provisions within the recommendation covenants are negotiated intensely.

Bases for Changing the Recommendation

A threshold issue in the recommendation covenants is whether the target's board of directors should be permitted to change its recommendation in favor of the buyer's deal and, if so, under what circumstances is it permitted to change its recommendation. The answer to the first question is, almost universally,

be prepared to respond to rumors that could have an impact on the company's stock price. Premature disclosure of a transaction can lead to unusual market activity in the company's stock price, making an immediate public announcement necessary in some transactions.

8. ANTI-TRUST MATTERS

- Engage anti-trust counsel: Because most public company transactions will need to be reported pursuant to the Hart-Scott-Rodino regulations, consideration should be given to whether the transaction will likely be scrutinized by regulators. Companies should consider engaging anti-trust counsel early in transactions that will involve a heightened level of review.

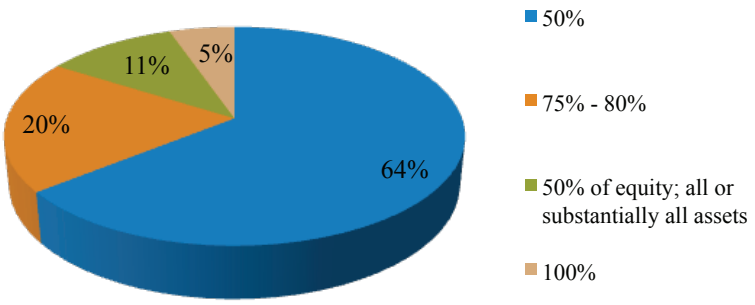
- Develop procedures for document creation: Any documents created for the purpose of analyzing a potential transaction may have to be submitted to anti-trust regulators. Companies should develop guidelines for creating written work product and particular attention should be paid to documents related to the impact on competition and consumers.

- Establish clean team (if necessary): As a general rule, parties to a transaction that are actual or potential competitors must remain full arms-length competitors until a deal closes. To facilitate the due-diligence process and exchange of information it may be necessary to establish a "clean team" consisting of members of the in-house legal department and outside advisors that will have access to potentially sensitive information.

yes. Virtually every public merger agreement, including each of the 59 merger agreements we reviewed, permits the target's board of directors to change its recommendation.

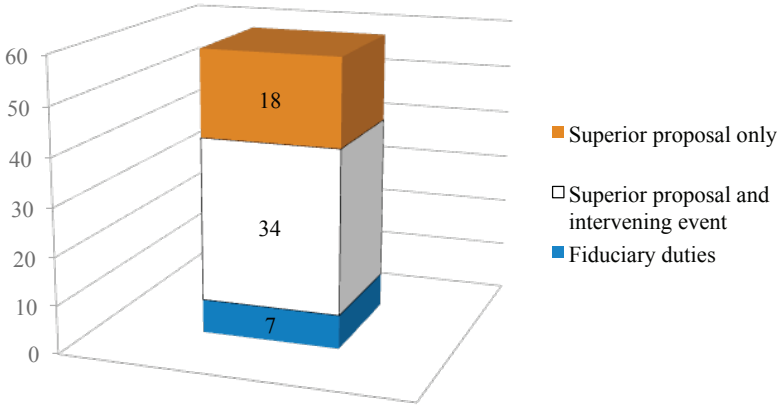
The circumstances under which the target's board is permitted to change its recommendation are less settled. The target will argue that its board of directors should be permitted to change its recommendation at any time it is necessary to comply with the board of directors' fiduciary duties. The buyer, on the other hand, will insist that the target's board of directors commit to the buyer's deal and only change its recommendation in the event it receives a "superior proposal." As shown in chart 5 below, typically a superior proposal must relate to an acquisition of a majority of the target's assets or equity.

Chart 5: Trigger for "Superior Proposal"



As buyers and targets have continued to negotiate the circumstances under which the target's board is permitted to change its recommendation, increasingly parties have agreed that the target's board is permitted to change its recommendation in response to either a superior proposal or an "intervening event."[2] This alternative represents a compromise between the target's traditional position that its board must retain ultimate flexibility to change its recommendation and the buyer's traditional position that a change of recommendation should be limited to a response to a superior proposal. Chart 6 below shows each of these formulations and the prevalence of those formulations in the precedent we reviewed.

Chart 6: Bases for Target Board of Directors to Change its Recommendation



2 We discuss the meaning of an intervening event in more detail below.

9. LOCAL COUNSEL

- Engage local counsel: Depending on the governing law and jurisdiction of incorporation of the parties involved in a potential transaction, it may be necessary to engage Delaware or other local counsel early in the negotiation process. Local counsel can provide valuable advice regarding compliance with fiduciary duties of directors, potential shareholder approval and/or appraisal rights that may be triggered in connection with the transaction.

10. DUE DILIGENCE

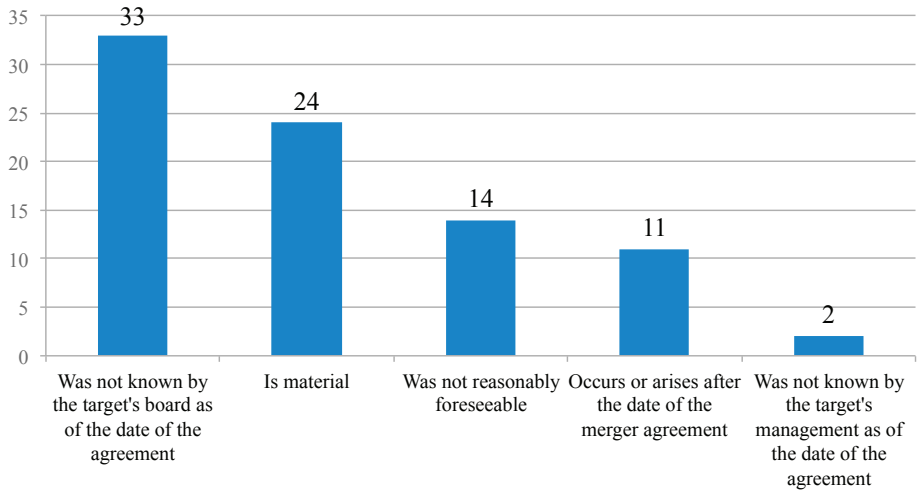
- Organize and obtain due diligence information: One of the initial steps in a transaction is the distribution of a lengthy due diligence request list that will likely cover accounting, financial, tax and legal due diligence items. In-house counsel will be responsible for collecting and organizing information and documents from various departments in the company without alerting individuals of the possibility of a transaction.

- Engage a third-party service provider: It has become increasingly common to respond to due diligence requests by placing documents into "virtual data rooms" where the company can restrict access to certain groups and monitor who is reviewing particular pieces of information.

Definition of "Intervening Event"

As noted above, increasingly the target's board of directors is permitted to change its recommendation in favor of the buyer's deal if the target is faced with an "intervening event." What constitutes an intervening event varies from deal to deal, but typically it requires a material event or circumstance that was not known by the target's board of directors at the time the merger agreement was signed, such as the often cited "gold under the headquarters" scenario. Often there is an additional requirement that the event or circumstance not be reasonably foreseeable at the time the merger agreement was signed. Chart 7 below sets forth some of the more common formulations and their prevalence in the precedent we reviewed.

Chart 7: Definition of "Intervening Event"



Determinations Regarding Fiduciary Duties

Once the target's board of directors determines that it may have a basis for changing its recommendation, it must look to the merger agreement to determine what other requirements must be satisfied. One of those requirements is that the target's board of directors determines that its fiduciary duties necessitate changing its recommendation. Although almost all merger agreements, including each of the 59 merger agreements we reviewed, contain such a requirement, parties often settle on different formulations of the requirement. In general, however, the various formulations are similar to those described above with respect to the no-shop covenants, where the target typically is required to make a similar determination before it can negotiate with an alternative bidder. Chart 8 below sets forth some of the more common formulations and their prevalence in the precedent we reviewed.

11. MAINTAINING A RECORD

- Design a plan to ensure an adequate record: Shareholder litigation challenging a sale transaction has become the norm in public company transactions. Maintaining an appropriate record of the negotiation process will be essential in dealing with these issues. In-house counsel should document the process through formal board minutes that should be regularly prepared after each meeting with the assistance of M&A counsel.

- Prepare in advance for required disclosure: Most transactions will also require that the target prepare and deliver a merger proxy statement to its shareholders to obtain the necessary shareholder approval for the transaction. The merger proxy statement or other public disclosure document is required to contain a description detailing meaningful interactions between the buyer and target and the internal consideration of the transaction.

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Chart 8: Fiduciary Determination Required Before Target Board of Directors Can Change its Recommendation

Standard	Number (Percentage)
"inconsistent with"	27 (45.8%)
"reasonably likely" and "inconsistent with"	9 (15.3%)
"reasonably likely" to be a breach	5 (8.5%)
"reasonably" be expected to breach	5 (8.5%)
"would violate" or "would be a breach"	4 (6.8%)
"required" or "necessary"	4 (6.8%)
"reasonably" and "inconsistent with"	2 (3.4%)
"more likely than not" to result in a violation	1 (1.7%)
"could be required"	1 (1.7%)
"would be a breach" for superior proposals and "reasonable" for intervening event	1 (1.7%)

Compliance with No-Shop Covenants

Buyers are often concerned about the possibility that the target will breach its no-shop covenants, and that breach will result in a superior proposal or other basis for the target's board of directors to change its recommendation. As a result, a buyer often will negotiate for a provision restricting the ability of the target's board of directors to change its recommendation if the target breaches the no-shop covenants. In response, the target will argue that it should only be subject to this restriction if the breach is material or if the breach results in the superior proposal at issue. As a result of this tension, there is no settled approach to this issue. Chart 9 below sets forth some of the more common formulations and their prevalence in the precedent we reviewed.

Chart 9: Compliance with No-Shop Covenants Before the Target Board of Directors Can Change its Recommendation

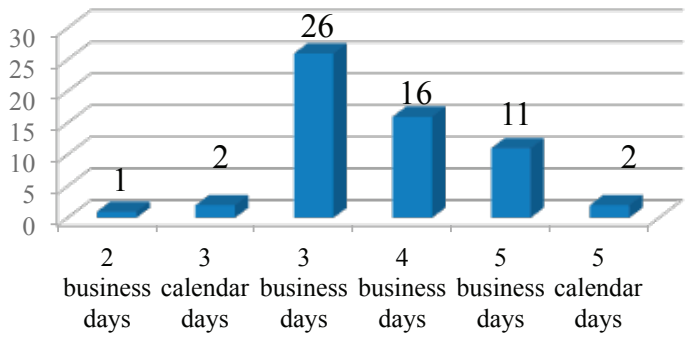
Standard	Number (Percentage)
Superior proposal must not have resulted from a breach	24 (40.7%)
Absolute compliance required	15 (25.4%)
Compliance in all material respects required (or other materiality qualifier)	11 (18.6%)
No compliance required	9 (15.3%)
Separate requirement of compliance with the covenants related to the proxy statement and stockholders meeting	1 (1.7%)

Matching Rights

In the event a target receives a superior proposal, or a material revision to that superior proposal, a buyer will want the opportunity to revise the terms of its existing deal with the target in order to match or exceed the superior proposal. This opportunity is often referred to as "matching rights." Matching rights are standard provisions in merger agreements—of the 59 merger agreements we reviewed, 58 provided the buyer with matching rights.

One common point of dispute with respect to matching rights is the period of time that the buyer has to respond. The vast majority of merger agreements provide for a matching period ranging from three to five business days—see chart 10 below. In addition, because matching rights typically apply to each successive revised superior proposal, not just the initial superior proposal, targets will argue that the buyer needs less time to consider and respond to successive revised superior proposals. As a result, in recent years merger agreements increasingly include shorter matching periods for successive revised superior proposals. Of the 59 merger agreements we reviewed, 26 included such shorter matching periods.

Chart 10: Matching Rights



Terminating the Merger Agreement

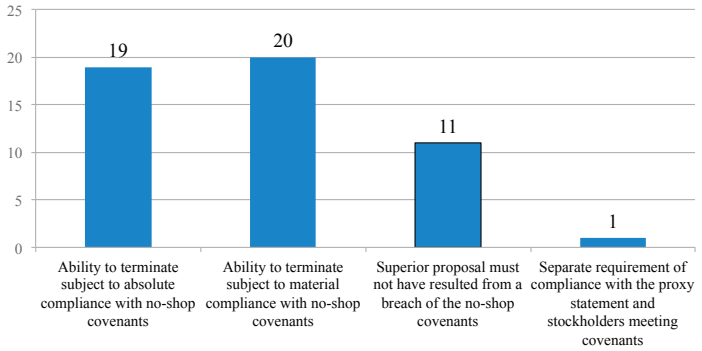
Deal certainty, or lack thereof, is at the heart of most merger agreement negotiations. As a result, the negotiations in connection with the no-shop and change in recommendation provisions in the merger agreement often include a particular focus on the termination provisions. As with a number of the other provisions discussed above, the buyer will want to limit the target's ability to terminate the merger agreement to pursue an alternative transaction, whereas the target will attempt to preserve as much flexibility as possible. Below we discuss a number of provisions in which this tension plays out in the merger agreement.

Force the Vote

Given the buyer's concerns about deal certainty, including the instability that results from the target receiving competing offers, the buyer may require that the merger agreement provide that the target cannot terminate the merger agreement in the event of a superior proposal or a change in recommendation by its board of directors. This is often referred to as "force the vote," because regardless of whether the target has a superior proposal waiting in the wings or an intervening event has occurred, the buyer can force the target's stockholders to vote on the buyer's deal. The target is likely to resist force the vote because it wants to retain its board of director's ability to maximize value for its stockholders by immediately terminating the merger agreement and entering into a more favorable transaction, rather than waiting for its stockholders to vote down a financially inferior transaction in the face of a superior proposal. Moreover, a target may be concerned that force the vote will deter potential bidders from making competing bids for the target because the alternative bidder's ability to enter into an agreement with the target will be necessarily delayed by the filings and processes associated with the stockholders' meeting to vote on the original transaction. Of the 59 agreements we reviewed, only eight include force the vote provisions.

In the event a merger agreement does not include force the vote, meaning the target can terminate the merger agreement in order to enter into a superior proposal, typically there will be a number of other requirements that must be met before the target can terminate. For example, nearly all of the merger agreements we reviewed require the target to have complied with the no-shop covenants. Often, the language is more buyer-friendly, requiring absolute compliance with the no-shop covenant. However, it's not uncommon for the target to successfully negotiate that there must be a connection between the breach and the superior proposal or that the breach must be material before the target loses its termination right. Chart 11 below sets forth the conditions that the target must satisfy before it may terminate a merger agreement in connection with a superior proposal.

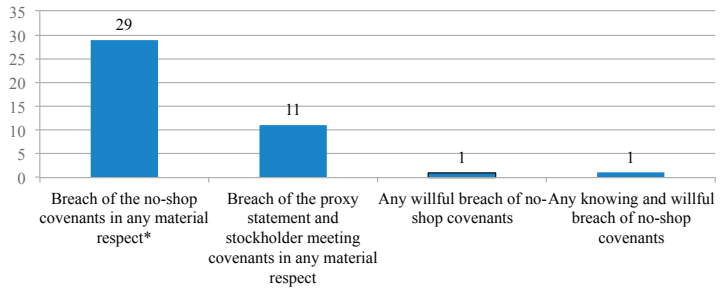
Chart 11: Conditions to Target's Termination in Order to Enter into a Superior Proposal



Buyer's Right to Terminate for Target Breaches of No-Shop and Stockholder Vote Covenants

Typically, a target's breach of the no-shop covenants gives the buyer the right to terminate the merger agreement. Of the 59 agreements we reviewed, only 23 do not provide this separate right to terminate. Beyond a breach of the no-shop covenants, a buyer may be able to terminate the merger agreement for a target's breach of certain covenants relating to securing the required target stockholder vote. Generally, these covenants relate to certain actions and timelines in connection with the filing of the proxy statement and the stockholders' meeting. Chart 12 below sets forth certain covenants that, when breached by the target, will provide the buyer with an independent basis for terminating the merger agreement.

Chart 12: Buyer's Right to Terminate for Breaches of No-Shop and Stockholder Vote Covenants



* Of such 29, two require willfulness, two require intent, one requires knowledge and willfulness, and one requires that the breach results in an acquisition proposal

Break-Up Fees

A target is likely to owe a break-up fee if the merger agreement is terminated by the buyer in connection with a breach of the no-shop covenants by the target, if the target terminates the merger agreement in connection with

a superior proposal or if the buyer terminates the merger agreement in connection with a change in recommendation. In fact, all of the agreements that do not have force the vote provisions require the payment of a break-up fee if the target terminates the agreement to enter into a superior proposal. Moreover, all of the agreements we reviewed require the payment of a break-up fee if the buyer terminates the agreement because the target's board changes its recommendation. Also, in about half of the agreements we reviewed, a break-up fee is triggered due to the target's breach of the no-shop covenants.

Typically, a target is also required to pay the break-up fee if an acquisition proposal is pending when the merger agreement with the buyer terminates (generally due to the target's stockholders' failure to approve the transaction or the expiration of the outside date) and the target subsequently completes or enters into a definitive agreement with respect to an acquisition proposal. The tail period usually is one year, but three agreements provided for a shorter period of nine months and one agreement provided for an eighteen-month period.

There is some variation in the size of break-up fees, and a few merger agreements that we reviewed provide for fees that vary based on the trigger. Nevertheless, it appears that most fees hover around 3% of equity value and few are greater than 3.5% of equity value.[3] Chart 13 below sets forth the distribution of break-up fee size in the agreements that we reviewed.

Chart 13: Break-Up Fee Amounts

Fee Amounts (as a percentage of the equity value)	Number (Percentage)
Expenses only (subject to cap)	2 (3.4%)
Less than or equal to 1%	1 (1.7%)
Greater than 1% and less than or equal to 1.25%	0 (0%)
Greater than 1.25% and less than or equal to 1.5%	2 (3.4%)
Greater than 1.5% and less than or equal to 1.75%	4 (6.8%)
Greater than 1.75% and less than or equal to 2%	2 (3.4%)
Greater than 2% and less than or equal to 2.25%	2 (3.4%)
Greater than 2.25% and less than or equal to 2.5%	5 (8.5%)
Greater than 2.5% and less than or equal to 2.75%	5 (8.5%)
Greater than 2.75% and less than or equal to 3%	7 (11.9%)
Greater than 3% and less than or equal to 3.25%	4 (6.8%)
Greater than 3.25% and less than or equal to 3.5%	14 (23.7%)
Greater than 3.5% and less than or equal to 3.75%	4 (6.8%)
Greater than 3.75% and less than or equal to 4%	1 (1.7%)
Greater than 4% and less than or equal to 4.25%	2 (3.4%)

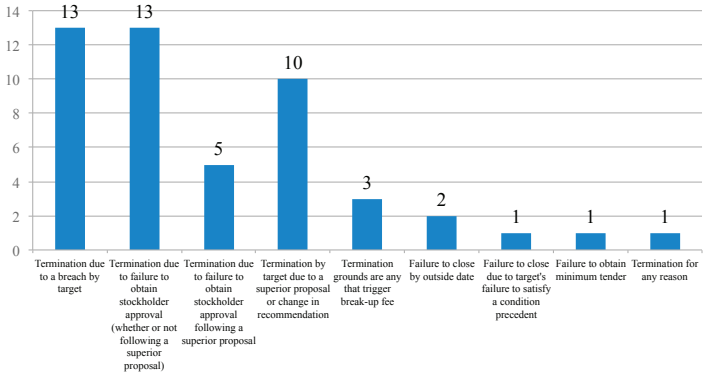
3 The size of a break-up fee may vary depending on the size of the transaction, with larger transactions having lower break-up fees as a percentage of equity value. As noted above, our data pool consists of 59 transactions, each involving an equity value of $1 billion or more.

Expense Reimbursements

A majority of the merger agreements that we reviewed (57.6%) provides for expense reimbursement of some kind. Most of these agreements provide for expense reimbursement payable solely by the target (65% of the agreements providing for expense reimbursement). About a quarter of the agreements providing for expense reimbursement provide for mutual expense reimbursement, while only two provide for expense reimbursement payable solely by the buyer. In addition, 22% of the agreements include a "naked no vote" expense reimbursement provision, meaning the target owes the buyer the expense reimbursement in the event the stockholders fail to approve the transaction, regardless of whether the target received an alternative proposal prior to the stockholders' meeting.

Expense reimbursement by a target may also be triggered by a termination due to failure to obtain stockholder approval after the target receives an alternative proposal, due to a superior proposal or change in recommendation, or due to a breach by the target. Chart 14 sets forth the triggers for expense reimbursement by a target.

Chart 14: Triggers for Expense Reimbursement by Target



Similarly, the most frequent triggers for expense reimbursement payable by the buyer are termination due to breach by the buyer, due to failure to obtain approval by the buyer's stockholders, and due to failure to close by the outside date.

The caps on expense reimbursement vary based on the trigger in only two cases. The vast majority of the merger agreements we reviewed includes a cap on expense reimbursements of 1.00% or less of equity value. Chart 15 below sets forth the distribution of expense reimbursement caps in the agreements that we reviewed.

Chart 15: Caps on Expense Reimbursements

Cap (as a percentage of the equity value)	Number (Percentage)
No cap	1 (1.7%)
Less than or equal to 0.25%	10 (16.9%)
Greater than 0.25% and less than or equal to 0.50%	14 (23.7%)
Greater than 0.50% and less than or equal to 0.75%	3 (5.7%)
Greater than 0.75% and less than or equal to 1.00%	2 (3.4%)
Greater than 1.00%	4 (6.8%)

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IN RE ANCESTRY.COM: HAS DELAWARE THREATENED THE USE OF STANDSTILLS IN AUCTIONS?

In the immediate aftermath of the *In re Complete Genomics* and *In re Ancestry.com* rulings, a number of market participants offered guidance on the importance of the rulings, focusing on the future use of so-called "don't ask, don't waive" provisions in standstill covenants. These provisions prohibit potential bidders from either publically or privately requesting that a target company waive the terms of the standstill provision. However, after reviewing the lineage of the opinions and rulings leading up to *In re Complete Genomics* and *In re Ancestry.com*, we are concerned these two rulings raise more questions than they answer; questions that go to the viability of Delaware companies using standstills with bidders combined with a no solicit covenant in the acquisition agreement.

Before we discuss the implications of these rulings, it is important to review the line of cases and rulings that led up to *Complete Genomics* and *Ancestry*, starting with then Vice-Chancellor Strine's 2007 opinion in *In re The Topps Company Shareholders Litigation*, C.A. No. 2786-VCS. While perhaps best remembered for the Court of Chancery's endorsement of the practice of using go-shop provisions to satisfy a board's *Revlon* duties, *Topps* importantly also addressed the situation when a seller relies upon an existing standstill agreement during a go-shop period to prevent a party from making a topping bid for reasons other than maximizing value for shareholders. In response to agitation from shareholders, Topps agreed to sell itself to Michael Eisner, the former CEO of Walt Disney, and the private equity firm Madison Dearborn (we will refer to the buyers collectively as Eisner). Importantly, Eisner agreed to retain senior management of Topps, including Topps' Chairman and CEO, who was the son of one of the company's founders. At Eisner's insistence, Topps did not engage in any pre-signing auction and instead relied on 40-day go-shop period in order to determine if there were any other buyers and to satisfy the board's *Revlon* duties. During the go-shop period, Topps' bankers held initial conversations with

Upper Deck, Topps' principal competitor and a company that had expressed interest in a transaction in the past. As was the case with all other parties interested in Topps, Upper Deck signed a non-disclosure agreement with a standstill provision. At the conclusion of the go-shop period, Upper Deck made an offer of $10.75 for Topps, a full dollar higher than the Eisner deal. However, Topps asserted it was concerned with Upper Deck's ability to finance the transaction and with the antitrust risk of the deal, and elected not to continue negotiations with Upper Deck. Upper Deck subsequently made a revised, unsolicited bid in which it attempted to allay the antitrust concerns with a "hell or high-water" provision, which was still deemed insufficient by Topps to warrant a negotiation.

In his opinion, Strine finds that the record "evidences [the Chairman/CEO's] diffidence toward Upper Deck and his comparatively much greater enthusiasm for doing a deal with Eisner. Eisner's deal is premised on continuity of management and involvement of the [founding family] in the firm's business going forward. Upper Deck is in the same business line and does not need [the Chairman/CEO] or his top managers." It is on this basis, the allegation of favoring one bidder over another in an end stage transaction, that Strine enjoins Topps from enforcing its standstill with Upper Deck so that Upper Deck could make an offer directly to Topps' shareholders. Importantly, Strine notes that "[s]tandstills serve legitimate purposes. When a corporation is running a sale process, it is responsible, if not mandated…to establish rules of the game that promote an orderly auction and to give the corporation leverage to extract concessions from the parties who seek to make a bid." However, Strine continues that "standstills are also subject to abuse…and can be used by a target to improperly favor one bidder over another, not for reasons consistent with stockholder interest, but because managers prefer one bidder for their own motives" and further notes that "Topps refused [to waive Upper Deck from its standstill], despite its undisputed right under the Eisner Merger Agreement to grant such a relief if the board believed its fiduciary duties so required."

Four years then pass until this issue next appears in a 2011 settlement hearing in *In re RehabCare Group, Inc. Shareholders Litigation*, C.A. No. 6197-VCL, a case before Vice-Chancellor Laster. The bulk of the hearing is spent on the amount of attorneys' fees to be awarded given the terms of the settlement agreement: (i) an increase in the consideration of $0.10 per share, (ii) a reduction in the deal protection provisions and (iii) supplemental disclosure regarding potential conflicts of interest with the target's financial advisor. One of the deal protection changes the parties voluntarily agreed to was a waiver of standstill provisions in place with financial sponsors that participated in the target's pre-signing auction. Importantly, there were no allegations of favoritism to one bidder to the detriment of another and the target viewed this as an "easy give." Specifically, the target shopped the company prior to signing, and no one, including the parties to the standstills, offered any indications of interest in acquiring the target. So in the context of a settlement agreement counsel to the target offered "the track record gives us comfort in agreeing to…reduce deal protection measures as part of settlements. Sometimes it's an easy give." The Court, in articulating the value conferred by the waivers, noted "I do think it is weird that people persist in the 'agree not to ask' in the standstill. When is that ever going to hold up if it's actually litigated, particularly after *Topps*….It doesn't give you any ultimate benefit because you know that the person can get a *Topps* ruling making you let them ask, at a minimum, or can ask in a back channel way." The Court never provides additional guidance on why a bidder who participated in an auction process that is free of allegations of favoritism would be able to get a "*Topps* ruling" to enjoin the enforcement of a standstill.

The key opinion which first linked the effects of standstill provisions with a no solicitation covenant came in 2012's *In re Celera Corporation Shareholder Litigation*, C.A. No. 6304 VCP. Like *RehabCare*, *Celera* was decided in the context of approving a settlement agreement. And like *RehabCare*, the parties agreed to waive the standstill agreements with bidders that had participated in Celera's pre-signing market check. The standstills in question included the now well known "don't ask, don't waive" provision and the standstill was styled in the opinion as a "Don't Ask, Don't Waive Standstill." When examining the value of waiving the standstills with previous bidders, Vice-Chancellor Parsons noted the standstills "block at least a handful of once-interested parties from informing the Board of their willingness to bid…, and the No Solicitation Provision blocks the Board from inquiring further into those parties' interest….Moreover, the increased risk that the Board would outright lack adequate information arguably emasculates whatever protections the No Solicitation Provision's fiduciary out otherwise could have provided." Parsons is focused on the effect the combination of a standstill, which prohibits a bidder from making an unsolicited offer, and the no solicitation covenant, which prohibits a target board from negotiating

with a competing bidder, has on the efficacy of the fiduciary out found in acquisition agreements.

Finally, we arrive at *In re Complete Genomics* and *In re Ancestry.com*. Somewhat surprisingly, these rulings have been described as the "don't ask, don't waive" rulings. But as we will discuss in greater detail below, the implications of these rulings are much broader. On November 27, 2012, Vice Chancellor Laster issued a bench ruling in *In re Complete Genomics, Inc. Shareholder Litigation*, C.A. No. 7888-VCL, enjoining the enforcement of a "don't ask, don't waive" provision in a standstill agreement. In Complete Genomics, the company explored a sale of the company and entered into several confidentiality agreements with standstills, some of which had "don't ask, don't waive" provisions. The company ultimately entered into a merger agreement with another party, but did not waive the existing provisions and continued to entertain proposals from other bidders. The Court analogized the "don't ask, don't waive" provision to an impermissible "no-talk" provision in a merger agreement, which prevents a target company from discussing alternative transactions with third parties. The Court found that the Complete Genomics board impermissibly limited its ability to discharge its ongoing statutory and fiduciary obligations by agreeing to such a provision. Specifically, the Court found that the board limited its ability to evaluate competing offers, to disclose material information, and to make a meaningful recommendation to stockholders on a merger.

On December 17, 2012, Chancellor Strine issued a bench ruling in *In re Ancestry.com Inc. Shareholder Litigation*, C.A. No. 7988-CS, in which the Court declined to enjoin a stockholder vote on the basis of a "don't ask, don't waive" provision in a standstill agreement and permitted the stockholder vote to go forward after the company made additional disclosures, including disclosures related to the use of the provision. There, the target company's board conducted an auction to sell the company and entered into several standstill agreements with potential bidders that included "don't ask, don't waive" provisions. Chancellor Strine noted that this provision is a "powerful tool" and boards must be aware of the "potency of the clause." Ultimately (during the pendency of the transaction litigation) the seller waived the bidders' "don't ask, don't waive" provisions and the Chancellor permitted the shareholder vote to approve the merger to proceed with additional disclosure regarding the preclusive effect the "don't ask, don't waive" provisions had on the bidders' ability to submit a topping bid. However, the Chancellor strongly suggests the additional disclosure, absent the waiver of the "don't ask, don't waive" provisions, would not have been sufficient to avoid his enjoining the shareholder vote.

Before we address where this line of rulings leaves Delaware companies going forward, allow us a quick aside on the practical implications of the relief granted in *Complete Genomics*. Upon waiving the "don't ask, don't waive" provision, each bidder was still subject to the standstill's prohibition on making an offer to acquire the target, but were obviously permitted to request a waiver of this provision. The target, however, was subject to the merger agreement's no solicitation covenant, which expressly prohibited granting "any permission, waiver or request under any 'standstill,' confidentiality or similar agreement or obligation," subject to the merger agreement's fiduciary out. The fiduciary out, however, was conditioned on the target's receipt of a "bona fide written unsolicited Acquisition Proposal that…constitutes or could reasonably be expected to result in a Superior Proposal." In a classic Catch-22, the bidder is of course prohibited by the standstill from submitting a bona fide acquisition proposal absent a waiver of the standstill. It is therefore unclear, at least to the authors of this note, what benefit this equitable relief bestowed upon the shareholders. The Ancestry merger agreement does not suffer this same fate as it includes a carve-out to the no solicitation covenant that affirmatively allows the target to waive any existing standstill; a bidder could therefore request a waiver to the standstill (assuming there is no "don't ask, don't waive" provision), the target could waive the standstill, the bidder could submit a superior proposal and the parties would find themselves in the familiar jumped-deal scenario. However, in our view of the market this represents the minority position in transactions that do not include a go-shop provision. This leads us to the implications of these decisions and rulings going forward. One could read *Complete Genomics* and *Ancestry* narrowly as only applying to "don't ask, don't waive" provisions. Under this narrow reading, the implications are fairly limited and parties may choose to waive the "don't ask, don't waive" provisions contemporaneously with the execution of the merger agreement. Parties will still most likely want the "don't ask, don't waive" provision during the pendency of the auction, since the provision does provide meaningful protection during the auction and in the case of a failed auction that does not result in a transaction, for the duration of the standstill. However, after tracing the genealogy of the doctrine that lead to the rulings (i.e., *Topps* and *Celera*) and the practical result of the waivers in *Complete Genomics*, it seems unlikely

this narrow reading will carry the day. Under the more expansive reading of the cases, which views *Complete Genomics* and *Ancestry* as extensions of *Celera*, the appropriateness of standstills generally after signing an acquisition agreement is unclear. On the one hand, we have Chancellor Strine's strong endorsement of the use of standstill's in *Topps* to "promote an orderly auction and to give the corporation leverage to extract concessions from the parties who seek to make a bid." However, we must also consider Vice-Chancellor Parsons' observation in *Celera* that such a provision, when combined with a no solicitation covenant, "block[s] at least a handful of once-interested parties from informing the Board of their willingness to bid…, and the No Solicitation Provision blocks the Board from inquiring further into those parties' interest."

Unfortunately, *Complete Genomics* and *Ancestry* raise more questions than they answer. Until such time as Delaware provides clear guidance on the role of standstills combined with a no solicitation covenant, boards and their advisors will have to simply rely on the Delaware maxim that there is no single blueprint in satisfying *Revlon* duties, and trust that reasonable decisions designed to maximize value for shareholders will create a record sufficient to survive judicial scrutiny.

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SHAREHOLDER ACTIVISM UPDATE

According to FactSet, in 2012 shareholder activists launched 219 campaigns against U.S. companies, a 22% increase from 2011. Third Point's successful campaign against Yahoo!, Starboard's proxy fight against AOL, and Carl Icahn's protracted battle with CVR Energy are just some examples of the many high-profile activist campaigns that attracted significant media attention during the last year. In light of the relative success of a number of prominent activist funds during 2012 and the increasing levels of investment in activist hedge funds, we expect shareholder activism to continue playing a prominent role in the corporate landscape during 2013. In that regard, we make the following observations:

Activist Funds Are Increasingly Targeting Large Cap Companies.

We are witnessing a significant increase in the number of large-cap companies that are the subject of activist campaigns, which in the past had typically been limited to middle-market and small-cap companies. According to data released by sharkrepellent.net, within the first 9 months of 2012 there was a 16.7% increase in campaigns against companies with a market capitalization of over $1 billion, compared to the same period in 2011 (a 150% increase compared to 2010 and a 289% increase since 2009). Forest Laboratories, Inc. for example, a company in the pharmaceutical space with a market cap of approximately $10 billion, elected one of four Icahn nominees to its Board after finding itself in the activist's crosshairs this past year. This trend is also evident outside the United States, demonstrated by Pershing Square's 2012 success with the Canadian company CP Rail. Activist funds understand that in light of ISS' and institutional shareholders' inclination to support short slates and general corporate governance proposals, it is not necessary to accumulate a significant stake in a large-cap company to run a successful dissident campaign.

Broadening of the Scope of Activists' Campaigns.

Over the last few years, activist campaigns have continued, on average, to broaden in scope. Although we continue to witness a number of instances where activists' main agenda is to precipitate a sale of the target company (normally for smaller targets), there has been a significant increase in the level of refinement of activists' proposals. In a number of recent instances, activists have successfully launched campaigns

seeking the reorganization of target companies through the divestiture of non-core assets and split-offs of non-complimentary businesses. For example, in August 2012, activist investor Nelson Peltz won a seat on the board of Ingersoll Rand, a company he had suggested breaking up into three separate entities. By the end of the year the company had announced plans to spin off the firm's security division. We expect that over the coming months activists will continue to mount campaigns at similarly large companies where they perceive the opportunity to create value by means of spin-offs, split-offs and similar transactions.

Other activist "asks" that we expect to continue include requests for representation on boards and committees, return of cash to shareholders (via dividends and buybacks), changes in strategic direction and capital allocation plans, and corporate governance reforms.

"We are witnessing a significant increase in the number of large-cap companies that are the subject of activist campaigns, which in the past had typically been limited to middle-market and small-cap companies."

Increased Willingness to Engage with Activists.

We have witnessed an increasing willingness on the part of corporate boards and management to engage in a dialogue with potential activists long before a public proxy battle erupts. A number of these engagements have actually resulted in target boards privately demonstrating to the potential activist analytical flaws in the activist's analysis or proposals, thus averting a public confrontation. In other instances, boards have deemed it appropriate to settle with the activist, offering one or two board seats in order to avoid a public and expensive proxy battle that would divert managerial attention and company resources for several months. Of course, in many instances the gap between the activist and target is such that no constructive engagement can bridge the gap, and a public battle cannot be averted. However, in light of the current state of shareholder activism, the power wielded by ISS and institutional shareholders, and the general political environment, it is generally recommended that target companies consider making an effort to constructively engage with a potential activist investor before the matter erupts into a public campaign.

Long Term Planning Is the Best Defense Against Activism.

Ultimately, the best defense against shareholder activism is long-term preparation. As a threshold matter, investors will generally acknowledge the efforts of a well-functioning and informed board that demonstrates a coherent long-term plan. Periodic reviews of business trends, company-specific information, long and medium-term objectives and available opportunities to create shareholder value, will all create a good record to defend the company against an activist campaign.

In addition, year-round engagement with proxy advisory firms and major institutional shareholders is highly recommended in order to cement support among the company's traditional shareholder base—large shareholders tend to be suspicious of a company that makes an effort to engage in a dialogue with its shareholders only after an activist publicly threatens to launch a proxy fight. Also, in-house investor relations teams should work continuously with management and outside advisors to monitor inbound calls from well-known activists. For example, we advise that investor relations teams keep at all times a list of the major activist funds and alert senior management of any inbound calls from these investors. Many activist campaigns commence with a casual call to the company's investor relations personnel.

Year-round stock-watch and shareholder identification programs have also been successful in assisting companies in the early detection of stock accumulation by activist funds. It is important for companies to keep in mind that activists can put together significant stakes in a company before they have to make public disclosure of their positions via a Schedule 13D filing.

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BAD NEWS...

6 THINGS TO DO FOLLOWING A SHARP STOCK PRICE DROP

A sharp drop in the price of a company's stock is all too often followed by a securities class action lawsuit and episodes of shareholder activism. While every company's situation will be different, we generally suggest that companies consider doing the following six things to best position themselves in the event a lawsuit is filed or an activist shareholder accumulates a significant stock position:

1 Protect Internal Analyses of "What Went Wrong"

Following an adverse development, senior company officials will often ask managers or department heads to prepare reports analyzing what went wrong. We recommend that any analysis of what went wrong should be created under the supervision of the company's attorneys and addressed either to the company's general counsel, another in-house lawyer, or outside counsel. All written communications regarding the analysis should be identified as privileged.

2 Monitor Court Filings and Internet Postings

Often, plaintiffs' counsel do not actually serve a complaint for several days or even weeks after filing the complaint. To learn of a new filing, have your outside counsel monitor the daily alerts they receive from online services such as Courthouse News Front Page, as well as by asking them to check the docket summaries in the jurisdictions where plaintiffs are most likely to file suit (usually the company's principal place of business and state of incorporation).

3 Review the Company's Insurance Policies

Collect and review copies of the company's insurance policies, including any directors and officers liability coverage. In the event that a lawsuit is filed, the company should promptly notify its primary and any excess carriers.

4 Establish A Media and Investor Relations Strategy

We recommend immediately developing a media strategy, including designating a person to handle media contacts. Generally, statements to the media regarding litigation should be limited to acknowledging that a lawsuit has been filed and stating that the company's attorneys are investigating the allegations. Similarly, any comments related, or in response, to stockholder activism should be fully vetted with counsel and senior management, as they will set the tone of discourse with the activist, other stockholders and proxy advisory firms. We recommend that the company's internal IR team have at all times a list of the most prominent activist stockholders, such that they can promptly alert senior management in the event any of them contacts the company.

5 Implement a "Stock Watch" Program

The company should promptly establish a program to closely monitor all trading activity in its stock to detect any usual trading pattern or stock accumulation.

6 Establish a Media Strategy

The company should conduct, with outside counsel, a comprehensive review of its defensive profile to assess and understand what vulnerabilities it has and what defense mechanisms are available in the event it becomes the subject of a stockholder activist campaign. A superficial "check the box" analysis, while convenient and inexpensive, may fail to uncover subtle vulnerabilities in a company's defenses. A company may believe it has the defensive protection provided by a particular provision in its organizational documents (such as a staggered board), but if that provision is not properly drafted, an activist may be able to exploit a flaw and render the protection useless before the company has time to react.

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