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M&A CONFERENCE SERIES

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Sweetening the Deal: Digitizing M&A for Market Advantage
Gregg Albert, Managing Director, M&A, Accenture Strategy
Gerald Duarte, Managing Director, M&A Accenture Strategy
Tim Ziemann, Senior Manager, M&A Accenture Strategy

Historically, strategic M&A has been an art. Today’s dealmakers, however, are offered a market advantage that can add science to the mix.

Digital technologies, applied correctly, can minimize the disruption that typically occurs in any merger or acquisition. They can not only reduce M&A risk, but also help companies get to growth faster.

Picture this: For a US$1B-revenue business sold at the median industry EBITDA multiple, being able to close the deal three months earlier could generate significant value. We have seen up to US$15-$30M for the buyer and US$15-$45M for the seller.

These are not castle-in-the-sky figures. They are actual advantages savvy companies create by using digital technologies to sweeten deals—adding speed and enabling new M&A business models.

Your company can do the same.

Break with tradition

Many companies continue to apply a traditional M&A approach to deals that are increasingly untraditional.

For example, recent Accenture Strategy research of 1,100 C-suite executives around the globe reveals the reasons spurring a deal are changing. While traditional reasons such as new markets will always exist, acquisitions centered on digital capabilities are on the rise. More than half of companies logging M&A activity (52 percent) described themselves as primarily acquiring digital companies or assets. This is not surprising, given more than a third (37 percent) of organizations are pushing business model transformation to drive projected 2020 growth.

To get to that growth more rapidly, in all deals – but particularly in those involving at least one highly digital party – M&A teams should be thinking beyond traditional closing models.

Companies actively acquiring digital companies are learning that they require different types of closing arrangements and agreements in part because of the competition for digital assets. The speed required to be truly competitive in M&A mandates companies operate within shorter sign-to-close windows.

Gains erode quickly if companies cannot reap the benefits of the merger or acquisition in short order. Digital is the only tool at their disposal that can deliver within the accelerated timeframe today’s rapid business pace demands. Many companies fall short in this area currently. One Accenture Strategy study shows only seven percent of respondents are currently able to acquire a progressive target from contact to closing within 120 days.

A joint venture between private equity and a large digital healthcare company purchased a multibillion dollar digital medical device business that spanned 100+ countries from a global life sciences company. Without its own infrastructure to run the business, the joint venture successfully achieved a sign-to-close window of just six months. It accomplished this by a combination of limited liability Distribution
Service Agreement (DSA), Interim Commercial Agreement (ICA), Technical Sales Office (TSO) and Secondments.

We believe one of the ramifications of increasingly digital M&A is that lengthy TSAs between a buyer and a seller will be a relic three to five years from now.

The TSA model has inherent disadvantages to both buyer and seller. The seller is saddled with long-term TSAs in operational areas of the sold business that distracts focus on the remaining business. It also delays rightsizing of their organization and brings potentially higher stranded costs.

While TSAs ensure business continuity for the buyer, they also delay synergies, create higher operational costs—as TSAs generally have markups anywhere from 5 to 20 percent—limit buyer flexibility and increase dependency on the seller.

A chemicals company bought by private equity wanted to introduce new products and go to new markets, but was dependent on the seller to make the relevant changes to IT systems to do so. The buyer’s speed-to-market was severely impacted due to the seller’s limited ability to move faster than the agreed upon service-level agreements.

Buyers and sellers are looking for different models to avoid such pitfalls while ensuring speedier close time, no adverse impact on business continuity and better financial outcomes. This requires rethinking how companies close the sale of a business or asset.

By replacing the elements of the traditional closing model with more innovative, technology-fueled ones, companies can drive a deal to conclusion faster, reduce stranded costs, achieve synergies faster and minimize cross-company dependencies. The appetite is there – roughly half of organizations cite their capacity and capability for M&A as a barrier to organic growth.

Eliminating TSAs with digital technology

Transitional Service Agreements (TSAs) are meant to provide business continuity after a deal, giving the new company or buyer time to transition to its own support solution. Within a TSA—typically lasting six months to two years—the seller must provide corporate functions such as back-office administration to the buyer.

While TSAs may appear to be purely administrative, in Accenture’s experience they often have strategic consequences for both buyer and seller. Not paying sufficient attention to TSAs increases the risk that players will leave value on the table.

Digital technologies like blockchain and smart contracts allow peer-to-peer data sharing in a secure, distributed ledger. Cloud technology will allow entire infrastructures to be shifted from one company to another quite rapidly, eliminating the need for the seller to maintain legacy infrastructure until the buyer gets up to speed and transfers can be made. Other types of “bridge services” provided by ecosystem players (e.g. distributors) can also reduce the need for TSAs.

Cloud, digital ecosystem players, blockchain and smart contracts make the transfer from one entity to another straightforward and speedy—eventually eliminating the need for TSAs of any nature.
Bridge services for speed and simplicity

Increasingly sophisticated digital technologies mean IT concerns no longer have to slow down a deal.

This should be good news for the 84 percent of executives surveyed who indicate they are interested in ways to industrialize the M&A process. Cloud platforms now allow IT vendors to provide bridge services to M&A parties, while expanding the available closing models. That means companies no longer have to rely on their own in-house IT capabilities to close a deal; a third party can help the acquisition for as long as necessary.

Bridge services allow buyers to execute a TSA with a third party who can minimize the disruption to the existing business. Eight out of 10 executives agree that M&A activities push their company to utilize third-party providers for new technology adoption. One company leveraged third-party driven lean distribution across key markets to make an asset more attractive to private equity buyers. The buyer was willing to pay a higher price than the seller’s best-case internal analysis because having the distribution handled allowed it to focus on increasing revenue, aligning the product portfolio and other market initiatives rather than on TSA exit plans. The seller was able to extract approximately $80 million more in price than their internal valuation analysis indicated was feasible.

Create a new digital capability

An increasing number of companies are stringing smaller acquisitions together to create or expand a capability.

Accenture has done just that in purchasing a series of digital and creative agencies. CEO Pierre Nanterme made the end goal clear: “. . . we are now a key player in the agency world. We are gaining massive market share. We’re becoming certainly a leader in digital marketing solutions.” When doing such string-of-pearls acquisitions, innovative closing models are key to maintaining speed and business continuity.

But while companies acquire more and more to create or buy a capability, they also need to create their own digital M&A capability. Acquiring digital assets to create true market advantage requires scientifically executing against a master plan. A solid capability cannot be created from a smattering of disparate digital assets. Instead, companies need to apply a deliberate strategy to speed time to close—creating a sustainable cohesive capability through an ecosystem of partners. Nine out of 10 executives agree that to be successful, companies must develop new M&A capabilities—specifically those that help them choose when to buy, partner, invest or incubate as they execute digital business models.

Getting to market advantage

With the stakes as high as they are – up to US$15-$30M for the buyer and US$15-$45 million for the seller – companies cannot begin soon enough to transform their M&A with digital. We suggest a few things to begin:

- **Frame buyer responsibilities early:** Start to define buyer responsibilities for Day 1 as early as the due diligence phase – even earlier if possible. In tandem, develop a TSA blacklist that breaks down the services essential to close the deal versus those that are off limits. Don’t let your organization’s current capabilities limit the possibilities.
• **Embrace the ecosystem, which will be partially tied to M&A value:** No one player will be able to provide the full capabilities business model transformation requires. Because of this fact, companies will need to agree on closing models that are more open, flexible and inherently collaborative.

• **Execute the business model at conference-room scale to test readiness:** Set up a minimal viable product that your team can use to simulate a set of transactions. Doing so will allow you to prove whether your model will work or not, clarifying if third-party providers truly have the capabilities your company requires.

**Sweeten the deal**

Focusing on the business of your business during and after a merger or acquisition is increasingly crucial due to the increased pace of business in a digital era.

Applying technology to help your company do just that can sweeten the results of any deal.
New Rules for M&A in Consumer Products

Scope deals are harder to get right.

By Peter Horsley, Allison Snider and Brian McRoskey
Peter Horsley is a Bain & Company partner based in London, and Allison Snider is a partner based in New York. Both are members of Bain’s Consumer Products and Mergers & Acquisitions practices. Brian McRoskey is a partner in Boston and a member of Bain’s Consumer Products and Organization practices.
At a Glance

- Over the past few years, industry disruption and growth challenges have changed the rules of the game for consumer products companies.

- In addition to initiatives to spur organic growth, many are turning to M&A, especially scope M&A, to respond to these challenges.

- At the same time, the industry continues to attract attention from financial investors and activists.

- To be successful in this new environment, the best consumer goods companies frequently update their M&A playbooks across strategy, diligence and integration approaches.

For decades, consumer products companies typically joined forces in megamergers designed to build scale and market-leading positions. A wave of consolidation has swept over the industry in the past 10 years, including some of the largest deals inked—Anheuser-Busch InBev and SABMiller, Coca-Cola bottlers’ integrations in Europe and Japan, and Mars and Wrigley, among many others. This was a tried and tested formula to boost earnings growth and margins, as well as the next round of consolidation.

The changing rules of the game

Now, companies are finding that’s not enough to help them respond to industry disruption. Times have changed. Nimble insurgents are taking an outsize share of category growth, Bain & Company research finds. While they may account for only 2%–3% of the market share in the 45 categories we analyzed, they captured around 35% of the growth over the last two years, up from 25% between 2012 and 2016. (For more, see “How Insurgent Brands Are Rewriting the Growth Playbook” and Local Insurgents Shake Up China’s “Two-Speed” Market.) Incumbents also grapple with digitalization, the emergence of low-cost retailers and online/offline retail ecosystems, and an unavoidable new fact of life: The benefits of scale in everything from media buying to retailer negotiations to go-to-market strategy are diminishing.

These factors, combined with an internal focus on the bottom line, have led to a growth slowdown for most consumer goods companies. In response, firms are taking short-term actions, such as trading off margins to regain market share. They are also undertaking different types of deals.

Responding to industry challenges with scope M&A

Strategic deal value in the consumer products industry increased by 9% to reach $181 billion in 2018. In addition to engaging in more M&A, many CP executives are turning to scope deals. Bain’s analysis of the top 200 strategic deals in consumer goods from 2015 to 2018 shows this rise. For the third year
in a row, scope deals outnumbered scale deals (see Figure 1). Scope deals are intended to spur growth in fast-growing new markets or geographies, or to get access to critical capabilities—not only to increase scale or generate cost synergies. Scope deals like the Keurig Green Mountain merger with Dr Pepper Snapple and Coca-Cola’s purchase of Costa Coffee now represent 66% of consumer goods M&A.

As these acquirers are learning, scope deals are harder to get right. They are more expensive due to higher deal multiples, which reflect the superior growth profile of the target assets. They call for new approaches to diligence and integration. They often require a new operating model to allow people to work together. Yet, they are increasingly an antidote to stave off the pressure of disruption while addressing the growth imperative.

**Ongoing involvement from financial investors and activists**

At the same time, financial sponsors, mainly private equity firms, are evolving their role. Many sponsors are behaving like strategics, with long-hold funds of up to 15 years, megafunds that enable megadeals and add-on dealmaking that drives industry consolidation. Add-on entries made up around one-third of all sponsor deals a decade ago. They comprise close to half of the total today.

**Figure 1:** Scope-oriented M&A has accelerated in consumer products

<table>
<thead>
<tr>
<th>Year</th>
<th>Primarily scale oriented</th>
<th>Primarily scope oriented</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>2016</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>2017</td>
<td>40</td>
<td>60</td>
</tr>
<tr>
<td>2018</td>
<td>34</td>
<td>66</td>
</tr>
</tbody>
</table>

Scope deals increased from 50% to 66%

Notes: Top 50 strategic deals announced in year, excluding nonstrategic deals such as asset or property acquisitions, financial investment deals, government acquisitions, internal reorganizations or minority stake acquisitions; deals classified by primary rationale using a proprietary classification framework, as per stated strategic rationale at the time of announcement; deals involve consumer product companies as acquirers or targets

Sources: Dealogic, Bain M&A deal database (2018)
While strategic acquirers still represent the overwhelming majority of deals (see Figure 2), financial sponsors like 3G Capital are increasing the competition. The number of private equity buyout firms hunting for deals has risen steadily each year for a decade. They are more active and hold record levels of uninvested capital. In addition to being competitors, they are also potential buyers of noncore businesses that consumer goods companies want to exit. More sponsors are proactively approaching consumer products companies with offers to buy assets that are not yet on the market.

Meanwhile, activist investors are intensifying their demands for companies to be sold in whole or in part. Between January and October 2018, across all industries activists targeted more than 800 companies. Overall, more than 20% of activist campaigns focused on M&A. This is no longer a US trend limited to the likes of Campbell Soup and Procter & Gamble. The trend has moved into Europe—think Danone and Nestlé.

This raises the bar on up-front strategic thinking for proposed deals and the preparation needed for shareholder engagement. Global consumer goods companies now need a proactive approach to managing and strengthening their portfolios, with a sharp eye to the value they add category by category. To avoid being surprised, many have learned to look at their business through an activist lens. As incumbents seek to become nimbler, with more focused category leadership, the spate of divestitures will likely continue.

**Figure 2:** Strategics gained share from sponsors in 2018

![Bar chart showing global consumer products deal value (in $B) and strategics' share (%) from 2008 to 2018. The chart indicates a trend where strategics' share increased from 95% to 88%.](chart)

Notes: Deal value based on announcement year, including deals that are currently pending; strategic buyer deal value includes acquisitions made by public or private companies, including any acquisitions from financial sponsors; sponsor buyer deal value includes leveraged buyouts and secondary buyouts; only rank-eligible deals included (i.e., excluding buyback programs and equity carve-outs).

Source: Dealogic
New Rules for M&A in Consumer Products

**Figure 3:** If done right, M&A creates value—especially with a repeatable model built upon a disciplined M&A capability

![Diagram](https://example.com/diagram.png)

Source: Bain analysis

To be successful in this new environment, the best consumer goods companies are updating their M&A playbooks across strategy, diligence and integration approaches. Let’s look at these areas one by one (*see Figure 3*).

### The imperative to future-proof M&A strategy and screening

More than ever, M&A strategy is the critical starting point for acquiring the assets and capabilities to support a company’s broader growth agenda. In today’s disruptive environment, there are two imperatives: embedding future-back thinking and adopting a broad portfolio approach to dealmaking.

Meeting current growth challenges requires taking a today-forward view of the business. This means looking hard for sources of growth and cost levers in the existing business footprint. Fundamental business transformation, on the other hand, requires taking a future-back view—that is, forming a vision of what the company should look like five years from now and redefining the corporate identity along those lines. Combining these views should be the starting point for M&A strategy (*see Figure 4*).

M&A strategy thus moves beyond market consolidation motives to guide the assets and capabilities that the company needs to acquire to fulfill a future-back mission. We expect a continuation of more growth- and capability-focused dealmaking as the long-term strategic focus pivots to the top line. Three new types of M&A together support this portfolio approach.
New Rules for M&A in Consumer Products

Figure 4: Consumer product majors embed future-back thinking into strategy

1. **Scale insurgent acquisitions**: Consumer goods companies are buying fast-growing scale insurgents to further accelerate insurgent growth, leveraging capabilities such as global distribution. That’s why PepsiCo acquired sparkling probiotic drink maker KeVita, for example.

2. **Cross-sector acquisitions**: Incumbents also are pursuing cross-sector acquisitions to move up the value chain to higher-margin, fast-growing, service-oriented offerings. In a world where the lines between products and services are blurring, these deals are expanding traditional business boundaries.

3. **Corporate venture capital (CVC) investing**: Meanwhile, established consumer products companies are making CVC investments in emerging brands and business models. The amount of corporate venture capital invested in consumer products increased sixfold from 2013 to 2018. These companies recognize that CVC investing will allow them to move fast enough (or identify the trends early enough) to capitalize on new opportunities. For example, Diageo’s Distill Ventures enables it to make small bets on emerging brands as consumer preferences change to healthier alternatives within the alcohol market.

Source: Bain analysis
Redefining due diligence

When pursuing scope deals or insurgent brands, companies need to be able to articulate why they are the right parent. What are the incremental and scalable capabilities that can accelerate the target’s growth trajectory? Articulating the synergistic value is also a point of differentiation from private equity players that may be looking at the same assets.

The focus of diligence is on the future market potential. Fast-growing assets, especially early-stage ones, are particularly tricky to evaluate for potential profitability at scale, yet the ability to be profitable at scale is a key input into the deal model to justify the valuation. We outline a simplified framework that many leading acquirers use to assess the future growth and profitability potential of insurgent brands (see Figure 5). This structured way to evaluate brand fundamentals helps acquirers increase confidence and clarity about how brand penetration may evolve and how they can use their own infrastructure and capabilities to accelerate it.

Given that scope acquisitions typically command 30% higher valuations and generate about 30% lower cost synergies than scale acquisitions, the acquirer needs to be comfortable with some uncertainty: No matter how robust the diligence, the deal may not deliver the expected value. While the potential growth rewards may be tremendous, so are the risks.

Figure 5: Brand diligence checklist

<table>
<thead>
<tr>
<th>Key elements</th>
<th>Typical metrics assessed</th>
<th>Brand performance (standalone and combined)</th>
<th>Illustrative tools</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Growth</strong></td>
<td>Unprompted awareness, conversion and repurchase, performance on key customer purchase criteria, Net Promoter Score®</td>
<td>Weak to Best in class</td>
<td>• Unaided awareness</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>• Penetration funnel</td>
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<td>• Consumer overlap/repertoire</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td>• Share of wallet</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Net Promoter Score and reasons</td>
</tr>
<tr>
<td><strong>Brand memorability</strong></td>
<td>Brand perception, distinctiveness, media reach and effectiveness (traditional and digital)</td>
<td>Weak to Best in class</td>
<td>• Brand associations</td>
</tr>
<tr>
<td></td>
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<td>• Perceptual map</td>
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<td></td>
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<td></td>
<td>• Social media sentiment</td>
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<td></td>
<td></td>
<td></td>
<td>• Quality of distinctive cues</td>
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<td></td>
<td></td>
<td></td>
<td>• Marketing mix and spend</td>
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<tr>
<td></td>
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<td></td>
<td>• Online engagement</td>
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<tr>
<td><strong>Shopper visibility</strong></td>
<td>Distribution reach and effectiveness, in-store execution, online store execution</td>
<td>Weak to Best in class</td>
<td>• Channel mix and penetration</td>
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<tr>
<td></td>
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<td>• Geographic distribution</td>
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<td></td>
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<td></td>
<td>• Retail shelf share and visibility</td>
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<td></td>
<td></td>
<td></td>
<td>• Online store execution</td>
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<tr>
<td><strong>Range productivity</strong></td>
<td>Product range, distribution effectiveness for leading SKUs, assortment strategy</td>
<td>Weak to Best in class</td>
<td>• SKU productivity</td>
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<td></td>
<td></td>
<td></td>
<td>• Price position</td>
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<td></td>
<td></td>
<td></td>
<td>• Promotion effectiveness</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Assortment coverage</td>
</tr>
<tr>
<td><strong>Profit and loss</strong></td>
<td>Trade margins and relationships, profit and loss shape</td>
<td>Weak to Best in class</td>
<td>• Trade relationships</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Trade margins</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Profit and loss shape</td>
</tr>
</tbody>
</table>

Notes: Key elements as per The Bain Brand Accelerator® product toolkit. The Bain Brand Accelerator® is a registered trademark of Bain & Company, Inc.; Net Promoter®, Net Promoter System®, Net Promoter Score® and NPS® are registered trademarks of Bain & Company, Inc., Fred Reichheld and Satmetrix Systems, Inc. Source: Bain analysis
Overcoming integration risks

Consumer goods companies face unique risks when integrating scope deals or insurgent brands—for example, paying too much up front, scaling them too quickly, burdening them with business processes and planning, and losing critical talent. Taking the wrong approach initially makes it more difficult to course correct later. The integration setup needs to ensure that the acquirer doesn’t crush the acquired asset under its existing weight, killing the very culture that led to the acquired brand’s growth. Often, the answer is a physical separation of headquarters and personnel to protect the brand’s culture and ways of working.

The flip side of overintegrating—keeping the brands entirely separate from the base business—doesn’t help to meet growth objectives, either. The acquirer can end up with a portfolio of assets that do not benefit from shared learnings or from the acquirer’s infrastructure. Successful integration relies on the deal thesis to dictate the integration thesis, which defines what activities should be integrated vs. kept separate. Companies need to ensure that the founder or founding team has the independence to make the most strategic decisions in areas such as product development, specialized sourcing and branding.

The functional integration approach in such deals requires an assessment of where to combine to gain scale efficiencies, where to keep the functions separate and where to invest to strengthen core capabilities. Integration approaches can allow the acquired company to opt in to any proposed functional integration. For instance, when L’Oréal bought makeup brand Urban Decay, it kept product design and R&D separate to protect the target’s creative independence and maintain continuity for customers. On the other hand, procurement in select categories and production were combined where possible to reduce costs through scale efficiency. Also, sales and distribution were integrated to expand Urban Decay’s international footprint utilizing L’Oréal’s distribution reach.

The best consumer goods companies not only update their M&A playbooks along these lines but they also acquire frequently. A repeatable M&A model that includes frequent activity is a
proven contributor to success. In fact, our M&A value-creation study, spanning 2007 to 2017, shows that frequent acquirers (those that completed 10 or more deals over that period) outperformed infrequent acquirers by 35% in terms of total shareholder return.

In the face of disruption and growth challenges, many consumer products executives are looking to scope M&A. This profound shift will change how they think about all areas of the M&A cycle, from strategy through diligence to integration and ongoing management. However, as the early experience of some companies shows, clarifying the strategy and mission, developing a portfolio of bets, and adopting a fit-for-purpose diligence and integration approach will determine the winners of the future.
Shared Ambition, True Results

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Bain advises clients on strategy, operations, technology, organization, private equity and mergers and acquisitions. We develop practical, customized insights that clients act on and transfer skills that make change stick. Founded in 1973, Bain has 57 offices in 36 countries, and our deep expertise and client roster cross every industry and economic sector. Our clients have outperformed the stock market 4 to 1.

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We believe a consulting firm should be more than an adviser. So we put ourselves in our clients’ shoes, selling outcomes, not projects. We align our incentives with our clients’ by linking our fees to their results and collaborate to unlock the full potential of their business. Our Results Delivery® process builds our clients’ capabilities, and our True North values mean we do the right thing for our clients, people and communities—always.
2018 Intralinks
Annual M&A Leaks Report
A study by Intralinks and the M&A Research Centre at Cass Business School, City, University of London
Introduction

In the days leading up to a merger and acquisition (M&A) bid announcement, significant trading in the shares of the target company can indicate that information about the deal has leaked. While not providing absolute confirmation of a leak in an individual deal, significant pre-announcement trading across a large sample of deals can be used to examine patterns and trends in leaking across time periods and geographies.

The Intralinks Annual M&A Leaks Report analyzes and reports on deal leaks globally. This report looks at deal leaks for the period from 2009-2017, while placing emphasis on the 2017 findings compared to previous years. The analysis of data for this report was conducted together with the M&A Research Centre at Cass Business School, City, University of London.

Methodology

M&A transaction data for announced deals during the period January 1, 2009 to December 31, 2017, share price and index price information were sourced from Thomson Reuters. The criteria for inclusion in the sample were that the target must be an entity listed on a public stock exchange, that the transaction must involve the acquisition of majority control of the target and that the target’s equity must have a sufficient trading history for its returns to be calculated. The final total sample of deals for the period 2009-2017 was 7,201. A transaction was identified as involving a leak of the deal prior to its public announcement using the event study methodology, which compares the cumulative daily returns of the target in the period from -40 to -1 days prior to the public announcement of the deal with its expected returns. The target’s expected returns are calculated using a linear regression model of the target’s returns during a “normal” trading period against the market return. A transaction was identified as involving a leak of the deal if the cumulative daily returns of the target in the period -40 to -1 days prior to the public announcement of the deal was statistically significantly different compared to its expected returns, at the 95 percent confidence interval for a normal distribution – meaning that there is only a 5 percent probability that the target’s observed returns compared to its expected returns would occur in a random distribution of data, i.e. would be due to chance. Unless otherwise indicated, all references to the region or country location of the target refers to the target’s primary listing location. The total number of leaked deals for the entire period was 558 out of the total number of deals of 7,201.
Key Findings

M&A deal leaks worldwide fell in 2017 compared to the prior year: 8 percent of all deals in 2017 involved a leak of the deal prior to its public announcement, compared to 8.6 percent in 2016. Despite the fall, the rate of leaks in 2017 was still above the average rate of deal leaks of 7.7 percent over the nine-year period from 2009-2017.

Over the period 2009-2013, Europe, the Middle East and Africa (EMEA) had the highest average rate of leaked deals at 10.4 percent; Asia Pacific (APAC) had the second highest average rate of leaked deals at 7.6 percent; and the Americas had the lowest average rate of leaked deals at 6 percent. However, since 2014, this trend has reversed: in each of the last four years, the rate of deal leaks in the Americas and APAC has been higher than in EMEA. The rate of deal leaks in the Americas peaked in 2015 and has since declined in each of the past two years. The rate of deal leaks in APAC has increased in each of the last three years to a nine-year high in 2017, making APAC the region with the highest rate of deal leaks for the second year running. In EMEA, the rate of deal leaks in 2017 fell compared to the previous year.

Figure 1. Percentage of worldwide M&A deal leaks, 2009-2017

Figure 2. Percentage of M&A deal leaks by region

<table>
<thead>
<tr>
<th>Year</th>
<th>Americas</th>
<th>APAC</th>
<th>EMEA</th>
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<tbody>
<tr>
<td>2009</td>
<td>7.9%</td>
<td>7.6%</td>
<td>8.7%</td>
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<tr>
<td>2010</td>
<td>5.2%</td>
<td>8.3%</td>
<td>12.5</td>
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<tr>
<td>2011</td>
<td>7.1%</td>
<td>5.8%</td>
<td>9.2%</td>
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<tr>
<td>2012</td>
<td>3.5%</td>
<td>8.7%</td>
<td>10.5%</td>
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For the ten countries with the most M&A activity, the top three for deal leaks in 2017 were Hong Kong, India and the U.S. The bottom three countries for deal leaks in 2017 were France, Germany and South Korea.

Countries with an increased rate of deal leaks in 2017, compared to the prior year, included Hong Kong and Canada. Countries which reduced their rate of deal leaks in 2017 included India, the U.S., Japan, Australia, the U.K., France, Germany and South Korea.

Hong Kong’s rate of deal leaks in 2017 more than doubled to 20.8 percent. The U.K.’s rate of deal leaks in 2017, at 1.5 percent, was the lowest for nine years. Three countries had no deal leaks at all in 2017: France, Germany and South Korea. South Korea’s reduction in deal leaks was particularly dramatic, as the country had the second highest rate of deal leaks in 2016.

The top three sectors for deal leaks worldwide in 2017 were TMT (Technology, Media and Telecoms), Consumer and Retail. Only two sectors increased their rate of deal leaks in 2017: TMT and Healthcare. The Real Estate sector, which has the highest long-term average rate of deal leaks, continued its fall to seventh place in 2017. The bottom three sectors for deal leaks worldwide in 2017 were Financials, Real Estate and Energy & Power.

Leaked deals are associated with significantly higher target takeover premiums than non-leaked deals. This has been true in each of the nine years analyzed for this report: from 2009-2017, the median takeover premium for leaked deals was 44.4 percent vs. 26.5 percent for non-leaked deals, a difference of almost 18 percentage points.

In 2017, targets in leaked deals achieved a median takeover premium of 34.4 percent vs. 20.6 percent for non-leaked deals, a difference of almost 14 percentage points. This was an increase from 2016, when the difference was around 12 percentage points.
Historically, leaked deals have been associated with a higher rate of rival bids for the target than non-leaked deals: from 2009-2017, a higher proportion of leaked deals attracted one or more rival bids for the target than non-leaked deals in five out of the nine years. However, in 2017, for the second year running, the rate of rival bids for leaked deals was less than for non-leaked deals. The historic tendency of leaked deals to attract a higher rate of rival bids for the target may partly explain the higher target takeover premiums for leaked deals, so it is interesting to note that the breakdown of this relationship in 2016 and 2017 occurred at the same time as a reduction in the difference in the target takeover premium between leaked and non-leaked deals.

Figure 6. Percentage of worldwide M&A deals attracting rival bids for the target

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</tr>
</thead>
<tbody>
<tr>
<td>Leak</td>
<td>1.0%</td>
<td>3.6%</td>
<td>6.4%</td>
<td>11.6%</td>
<td>9.8%</td>
<td>6.5%</td>
<td>5.3%</td>
<td>7.7%</td>
<td>5.8%</td>
<td>5.7%</td>
</tr>
<tr>
<td>No Leak</td>
<td>4.4%</td>
<td>4.8%</td>
<td>4.4%</td>
<td>5.8%</td>
<td>7.0%</td>
<td>5.9%</td>
<td>6.3%</td>
<td>6.2%</td>
<td>7.2%</td>
<td>5.7%</td>
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There is some evidence that leaked deals, on average, take longer to complete than non-leaked deals (although not in 2016 or 2017): from 2009-2017, leaked deals took longer to complete than non-leaked deals in five of the nine years. Analyzing the five years when leaked deals took longer to complete shows that the median difference in those years was 13 days, whereas in the four years when non-leaked deals took longer to complete, the median difference was 11 days.

Figure 7. Median time from announcement to completion of worldwide M&A deals (days)

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</tr>
</thead>
<tbody>
<tr>
<td>Leak</td>
<td>56</td>
<td>72</td>
<td>90</td>
<td>108</td>
<td>77</td>
<td>62</td>
<td>92</td>
<td>84</td>
<td>81</td>
<td>77</td>
</tr>
<tr>
<td>No Leak</td>
<td>70</td>
<td>82</td>
<td>82</td>
<td>89</td>
<td>80</td>
<td>74</td>
<td>75</td>
<td>82</td>
<td>63</td>
<td>77</td>
</tr>
</tbody>
</table>

One theory for the increased tendency for leaked deals to have extended completion times could be that leaking a deal adds additional complexity. Leaked deals require both acquirers and sellers to manage stakeholders, issue statements and address key deal issues such as financing, approvals and any political questions prematurely. This is likely to result in deals that are more complex (and may also be costlier to execute). There is also some evidence that leaked deals have a marginally higher completion success rate than non-leaked deals. From 2009-2017, leaked deals had a higher completion success rate than non-leaked deals in six of those years, whereas in the other three years non-leaked deals had a higher completion success rate. Overall, on average, for the period 2009-2017, the completion success rate for leaked deals was one percentage point higher than for non-leaked deals. In the last three years, however, the completion success rate for leaked deals has been over two percentage points higher, on average, than for non-leaked deals.

Figure 8. Median worldwide M&A deal completion success rate

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<tbody>
<tr>
<td>Leak</td>
<td>92%</td>
<td>96%</td>
<td>90%</td>
<td>95%</td>
<td>84%</td>
<td>98%</td>
<td>82%</td>
<td>85%</td>
<td>90%</td>
<td>90%</td>
</tr>
<tr>
<td>No Leak</td>
<td>91%</td>
<td>91%</td>
<td>89%</td>
<td>88%</td>
<td>90%</td>
<td>88%</td>
<td>90%</td>
<td>89%</td>
<td>85%</td>
<td>89%</td>
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These results could point to one other perceived benefit of leaking a deal – it potentially leads to a better match between acquirer and target. Leaking a deal may flush out the “optimal” acquirer, i.e. the one who has the greatest synergies with the target (and who can therefore pay the highest price, hence the higher target takeover premiums for leaked deals) and therefore also the acquirer who has the greatest incentive to complete the deal. To quantify this, in 2017 the difference in the median target takeover premium for leaked deals compared to non-leaked deals was US$7.7 million, i.e., an average of an extra US$7.7 million accrued to the shareholders of the targets in deals that leaked. However, this was the lowest “leak premium” difference for nine years.

Figure 9. Median worldwide target takeover premium (US$)

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</tr>
</thead>
<tbody>
<tr>
<td>Leak</td>
<td>17.0</td>
<td>82.4</td>
<td>110.0</td>
<td>316.6</td>
<td>36.7</td>
<td>45.3</td>
<td>80.7</td>
<td>38.9</td>
<td>22.5</td>
<td>44.5</td>
</tr>
<tr>
<td>No Leak</td>
<td>9.3</td>
<td>26.9</td>
<td>18.2</td>
<td>25.6</td>
<td>28.1</td>
<td>35.7</td>
<td>29.7</td>
<td>28.7</td>
<td>13.5</td>
<td>23.5</td>
</tr>
<tr>
<td>Leak vs. No Leak</td>
<td>7.7</td>
<td>55.5</td>
<td>91.8</td>
<td>291</td>
<td>8.6</td>
<td>9.6</td>
<td>51</td>
<td>10.2</td>
<td>9</td>
<td>21</td>
</tr>
</tbody>
</table>
Conclusions

M&A deals leaks are a function of a number of competing pressures. Our research has conclusively shown that leaking deals leads to higher takeover premiums. Therefore, there is an economic incentive on the sell-side of a deal to engage in a leak which may increase the valuation of the target. However, financial services regulators worldwide are increasing regulations and enforcement against what they consider to be different forms of market abuse, including M&A deals leaks.

A statement from the U.K.’s Financial Conduct Authority’s Market Watch newsletter in 2010 perfectly illustrates this trend: “Strategic leaks, designed to be advantageous to a party to a transaction, are particularly damaging to market confidence and do not serve shareholders’ or investors’ wider interests. It is therefore in all interests to ensure that senior management of all organizations who handle inside information establish (and are seen to establish) a much stricter culture that firmly and actively discourages leaks.”

Therefore, M&A dealmakers must weigh the perceived benefits of leaking deals against the regulatory and reputational risks if they are caught. High-profile cases, such that of Ian Hannam in the U.K., have undoubtedly focused minds among dealmakers and contributed to the decline in the rate of deal leaks in developed markets.

While the worldwide rate of M&A deal leaks fell in 2017, the APAC region continued to see an increase. This is undoubtedly a reflection of a less well developed regulatory and enforcement environment against market abuse in that region, as well as a culture of greater acceptance of deal leaking. As developing markets align their regulatory standards and levels of enforcement with developed ones, we can expect the worldwide trend in deal leaks to continue to fall.

References

[1] In February 2012, the U.K. financial services regulator fined Mr. Hannam, the former Chairman of Capital Markets at J.P. Morgan and global co-head of U.K. Capital Markets at J.P. Morgan Cazenove, £450,000 for improper disclosure of inside information contrary to section 118 (3) Financial Services and Markets Act 2000. The Upper Tribunal found that Mr. Hannam had leaked inside information in an email about a potential M&A deal that one of his clients may be involved in as the target. No insider trading occurred in this case, but Mr. Hannam received a heavy fine and the disgrace of a court appearance, and he resigned from J.P. Morgan.

About Cass

Cass Business School, which is part of City, University of London, is a leading global business school driven by world-class knowledge, innovative education and a vibrant community. Located in the heart of one of the world’s leading financial centers, Cass has strong links to both the City of London and the thriving entrepreneurial hub of Tech City. It is among the global elite of business schools that hold the gold standard of triple-crown accreditation from the Association to Advance Collegiate Schools of Business (AACSB), the Association of MBAs (AMBA) and the European Quality Improvement System (EQUIS).

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About Intralinks

Intralinks is a leading financial technology provider for the global banking, deal making and capital markets communities. As pioneers of the virtual data room, Intralinks enables and secures the flow of information facilitating strategic initiatives such as mergers and acquisitions, capital raising and investor reporting. In its 22-year history Intralinks has earned the trust and business of more than 99 percent of the Fortune 1000 and has executed over US$34.7 trillion worth of financial transactions on its platform.

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Understanding how to match contractual language to deal intentions

Despite the current geopolitical landscape and uncertainties, companies continue to search for growth via dealmaking. In fact, according to EY’s latest US Capital Confidence Barometer (CCB), more than half of respondents are planning acquisitions in the next 12 months and the vast majority of respondents expecting the overall global M&A market conditions to improve over the next twelve months. Barriers to entry are continuing to shrink in most industries as technology advances are converging with traditional industry structures. Buyers and sellers alike are realizing that M&A can be the fastest way to transform their portfolio and reshape the future direction of their business. While there is a strong desire to get ahead of the pace of change and make bets on future technology, the rising geopolitical tensions around the globe, a more aggressive antitrust regulatory environment and concerns about disruptive forces like digital transformation and changing customer behaviors create uncertainties and complex risks that executives must navigate. Consequently, this is becoming one of the most exciting and challenging business environments in decades, and there is a clear forecast of an increase in cross-sector and cross-border M&A.

As acquirers are looking outside of their industry, sector and country to make deals, the risk for surprises in the transaction as well as more complex negotiations, disagreements or disputes often arises. Buyers more than ever have a desire and need to plan for a robust and thorough diligence process as the timetable of the transaction will allow, and should consider all ways to mitigate cross-sector and cross-border risk in order to achieve a successful deal outcome.

Deals can fall short of buyer or seller expectations, or can be viewed as unsuccessful for a variety of reasons, including regulatory or compliance issues, business integration challenges, economic and market factors and costly post-close disputes. The most common post-close disputes that involve accounting and financial-reporting issues relate either to the purchase-price adjustment mechanism contemplated in the purchase agreement, or the buyer claiming violations of the seller’s representations or warranties. Dealing with these post-close disputes can be a costly and time-consuming process.

So what should parties do on their next deal to avoid or reduce these potential headaches? There are three simple steps:

1. Include specific contractual definitions

Most transaction agreements contain a provision requiring that the closing statement conform to the applicable accounting guidance (GAAP, IFRS or other guidance) and that such guidance be consistently applied over a relevant historical period. Parties to M&A transactions often mistakenly believe that the applicable accounting guidance defines one correct methodology and that little or no disagreement can arise regarding the application of that methodology. Disagreements often occur post-close over whether the seller’s historical accounting methodologies are more appropriate than those preferred by the buyer. These differences can significantly affect the final purchase price and may result in a dispute between the parties, particularly in areas where accounting guidance is somewhat “gray” or is heavily dependent on management estimation or judgment. Management estimation or judgment can often be
the very essence of a dispute particularly in determining reserves or allowances, in accordance with GAAP. Buyers may reach new and different judgments and conclusions than Sellers based on more complete or recent information and can argue their application of GAAP is the same as that of the Seller: the same methodology, just a different judgement or conclusion. This is often the case with areas such as inventory, reserves or bad-debt allowances.

In an accounting arbitration setting, the consistent application of an acceptable accounting methodology will usually prevail over a claim to change to an alternative – although still acceptable – accounting methodology. If the financial-statement preparer has consistently applied an accounting principle in accordance with the relevant accounting guidance, an accountant arbitrator would generally not take exception. While authoritative accounting principles, such as those provided by GAAP, do not recognize any acceptable method as preferable over another acceptable method, a determination made by the accounting arbitrator must consider the specific terms and conditions of the transaction agreement at issue. The accounting arbitrator should disregard any claim that one acceptable method is preferable to another acceptable method and should only prefer one method over the other if it is indisputably a ‘better’ (as contractually defined) representation of the appropriate valuation of the asset or liability. If a party successfully argues that the historical accounting for an item at dispute does not comply with GAAP, however, then the GAAP-compliant methodology proposed by such party or as determined by the accountant arbitrator would prevail, absent language in the contract requiring consistency with past practices instead of GAAP. Contractual language requiring consistency with past practices can potentially force parties into a calculation of working capital that employs “consistently wrong” or “consistently non-GAAP” methods if the company’s past practices as applied to the transferred assets and/or liabilities are non-GAAP, inconsistent or inaccurate in some way.

Conflicts often arise as to whether applicable accounting guidance for the transaction or consistency takes precedence when applying an accounting methodology to a particular transaction or a particular account balance, especially in the preparation of the closing statement. When the applicable accounting guidance and consistency requirements appear to conflict, accounting arbitrators usually choose the applicable accounting guidance as the higher and controlling standard. For example, if a seller historically used consistent but non-GAAP accounting methodologies, the closing statement should conform to GAAP if the transaction agreement requires such compliance, absent other pertinent contractual provisions.

If a seller has historically employed non-GAAP (or other contractually governing accounting principles) practices in accounting for certain items, the parties can agree to include disclosures and definitions to such effect in the transaction agreement that specify consistency with respect to such items regarding such non-GAAP treatment. With the proper thought and drafting of the relevant definitions, consistency will prevail over the applicable accounting guidance if so disclosed, defined and agreed to by the parties. To ensure clarification, the parties should always carefully draft such contractual disclosures and include supporting definitions, examples, calculations and schedules.

Disputes can also arise regarding the application of the term “consistent.” For example, consider the following language: the company “consistently provides an allowance for bad debts,” versus “provides
an allowance using a consistent calculation methodology.” The vagueness of the first statement provides no protection for the seller regarding its historical methods, while the second statement’s specificity avoids differing interpretations. The transaction-agreement language regarding such disclosures, representations or warranties (and other information obtained in due diligence procedures) provides important documentation of the understanding between the parties. However, parties to a transaction should never rely on generic accounting definitions for protection.

Also consider the language that GAAP must be applied “on a basis consistent with the past practices, procedures, methodologies and policies” of the company. While this may seem to be specific-enough language to protect against dispute, disputes often arise in this situation where the past practices or procedures of the company are different than the formally written accounting policies or methodologies. Because most companies apply more rigorous financial-statement closing procedures at year-end, the question often arises regarding the extent of precision in the financial-statement closing procedures the seller will use in the financial statements referenced in the transaction agreement. Using financial statements for negotiations that were prepared at a month-end or fiscal period-end, while the closing statement is based on a year-end, or vice versa, can have a significant financial impact – and a mid-month closing date may quickly turn into an administrative accounting nightmare, if not a full-blown dispute. Without clear contractual language to define the specific closing procedures, disputes can arise around which past practice is appropriate, depending on the closing date of the transaction. More specificity around application of historical practices is the best way to avoid disagreements post-close. Including an appendix to the purchase agreement with a detailed listing of procedures to be used for each area of the balance sheet (e.g., listing of percentage reserve to be applied to various accounts-receivable aging buckets, description of review and analysis of discretionary reserves, description of inventory-count procedures at closing) can save time and headaches on the backend of the transaction.

2. Include example calculations

Including a specific example calculation of the contractual accounting true-up mechanism, such as an example calculation of net working capital, can help avoid potential disputes down the road. Purchase agreements will often include an example calculation as an exhibit or appendix to the agreement, but such example calculations vary widely in terms of detail and specificity.

While including any example calculation (such as how certain reserves are calculated to demonstrate application of a historical method) can provide more specificity than the text in the agreement defining net working capital (or other relevant transaction closing calculation), sometimes the example calculation itself can give rise to a dispute. Example calculations that include general categories of current assets or current liabilities often may not contemplate all possible current assets or liabilities relevant to the business. These basic examples may or may not include actual values for each line item as that of a recent audit period date. Including “dummy values” or values that do not directly link to a recent financial statement can cause further complication or confusion.
Some purchase agreements may include an example calculation with specificity as to each specific account number from the general ledger that belongs in the calculation. This type of example is often a best practice, as it eliminates confusion and also does not allow for as much misinterpretation by either party. The example calculation can be even stronger if the dollar values associated with each general ledger account include actual values from a recent audited period-end. Including such example values also demonstrates the appropriate historical accounting treatment for that account – and documents the record as to the agreement of the parties for determining that account balance, and therefore the underlying accounting treatment of that account. While these efforts help reduce disputes, even with such specificity, new issues can still arise with regard to assets or liabilities not specifically included in the current general ledger or chart of accounts.

Another consideration is to ensure consistency between the text in the purchase agreement defining net working capital and the example calculation itself. If there is a component of net working capital that is specifically excluded in the definition, but included in the example calculation, that can easily give rise to a dispute between the parties. Bottom line: the inclusion of an example calculation should provide more clarity and help the parties avoid a potential dispute – and it should not create more ambiguity or inconsistency with defined terms in the agreement. While we are only highlighting net working capital issues, other issues arising with earn-out calculations can potentially be even more problematic.

3. Define the dispute resolution process in the purchase agreement

When parties are headed to arbitration, vagueness in the contract around the arbitration process itself can drastically delay resolution between the parties. In order to promote a relatively speedy and worry-free process, parties are best served to finalize what this process will look like within the language of the purchase agreement rather than when they are in the middle of an accounting dispute.

Many contracts will specify a net-working-capital mechanism process that allows for the buyer to prepare an initial closing date calculation of net working capital, which must be provided to the seller after closing, usually 60 to 90 days post-close. The number of days recommended often is the approximate number of days a typical year-end closing process has historically taken. The seller then typically has a period of review before issuing a dispute notice for any areas of disagreement (often 30 to 60 days). Most purchase agreements also specify a period of “good faith” negotiation after the issuance of a dispute notice before the process would move forward to an “arbitrator” or “resolution accountant” (usually 30 days). From there, many contracts are no longer specific about what the accounting arbitration process will look like. A specific clause that lists an individual or firm to serve as the arbitrator can alleviate headaches when the parties are ready to start the process. Even better, the contract may specify several firms that could serve as the neutral arbitrator, and in which order those firms should be contacted in the event one firm is not able to serve as the arbitrator (conflicts are sometimes identified by a potential arbitrator precluding their engagement as the arbitrator). Even if not addressed specifically in the purchase agreement, the selection of an accounting-type arbitrator should be made with great care, paying specific attention to his or her accounting background and
licenses, expertise as an arbitrator, experience in post-transaction disputes and/or M&A transactions and possible relevant industry experience. Subject matter expertise does not necessarily make a good arbitrator and a lack of relevant arbitration experience can yield results no one is happy with. Parties should also consider including language to specify the arbitration process with the arbitrator, including timing of initial and rebuttal submissions (simultaneous vs. staggered), timing of questions by the arbitrator to the parties (and timing of responses), the possibility of hearings and under what circumstances, how the arbitrator’s fees will be shared between the parties (based inversely to the percentage of disputed items won vs. 50% split to each party vs. another contractually agreed-upon basis), the number of days the arbitration will take once begun, the ultimate scope of the arbitrator’s role and even possibly the format of the final and binding determination (including the level of detail around the arbitrator’s rationale in the final determination).

The parties sometimes consider including “all or nothing”-type language around the scope of the arbitrator’s ruling, which can often be used as a dispute deterrent for the parties post-close. This type of language may contractually limit the arbitrator to rule 100% in favor of the buyer or seller’s position with respect to each disputed item, and can even go so far as to limit the arbitrator to rule 100% in favor of the buyer or seller’s entire balance-sheet position. While this can be quite a favorable outcome to the winning party, it often carries a high degree of risk to the party that ultimately loses – particularly when there is a large range between each party’s position. For example, if the buyer believes an accrual within net working capital should be $0 and the seller argues for $3 million, the arbitrator would be limited to rule in this situation for either $0 or $3 million. If the arbitrator believes the accrual is valid but is probably closer to $1 million, the arbitrator would still be contractually forced to rule for $3 million. Parties should carefully consider if including this limiting condition in the contract will be beneficial.

It is well worth the parties’ efforts to spend extra time prior to closing to draft, define and further tighten contractual language. On your next deal, consider the benefits of a contractual language assessment by someone suitably experienced with common accounting disputes arising in deals and work to include as much specificity as possible around the mechanics of the accounting mechanism and the post-closing process. Forensic accountants can often serve as valuable resources, both to deal teams and counsel to assist in recognizing the potential pitfalls between the intended language in a contract and the financial implications.

Christen L. Morand christen.morand@ey.com Gregory E. Wolski gregory.wolski@ey.com

EYG no. 01980-181Gbl
Antitrust remedies and reverse break fees

Analysis of US public merger agreements where an HSR Second Request was issued and disclosed – 2010-1H 2018

September 2018
It is unusual for a HSR Second Request to be issued when the parties had not foreseen some level of antitrust scrutiny.

Deals where antitrust scrutiny was anticipated would seem to be the most useful precedents for negotiating antitrust risk allocation provisions.

We compiled a database of 141 (out of 1,412) US public merger agreements from 2010 to 1H 2018 where an HSR Second Request was issued.

Reverse regulatory break fees and other risk allocation provisions matter most when the parties anticipate antitrust scrutiny.

% of Second Requests Issued

- No Second Request: 90%
- Second Request: 10%
Commitments to divest are the most common way to shift antitrust risk

- However, reverse antitrust break fees have become more common;
- Hell or high water provisions are rare
- And it is very uncommon for agreements to remain silent on antitrust risk.

<table>
<thead>
<tr>
<th>Description</th>
<th>Percentage</th>
<th>Deals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Of all deals had neither a reverse break fee nor a divestiture commitment</td>
<td>9.93%</td>
<td>14 out of 141</td>
</tr>
<tr>
<td>Of all deals had a hell or high water provision</td>
<td>7.09%</td>
<td>10 out of 141</td>
</tr>
<tr>
<td>Of all deals had a commitment to divest up to some non-numerical limit</td>
<td>44.68%</td>
<td>63 out of 141</td>
</tr>
<tr>
<td>Of all deals had a commitment to divest up to a numerical limit</td>
<td>32.62%</td>
<td>46 out of 141</td>
</tr>
<tr>
<td>Of all deals had a reverse antitrust break fee</td>
<td>39.72%</td>
<td>56 out of 141</td>
</tr>
</tbody>
</table>

*Includes divestitures up to a material adverse effect (MAE)
Looking at it another way

All Deals (141)

- Divestiture only 44.0%
- Divestiture + break fee 33.3%
- Silent 9.9%
- HoHW 7.1%
- Break fee only 5.7%
Divestiture commitments have historically been the most common

* Percentages are for transactions with commitments to divest, including those (shaded) coupled with a reverse regulatory break fee

* Freshfields Bruckhaus Deringer
Use of reverse antitrust break fees has been generally increasing since 2010

*Note that 2017(1H) includes only transaction announced during the 1H of the year.
Antitrust break fees as a percentage of deal value have been decreasing*

*There is only one antitrust break fee in 2017.
The median and range of reverse antitrust break fees has also been getting smaller

<table>
<thead>
<tr>
<th>Time Period</th>
<th>% of Equity Value</th>
<th>% of Enterprise Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010-2012</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Range: 0.21% to 37.26%</td>
<td>Range: 0.14% to 27.93%</td>
</tr>
<tr>
<td></td>
<td>Mean: 8.30%</td>
<td>Mean: 6.74%</td>
</tr>
<tr>
<td></td>
<td>Median: 5.34%</td>
<td>Median: 4.78%</td>
</tr>
<tr>
<td></td>
<td>St. Dev: 8.52%</td>
<td>St. Dev: 6.13%</td>
</tr>
<tr>
<td>2013-2015</td>
<td>Range: 1.21% to 11.62%</td>
<td>Range: 0.91% to 9.40%</td>
</tr>
<tr>
<td></td>
<td>Mean: 5.22%</td>
<td>Mean: 4.50%</td>
</tr>
<tr>
<td></td>
<td>Median: 4.03%</td>
<td>Median: 3.74%</td>
</tr>
<tr>
<td></td>
<td>St. Dev: 2.75%</td>
<td>St. Dev: 2.57%</td>
</tr>
<tr>
<td>2016-1H 2018</td>
<td>Range: 0.60% to 6.49%</td>
<td>Range: 0.48% to 5.21%</td>
</tr>
<tr>
<td></td>
<td>Mean: 4.21%</td>
<td>Mean: 3.45%</td>
</tr>
<tr>
<td></td>
<td>Median: 4.17%</td>
<td>Median: 3.28%</td>
</tr>
<tr>
<td></td>
<td>St. Dev: 1.45%</td>
<td>St. Dev: 1.27%</td>
</tr>
</tbody>
</table>
Takeaways

• Divestiture commitments are the most common means for addressing regulatory risk.

• Hell or high water provisions are exceedingly rare.

• The percentage of deals with a known second request that had a reverse antitrust break fee has been generally increasing.

• While use of reverse antitrust break fees has been increasing, the size of the break fee as a percentage of deal value has been decreasing.
Thank you

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*Posted by Jason Halper, William Mills, and Joshua Apfelroth, Cadwalader, Wickersham & Taft LLP; on Tuesday, April 23, 2019*

**Tags:** Acquisition agreements, Delaware cases, Delaware law, Merger litigation, Mergers & acquisitions, Termination, Termination fees

**More from:** Chelsea Donenfeld, Jason Halper, Joshua Apfelroth, William Mills, Cadwalader

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In *Vintage Rodeo Parent, LLC v. Rent-A-Center, Inc.*, C.A. No. 2018-0928-SG (Del. Ch. Mar. 14, 2019), Vice Chancellor Glasscock of the Delaware Court of Chancery found that Rent-A-Center, Inc. (“Rent-A-Center”) properly terminated its merger agreement with Vintage Capital Management LLC (“Vintage”) after Vintage failed to submit a notice to extend the drop-dead date for its pending $1.37 billion buyout of Rent-A-Center. In doing so, the Court strictly interpreted the express language of the merger agreement and permitted Rent-A-Center to terminate the merger unilaterally by delivering a termination notice only hours after the extension deadline passed.

**Background**

The merger agreement between Vintage and Rent-A-Center provided that each party had the unilateral right to extend the end date of December 17, 2018 to March 17, 2019, by giving the other party written notice of its election to extend on or before December 17, 2018. If neither party elected to extend the end date, the parties would still be bound by the merger agreement, but either party could terminate the merger agreement by delivering a written notice to the other party. Moreover, the merger agreement provided that, upon termination, Vintage would be obligated to pay to Rent-A-Center a reverse breakup fee equal to 15.75% of the transaction’s equity value.

In light of the prolonged, ongoing Federal Trade Commission approval process for the merger, it was clear to each party that the merger would not be completed by the initially scheduled end date. Shortly before the deadline, the Rent-A-Center board determined that it would not unilaterally extend the end date, and that, if Vintage did not extend, Rent-A-Center would elect to terminate the merger agreement. While Rent-A-Center anticipated that Vintage would elect to extend, to Rent-A-Center’s surprise, Vintage did not extend the end date by the prescribed deadline. On the morning of December 18, 2018 (only a few hours after the deadline had passed), Rent-A-Center delivered a termination notice to Vintage and demanded that Vintage pay the breakup fee. Despite Vintage’s arguments that an extension notice was constructively delivered or waived, the Court came to the “startling conclusion” that Vintage “simply forgot” to deliver the extension notice. Seeking a declaratory judgment, Vintage filed suit against Rent-A-Center, seeking to invalidate Rent-A-Center’s termination notice on the basis that the extension deadline had been extended by the conduct of the parties and that Rent-A-Center breached its implied covenant of good faith and fair dealing. Rent-A-Center asserted a counterclaim for breach of contract, seeking payment of the breakup fee.

Following a two-day trial, the Court found that Rent-A-Center’s termination was valid and effective. In so finding, the Court rejected Vintage’s arguments that (1) its failure to provide written notice to extend the end date was obviated by the
parties’ conduct; (2) Rent-A-Center breached its obligation to use commercially reasonable efforts to close the transaction by failing to remind Vintage of its obligation to deliver an extension notice or inform Vintage of its intention to terminate if Vintage failed to deliver an extension notice; and (3) Rent-A-Center fraudulently induced Vintage to believe that Rent-A-Center still wanted to consummate the merger.

Takeaways

The *Vintage Rodeo v. Rent-A-Center* decision provides key insights for M&A practitioners and litigators into how the Court will interpret express contractual agreements between merger parties.

1. **The Court Will Not Second Guess Unambiguous Drafting.** The Court observed that the terms of the notice provision at issue in this case are “clear and unambiguous.” However, Vintage argued that, notwithstanding such clarity, the actions of the parties satisfied the “purpose” of the notice provision, and as such, constituted substantial compliance that amounted to delivery of an extension notice. According to Vintage, the joint timing agreement entered into among Vintage, Rent-A-Center and the FTC, which contemplated a closing date after the end date, served as an extension of the end date or waiver to the requirement that a written extension notice be delivered. Vintage further argued that a financial model prepared by Rent-A-Center listing a closing date that was after the end date amounted to an extension of the end date. The Court strongly rejected these “after-the-fact rationalizations,” stating that these “contractually-required expenditures of time and effort” did not equate to a notice to extend the end date. The Court emphasized that, when the terms of a contract are clear and unambiguous, judicial review of such terms generally stops, unless a party “justif[i]es] its deviation, by, for instance, showing that it has acted reasonably, in light of the circumstances, to substantially comply in a way that preserves the benefits of the contract to the counterparty.” The Court found that the facts of this case did not warrant such an exception. Instead, the Court held that the end date and the extension thereof were “matters of importance” and were “heavily negotiated,” and as such, the parties are “bound to their contractual bargain.” This case serves as a reminder that the Court generally will strictly enforce the clear and unambiguous terms of a merger agreement.

2. **Commercially Reasonable Efforts Do Not Require Reminding a Counterparty of Its Contractual Rights.** As is typical, the merger agreement provided that the parties would expend commercially reasonable efforts to consummate the transaction. Vintage argued that Rent-A-Center, by affirmatively concealing its intent to terminate the merger if Vintage elected not to extend the end date, failed to use commercially reasonable efforts to consummate the merger, and therefore, breached the agreement, rendering its termination of the transaction invalid. In support of its argument, Vintage compared its situation to that of *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, 965 A.2d 715 (Del. Ch. 2008) (“Hexion”), where the court found that termination of a merger agreement was wrongful because the Hexion defendants “were aware of a ‘problem,’” which was the impending failure to satisfy a condition precedent, and chose not to make the effort to alert and work with its counterparty to satisfy the condition. The Court distinguished this case from *Hexion* in finding that Rent-A-Center did not sabotage satisfaction of a condition precedent and that Vintage simply lacked an understanding of its explicit rights under the merger agreement. In so holding, the Court acknowledged that, under Delaware law, “parties are assumed to have knowledge of their own contractual rights,” and that to analogize this situation to that of *Hexion*, Rent-A-Center would have had to have been aware of Vintage’s misunderstanding of its contractual rights. Because there was no such evidence, the Court found that Rent-A-Center’s failure to remind Vintage of its notice obligations did not result in a breach of the merger agreement.

3. **Counterparties Have No Duty to Warn of an Impending Termination.** Vintage also argued that Rent-A-Center’s obligation to use commercially reasonable efforts to consummate the merger required Rent-A-Center to provide Vintage with advance notice that Rent-A-Center did not intend to extend the end date and planned to terminate the transaction if Vintage also elected not to extend. The Court found that such obligation would be inconsistent with the express terms of the merger agreement, and that if the parties in fact had agreed to include an advance notice provision in the merger agreement, they would have done so expressly. Rent-A-Center had no duty to remind Vintage of its contractual rights, and thus was entitled to conceal its intention not to extend the end date and to terminate the merger.

4. **Rent-A-Center’s Right to Terminate Was Not Limited by the Implied Covenant of Good Faith and Fair Dealing, Estoppel or Quasi-Estoppel.** Vintage argued that the implied covenant of good faith and fair dealing
should be applied to prevent Rent-A-Center’s termination. The Court rejected this argument, stating that the implied covenant of good faith and fair dealing serves as a “gap filler” that applies only when parties expressly failed to include terms that are “so obvious.” The Court stated that not only did Vintage fail to claim that Rent-A-Center committed fraud by terminating the merger agreement, but that there was no “gap to fill,” as the parties “vigorously negotiated” the circumstances under which a party had the right to extend the end date. Similarly, the Court found that Rent-A-Center’s right to terminate was not barred by the principles of equitable estoppel or quasi-estoppel. With respect to Vintage’s estoppel argument, the Court found that Rent-A-Center’s conduct did not lead Vintage to “change [its] position to [its] detriment” because, in fact, Vintage did not change its position not to send a notice of election to extend the end date based on Rent-A-Center’s “business as usual” conduct following the Rent-A-Center board meetings; Vintage “simply forgot” to send its notice. Lastly, the Court found that the commercially reasonable efforts Rent-A-Center expended prior to the extension of the expected closing were not inconsistent with its exercising its contractual right to terminate the merger, and therefore, the principle of quasi-estoppel was not applicable.

5. The Court Left Open the Possibility That the Breakup Fee is Not Payable Based upon the Implied Covenant of Good Faith and Fair Dealing. Interestingly, the Court left open the question of whether Vintage should be responsible to pay to Rent-A-Center the breakup fee in light of the implied covenant of good faith and fair dealing. Here, the Court questioned whether the parties intended for the breakup fee to apply in a situation where the buyer is ready and willing to close, but inadvertently failed to notify the other party of its election to extend. As such, the Court requested supplemental briefing on the applicability of the implied covenant to payment of the breakup fee before rendering a decision on whether the breakup fee must be paid.

Please click here for the full opinion.

Trackbacks are closed, but you can post a comment.
Exiting an investment is an inherently uncertain process. Even for a thriving business with a viable equity story, committed stakeholders and the right advisers, the final deal terms and valuation are typically guided by factors beyond a company’s control. These include prevailing market sentiment, current appetite for acquisitions in a particular sector and the political and economic environment, all of which can change well within a given transaction timetable. In the face of a global economic slowdown, ongoing trade wars, Brexit, heightened market volatility and other sources of uncertainty, it is becoming increasingly important to consider how deals can be run to maximize transaction certainty and achieve optimal valuation.

Pursuing a “dual-track” process involves preparing for an initial public offering at the same time as running a private M&A process, often through an auction. Relative to choosing a single exit strategy, a dual-track process tends to be more complicated and resource-intensive, while also posing some specific risks. However, if the right dynamic is created, a dual-track process can provide visibility of relative valuation and the benefit of optionality, maximizing the chance of securing the most favorable terms. Whether there’s a looming threat of a government shutdown or a sudden stock market sell-off, or the auction bids come in below expectations, the alternative track may present a superior exit option. A dual-track process reduces the possibility that the vagaries of the stock market and industry-specific dynamics will have a detrimental effect on the overall exit by opening the investment opportunity to public markets as well as financial and strategic investors, with each influenced by the others.

To determine whether a dual-track process is right for your company, consider these six key questions:

1. Do you have buy-in for the transaction from all relevant stakeholders?

Identifying which stakeholders hold the key to the success of either track is crucial. As well as controlling shareholders, who may need to approve either transaction, the degree of alignment between common and preferred shareholders, the board and senior executives is an important consideration. The nature of an exit will affect the value of any equity held by shareholders, including employee option holders, and so the short- and long-term effects of attracting, incentivizing and retaining the right team should be considered. It is also important to consider the implications of any
change of control provisions in material contracts in the M&A scenario, which may require consent from strategic or financial counterparties. Capital intensive businesses will also need to consider the prospective implications of any M&A transaction under their financing facilities, including potential changes to their credit ratings, so it will be necessary to socialize the transaction with lenders ahead of time.

2. Is the objective to achieve a partial or complete exit?

A private sale can be structured to achieve a complete exit for existing equity holders, with possible deferred consideration, earn-outs and escrows. Meanwhile, an IPO, which is typically structured as a primary equity issuance, will generally permit such investors to sell down over time in the public markets, subject to contractual lock-ups with underwriters (typically for 180 days), insider trading restrictions (which can be mitigated through the use of 10b5-1 plans in the United States) and statutory resale restrictions (which, in the United States, can be particularly limiting for affiliated shareholders with large positions).

Even where pre-IPO holders are able to participate in a hybrid primary-secondary IPO, the transaction will not serve as a complete exit for pre-IPO holders since new investors will ensure that they retain significant skin in the game. Stock market forces also make the timing of an eventual outright exit and the final blended valuation of equity sales over time uncertain. However, delayed exit through the public markets may also increase the overall value to pre-IPO holders by allowing them to take advantage of any public market premium.

For either track, a partial exit gives rise to the question of control. If the pre-IPO holders want to maintain a certain level of influence over a business following the transaction, doing so may be easier in a private sale, through a shareholders’ agreement. In an IPO, selling shareholders may choose to adopt a multiclass or an enhanced voting rights equity structure, potentially fettered through “sunset” provisions. However, multiclass and enhanced voting rights structures are only eligible for listing on certain markets, might not receive indexation (losing out on passive investor flows) and have come under scrutiny by investors in the United States due to perceived corporate governance failures at leading technology companies. In each case, the potential benefits of enhanced control rights will need to be weighed against the possible negative impact on valuation.

Where a partial sale process is primarily driven by the need to obtain further investment rather than to achieve an exit, a dual-track process can also be suitable, but a further set of considerations come into play. These include how debt and equity can be used by the business to optimize its cost of capital.

3. Is the IPO track suitable for (and available to) the business?

The requirements of regulators and stock markets vary from venue to venue, but it is necessary to understand whether the business, its track record and financial reporting (audited to the appropriate accounting standard), will meet those requirements. The intended post-transaction ownership will also affect how the offering is structured and its viability.

The usual pros and cons of being a publicly traded company will also need to be considered. Some of the benefits, of course, include the ability to use listed paper as acquisition currency and to offer liquid stock options to employees, heightened corporate visibility and public company premium valuation. These should be balanced with the need to address any outstanding tax, legal or accounting issues that should be remedied before an IPO. It will be more difficult to deal with potential issues in the
public eye, due to extensive disclosure requirements and increased exposure to litigation for any material misstatements or omissions in public filings. Having the necessary infrastructure is also key. This includes the additional resources and know-how that will be necessary to maintain the extra administration and reporting requirements of a publicly traded company, particularly in the finance function.

4. What’s the time frame?

As for any transaction, timing is one of the key considerations and will determine whether a dual-track process is suitable. Undertaking an IPO typically takes three to six months and a large part of the timetable is influenced by third parties who help prepare and review the offer document. In addition, market timing is critical for an IPO process, and even a promising offering can be stymied by investor reticence in a market downturn. An M&A process can be much shorter, but can be equally sensitive to external processes, such as competition or regulatory clearances.

It is therefore necessary to understand the expected timetable for both tracks, including the maximum time frames for satisfying any conditions to launching/closing. This timetable needs to be assessed in light of the business’ cash position, debt obligations and upcoming milestones, as well as the potential “staleness” of financial information. Flexibility to restructure transaction timetables is critical in managing a dual-track process. However, it can be difficult in practice due to the rigors of operating a business while simultaneously coordinating multiple prospective strategic transactions and financial statement staleness considerations in the IPO process.

The business’ roadmap (particularly for life sciences companies expecting clinical or regulatory results), cyclicality or seasonality all have the potential to affect the timetables and, like political and market events, can be hard to plan for, whether they are expected or not.

5. Which transaction is most likely to generate the best valuation?

The valuation of a business by public markets vs. a financial or strategic buyer can vary significantly. IPOs are affected by stock market sentiment, volatility and comparisons (whether valid or not) with the recent trading performance of peers. When equity markets are strong, the IPO track can act as a “stalking horse” in eliciting M&A buyers. Valuation in an M&A process, on the other hand, is often driven by considerations such as realizing synergies, pursuing short- versus long-term business plans, obtaining critical assets (often intellectual property), industry consolidation trends and recent comparable transactions.

With a private sale, it will never be possible to know with certainty how the stock market would have valued a business for comparison. But a private sale provides the certainty of proceeds that an IPO can rarely provide to selling shareholders, particularly given customary 90/180/360-day lock-ups. However, pre-IPO companies can and should take the opportunity to assess market receptivity by taking advantage of confidential meetings with investors – dubbed “testing-the-waters” meetings in the United States or “early look” or “pilot fishing” meetings in Europe – subject to restrictions on the nature of the investors and the content of the meetings.

6. Can the business and the deal team cope with the extra demands?

On their own, each of the IPO and M&A processes place significant demands on a business and its management. Having to deal with two processes at once will inevitably put even greater strain on time and resources, so it’s necessary to assess the capacity, expertise and experience of the team that will
be responsible for the processes, and whether it will be necessary to add supplemental staff or rely more heavily on outside advisers.

A dual-track process can be managed to limit interference with the day-to-day operations of the business. Coordinating/aligning work streams, such as due diligence and the preparation of the business plan that are critical to both processes, is essential and will reduce the costs and disruption of running a dual-track process. For example, preparing an offering document can be aligned with preparing an information memorandum, and aspects of the verification of that offering document can be completed using sources in the virtual data room created for an acquisition process. Select members of management can be appointed to oversee and coordinate both processes. When it comes to outside advisers, most sophisticated advisers can field teams that can advise on both processes, often with some cost savings, while remaining equally incentivized to succeed under either track.

Finally, not all dual-track processes are created equal – there is no “one size fits all.” Maintaining confidentiality (of competing valuations, timing, drivers, etc.) is key to the success of a dual-track process, so it’s important to limit the size of the deal teams inside and outside of the company, and of course to obtain non-disclosure agreements from prospective M&A counterparties. Opting for an IPO would not require an issuer to disclose the fact of the parallel (abandoned) M&A process, but leaks or intentional disclosure during the process may have adverse consequences for both tracks. Conversely, knowledge that a company may be pursuing an IPO exit could drive the M&A valuation higher, particularly with strategic buyers. The optionality afforded by a dual-track process should be maintained for as long as possible to keep maximum pressure on timing, valuation and general competitive tension. Ultimately, the goal is to play each track off against the other to secure the best overall deal for stakeholders.
The Delaware Supreme Court's Decision in Verition Partners Master Fund Ltd. v. Aruba Networks, Inc.—Calculating Fair Value in Statutory Appraisal Cases

April 22, 2019

In a decision as notable for its criticisms of the trial court judge as its contributions to Delaware appraisal jurisprudence, the Delaware Supreme Court in Verition Partners Master Fund Ltd. v. Aruba Networks, Inc. reversed a decision of the Delaware Court of Chancery in a statutory appraisal proceeding. The lower court had relied on the 30-day unaffected stock price to determine that $17.13 per share was the fair value of Aruba Networks, Inc. at the time of its acquisition by Hewlett Packard Companies (“HP”). The Supreme Court—in a unanimous per curiam decision—held that Aruba’s fair value per share was $19.10, representing the deal price minus synergies that were paid for by HP in the merger, and that the Court of Chancery abused its discretion by relying on the 30-day unaffected market price of Aruba’s stock before the transaction was publicly announced. In so holding, the Supreme Court remarked that the decision by the trial judge to rely exclusively on the unaffected market price—even though neither party advanced that argument until the judge broached the subject in connection with post-trial briefing—“could be seen” as a “results-oriented move to generate an odd result compelled by his personal frustration at being reversed in Dell [Inc. v. Magnetar Global Event Driven Master Fund Ltd].” The Supreme Court also clarified its holdings in DFC Global Corporation v. Muirfield Value Partners L.P. and Dell, and affirmed its longstanding recognition of merger consideration as strong evidence of fair value in statutory appraisal actions involving transactions resulting from a fair and competitive sale process. Given the decision’s emphasis on the agreed-upon merger consideration in determining a company’s fair value (coupled with the requirement to reduce that amount by any synergies included in the deal price), appraisal arbitrage in Delaware is likely to remain at reduced levels.

Background

In 2017, the Delaware Supreme Court reversed two Court of Chancery appraisal decisions, holding that the lower courts did not properly consider deal price in calculating the fair value of the acquired company’s shares. In DFC Global, the Supreme Court held that the lower court erred by according equal weight to the transaction price, an expert’s discounted cash flow analysis, and a comparable companies analysis. According to the Supreme Court, “the sale value resulting from a robust market check will often be the most reliable evidence of fair value, and [second-guessing

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the value arrived upon by the collective views of many sophisticated parties with a real stake in the matter is hazardous.”¹ Likewise, in Dell, the Supreme Court held that “the trial court erred in not assigning any mathematical weight to the deal price” because “the deal price deserved heavy, if not dispositive, weight.”² Notably, however, in its opinions in DFC Global and Dell, the Court explicitly refused to create a presumption that transaction consideration is always the best evidence of fair value. As the Court further explained in DFC Global (and reiterated in Dell), “economic principles suggest that the best evidence of fair value was the deal price,” but only so long as that price “resulted from an open process, informed by robust public information, and easy access to deeper, non-public information, in which many parties with an incentive to make a profit had a chance to bid.”³

On the heels of DFC Global and Dell, Vice Chancellor Laster issued his decision in Aruba Networks.⁴ In their pre- and post-trial briefs, plaintiffs contended that Aruba’s fair value was $32.57 per share, while Aruba contended that its fair value was “deal price less synergies,” or $19.10 per share. After finding that the transaction consideration provided “reliable evidence of fair value,” Vice Chancellor Laster calculated his own “deal-price-less-synergies” estimate of $18.10 per share.⁵ However, noting that a “deal-price-less-synergies” calculation that he performed on his own “could have errors at multiple levels,” and that the calculation of fair market value would also need to exclude “reduced agency costs” (i.e., costs associated with competing interests of shareholders and management), Vice Chancellor Laster arrived at a fair value of $17.13 per share—approximately 30.6% below the merger consideration—by averaging the unaffected market price of Aruba’s shares in the thirty days before the merger was publicly disclosed.⁶ Vice Chancellor Laster was satisfied that this calculation struck the proper balance between DFC Global and Dell’s directive that courts consider “the collective judgement of the many” in determining fair value and mitigating the prejudice derived from the court’s “own fallible determination[.]”⁷ After the Court of Chancery rejected plaintiffs’ motion for reargument, plaintiffs appealed.

On appeal, the Court found that the Court of Chancery’s decision “to rely exclusively” on Aruba’s stock price instead of the merger price less synergies was “rooted in an erroneous factual finding that lacked record support.” Accordingly, the Supreme Court reversed and remanded the case to

¹ 172 A.3d 346, 366 (Del. 2017).
² 177 A.3d 1, 23 (Del. 2017).
³ 172 A.3d at 349; Dell, 177 A.3d at 21.
⁴ 2018 WL 922139 (Del Ch. Feb 15, 2018).
⁵ Id. at *2, 44.
⁶ Id. at *54.
⁷ Id. (quoting DFC, 172 A.3d at 369-70).
the Court of Chancery to enter a final judgment for the plaintiffs awarding them $19.10 per share, reflecting Aruba’s initial calculation of “deal price less synergies.”

**Takeaways:**

Transaction consideration can be strong evidence of fair value even in the absence of multiple bids for the target: The Supreme Court reaffirmed “giving important weight to market-tested deal prices” in determining fair value where that price is the result of arm’s-length negotiation and otherwise the product of a robust sales process. The lower court questioned the reliability of the merger consideration as evidence of fair value because, among other things, no other strategic bidder showed interest in Aruba when HP first approached with an offer, and there were no other bids once the merger was announced. Viewing deal price as reliable evidence of fair value would, in the Court of Chancery’s view, “discount the importance of competition.” The Supreme Court strongly disagreed, stating that “DFC and Dell recognized that when a public company with a deep trading market is sold at a substantial premium to the preannouncement price, after a process in which all interested buyers had access to confidential information and a fair and viable opportunity to bid, the deal price is a strong indicator of fair value.” Here, Aruba engaged a financial advisor to conduct a pre- and post-signing market check whereby multiple potential strategic buyers received access to non-public information and were solicited regarding a transaction. According to the Supreme Court, the fact that the logical strategic buyers that Aruba approached both before and after signing a merger agreement with HP were not interested does not “signal[] a market failure simply because buyers do not believe the asset on sale is sufficiently valuable.” In the view of the Court, “[i]f that were the jurisprudential conclusion, then the judiciary would itself infuse assets with extra value by virtue of the fact that no actual market participants saw enough value to pay a higher price. That sort of alchemy has no rational basis in economics.”

Bidder’s access to non-public information regarding the target supports the reliability of merger consideration as evidence of fair value: The Supreme Court again affirmed its acceptance of the efficient capital markets hypothesis, whereby when a “market was informationally efficient in the sense that ‘the market’s digestion and assessment of all publicly available information concerning [the Company] [is] quickly impounded into the Company’s stock price,’ the market price is likely to be more informative of fundamental value.” Thus, according to the Court, the unaffected market price can be “a proxy for fair value” but should not be exclusively relied upon in determining a company’s fair value in an appraisal or fundamental value in economic terms. Rather, “when that market price is further informed by the efforts of arm’s-length buyers of the entire company to learn more through due diligence, involving confidential non-public information, and with the keener incentives of someone considering taking the non-diversifiable risk of buying the entire entity, the price that results from that process is even more likely to be indicative of so-called fundamental value.” In this case, HP had access to substantial non-public information as a result of due diligence and, as HP was aware, knew about “Aruba’s strong quarterly earnings before the market did, and likely took that information into account when pricing the deal.” The Court also noted that,
while Section 262 requires the Court of Chancery to assess fair value as of “the effective date of the merger,” the unaffected market price relied on by Vice Chancellor Laster “was a measurement from three to four months prior to the valuation date,” during which it was possible for new, material information regarding the company’s future earnings to emerge, and HP had a greater incentive to evaluate Aruba more closely than an ordinary trader of small blocks of Aruba’s shares. Indeed, in this instance, HP became aware of Aruba’s strong quarterly earnings before the market did and after the date from which the unaffected market price was determined, and the Court noted that HP likely took such updated information into account in pricing the deal.

Due process and fairness concerns: The Supreme Court also observed that the Court of Chancery’s decision implicated due process and fairness concerns. By raising the idea of using the unaffected stock price as an appropriate measure of fair value for the first time during the parties’ post-trial supplemental briefing, the Court of Chancery did not provide the parties with an opportunity to develop a full factual record during pretrial discovery and at trial as to whether the stock price was, in fact, reliable evidence of fair value. According to the Supreme Court, “the extent to which the market price approximated fair value was never subjected to the crucible of pretrial discovery, expert depositions, cross-expert rebuttal, expert testimony at trial and cross examination at trial.” These issues impacted the substantive rights of the parties because “[t]he reason for pretrial discovery and trial is for parties to have a chance to test each other’s evidence and to give the fact-finder a reliable basis to make an ultimate determination after each side has a fair chance to develop a record and to comment upon it.”

Litigants need to carefully consider which arguments to raise regarding appropriate evidence of fair value before trial or risk abandoning them: The Supreme Court observed that neither party requested supplemental briefing after it issued Dell nor did any party advocate relying on the unaffected market price as evidence of fair value. Rather, after the lower court requested supplemental briefing on “the market attributes of Aruba’s stock,” “Aruba pivoted from its previous reliance on its expert’s discounted cash-flow model and the deal price minus synergies to ask for the first time that the court set fair value at the unaffected thirty-day average market price.” The Court was obviously skeptical of Aruba’s “pivot” at that late stage: “We chalk up this about-face to a litigant receiving a more favorable outcome than they argued for and trying to cement that unexpected victory on appeal.” While that late-stage change in position most likely did not affect the outcome in this case (i.e., even had it been raised earlier, the Court seems likely to have rejected unaffected market price for other reasons), and Aruba and its advisors very well may have considered and rejected advocating for unaffected market price as fair value at an earlier stage, the decision highlights the potential consequences that result from not raising an argument in pre-trial proceedings. On the other hand and equally important, litigants need to consider the potential loss of credibility that can result from arguing in favor of relying on evidence that is questionable under the circumstances.
Agency costs are encompassed by a calculation of synergies when two public companies merge. Under Delaware General Corporation Law § 262, a stockholder is “entitled to an appraisal by the Court of Chancery of the fair value of the stockholder’s shares of stock” that is “exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation.” The Delaware Supreme Court has interpreted Section 262 to require the Court of Chancery to exclude from any appraisal a “reasonable estimate” of any value that “the selling company’s shareholder would receive because a buyer intends to operate the subject company, not as a stand-alone going concern, but as part of a larger enterprise, from which synergistic gains can be extracted.” As a result, expected synergies included in the deal price need to be deducted from merger consideration in arriving at fair value in circumstances where merger consideration is reliable evidence of value.

Here, the Supreme Court held that the Court of Chancery’s reliance on unaffected market price was erroneous for the additional reason that the Vice Chancellor did so “on the inapt theory” that he “needed to make an additional deduction from the deal price for unspecified ‘reduced agency costs.’” Such a reduction had “no basis in the record” or in “corporate finance literature given that all the cost reductions HP expected as a widely held, strategic buyer were likely to be fully accounted for by its expected synergies.” The Court further noted that “agency costs” are more likely to arise in connection with an acquisition by a private equity buyer by replacing “a dispersed group of owners with a concentrated group of owners,” which could, theoretically, “add value because the new owners are more capable of making sure management isn’t shirking or diverting the company’s profits.” However, these types of costs may be difficult to prove and, even if proven, the buyer must further prove that a portion of the purchase price was attributable to all or a portion of such agency costs in order to exclude them from the calculation of fair market value in an appraisal claim. In the Aruba-HP merger, the court noted that Aruba did not present any evidence to suggest that any portion of the purchase price included agency costs that were not otherwise subsumed by its synergies calculation, which was not surprising as HP’s acquisition of 100% of Aruba’s shares would have “swap[ped]” out one set of public stockholders for another: HP’s.

Appraisal arbitrage in Delaware is likely to remain at reduced levels: Appraisal arbitrage refers to situations where stockholders, often hedge funds, purchase shares of a target after a transaction is publicly announced and commence an appraisal proceeding in the hope that the court will find fair value to be in excess of the merger consideration. In addition, a stockholder seeking appraisal is entitled under Section 262 to receive interest on the court’s fair value award at the rate of 5% above the federal funds rate, compounded quarterly, for the period the lawsuit was pending. This above-market rate could provide an additional incentive for stockholders to engage in appraisal arbitrage (although 2016 amendments to Section 262(h) provide corporations the option to prepay appraisal claimants an amount of their choosing to cut off or reduce the accrual of interest payments). Nonetheless, while the decision in Aruba may provide some comfort to merger arbitrageurs seeking to limit the potential downside of an appraisal claim presented by a fair market
value determination at the unaffected market price, the Supreme Court’s trilogy of decisions relying on merger consideration less synergies as evidence of fair value, in *Dell*, *DFC*, and now *Aruba*, may continue to provide a strong deterrent to commencing such litigation absent persuasive reasons to believe that the merger consideration is not reliable evidence of value. That would be the case, for instance, where conflicts of interest on the part of directors, officers, financial advisors, or significant stockholders undermine the quality of a company’s sales process or where all logical bidders are not given access to accurate confidential information or a fair opportunity to participate in a sale process. But absent such facts, it appears that Delaware courts are likely to rely on the transaction price negotiated at arm’s-length by motivated buyers and sellers, less synergies proven to be included in the transaction price.

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Attention to accretive M&A as a solution to investor pressure when growth slows has led to pressure on merger parties to “cut corners” on process that puts at risk compliance with fiduciary duties. It is critical for acquirors to take steps to assure that the boards of their targets have been complying with their duties.

Buyers in M&A transactions often overlook (or feel powerless to address) this risk that the target’s board may have breached its fiduciary duties in connection with a transaction. A buyer’s failure to account for breaches of fiduciary duties by the target’s board can lead to deal execution risk and/or post-closing liability for the buyer once it has acquired the target (together with its attendant liabilities. When considering the potential for a target board’s breach of fiduciary duties, buyers cannot rely on the typical due diligence process or customary sets of representations and warranties to determine whether such breaches have occurred. However, the buyer can take steps to minimize the risks associated with such breaches.

Conduct by the Target’s Directors and Management

— Conflicts within the Capital Structure. In the event the target has multiple types or classes of outstanding equity, the buyer needs to be focused on the potential for conflicts that will trigger breaches of duty. For example, when members of the target’s board hold, or are affiliated with holders of, preferred stock with a preferred return or put rights, these members may be incentivized to vote in favor of a transaction in which the preferred shareholders receive a healthy payout while common shareholders are left receiving little, or nothing, in the way of merger consideration. Alternatively, in the case of a company with high-vote and low-vote stock, special consideration will need to be given to the process employed by the board of directors when the high-vote and low-vote stock receive different consideration. A court reviewing these types of transactions may apply a higher level of scrutiny to the transaction terms if it determines that board members approving the transaction were not disinterested. Buyers should consider:

• Requiring the target to obtain the approval of the shareholders who are not associated with interested directors;

• Requesting that the board ask the target financial advisor to provide a fairness opinion in respect of each class of stock;
• Asking the target if it has considered running the process with a committee of independent directors; and/or

• In the context of a private deal, requiring indemnification for claims arising in connection with a breach of fiduciary duty.

— Management Conflicts. Although buyers may view a good relationship with a CEO or other senior officers of the target as a benefit during deal negotiations, buyers should be wary of the potential for officers of a company to “get out ahead of” their board during deal negotiations. Buyers should consider taking the following steps to ensure that pre-closing discussions with a senior officer do not become an unwanted point of focus in a shareholder lawsuit:

• Confirm that the insider is not “in front of” his or her board by addressing buyer’s written communications to the full board and getting feedback from the target’s financial advisor and outside counsel about the board’s role; and

• Agree on material transaction terms before negotiating or having substantive conversations about the terms of any post-closing relationship with officers or directors of the target.

Conduct by the Target’s Financial Advisors

A target’s financial advisor’s failure to disclose its relationships (or potential relationships) with the buyer can also lead to claims of breach of fiduciary duty by the target board. Courts have allowed shareholders to claim breach of fiduciary duty when the target’s board allegedly failed to act in an informed manner when the board was unaware of its financial advisor’s potential conflicts, especially those involving the target financial advisors’ investments in, relationships with, and promises to and from the buyer and its affiliates. Though target boards have generally been able to avail themselves of exculpation under 102(b)(7) in the case of such claims, such claims have nonetheless exposed financial advisors to aiding and abetting claims by shareholders, which, post-closing, can result in reputational harm to the buyer as well as potential claims against the target (now as the buyer’s subsidiary) by the financial advisor for indemnification.

Buyers should be mindful of their current and potential interactions and take stock of their past interactions with the target’s financial advisor. Buyers should take steps to ensure that the target and its counsel are aware of any potential conflicts of interest on the part of the target’s financial advisor that arise from connections with the buyer and that these conflicts have been disclosed to the board.

Cleansing

Finally, to the extent buyers become aware (in advance of target shareholder approval of the transaction) of any potential grounds for breach of fiduciary duty claims against the target board, they should require that these claims be included in the merger proxy statement, so that the breaches may be cleansed by a fully-informed shareholder vote.