Deal Certainty

February 2016
Setting the Stage

February 2016
Setting the Stage

- **Potential Risks to Closing**
  - Adverse developments with the target between signing and closing
    - Material Adverse Effect
  - Failure to obtain required regulatory approvals
    - Antitrust
  - Buyer failure to obtain financing
  - Buyer breach
- **Agreement architecture to allocate risks and increase certainty**
  - Closing Conditions
  - Buyer Covenants
  - Remedies
Allocating the Risk of Adverse Developments

February 2016
Material Adverse Effect

February 2016
Material Adverse Effect – “MAE”

- MAE is essentially an event or change in circumstances in the target that is adverse and significant such that the buyer is reluctant to proceed with the deal on the agreed-upon terms.
- The absence of MAE can be both a stand-alone closing condition and a qualifier in representations and bring-down.
- Very difficult to trigger:
  - Substantial threat to overall earnings (or EBITDA) potential, relative to past performance, not projections.
  - Typically measured using long-term perspective of a reasonable buyer (years, not months).
  - Buyer bears burden of proof.
• Exceptions and limitations are heavily negotiated and may include:
  • Macro trends
    • Changes in (1) economy, markets, or conditions generally applicable to the industry; (2) law or accounting standards
    • War, terrorism, political conditions, natural disasters, “acts of God”
    • Macro trends should not be excluded “to the extent” disproportionately adverse to target relative to industry
  • Failure to meet projections, stock price, credit rating of target (but not underlying facts)
  • Impact of deal announcement/consummation, including impact on business relationships (other than no-conflicts rep and similar provisions)
  • Actions to which buyer consents
• Debt financing commitment should use the same MAE definition as the purchase agreement with the same governing law for MAE
MAE – Conclusion

- Very difficult to trigger
  - High standard: Delaware courts have never found an MAE
  - Only long-term, target-specific problems
- Still important
  - Buyer will have difficulty proving MAE in court
  - Provides some protection for buyers by providing threat-of-litigation bargaining leverage if meltdown at target
Allocating Antitrust Risk

February 2016
Allocating Antitrust Risk

• In general, deals over certain threshold ($78.2 million as of 2016) require an HSR filing with the Premerger Notification Office of the FTC
• Potential Antitrust-related Risks
  • Delay and expense
  • Forced divestiture or restriction on integration
  • Failure to close (or rescission after close)
Allocating Antitrust Risk (cont’d)

- Agreement Architecture
  - Closing Conditions
  - Buyer Covenants
  - Reverse Termination Fee
  - Other Considerations
Allocating Antitrust Risk – Closing Conditions

• Mutual closing condition for receipt of required antitrust approvals (or expiration of 30-day waiting period)
• Jurisdictions covered by condition
  • U.S., E.U. and Canada generally specified where applicable
  • Other jurisdictions often subject to negotiation
    • Buyer will want to cover any jurisdictions in which a waiting period or approval is required
    • Seller will want to reduce conditionality by limiting to the most material jurisdictions (particularly when whole company sold)
    • Consider materiality of activity in jurisdiction, any heightened sensitivities of parties, and potential for criminal enforcement
    • List/schedule specific jurisdictions or materiality of risk
• Consider risk of pre-closing objection to deal where no filing required
Allocating Antitrust Risk – Buyer Covenants

- Level of Efforts
  - Commercially reasonable / Reasonable best / Best
  - Filing (generally same jurisdictions as closing condition), cooperation, prompt response
  - No action (e.g., acquisition) that would hinder antitrust clearance

- Commitment to Divestitures
  - Hell-or-high water
    - Buyer must do whatever it takes to obtain regulatory approvals
  - Divestitures up to a threshold
    - Materiality, revenue, EBITDA, specified product lines
  - Required divestitures should not trigger MAE

- Commitment to Litigate
  - Buyer agrees to litigate through final appeal to obtain approvals or overturn regulatory denials

- Anti-divestiture exception to efforts
Allocating Antitrust Risk – Reverse Termination Fee

- Fee paid if transaction does not close as a result of failure to receive antitrust clearance
  - All conditions satisfied but for required antitrust approvals (and waiting periods) and/or related governmental actions/orders
  - Seller must have complied with its obligations
  - Should not limit recourse for buyer breach
  - Consider risk of court referencing RTF as measure for damages
- Typically 4-6% of deal price
- Generally an alternative to divestiture commitment
Allocating Financing Risk

February 2016
Financing Risk – Setting the Stage

- The cast of characters
  - Buyer agrees to purchase a target company from a seller
  - Buyer and Seller rely on the banks to provide debt financing for the acquisition
    - To a greater extent for financial buyers, but also some strategic buyers
  - Private equity sponsor provides equity for LBO transactions
- Who delivers Commitment Letter to whom?
  - **Financing** sources provide commitment to the buyer
  - **Buyers** use commitment letters to demonstrate availability of funds to sellers pay the purchase price
  - **Sellers** take comfort in the buyers having committed financing
Typical LBO Deal Structure

Sponsor Fund

Equity Contribution

Holdings
(shell company – usually stays in place)

Equity Contribution

Purchase Price = (equity + bank + bond)

Target Company
(Acquired Business)

Target Company’s Stockholders

Acquisition Co.
(Borrower)
(Issuer)
(Company)

Senior Secured Bank Debt

Senior or Subordinated Bond Debt
Financing Risk – Two Commitments

- Two commitments are being made
  - Buyer **making** a commitment to seller to purchase the Target
  - Buyer is **receiving** a commitment from banks to provide financing for the acquisition
  - Buyer needs to **balance** the commitment it is making with the commitment it is receiving
  - Seller and bank need to be mindful of this balance while **protecting their interests**
Financing Risk – Historical Evolution

- Historical evolution of deal certainty and risk allocation
  - Pre-2005 deal making – Era of the financing out
  - 2005-2007 deal making – Reverse termination fee enters
  - 2007-2008 broken deals – Buyers use RTF as a walk-away option
    - Key focal point during the financial crisis concerned ability of buyer to get financing and seller’s right to enforce financing commitments
- The lasting and evolving impact of the 2007/2008 financial crisis
  - Sellers increasingly refuse to assume financing risk
  - Buyer continued exposure to financing failure and other risks
Financing Risk – Historical Evolution (cont’d)

- Issues involved in evolving deal architecture
  - Buyer’s representations regarding and covenants to pursue financing
  - Buyer’s financing covenant
  - Seller’s right to rely on buyer’s commitment letter
    - Guaranty or third-party beneficiary status
Buyer Representations Regarding Financing

- **Buyer Representations: Financing Commitments**
  - Generally describes the equity and debt commitments required to finance the acquisition
    - Rep that buyer has provided true, correct and complete copies of financing commitment letters
    - Confirm no reason to believe conditions won’t be satisfied and that there are no undisclosed conditions
    - Disavow any side letters or understandings
    - Confirm proceeds of the committed financings sufficient to pay all consideration, transaction costs and fees and expenses
Buyer Financing Covenant

- Generally describes the actions buyer will take to obtain financing on terms of commitment letters
- Buyer agrees to enforce rights under commitment letters and pursue litigation
- Buyer covenant no better than underlying commitment
Seller’s Right to Rely on Commitment Letters

- “Xerox Language” in Acquisition Agreement
  - Generally limits sellers’ ability to bring certain claims against banks for failure to fund
- Equity Commitment Letters
  - Third party beneficiary
  - Right to enforce
Remedies for Buyer Breach – Damages

February 2016
Remedies – Damages

- Buyers are concerned about potential exposure if financing is not available
- Additional uncertainty created by courts interpreting MAE clauses differently in merger agreements vs. financing agreements
- Often there is a general reluctance on behalf of sponsors to have potentially uncapped damages
- Measurement of damages creates some uncertainty on the part of sellers
- Some concerns can be addressed by liquidated damages or reverse termination fee provisions
Remedies for Buyer Breach – Reverse Termination Fee
Remedies – Reverse Termination Fee

- Fee paid by buyer if the transaction does not close either as a result of a financing failure or a breach by buyer of its obligations under the acquisition agreement

- Purpose:
  - Incentivize buyer to close
  - Compensate seller for financing risk

- Structure of Reverse Termination Fee
  - One-tier: One fee payable if buyer fails to close for any reason (“walk-away” right or pure option)
  - Two-tier: One fee payable if the failure to close is due to failure of lenders to fund; higher fee payable in case of a “willful” breach
    - E.g., debt financing available and buyer fails to close or breaches covenants
• While reverse termination fees are seen by buyers as limiting their liability, sellers also favor them because they reduce or eliminate uncertainty over amount of damages.
• Tender offer context: ensure that buyer is not directly obligated to the stockholders to close the tender.
Remedies – Size of Reverse Termination Fees

• Reverse termination fees were initially the same amount as seller break-up fees under a fiduciary out
• Reverse termination fees have recently increased relative to the size of break-up fees
• Similar trends are also seen in size of reverse termination fees for private deals
Remedies for Buyer Breach – Specific Performance

February 2016
• Although specific performance has been imposed in certain merger-related cases, imposition of the remedy is not a given:
  • Common law disfavors enforcing specific performance where money damages are ascertainable and sufficient
  • Courts apply specific performance remedies narrowly
• Since *Hexion*, practitioners have assumed that carefully worded specific performance clauses will be enforced—including specific performance of the obligation to close if debt financing is available—and that sellers will not be limited to reverse termination fees
Deal Protection Mechanisms

February 2016
What Are Deal Protections?

February 2016
An M&A transaction is vulnerable between signing and closing. Deal protections are intended to ensure that a transaction closes by:

- Providing buyer with some protection from any interfering third-party bidder
  - Buyer does not want to be stalking horse for other bidders
  - Compensating buyer for expense and risk of a failed bid if a third party breaks up the deal
- Deal protection mechanisms involve an inherent tension
  - Buyer’s need to protect the deal
  - Target board’s need to properly discharge fiduciary duties
Types of Deal Protections

February 2016
Types of Deal Protections

- No-Shop Provisions
- Go-Shop Provisions
- Change/Withdrawal of Board Recommendation
- Force-the-Vote Provisions
- Termination Rights
- Termination Fees
- Stockholder Lockup Agreements / Voting Agreements
- Specific Performance
- Reverse Break-up Fees
What Factors Should Be Considered?

February 2016
What Factors Should Be Considered?

In determining the appropriate level of deal protection in a specific transaction, parties should consider:

- Nature of target’s stockholder base (significant/controlling stockholder vs. broadly held company)
- Likelihood of third-party bidders / interlopers
- Degree to which the target was “shopped” prior to announcing the transaction
- Relative bargaining power of buyer and target
- Nature of buyer (strategic vs. financial)
- Whether the inclusion of these provisions will potentially induce higher-value bids or deter third-party bids
Parties must also consider key factors utilized by courts in determining whether certain provisions are unduly restrictive. Some relevant factors, which are analyzed as a whole and in light of the transaction history, are:

- The overall size of the termination fee (and its percentage value)
- The benefit to target stockholders, including a premium (if any) that directors seek to protect
- The absolute size of the transaction, as well as the relative size of the parties to the merger
- The degree to which a counterparty found such protections to be crucial to the deal
- The preclusive or coercive power of all deal protections included in a transaction and taken as a whole

If a court finds a provision to be unduly restrictive, they may enjoin its enforcement or require revision of the provision after signing.
No-Shop Provisions

February 2016
No-Shop Provisions

• Generally prevent the target from conducting the following activities in the period between signing and closing:
  • Soliciting alternative “Acquisition Proposals”
  • Offering information to potential buyers
  • Initiating or encouraging discussions with potential buyers
  • Continuing ongoing discussions or negotiations
  • Waiving outstanding standstill agreements with third parties

• Typically cover officers, directors, employees, agents and representatives
• Because of target board’s fiduciary duties, No-Shop provisions often contain exceptions – target generally cannot refuse to respond to or learn more about all unsolicited offers.

• Fiduciary duties apply when the target’s board, in good faith, determines or believes that:
  • The third-party proposal is bona fide
  • After consultation with its financial advisors and outside counsel, the proposal constitutes or is reasonably likely to result in a “Superior Proposal”
  • Taking action is necessary to comply with its fiduciary duties to the target’s stockholders

• When No-Shop clauses are so restrictive that they function as a “No Talk” (prohibiting the target board from even familiarizing themselves with potentially superior third-party bids), Delaware courts have enjoined these provisions (QVC and Phelps Dodge)
No-Shop Provisions (cont’d)

No Shops and *Public* Targets

- Virtually every acquisition of a public target contains both a No-Shop provision and some form of exception to allow discussion with unsolicited bidders
- While fiduciary duties apply equally in deals involving either public or private targets, the large stockholder base of public targets dramatically increases the likelihood that the plaintiffs’ bar will sue the target/directors/officers for breach of fiduciary duty
No-Shop Provisions

No Shops and *Private* Targets

- In 2014, approximately 90% of private target acquisitions contained a No-Shop provision (up from 85% in 2012) (*2015 ABA Deal Points Study*)
  - Generally noncontroversial to include a No Shop in private deals, because: (i) presumption is that stockholder support for deal exists at signing, therefore target has less practical need for the “fiduciary out,” and (ii) there is a low(er) likelihood of the plaintiffs’ bar pursuing litigation due to the smaller stockholder base
No-Shop Provisions Exception for a “Superior Proposal”

- Typically target not permitted to engage with potential interloper unless Acquisition Proposal reasonably likely to result in a “Superior Proposal”
- Factors used to determine what is a Superior Proposal include (but are not limited to):
  - Superiority from a financial point of view
  - More favorable contractual terms/requirements for target
  - Likelihood of consummation
  - Financing commitment (in cash deals)
  - Value of buyer’s stock price and prospects of buyer (in stock deals)
- Parties may set a percentage threshold of either target’s assets or stock that must be acquired in order to qualify as a Superior Proposal
No-Shop Provisions – “Superior Proposal” (cont’d)

- If target board determines that a third-party proposal could lead to a Superior Proposal, then the board may:
  - Furnish information to that third party
  - Participate in discussions/negotiations with that third party
- What are the buyer’s rights?
  - Prompt visibility into interactions between target and third party (e.g., information or advance notification rights)
  - In some instances, to match or beat the third party’s offer
No-Shop Provisions – What Are the Target’s Potential Actions?

- If a Superior Proposal is received, target board may have right to:
  - Change/withdraw its recommendation
  - Terminate transaction
- Buyer typically is given “matching rights” to match third-party bid within a few days of termination notice
  - Buyer will often request “last look” or “reset” matching rights – allows buyer to continuously match a third party’s improved offer
Go-Shop Provisions

February 2016
Go-Shop Provisions

• In contrast to the No Shop, the Go-Shop provision gives a target company specific authorization to actively solicit competing proposals for a specified period of time after signing a merger agreement:
  • Time period typically ranges from 30 to 50 days
  • Break-up fee often bifurcated (i.e., set lower during the Go-Shop period)
Go-Shop Provisions (cont’d)

• Considerations
  • Duration
  • Amount of break-up fees (and whether to bifurcate the fee)
  • Matching rights
  • Only allowing target to approach a specified group of bidders

• Potential Benefits of Go-Shop Provisions
  • **For target**: ability to better gauge the market after entering into merger agreement and find the “best” possible
  • **For bidder**: inclusion of go-shop provision may eliminate need for costly auction process
Change/Withdrawal of Board Recommendation

February 2016
Merger agreements typically provide that the target’s board must recommend that the target’s stockholders accept the transaction.

- Target’s board typically negotiates a fiduciary-out to its contractual obligation to recommend to the stockholders that they approve the transaction.
- In response, buyer may seek right to be notified of and to have the ability to match competing bids that target board could consider under fiduciary-out.

Scope of fiduciary-out may vary

- Limited fiduciary-out
  - Target’s board may withdraw or change its recommendation only for a Superior Proposal.
- Intervening Event
  - Target’s board may withdraw or change its recommendation if other events make deal no longer attractive (e.g., “gold under the headquarters”).

February 2016

- Information & Matching Rights
  - Information rights grant a bidder the right to receive information about other competing offers, enabling tailored and competitive counter-offers
  - Matching rights can take various forms, but contractually provide a bidder the right to match a competing offer
    - “Last Look” or Reset Matching Rights: Give the initial bidder the right to match all competing bids on an ongoing basis.
    - Single-Trigger Matching Rights: Give the initial bidder the right to match a competing bid only once
Information & Matching Rights and Advance Notice Provisions (cont’d)

- Advance Notice Provisions
  - Require the target to provide bidder with advance notice before:
    - The target board changes its recommendation or exercises its fiduciary out right to terminate the merger agreement; or
    - The target provides information to another competing third-party bidder under the No-Shop provision
Force-the-Vote Provisions

February 2016
Force-the-Vote Provisions

- Require the target’s board to present the transaction to a stockholder vote, even if the board changes or withdraws its recommendation
- Force-the-vote provisions are explicitly allowed by Delaware law (see Section 146 of the DGCL)
Force-the-Vote Provisions (cont’d)

• Force-the-vote provisions can benefit buyer by: (i) improving overall deal certainty (especially when stockholders favor buyer’s offer); and (ii) requiring that target’s stockholders vote up or down on buyer’s offer before they can vote on any competing bid
  • Used as a tool to dissuade potential third-party bidders, as such bidders may not want to wait around while the proxy solicitation process occurs for the already signed deal
• While still occasionally used, the number of transactions with force-the-vote provisions has declined over the past few years
Stockholder Voting & Lockup Agreements

February 2016
In transactions where one or more significant stockholders own shares of the target, buyer may request that those stockholders execute various agreements obligating themselves, including:

- **Stockholder Voting Agreements** – Stockholders may agree to:
  - Vote in favor of the transaction
  - Grant buyer a proxy to vote the stockholder’s shares in favor of the transaction
  - Not support competing transactions

- **Lockup Agreements** – Stockholders agree not to transfer their shares (for a specified period)

- **Term and Scope of Stockholder Agreements**
  - A change in board recommendation or termination of the merger agreement may also trigger the termination of certain stockholder agreements
Termination Rights

• Sample Termination Provisions in Merger Agreements:
  • Either party may terminate the agreement in the event that:
    • Stockholders vote down transaction
    • Drop dead date is reached (closing has not occurred by specified date)
    • Other party breaches the agreement
  • Target may terminate the agreement:
    • To enter into a Superior Proposal
    • Some agreements provide that the target must: (i) notify the buyer before accepting a Superior Proposal and/or (ii) give the buyer a period of time to match or beat the Superior Proposal
  • Buyer may terminate the agreement:
    • Failure of target’s board to reaffirm its recommendation
    • Target board’s change in recommendation
    • Target’s violation of No Shop
    • “Material adverse change” in the target’s business
Termination Fees

February 2016
Termination Fees

What are termination fees?

- A fee *paid by the target* to buyer if the transaction is terminated for certain reasons (including target’s acceptance of a superior proposal or other specified circumstances)
  - Also known as “break-up” fees
  - Termination fees may be bifurcated (*e.g.*, if Go-Shop periods applicable)
- Designed to compensate unsuccessful bidders for risks and costs incurred and to incentive potential bidders to undertake costs of evaluating the target
Termination Fees (cont’d)

How big are termination fees?
- Generally 2% to 4% of equity value of the transaction but context matters; consider:
  - Reasonableness
  - Size of transaction
  - Equity value vs. levered value
  - Process
  - Relative size of parties
  - Transaction benefits to stockholders
  - Importance to buyer
  - Fee triggers (alternative offer vs. failure to approve by stockholder vote vs. target board’s change in recommendation to another bidder)
- Excessive termination fees may be found to be a breach of fiduciary duty, if they are deemed to be so high as to be “coercive” or “disruptive”
Termination Fees (cont’d)

• Common triggers causing a termination fee to become payable
  • Change/Withdrawal of target board’s recommendation
  • Acceptance of a third-party offer (Acquisition Proposal/Superior Proposal)
    • Often payable at entry into agreement with third party; sometimes payable only upon consummation of transaction with third party
  • Target breaches No-Shop provision
• Common expense reimbursement triggers (less than termination fee)
  • Stockholders fail to approve the transaction
  • Breach of a representation, warranty or covenant causing a failure to close
“Tail Period” triggers resulting in full termination fee becoming due post-termination:

- **First trigger** – Drop dead date passes, or stockholders reject merger, in either case where an Acquisition Proposal was made prior to termination
- **Second trigger** – Target enters into an Acquisition Proposal with a third party within specified post-termination period
Specific Performance

February 2016
Specific Performance

What is specific performance?

- Merger agreement provisions that allow a party to require the other party to do what the agreement requires (i.e., close the transaction)
Protection for Target – Reverse Break-Up Fees

February 2016
Protection for Target – Reverse Break-Up Fees

- Reverse Break-Up Fees are **fees paid by the buyer** to the target if the transaction is terminated for certain reasons.
- Amount of reverse break-up fee not necessarily subject to the same legal limitations as a break-up fee:
  - Fees to be paid by buyers aren’t limited by fiduciary duties of buyer in the same way target can’t agree to high fee to lock up deal to detriment of stockholders.
  - Reverse break-up fees have evolved to become larger than corresponding break-up fee.
Protection for Target – Reverse Break-Up Fees (cont’d)

• Potential triggers of Reverse Break-Up Fee may include:
  • Lack of antitrust or other regulatory approval
  • Drop dead date
  • Lack of stockholder approval by buyer (if required)
  • Lack of available financing
  • Breach by buyer of representation, warranty or covenant

• Multi-Tier Reverse Break-Up Fees
  • Parties can negotiate such that a lower fee is available in some situations and a higher fee is available in other situations
An Overview of Stockholder Rights Plans

February 2016
Stockholder Rights Plans: Overview

Rights agreements, if properly used, provide directors with “a shield to fend off coercive offers and with a gavel to run an auction”  
*(Facet Enterprises, Inc. v. The Prospect Group, Inc.)*

<table>
<thead>
<tr>
<th>PURPOSE</th>
<th>To provide a window of time for the Board to evaluate the potential threat and review and develop alternatives, and for the stockholders to be informed of and evaluate those alternatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>EFFECT</td>
<td>Protects against acquisition of greater than 10–20% of the Company's shares (and caps accumulations that already exceed that threshold), either in the open market, private block purchases or in a tender offer, without prior Board approval</td>
</tr>
<tr>
<td>LIMITATIONS</td>
<td>A rights agreement will not:</td>
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<tr>
<td></td>
<td>• prevent a fully valued takeover bid</td>
</tr>
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<td></td>
<td>• defend against a proxy contest</td>
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<tr>
<td>FLEXIBILITY</td>
<td>Board may amend or redeem a rights plan following negotiation to acceptable value or other agreed outcome</td>
</tr>
<tr>
<td>COLLATERAL CONSEQUENCES</td>
<td>There are no accounting or tax consequences associated with the initial grant of the rights</td>
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<td>Adverse investor reaction</td>
</tr>
<tr>
<td></td>
<td>• Principally in the abstract (adoption absent apparent threat)</td>
</tr>
<tr>
<td></td>
<td>• In context of an offer or insurgency, rights plan is usually a sideshow</td>
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</tbody>
</table>

**CORPORATE GOVERNANCE AND ISS POLICY**

Since their inception, rights plans have been targeted by corporate governance advocates, including proxy advisor firms like Institutional Shareholder Services (“ISS”), as devices that purportedly entrench boards and prevent shareholders from exercising the right to sell their shares to a willing buyer.

ISS recommends that stockholders withhold votes for the entire board of directors if, without stockholder approval, the Board:

- Adopts a rights plan with a term of more than 12 months; or
- Renews any rights plan, including any “short-term” rights plan with a term of 12 months or less

Commitment or policy to put a newly-adopted rights plan to a binding stockholder vote may potentially offset ISS’s adverse vote recommendation, but obtaining a favorable recommendation requires compliance with ISS guidelines.

ISS considers on a case-by-case basis any boards that adopt a rights plan with a term of 12 months or less without stockholder approval.

Increasingly rights plans are kept “on the shelf” and adopted in response to specific or publicly announced threats (so called “in-play” adoptions).
Characteristics of Typical Rights

- Dividend of one right to purchase a fraction of a share of preferred or common stock, at a fixed purchase price
- Rights trade with the existing common stock until “distribution date” and have no economic impact until occurrence of “flip-in” or “flip-over” triggering event at specified ownership threshold (i.e., 10%–20% ownership)
- Purchase price impacts dilutive power of rights plan and is customarily based on advice from financial advisor
- Historically expired in 10 years, but shorter duration of 1–3 years is becoming more common
- Grandfather clause exempts existing stockholders who hold the specified trigger threshold or more, but caps future accumulations
**Stockholder Rights Plans General Mechanics (cont’d)**

- **Flip-In Provision**
  - “Flip-in” occurs when any person becomes an “acquiring person” by acquiring a specified percentage (i.e., 10%–20%) or more of the Company’s common stock.
  - After the “flip-in” event, each right holder (other than the acquiring person) may purchase, for the purchase price, shares of the Company’s common stock having a then-current market value of twice the purchase price.
  - Entitles each right holder (other than the acquiring person) to purchase the Company’s common stock for ½ price.
  - Typically excludes inadvertent trigger, if acquiring person reduces level of ownership.
Stockholder Rights Plans General Mechanics (cont’d)

- **Flip-Over Provision**
  - “Flip-over” occurs when the Company is acquired in a merger or other business combination, or when 50% or more of its assets or earnings power is sold or transferred
  - Flip-over provision entitles each right holder, upon the occurrence of one of the above triggering events, to purchase, for the purchase price, shares of the acquirer's most senior voting securities having a then-current market value of twice the purchase price

- **Exchange Provision**
  - Board may exchange rights for common stock on a one-for-one basis after any person becomes an acquiring person
# Standard of Review for Board Action under Delaware Law

<table>
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<tr>
<th>BOARD ACTION</th>
<th>STANDARD OF REVIEW</th>
<th>ESSENTIAL TERMS</th>
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<tbody>
<tr>
<td>Sale for cash (or to a controlled company for stock) or liquidation of the company</td>
<td>Revlon</td>
<td>The duty of the board changes from preserving the corporate entity to maximizing stockholder value through pursuit of the best transaction reasonably available for the stockholders. Delaware courts indicated in subsequent cases (<em>Paramount Communications Inc. v. QVC Network, Inc.</em>, <em>Barkan v. Amsted Indus., Inc.</em>) that there is “no single blueprint that a board must follow to fulfill its duties.”</td>
</tr>
<tr>
<td>Defensive measures and actions</td>
<td>Unocal / Unitrin</td>
<td>The board must justify the reasonableness of specific defensive tactics employed in relation to the nature of the particular hostile threat to stockholder and corporate interests. In general, a defensive measure will be found improper or “disproportionate” if it is either “draconian” (coercive or preclusive) or falls outside a “range of reasonable” responses.</td>
</tr>
<tr>
<td>Conflict of interest transaction involving controlling or dominant stockholders</td>
<td>Entire Fairness</td>
<td>Directors are “required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.” Fundamentally, a transaction is “entirely fair” if it mimics a hypothetical arms’ length negotiated transaction. The standard has two component parts – “fair dealing” and “fair price” – although the analysis is more fluid in practice and looks to all aspects of the transaction.</td>
</tr>
<tr>
<td>Actions intentionally affecting stockholder franchise</td>
<td>Blasius</td>
<td>Directors must prove a “compelling justification” for their actions, which has been interpreted to mean the board bears the burden of proving that their action: (1) serves, and is motivated by, a legitimate corporate objective; and (2) is reasonable in relation to this legitimate objective and not preclusive or coercive with respect to shareholder voting.</td>
</tr>
<tr>
<td>All other Board decisions and actions</td>
<td>Business Judgment Rule</td>
<td>Creates a presumption that a decision was made by directors who were disinterested and independent, acted in subjective good faith, and employed a reasonable decision making process. Under those circumstances, the directors’ decision is reviewed not for reasonableness but for rationality. A director will not be held liable for a decision—even one that is unreasonable—that results in a loss to the corporation, so long as the decision is rational.</td>
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Stockholder rights plans are viewed as defensive
# Considerations for Adoption of Rights Plan vs. “On the Shelf”

<table>
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<tr>
<th>REVIEW UNDER DELAWARE LAW</th>
<th>Adoption of Rights Plan</th>
<th>Use of Rights Plan</th>
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<tr>
<td></td>
<td>• Rights plans are viewed as defensive and subject to enhanced scrutiny under the <em>Unocal</em> / <em>Unitrin</em> standard</td>
<td>• A board’s use of a rights plan in the future, in response to particular takeover proposals, is subject to continued <em>Unocal</em> / <em>Unitrin</em> scrutiny</td>
</tr>
<tr>
<td></td>
<td>• Adoption of a rights plan has consistently been upheld as a reasonable response to threats of abusive tactics, even if no current takeover proposal is pending</td>
<td>• A court will review carefully use of a rights plan in a manner discriminating among bidders or which appears motivated by “entrenchment”</td>
</tr>
</tbody>
</table>

## PUT RIGHTS PLAN “ON THE SHELF”

- ↑ Allows more thoughtful Board review of rights plan
- ↑ Board evaluation conducted absent pending threat
- ↑ Allows quick implementation in response to rapid share accumulations
- ↑ No public notice / ISS response
- ↓ Deterrent effect delayed
- ↓ Effectiveness depends upon “early warning systems” and ability to identify stake building or other unusual activity, given trading volume and liquidity

## ADOPT RIGHTS PLAN

- ↑ Immediate deterrent effect
- ↑ Mitigates risk of “early warning” system failure
- ↓ Will draw “withhold” vote recommendation from ISS at next annual meeting, unless term is less than one year or rights plan is submitted for stockholder approval
- ↓ Potential rallying point for activist investors
## Activist Share Accumulations: Early Warning and Defensive Mechanisms

<table>
<thead>
<tr>
<th>MECHANISM</th>
<th>“TRIPWIRE” / NOTICE</th>
<th>EFFECT</th>
<th>CONSIDERATIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hart-Scott-Rodino Antitrust Improvements Act</td>
<td>$76.3MM, requires filing with federal government and notice to company</td>
<td>Freezes further accumulation until antitrust approval</td>
<td>• Less useful at smaller cap companies</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Does not capture securities without voting power</td>
</tr>
<tr>
<td>Schedule 13D</td>
<td>5% of outstanding shares, requires filing within 10 days with amendments filed promptly for additional 1% accumulations</td>
<td>Notice only, but does require disclosure of “purposes”</td>
<td>• Will not capture initial derivative accumulations</td>
</tr>
<tr>
<td></td>
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<td></td>
<td>• Ten day filing window allows large additional accumulations</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Does not capture “wolf pack activities”</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• If initial filing on 13G, conversion to 13D not necessary until intent of filer has changed, a standard that is not well defined</td>
</tr>
<tr>
<td>Stockholder Rights Plan</td>
<td>Typically 10% or 15%, depending on the terms of the Rights Plan adopted by the board</td>
<td>Freezes accumulation until board approval or rights are redeemed</td>
<td>• “In place” rights plans (without stockholder approval) draw negative ISS recommendations</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Implementation “in play” can draw additional activist criticism</td>
</tr>
<tr>
<td>Freezeout Statutes (e.g., DGCL §203)</td>
<td>15%</td>
<td>Limits ability of accumulating stockholder to engage in subsequent transactions with company, including “second step” mergers</td>
<td>• Limited deterrent to activists</td>
</tr>
</tbody>
</table>
## Adopting a Rights Plan: Threats that Could Result in Adoption

### THREAT TYPE

<table>
<thead>
<tr>
<th>Accumulations</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Significant share accumulation by (i) a strategic buyer, hedge fund or other non-passive investor or (ii) multiple non-passive investors creating a “wolf pack” that could result in either:</td>
</tr>
<tr>
<td></td>
<td>• “Negative control” - the disproportionate control and influence over major decisions, if permitted to continue, or</td>
</tr>
<tr>
<td></td>
<td>• “Creeping control” - the establishment of a controlling stake without paying a control premium</td>
</tr>
<tr>
<td>Unsolicited Bids</td>
<td>• Receipt of “bear hug” letter or other indication of potential hostile activity</td>
</tr>
<tr>
<td></td>
<td>• Tender offer announced or commenced</td>
</tr>
<tr>
<td>Market Movement</td>
<td>• Market rumor, conference call innuendo or internet message boards suggest potential hostile activity, including “wolf pack” tactics by hedge funds</td>
</tr>
<tr>
<td></td>
<td>• Temporary decline or volatility in the Company’s share price not reflective of Board’s view of long-term fundamental value</td>
</tr>
<tr>
<td>Other</td>
<td>• Other activity not in the best long-term interests of stockholders</td>
</tr>
</tbody>
</table>
## Adopting a Rights Plan: Determinations to be Made by the Board

### Threats that Could Result in Adoption
- Implementation of Rights Plan
- Board Acts Unilaterally to Implement

<table>
<thead>
<tr>
<th>PROVISION</th>
<th>DETAILS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase Price</td>
<td>Established in consultation with financial advisor</td>
</tr>
<tr>
<td>Trigger Threshold</td>
<td>10%-20%, absent unusual circumstances</td>
</tr>
<tr>
<td>Second Trigger</td>
<td>A “two-tier” structure allows passive investors filing on a Schedule 13G (rather than a Schedule 13D) to accumulate to a higher trigger threshold, such as 20%</td>
</tr>
<tr>
<td>Expanded Trigger</td>
<td>Synthetic equity trigger addresses undisclosed accumulations through equity derivatives</td>
</tr>
<tr>
<td>Grandfather Clause</td>
<td>Stockholders exceeding trigger at adoption of plan must be excluded as to the shares held at that time, but additional accumulations will customarily trigger the Rights Plan</td>
</tr>
<tr>
<td>Duration</td>
<td>Historically, rights plans had 10-year terms, but a shorter term of 1 to 3 years may be appropriate, depending on the nature of the threat, and may reduce risk of “withhold” recommendations in subsequent director elections</td>
</tr>
<tr>
<td>Qualifying Offer</td>
<td>If the Board refuses to redeem the rights plan 90 days after a “qualifying offer” is announced, 10% of the shares may call a special meeting or seek a written consent to vote on rescinding the rights plan</td>
</tr>
<tr>
<td>Shareholder Approval</td>
<td>Avoids a “withhold” recommendation for the duration of the rights plan; ISS will recommend stockholders approve rights plans with a 20% trigger threshold, a term less than 3 years and a qualifying offer provision</td>
</tr>
</tbody>
</table>
Adopting a Rights Plan: Implementation of Rights Plan

Threats that Could Result in Adoption

Specific Determinations to be made by the Board

Board Meeting Called in Response to Threat

Implementation of Rights Plan

Board Acts Unilaterally to Implement

**STEPS TO IMPLEMENT RIGHTS PLAN**

1. Approve Rights Plan and Certificate of Designation
2. Declare dividend of rights
3. Execute Rights Plan with Rights Agent, upon which Rights Plan is effective
4. Issue press release
5. File Certificate of Designations with Delaware
6. File with SEC and NYSE
7. Distribute a summary of the Rights Plan to stockholders of record
Benefits of Going Private

February 2016
Benefits of Going Private

- A “going private” transaction is a transaction with a controlling stockholder or other affiliate that reduces the number of stockholders of a public company, allowing the company to remove its public company status and reporting obligations.

- Common types of going private transactions include:
  - Acquisitions by a controlling or significant stockholder of a subsidiary with publicly traded shares.
  - Leveraged buyouts by a private equity fund or other third-party working with management.
Reasons for Going Private

February 2016
Reasons for Going Private

- Allows management to focus on long-term growth or a significant strategy shift, rather than trying to meet the expectations of Wall Street every 90 days
- Eliminate management distraction created by quarterly reporting obligations
- Allow management to regain a sense of control and confidentiality
- Facilitate integration of operations without concern of impact on public stockholders
- Allow the company to have a more leveraged capital structure than might otherwise be acceptable for a public company
Reasons for Going Private (cont’d)

- Provide an opportunity to recalibrate management compensation packages without public stockholder scrutiny or pushback
- Increase competitiveness by keeping competitors in the dark
- Allow the company to change corporate form to realize tax benefits
- Lower ongoing legal, accounting, D&O insurance and investor relations expenses
Mechanics of Going Private

February 2016
Mechanics of Going Private – “Friendly”

- Management-led buyout group creates new company to acquire the public company, and submits proposal to public company Board
- Board of Directors appoints special committee of independent directors to negotiate on behalf of public stockholders
- Once an agreement has been reached between the buyout group and the special committee, buyout group either:
  - Launches a tender offer, with the goal of gaining at least 90% (or a simple majority if using a DGCL 251(h) structure) of the outstanding shares so that it can cash-out non-tendering stockholders in a “short-form merger”; or
  - The public company seeks stockholder approval for a merger transaction, typically by holding a special meeting, and using a proxy statement
- Upon merger, public stockholders are entitled to cash consideration or appraisal rights under state law
Illustrative Transaction Timeline

February 2016
Note: Assumes Target board agrees not to conduct a pre-signing auction, no antitrust or other regulatory delay in transaction and no delay due to Target interloper bid.
Legal Issues

- **Fiduciary Duties**
  - Conflict of interest between buy-side “Insiders” (controlling stockholders and/or management) and sell-side public stockholders
  - Controlling stockholders owe fiduciary duty to minority stockholders
- **Disclosure Requirements**
  - Rule 13e3 and the accompanying Schedule 13E-3 require certain additional disclosures for going private transactions, including:
    - Purpose of the transaction, including a statement describing any alternatives and why they were rejected
    - An affirmative statement as to whether the filer reasonably believed the transaction is fair or unfair
    - A description of all reports, opinion and appraisals from outside parties that are materially related to the transaction
  - Company must issue a proxy statement soliciting approval of the merger
Entire Fairness Doctrine

February 2016
Traditional “Entire Fairness” Doctrine

• To address conflicts of interest at the board level, Delaware law has developed a rigorous standard of “Entire Fairness”
• Entire Fairness analysis is typically applied in the context of “going-private” transactions and is based on a holistic demonstration of “fair price” and “fair dealing”
• Entire Fairness requires “Fair Price” and “Fair Process”
• The “Fair Price” prong focuses on the substantive fairness of the transaction, i.e., whether the transaction was economically fair to stockholders
• The “Fair Process” prong focuses on the manner in which the transaction was timed, initiated, structured, negotiated, disclosed to the board and how the buyout group obtained stockholder and director approval
Business Judgement Rule

February 2016
• Some Delaware court rulings have appeared to reduce the standard of review from “Entire Fairness” to the much less rigorous “Business Judgement Rule” in certain instances.

• The Business Judgement Rule requires only that the Board act in good faith and on an informed basis.

• In a squeeze-out merger initiated by a controlling stockholder, if both a special committee of independent, disinterested directors and an informed majority-of-the-minority of stockholders approve the transaction, the standard of review drops to the Business Judgement Rule.

• Delaware court rulings suggest that a tender offer followed by a short-form merger would also receive Business Judgement Rule treatment if it had both of these safeguards.
Special Considerations for Management Buyout

February 2016
Special Considerations for Management Buyout

• Management dealings with partners in a buy-out group:
  • Don’t give buyout partner non-public information without confidentiality letter
  • Be sensitive to board concerns about providing non-public information to third parties even with confidentiality letter
  • Be sensitive to need for level playing field
  • Can run “beauty contest” for potential partners based on price and other factors

• Formation of special committee
  • Recommend only truly independent directors
  • Stacking Committee may backfire
  • Let Committee choose own legal and financial advisors
  • Committee may consider shopping company or doing a “market check” to address Entire Fairness standard; however, management/controlling equity concentration may limit utility of market check/shop
Other Strategic Issues for Insiders

February 2016
Other Strategic Issues for Insiders

- Timing of initial involvement and negotiations with board
- How much advance negotiation between management and any buyout partners
- Timing of creation of special committee and scope of authority
- Timing of discussions with financing sources

- How to prevent/limit competing bids or auction process
  - Within confines of Insider’s fiduciary duties
  - Within confines of Insider’s share ownership
  - Concentration of insider ownership may effectively limit effectiveness of market check/shop of the company
The Special Committee

February 2016
The Special Committee

- Special Committee should be independent
  - “Independent” means an outside director without any conflicting interest in the transaction
  - “Interest” includes relationships with Insiders
    - Prior relationships (broadly defined) considered
    - Delaware case found that a combination of social and institutional connections undercut the independence of two directors
- Special Committee should, at a minimum:
  - Hire independent counsel
  - Hire independent investment bankers
  - Try to get best available deal
Strategic Issues for Special Committee

February 2016
Strategic Issues for Special Committee

- Obtaining access to critical information about company
- Creating adequate time frame and internal process for review and negotiation
- Deciding how and when to negotiate price and other terms—“arm’s length”
- How to address need or special committee desire for a “market check”
Role of Committee Financial Advisor

- Provide independent, balanced financial and strategic advice
- Assist committee in formulating and executing Fair Process and obtaining Fair Price
  - Negotiation with Insiders on price and other terms
  - Developing alternatives where feasible
- Financial analysis and opinions
  - SEC disclosure of presentation materials and pitch books
  - Special issues for companies with two classes of stock
Litigation Risk and Potential Pitfalls

February 2016
Litigation Risk

• Why the plaintiff's bar pursues these cases
  • Enhanced judicial scrutiny
  • Monetary liability
• Role of process
• Role of insurance
  • Settlement
  • Allocation
Potential Pitfalls

- Making offer while in possession of material, nonpublic information
- SEC rules may require disclosure of certain information provided to other members of the buy-out group (if any) regarding the potential value of the company (e.g., projections, future plans, etc.); need to carefully evaluate any information provided to all parties
- Conflict of interest issues for management
- Lawsuits following announcement of a transaction
Management Do’s and Don’ts
At Initiation of Deal

February 2016
Management Do’s and Don’ts At Initiation of Deal

• **Do**
  - Consult with your board early and often (especially before you initiate any meaningful contact with PE sponsors or other controlling persons)
  - Assess strategic alternatives with an open mind and fairly report them to your board
  - Include strategic buyers in sale process unless board concludes it would be harmful to stockholder interests
  - Maintain a level playing field for all bidders, whether strategic or financial, to extent feasible

• **Don’t**
  - Conduct a “pre-auction” away from your board
  - Agree to NDAs without prior board approval or ignore or go “easy” on standstill provisions as part of NDA
  - Have discussions without prior board approval that could compromise management’s neutrality, particularly discussions of management’s post closing role and compensation
Management Do’s and Don’ts In Conduct of Auction

February 2016
Management Do’s and Don’ts In Conduct of Auction

- **Do**
  - Keep board up-to-date and involved throughout process
  - Play fair and even-handed throughout due diligence and negotiations
  - Negotiate “hard” on proposed merger agreement provisions and details
  - Be particularly mindful of fiduciary duty to stockholders in negotiation of “deal protection” provisions

- **Don’t**
  - Resist formation of special committee or hands-on board supervision of sale process
  - Use due diligence or negotiations as “under the radar” means to favor certain bidder(s)
  - Assume your board or the court will simply defer to your judgment on negotiation tactics or deal terms
Management Do’s and Don’ts for Topping Bids

February 2016
Management Do’s and Don’ts for Topping Bids

• Do
  • View topping bid as beginning of renewed auction
  • Follow basic principles for conducting an auction

• Don’t
  • Forget investors will have final say and are concerned only about maximizing value
  • Stay wedded to incumbent bidder if it has a losing economic hand
Board Do’s and Don’ts At Initiation of Deal

February 2016
Board Do’s and Don’ts At Initiation of Deal

- **Do**
  - Insist on full review of strategic alternatives before authorizing exploration of a sale transaction
  - Establish board’s active role in sale process
  - Consider desirability of creating special committee for legal or governance purposes
  - Determine independence of company’s legal and financial advisers
  - Issue clear guidelines to management with respect to its involvement in due diligence, deal negotiation and post-closing role and compensation

- **Don’t**
  - Ignore that investors and courts look to the board to counter management “conflicts of interest” in any sale transaction, especially a take-private deal
  - Ignore or disadvantage strategic buyers without careful consideration
  - Assume sale process or deal structure and terms must fit template of another deal—there is no “one size fits all” sale process
  - Be casual about meetings or records of meetings—insist on full discussion of issues and preparation of appropriate contemporary minutes
Board Do’s and Don’ts in Conduct of Auction

February 2016
Board Do’s and Don’ts in Conduct of Auction

- **Do**
  - Be mindful of strong investor and judicial preference for “level playing field” auctions
  - Monitor process carefully and frequently in active oversight role
  - Focus on critical contract terms, including
    - No shop/go shop
    - Termination fees and triggers
    - Reverse break fees and triggers
    - PE Sponsor liability limitations

- **Don’t**
  - Ignore issues of sharing competitively sensitive information with strategic buyers
  - Ignore benefits to auction of providing and enforcing bidding rules even-handedly
  - Assume following deal precedents is a substitute for analysis and bargaining over deal terms, particularly on critical contract provisions
    - Courts react adversely to “cookie cutter” explanations
Board Do’s and Don’ts for Topping Bids

February 2016
Board Do’s and Don’ts for Topping Bids

- **Do**
  - Remember over-riding duty is to maximize stockholder value
  - Remain open to a renewed auction — may be challenging, but is often a creator of additional value

- **Don’t**
  - Be emotionally wedded to incumbent “buyer”
  - Let management’s stake in a victory by either bidder influence board decisions focused on stockholder value