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Activists and Regulators

A Word from Rodgin Cohen

Editor's Note: Rodgin Cohen of Sullivan & Cromwell, the premier M&A expert on financial institutions, recently gave an address to the Dickinson School of Law/ City Bar Association on activist investors and the regulatory process for bank deals.

I'd like to discuss activist investors and then a little bit about one aspect of the current regulatory environment as it affects financial institutions and M&A. It's not something that's been written about very much, if at all.

Let me start with shareholder activism. I think the best way to begin is to ask what do we mean by shareholder activist? I'm talking about shareholders who are seeking change in the board, management or the strategic direction of the company, and distinguishing them from those who come in and want corporate governance changes alone. Now, shareholder activists may very well also seek corporate governance changes but that is usually as a wedge issue to gain favor with shareholders. Shareholder activists typically involve a large pool of money but they are often personified by an individual.

Now obviously shareholder activism isn't new, so you may ask why does it have all this notoriety recently? I think there are several reasons. First, the activists are now prepared to take on the very largest companies, and even companies which may previously have been thought to be impregnable, for example because of large family ownership. In the past, the activists tended to fall on some of the wounded companies with core financial performance or market performance issues, smaller companies. They know no bounds today. Second, activists have achieved success in some very high-profile recent cases. And third, a number of the most prominent activists are masters of self-publicity.

In addition to those factors, there have been a number of others that have emerged to encourage shareholder activists in their pursuit. The first has been a decided shift in power in recent years from directors to shareholders and, in particular, the dismantling of obstacles to the election of dissident directors: these include recent majority voting requirements for directors; the elimination of broker discretionary voting; increasingly the rights of the minority of shareholders to call a spe-

Cohen ➔

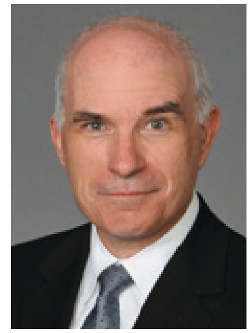
DON'T MISS WHAT'S STILL AHEAD...

In our next issue, we will be covering the state of M&A, a survey of 2013 and predictions for 2014 from many of the most prominent M&A observers.

Soon after that, we will also be attending the annual Tulane conference, which this year is to include a conversation with Marty Lipton about his M&A career, his view of developments in dealmaking, and his perspective on the future of M&A.

Buyer Know Thyself

by Paul M. Crimmins and Christine M. Shepard



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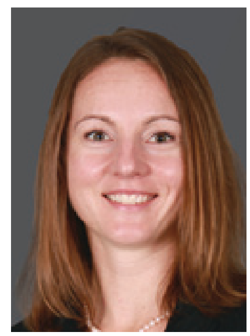

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When a buyer decides to pursue an acquisition, it necessarily focuses a good deal of time and effort in performing due diligence on the target.

But, a buyer's understanding of *its own* contracts and arrangements is critical to effectively managing its deal process and validating deal valuation. This article highlights certain steps a buyer should take to evaluate its own affairs to ensure that it understands how its existing arrangements could impact a contemplated acquisition. Buyers should satisfy themselves both that their internal arrangements allow them to undertake the acquisition from a legal perspective and also that they understand the economic ramifications these arrangements could have on expected synergies and deal economics.

Knowing the details of its internal arrangements is essential to a buyer's ability to complete effective due diligence on a potential target. The buyer surely has assumptions about its ability to undertake a transaction. Do those assumptions hold true? Does the buyer understand the nature of its own contracts and how its own contractual obligations might render the deal less desirable or, worse, require a change in pricing or abandonment of the transaction? The following checklist highlights several essential considerations for transaction teams contemplating an acquisition. These areas essentially boil down to understanding the consequences of the target becoming an affiliate of the buyer.

1. Union contracts. A buyer should consider whether the target's labor arrangements can persist after an acquisition, or even extend by their terms to the buyer's pre-existing operations. But, post closing, the target will be an affiliate of the buyer. Will the buyer's existing union contracts affect the synergies it hopes to achieve with the target? If the buyer's union contracts will apply to the target as a future-acquired facility, the perceived value of a target could be affected. The buyer also should consider if its union contracts will permit implementation of its post-acquisition operational goals and whether the buyer's own union contracts impose any additional consent requirements on the buyer. The buyer's anticipated commercial arrangements to be implemented as a result of the acquisition—including, for example, from where the buyer may source materials post closing—might be restricted by its union contracts. The buyer should consider how the target's commercial arrangements, and any expected deal synergies, fit with this framework.

2. Requirements or exclusive dealings contracts. An entity's ability to source goods at a low price may make it an attractive target. A buyer should consider whether its own contracts will allow the target to continue to source those goods once the target becomes an affiliate of the buyer. If the buyer has requirements or exclusive dealings contracts in place, the terms of these contracts might require that the target source goods from the buyer's exclusive vendor. If the buyer's exclusive dealings obligations extend to its affiliates, the target's pre-acquisition vendor arrangements might be held to cause the buyer to be in violation of its obligations once the target becomes an affiliate. This result could negatively affect perceived deal value.

3. Most-favored nation clauses. In a most-favored nation clause, the buyer promises a third party that it will offer that party price and/or terms as good as the buyer offers to any other party.[1] If the buyer lowers its price for one customer, for example, it has promised to give the

Buyer ➔

1. Most-favored nation clauses typically would extend only to arrangements of like kind, e.g., to purchases of similar volume.

Buyer

continued

third party with a most-favored nation clause in its contract the same low price. A potential buyer with such agreements in place should consider whether the target offers terms to its customers that are better than the buyer's best terms. If the buyer's agreements with most-favored nation clauses would apply to transactions by the buyer and its affiliates, the buyer might be obligated to lower its prices after an acquisition. Such a situation can materially affect perceived deal value.

4. Non-competition arrangements. A buyer must understand the areas in which it has agreed not to compete and whether those areas may overlap with areas in which the target operates. If the buyer's non-competition arrangements apply to its affiliates, the target's activities might be held to run afoul of the buyer's existing non-competition agreements. Consideration should be given to the geographic areas in which the target operates and also to the scope of activities performed by the target.

5. Hart-Scott-Rodino Act ("HSR") Filing; Items 4(c) and 4(d): If the buyer is required to submit an HSR filing, it should identify early in the process, documents that are required to be discussed pursuant to Items 4(c) (generally, documents evaluating the acquisition from a competitive standpoint) and 4(d) (generally, confidential confirmation memoranda, certain documents prepared by third party advisors and documents concerning synergizes and efficiencies). Deal lawyers should engage antitrust counsel to determine whether any of these documents will be deemed problematic and assist in articulating an explanation for the documents, if necessary.

6. License arrangements. If a buyer licenses its technology to third parties, it should consider whether the licenses it has granted provide the licensee a license to new or after-acquired technology. In such a situation, a third party with such a license to the buyer's technology might be held to be entitled to a license to the target's technology after an acquisition. If a buyer licenses technology from third parties, it also should ensure that the grantee and field of use provisions in its current licenses will not inhibit its ability to use that technology in the target's field, if that is the buyer's intention.

7. Branding. If the buyer will re-brand the target with the buyer's corporate brand, the buyer should consider if any of the target's products, as branded under the buyer's brand, might infringe on third-party rights. For instance, the buyer could have been co-existing with a company with a similar brand in a field in which the target operates but the buyer does not. By re-branding the target, the buyer might be in violation of that third party's rights.

8. Credit or debt arrangements. A buyer should consider how the target becoming part of the buyer's corporate family will affect the buyer's existing credit and debt arrangements. The buyer must first understand its debt arrangements. It must consider whether the acquisition would violate any restrictive debt covenants. Another consideration is whether the buyer's credit and debt agreements have any operational restrictions that would be violated by the intended integration and post-closing operation of the target.

9. Service Agreements. When acquiring a target, the buyer must consider how long to request to keep the target on the seller's service agreements or whether it will place the target on the buyer's service agreements.[2] A buyer has several considerations as it transitions the target to its systems. If the buyer's service agreements apply to affiliates, is the definition of "affiliate" in the buyer's agreements static or dynamic? How do the agreements handle pricing? Will the buyer pay more for the services to be provided to the target? Service agreements might also restrict location of use. At what site will the target use these services and will such use be in compliance with the buyer's agreements? If the target has its own agreement with the same provider, do the buyer's and target's agreements allow for those agreements to be merged? One party's agreement might have better terms. Do the agreements dictate how such a situation will be handled? If not, the service provider might have an opening to try and impose terms that are more favorable to the provider. In general, the buyer should review its service agreements to understand what resources it has in place so that it understands, upon performing due diligence on the target, which of the target's needs it can service and which it cannot.[3]

10. Challenges. Where deals occur on expedited schedules with confidentiality and, possibly, cost restrictions, performing this threshold in-house diligence can sometimes be difficult for

2. For a discussion of transition services in the M&A context, see Brad Peterson, Paul Chandler & Mike Murray, *Services Agreements in M&A Transactions*, The M&A Journal, Volume 11, Number 1.

3. It is equally important to understand whether and how easily the target can separate from the seller. If the target and seller's data are integrated, separation could be difficult.

buyers. Furthermore, the business client might feel that to diligence the buyer's own contracts would be a waste of time and resources. A further challenge to understanding the company's complex internal arrangements arises when companies have different deal teams for each transaction. Nevertheless, the transactional team cannot fully understand the due diligence of the target unless it understands its own arrangements.

The issues highlighted in this article provide a useful checklist for transaction teams pursuing acquisitions. The deal lawyer will create more value for his or her client if, in advance of a deal, the lawyer has considered and helped the client understand these issues.

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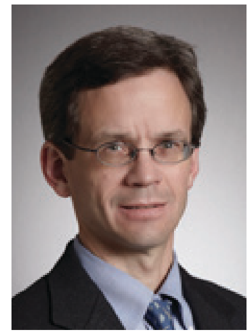
In Delaware, Privilege Goes to the Buyer

By Michael O'Bryan and Alexa Belonick, Morrison & Foerster



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The Delaware Court of Chancery held recently that control over a target company's attorney-client privileged communications, including communications between the target company's counsel and its pre-merger stockholders, passes to the acquiror upon the closing of the merger. *Great Hill Equity Partners IV, LP v. SIG Growth Equity Fund I, LLLP* (Del. Ch. Nov. 15, 2013). As a result, the former stockholders of an acquired company were barred from asserting the attorney-client privilege over merger-related communications with the company's legal counsel that the buyer discovered on the company's computer systems after the closing of the merger.

The court noted, however, that the parties could have provided for a different result by contract through an appropriate provision in the merger agreement or other agreement.

Background

A buyer acquired a company through a merger in which the target company survived. Over a year later the buyer sued the company's former stockholders for fraudulent inducement. The buyer also notified the former stockholders that it had found on the company's computer systems communications, regarding the merger, between the former stockholders and the legal counsel for the company in the merger.

The former stockholders attempted to prevent the buyer's use of the communications in litigation by asserting attorney-client privilege, claiming that they, and not the surviving company, retained control of the privilege over the company's communications regarding the negotiation of the merger agreement. The former stockholders cited cases[1] in which courts had distinguished between communications regarding general business operations and communications relating to merger negotiations, with privilege over the former passing to the surviving company and privilege over the latter remaining in the control of the target company stockholders.

Court Finds Privilege Controlled by Buyer

Application of Delaware Merger Statute. The court cited the Delaware General Corporation Law, which provides that, following a merger, "all property, rights, privileges, powers and franchises … shall be thereafter as effectually the property of the surviving … corporation as they were of the several … constituent corporations…."[2] The court found that the plain meaning of the statute was that the attorney-client privilege held by the target company before the merger, along with all the other privileges and specified assets of the target company, passed to the surviving company; in short, with respect to the categories enumerated in the statute, "*all* means *all*" (emphasis by the court).

The court declined to follow the distinction made in the cases cited by the former stockholders, saying that how Delaware law addressed the issue was a question of statutory interpretation and refusing to "invent a judicially-created exception to the plain words 'all . . . privileges.'"

Ability to Negotiate Contractual Protections. The court noted, though, that parties can negotiate contractual agreements to specify who will own or control different aspects of the privilege. The court referred to several examples of such provisions that the buyer had submitted. The court also noted that one of the cases cited by the former stockholders[3] involved an asset sale

Privilege ➔