California LAWYER

Mergers and Acquisitions

EXECUTIVE SUMMARY

Last December business publications were predicting that 2011 would be a boom year for deals because companies with cash would be hunting for strategic acquisitions. And for the first quarter of the year, M&A activity certainly is up compared to the same time last year, with the March announcement of the $39 billion AT&T/T-Mobile deal leading the way.

This month's panel of experts discusses the reasons for the increase in deals as well as other topics, including the threat of litigation, *Revlon* duties, and the impact of *In re Del Monte* on transactions. The panelists are Doug Cogen of Fenwick & West, Allan Duboff of Loeb & Loeb, and Robert Ishii of Wilson Sonsini Goodrich & Rosati. *California Lawyer* moderated the roundtable, which was reported by Krishanna DeRita of Barkley Court Reporters.

MODERATOR: The year 2011 has been predicted as the year of M&A. Is the prediction coming true? If so, what are some reasons for the uptick?

COGEN: The year is off to a strong start. *Thompson Reuters* reported that the Q1 deal activity is about $800 billion, up 54 percent over Q1 of last year. It does seem like we are 50 percent busier than last year. Last year, strategic M&A was about the same as 2009, but down from what was done in 2007. So we are certainly feeling intense volume. One reason is that deals are driven by scarcity. So a mega deal like AT&T/T-Mobile or the battle going on between NASDAQ and the New York Stock Exchange—you see these consolidating industries where there are only a few players of scale.

DUBOFF: The *Daily Journal* reported that this past quarter saw the highest level of M&A activity in four years, and that private equity investing also was up. Clearly 2011 is getting off to a strong start and is picking up on the momentum from the end of 2010. We've had two really bad years and everyone has been waiting for new activity to commence. During that time, you had a lot of companies that had retrenched and cut costs to build up their cash reserves. As the economy rebounds, companies with cash will look for ways to facilitate growth and many may see M&A as a better alternative than organic growth. Additionally, there's pent-up demand both on the sell side and on the buy side, and on the private equity side. Private equity funds held on to portfolio companies longer than planned because valuations were just too low to sell or they needed to deal with economic issues. As the market picks up momentum, it gives both private equity funds and public companies the confidence to go back in and make acquisitions. Additionally, if your competitors are making acquisitions as a way of building market share or facilitating growth, you can't afford to be left out of the M&A market.

ISHII: Confidence in the market is an enormous factor. There are also the macroeconomic factors. The equity markets are coming back and the general climate for economic growth both generate confidence, and then the debt markets are very conducive to inexpensive financing. It's almost a perfect storm for the M&A market.

COGEN: On the financing point, JP Morgan wrote a $20 billion commitment letter to AT&T to finance the T-Mobile deal. That's the single biggest loan ever for financing a deal. They quickly were able to syndicate that, but that gives you a sense of how much cheap and solid financing is available.

ISHII: The pent-up demand is there from the lender, too, because they have not been lending as actively in the last couple years. And buyers have not been buying. On the seller's side, venture-backed startups had no place to go. Suddenly, all of those factors are coming together to create a robust M&A market.

COGEN: There's also the pressure on the acquirers to do something with their cash. In the tech industry, there are many companies with tens of millions in cash who are under tremendous pressure from shareholders who want to see something done with that cash right now. They want to see it returned in a dividend or stock repurchase, or put to good use in a deal since that has the most potential to move the stock.

DUBOFF: As an example of how financing availability has changed, I look to one of our lending clients who was flush with cash and in a very strong position to make loans the last few years when other banks were having financial problems. But in light of the deep decline in the economy, the bank did not have a comfort level in establishing financial covenants. Because of that uncertainty, they were not making new loans. Now, as there is more certainty regarding the economy, they are again providing new financing.

COGEN: One way to look at M&A is that it's a liquidity event, but it's not the only one for a venture-backed startup. Historically if you average it out over many years, you see something like a 20 to 1 ratio of mergers to IPOs. During the height of the bubble, it got to be single digits. Right now, there are many potential IPOs, and it could result in a ten to one ratio for 2011.

DUBOFF: Over the last ten years, companies had the option of an M&A exit or an IPO exit, but the analysis has changed from a cost standpoint. An IPO used to be a viable option for small-cap and lower middle-market companies. Now, after Sarbanes-Oxley, with the increase in additional costs for being a public company, many companies no longer see IPOs as a viable option until they are much larger than they historically had to be to consider that option. For many small-cap and middle-market companies, that M&A to IPO ratio has been flipping in favor of M&A because of the tremendous reluctance to take on all the costs.

ISHII: Another interesting aspect is that the public markets are much less receptive today to a company going

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public without earnings or tremendous prospects going forward. So not only is there a cost of going public, but there's also the inability to go public if you are not a premier startup or private company.

MODERATOR: Are you seeing more litigation?

COGEN: It's safe to say that just about every public target deal will be sued. And it could be the most well-shopped, highest-premium and perfectly conducted process with the greatest result for universally happy shareholders, and that deal will get sued.

ISHII: And there have been four or five enjoined transactions this year, which is remarkable. It used to be rare to see a transaction enjoined. And now we've seen multiple injunctions in the last few months. I'm seeing much more litigation, and it's much more vigilant today.

COGEN: Take the case of *Atheros* (*In re Atheros Communications, Inc. S'holder Litig.*, C.A. No. 6124-VCN (Del. Ch. 2011)). The issue there was primarily disclosure of the banker's fee. Now, without addressing the merits of that issue, you could agree it's a relatively marginal issue in the larger deal that occurred, and yet the chancellor thought it appropriate to enjoin the closing. That's interesting in terms of the role of the Delaware courts. You could call it vigilance; it's definitely a more muscular bench.

DUBOFF: Boards are well aware of the possibility of litigation as they consider the decisions they are going to make. It's become part of the day-to-day reality.

COGEN: A deal will get sued before the proxy has even been filed describing what the process was that led to the deal. The adequacy of the board's conduct of its fiduciary duties and the terms of the deal are all being attacked before those terms have even been understood publicly.

ISHII: Nine out of ten merger agreements contain a provision that says that you'll cease all discussions and contact other bidders and have them return or destroy confidential information. Deals are being sued so fast now that there's litigation pending prior to sending that notice at times, and if you send that notice, you may be destroying evidence in a pending litigation. I just saw an interesting merger agreement that had an exception to the outside date termina-

tion for an injunction, which I've never seen before. With so many deals being enjoined, those two law firms were skittish.

COGEN: That gives the plaintiffs tremendous leverage to potentially settle even if there's nothing substantive that deserves settlement.

ISHII: In the Delaware Chancery Court, bankers are taking a lot of the hits these days. The court reacted negatively in *Del Monte* to the bankers running a flawed process. Then there were concerns about conflicts of interest; in *Del Monte*, the bank was on the buy side as a financing source and the sell side as financial advisor at the same time. The court didn't take kindly to that, although it's not an uncommon practice. But that's just one source of ire that bankers are facing in the Delaware courts right now. In *Occam*, it was similar—bankers were seen as not particularly forthcoming in the litigation, and the court unleashed on them. In *Atheros*, there were disclosure issues with respect to banker fees.

COGEN: It's part of a larger trend that's anti-Wall Street right now. Probably the next place that this gets focus is at the U.S. Securities and Exchange Commission (SEC). Right now, what are essentially disclosure rules are getting enforced by the Delaware court system instead of by the nation's regulator for disclosure.

DUBOFF: Lawyers and public companies historically looked to the SEC to weigh in on whether proxy disclosures relating to the sales process were adequate in the context of securities disclosure requirements. The decisions in *Del Monte* and *Atheros* have reminded people that, whether or not the SEC engages in a full review of the proxy statement, disclosures must also satisfy Delaware full disclosure requirements, particularly in situations involving potential conflicts, such as a judgment as to whether the compensation being paid to investment bankers or management may have influenced their recommendations.

MODERATOR: What impact could *Steinhardt* have when *Revlon* duties apply?

ISHII: I represented Occam in that transaction, so I have some firsthand exposure to the board's thinking on *Revlon* duties. At the end of the day, the court was interested in the percentage of the combined company that the target shareholders would eventually own, as one of the tests that it would apply to determine whether *Revlon* duties were triggered. At some level, we all do that as practitioners, because notwithstanding *Arnold* [*Arnold v. Society for Savings Bancorp, Inc.*, Del 1999], if a $50-billion dollar company buys a $100 million-dollar company and it issues some stock, none of us would be comfortable telling the target's board that they don't have to think about price maximization. As a practical matter, I don't think that *Occam* changes how we approach those types of transactions.

COGEN: Being a conservative lot, M&A lawyers will advise a board as to their *Revlon* duties and you will try to construct a process leading up to a merger agreement that would withstand a *Revlon* level of scrutiny. I don't think one should read *Steinhardt* as moving off the idea that the key to what *Revlon* is about is a final-stage transaction, or the idea that this is the last significant opportunity for shareholders to realize their share of that corporate asset—a control premium.

ISHII: "Final-stage transaction" were the court's words in *Steinhardt*. Typically we would think about *Revlon* duty triggers as a change of control or a liquidation. Different words could apply other than a final-stage transaction. It's interesting phraseology to talk specifically about whether the shareholders would be able to obtain a control premium in the future. But would it have been a different result if the 50/50 was 80/20, stock to cash, but the 80/20 still represented the same portion of the combined company? What caught everybody's attention was the 15 percent ownership. That had not previously been the test in Delaware.

DUBOFF: Regardless of *Steinhardt*, discussions of a sales process should operate on the assumption that *Revlon* duties should be taken into account. I would suggest taking a conservative outlook in trying to fashion a process that is going to appear reasonable to an outsider. There is no single blueprint for a sales process. Whether a process will stand up in litigation depends on the particular facts. I don't think *Steinhardt* will have much effect on how lawyers will advise boards.

ISHII: Practice might change a bit on the buy side if your client wants to be particularly aggressive. Sometimes it's hard when the buyer is trying to protect a deal and is looking to be aggressive. And often, a buyer may be willing to take some risks. In that case, it's more a matter of whether the target is able to restrain them and refuses to go along.

MODERATOR: What are the potential ripple effects of the recent decision in *In re Del Monte*?

COGEN: What the court focused intensely on in this case was the fact that a bank was on both sides of the transaction; bankers created teaming relationships between potential bidders. So something I've been trying to start instituting on our target-side investment banker engagement letters is language that specifically restricts the bank from pursuing a teaming discussion without client consent. This might already be governed by a non-disclosure agreement, but it might not be. When banks have been asking about it, my view is that *Del Monte* is a reminder to practitioners that boards need to keep tight control over their sell-side processes.

ISHII: My reaction to that approach is that it's difficult to legislate good behavior. If you try to write into a contract that the bank is going to adhere to a certain set of principles or that it is going to run a good process or be free from conflicts, it's tough to write all of those things into an engagement letter.

COGEN: It's not necessarily about telling them how to run the process, but on some elements, it's about telling them how *not* to run it. So at least you're making sure that the board has an understanding of the way the process is being run.

DUBOFF: When representing investment bankers, you must be cognizant of conflict situations. *Del Monte* involved a set of egregious facts, but because of these egregious facts, is there now generally a need to take a more conservative approach? It's easy to see the line is crossed as the bankers did in *Del Monte*, but in most situations, it isn't as easy to tell. A result may be that bankers and boards become much more conservative as issues develop and analyze the issues in ways that I don't think boards traditionally did in terms of dealings with their bankers.

ISHII: Do you think it will change the use of stapled financing?

COGEN: With proper disclosure, there's nothing wrong with stapled financing, but it's important that

as you step into that kind of relationship, the board is directing things and has an active role. It needs to maintain an understanding about what's happening at each stage.

DUBOFF: There will be process changes from a disclosure standpoint. When it's time for a board to sign-off, the board will take a more careful look at it. This has the potential to develop a bit of a wedge between the board and the financial advisors, compared to the more customary advisory role, but then again, this situation will not come up often.

COGEN: Many boards are cognizant that they are relying in part on fairness opinions from that bank in terms of their own decision-making process and they want to feel confident that there are no other factors that are going into the bank's view of the transaction.

ISHII: Any board that I'm advising is going to be aware that there's a conflict created by buy-side financing, and in *Del Monte*, the fees on the financing were larger for the financing than for the financial advisory relationship. That is a difficult situation for a board, even in the best of situations where there are ethical walls between the financing team and the financial advisory team, but it's still tough to ignore the fact that the bank's lending group is going to make $24 million on the transaction and the investment bank's financial advisory group is only going to make $21 million. How do the incentives of the bank, as a whole, affect things? On the other hand, there are certainly times where stapled financing is beneficial to the target—if the bank is facilitating a transaction by pre-establishing financing for any bidder and the bidders all walk into the same financing package on the same terms, it helps level the playing field.

COGEN: The watch words are: good disclosure, a cognizant board, and reasonable terms. If all of those things are true, then in almost any situation you will be fine. But those things aren't necessarily going to be true unless you, the lawyer, keep an active role in managing those pieces.

MODERATOR: What other cases, decisions, trends or issues are affecting your practice and why?

DUBOFF: Although we have been discussing issues affecting acquisitions of public companies, there is always a much greater number of acquisitions of private companies. The most prevalent issues that arise in private-company transactions are related to the overall economic deal—not simply price but the issues that end up being negotiated after the parties agree on the basic price.

For example, what are the terms of a working capital or closing balance sheet adjustment? In order to bridge a valuation gap, did the parties agree to an earn-out provision? Is there going to be an escrow or holdback to protect the buyer? Are the selling shareholders in effect providing seller financing by rolling over part of their stock? Is the buyer trying to keep management or the selling shareholders active in the management of the company post acquisition? If so, employment agreements, consulting agreements, stock options, and so forth need to be negotiated with an eye toward both retention and eventually terminating the relationship. In addition, the selling shareholders will be concerned about potential indemnification liability while the buyer, through indemnification, will try to protect itself to make sure that from a dollar standpoint it is getting what it thought it was paying for. All of these issues take a tremendous amount of time to negotiate and work through.

> **"Deal activity is about $800 billion, up 54 percent over last year…we are certainly feeling intense volume."** *—Doug Cogen*

ISHII: Are deal terms getting tougher on sellers because of large serial acquirers demanding onerous terms, or are sellers getting better terms today because of increased competition or buyers realizing that there is limited exposure with respect to post-closing indemnification issues?

DUBOFF: It's fact specific as to the type of acquisition. I see seller-favorable terms when it's an attractive target and there's a competitive auction, and sometimes when it's viewed as a proprietary deal where the buyer either is a fund that is just negotiating separately or it's a strategic buyer, where they know the target. In other situations, terms will be more favorable for the buyer.

COGEN: The trend overall over the last few years is that things have generally skewed more favorably for the buyer, although I agree that leverage and competition affect where the terms come out.

ISHII: That's true in the last few years, but we are swinging back a bit. If you look at macroeconomic factors, the market loosens up some and M&A increases. I would suspect that we will see more attractive sellers, with more competition for them on the buy side, and as a result, we will see some lightening of terms.

COGEN: But the competing buyers are generally companies used to getting their terms. So you could have a number of serial acquirers bidding after the same target and what you will get is some intense price competition. When somebody wins the auction, the legal terms they'll seek—the indemnities and the like, will be tough.

DUBOFF: It depends on the situation and relative negotiating leverage. Over the last few years, a seller often was a distressed seller and there were a small number of terms that would go the seller's way. I'm sure there is still a hangover on that where buyers are trying to get as much as they can get, but it's still going to come down to being fact specific.

ISHII: What do you guys think of antitrust enforcement and how that's affecting transactions?

COGEN: I can't say a lot of deals are getting held up. We have had a couple of transactions where some divestitures were expected going into it, and lo and behold they occurred to get the deal through. But I can't say I've seen, under the Obama administration, massive change in the tone coming out of the regulators.

DUBOFF: There haven't been any surprises. Antitrust enforcement is not a concern for most deals. When it is a concern, there is an expectation that there may be a condition imposed that you'll need to deal with, and state regulators or politicians may want to weigh in. But again none of that is a surprise.

ISHII: In the last Bush administration, we got a bit of a pass when it came to antitrust. The Obama administration has sought to enforce antitrust laws more vigilantly in my view.