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The Ropes Recap

Mergers & Acquisition Law News

A quarterly recap of mergers and acquisition law news from the M&A team at Ropes & Gray LLP.

Contents

News from the Courts

Chancery Court Denies Enforcement of Drag-Along Right in Transaction Where Notice to Minority Stockholders Was Improperly Provided After Majority Stockholder Approval

In *Halpin v. Riverstone National, Inc.*, the Chancery Court denied enforcement of customary drag-along rights where the controlling stockholders failed to properly exercise their drag-along rights in accordance with the governing stockholders agreement. The Chancery Court's decision highlights the importance of adhering to the letter of a stockholders agreement when exercising drag-along rights.

In *Halpin*, the acquisition of the company via a merger was approved by the written consent of the controlling stockholders. The stockholders agreement contained a customary drag-along right that required the minority stockholders to agree to a change of control transaction approved by the majority stockholders. When the company delivered an information statement to the minority stockholders after the merger was effectuated exercising the drag-along right and asking the minority stockholders to consent to the transaction after the fact, the minority commenced an appraisal action in lieu of consenting.

On summary judgment, the Chancery Court rejected the company's argument that the minority holders had waived their appraisal rights by virtue of agreeing to the drag-along rights in the stockholders agreement. The Court characterized the drag-along provision as an agreement by the minority stockholders to take action that, if taken, would have resulted in the waiver of their appraisal rights. But the minority stockholders were never called upon to take that action because the majority stockholders used their unilateral ability to approve the transaction by written consent. Consequently, the voting shares of the minority stockholders were extinguished before they received the information statement regarding the transaction and could be called upon to vote or provide their own consent. Had the majority holders followed the process contemplated by the stockholders agreement and compelled the minority holders to vote or consent in advance there would have been a different result.

The Court's ruling did not address the issue of whether it is possible for common stockholders to affirmatively waive statutory appraisal rights in advance in the form of an explicitly worded drag-along provision. While Delaware case law has held that preferred stockholders can affirmatively waive statutory appraisal rights in that manner, the issue of whether an advance waiver of statutory appraisal rights by common stockholders is enforceable remains unsettled.

Halpin v. Riverstone Nat'l, Inc., C.A. No. 9796-VCG (Del. Ch. Feb. 26, 2015)

Price Paid to Ancestry.com, Inc. Stockholders Determined to be Fair, Despite Contrary Arguments from "Appraisal Arbitrage" Investors

In a January 30, 2015 Chancery Court decision, *In Re Appraisal of Ancestry.com, Inc.*, Vice Chancellor Glasscock found that the price paid for the $1.6 billion buyout of Ancestry.com ("Ancestry") by private equity firm Permira Advisers LLC ("Permira") was fair.

In recent years, certain hedge funds have pursued an investment strategy known as "appraisal arbitrage" pursuant to which they acquire stock of a public company after a merger is announced, in the hope that the Chancery Court will determine that the fair value of such stock is actually higher than the merger price. Under Section 262 of the Delaware Code, dissenting stockholders who have perfected appraisal rights have the right to a judicial determination of the fair value of their stock based on the value of the acquired firm as a going concern. The returns associated with appraisal arbitrage can be substantial, including because the statutory interest rate for appraisal awards (which begins to accrue as of the merger's effective date) is the Federal Reserve discount rate plus 5%. In 2012, for example, Orchard Enterprise Inc. was ordered to pay hedge funds that successfully exercised appraisal rights more than twice the per share merger price. Appraisal arbitrage is not, however, without its risks. In assessing fair value, the Chancery Court may also determine that the fair market value for shares of an acquired company is at or below the merger price.

The acquisition of Ancestry by Permira was announced on October 22, 2012 at a price of $32 per share, which represented a 41% premium above the trading price of Ancestry's stock. Ancestry subsequently received written demands for appraisal on behalf of hedge fund stockholders collectively holding approximately 1.4 million shares. On December 27, 2012, Ancestry's stockholders approved the transaction, with 99% of the shares present and voting at the meeting voting in favor of the transaction.

Acknowledging that he found the approach taken by valuation experts on either side to be "less than fully persuasive," Vice Chancellor Glasscock nevertheless determined that "fair value" was "best represented by the market price," noting that the discounted cash flow valuation came close to the market price and gave comfort that "no undetected factor skewed the sales process." The Chancery Court allowed the petitioners to collect interest, limiting their potential losses.

Many see *In Re Appraisal of Ancestry.com, Inc.* as a blow to the practice of appraisal arbitrage. There is language in the decision underscoring that the Chancery Court will look closely to the market in assessing fair value, barring exceptional circumstances, such as a poorly run sale process. In a transaction resulting from an arm's length process between independent parties where there are "no structural impediments" that might materially distort "objective market reality," the Court is likely to give "substantial evidentiary weight to the merger price as an indicator of fair value."

In a separate ruling earlier in January against Ancestry, the Chancery Court confirmed that for purposes of determining legal standing it is the record holder, not the beneficial owner, who must not have voted the shares for which appraisal is being sought. Furthermore, in the case of shares held in fungible bulk by a record owner, a record holder need only have at least as many shares not voted for in favor of a merger as those for which appraisal is being sought. Below, our Delaware Legislative Update summarizes some recently proposed amendments to the appraisal statute in response to the increasing prevalence of appraisal arbitrage.

In Re Appraisal of Ancestry.com, Inc., C.A. No. 8173-VCG (Del. Ch. Jan. 30, 2015).
In Re Appraisal of Ancestry.com, Inc., C.A. No. 8173-VCG (Del. Ch. Jan. 5, 2015).

In Earnout Dispute Cases, Chancery Court Rules on Implied Covenant of Good Faith and Scope of Arbitration

Even the most carefully drafted earnouts can become fertile ground for legal battles. In two recent decisions, the Delaware Chancery Court explored legal issues that are commonly implicated in earnouts.

In *Fortis Advisors LLC v. Dialog Semiconductor PLC*, the Court considered an earnout construct under which the acquirer of the business was required to use "commercially reasonable best efforts" to achieve the earnout targets. The merger agreement also included a number of specific obligations and prohibitions on the acquirer in connection with its operation of the business during the earnout period. Although the fact-intensive issue of whether the acquirer met the standards of the earnout provision still remains to be litigated, the Court dismissed the seller's alternative theory that the acquirer's conduct had breached the implied covenant of good faith and fair dealing. The Court noted that the implied covenant only applies where the written contract has left a gap that must be filled, with the covenant being violated if one party acts in a way that is clearly contrary to what the parties would have agreed had they addressed the gap. In *Fortis*, however, the Court found that the earnout provision left no gaps in defining the standard for the acquirer's conduct during the earnout period, and as a result the implied covenant was not implicated. *Fortis* confirms that plaintiffs cannot use the implied covenant of good faith and fair dealing as an end-run around a clearly drafted standard of conduct in an earnout provision.

In *Weiner v. Milliken Design, Inc.*, the Court refused to rule on certain issues relating to an earnout dispute where the earnout provision of the purchase agreement required the parties to submit earnout disputes to an arbitrator. The Court reasoned that, given that the parties' clearly expressed intention to arbitrate earnout disputes, the Court would not interfere with the arbitrator's discretion to adjudicate the dispute. *Weiner* illustrates that, as we described in our report on *Garda USA v. SPX* in the First Quarter 2013 edition of the Ropes Recap, Delaware Courts will give effect to arbitration provisions and parties should be aware that entrusting an arbitrator to interpret earnout or (in the case of *Garda*) purchase price adjustment provisions may result in a different interpretation than what might have been provided by a court.

Fortis Advisors LLC v. Dialog Semiconductor PLC, C.A. No. 9522-CB (Del. Ch. Jan. 30, 2015); *Weiner v. Milliken Design, Inc.*, C.A. No. 9671-VCP (Del. Ch. Jan. 30, 2015).

Chancery Court Declines to Apply Fee-Shifting Bylaw to Former Shareholder

In deciding what it characterized as an issue of "first impression," the Chancery Court recently held a fee-shifting bylaw to be inapplicable due to the timing of the bylaw's adoption. The plaintiff in the action, *Strougo v. Hollander*, challenged the fairness of a 10,000-to-1 reverse stock split completed by First Aviation Services, Inc. ("First Aviation") on May 30, 2014. The transaction had the effect of involuntarily cashing out the plaintiff and making First Aviation a privately-owned company controlled by its chairman and chief executive officer. A few days later, on June 3, 2014, the company's board of directors adopted a fee-shifting bylaw modeled after the bylaw considered in *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014).

Applying contract principles, Chancellor Bouchard held that the fee-shifting bylaw could have no application to the plaintiff because it was adopted after his interest in the corporation had been eliminated and he therefore was no longer a party to the bylaws at the time of the fee-shifting provision's adoption. The Court further reasoned that the omission of "former" stockholders from the text of Section 109(a) of the Delaware General Corporation Law indicated that that Section 109(a) only authorizes bylaws relating to the rights or powers of current stockholders.

The Court took care to emphasize that it was not called upon to decide broader issues involving the bylaw's application, including the "serious policy questions implicated by fee-shifting bylaws in general." As discussed below in our Legislative Update, the validity of fee-shifting bylaws remains subject to ongoing debate.

Strougo v. Hollander, C.A. No. 9770-CB (Del. Ch. Mar. 16, 2015).

Substantial Damages Awarded for Breach of Contractual Obligation to Negotiate in Good Faith

The Second Quarter 2013 edition of the Ropes Recap summarized *SIGA Technologies, Inc. v. PharmAthene, Inc.*, a case in which the Delaware Supreme Court affirmed that a contractual obligation to negotiate in good faith is enforceable. In that case, SIGA Technologies and PharmAthene had negotiated a "nonbinding" license agreement term sheet. After the negotiation of the term sheet, PharmAthene provided SIGA Technologies with a bridge loan and the parties subsequently negotiated and executed a merger agreement. Both the bridge loan and the merger agreement contemplated that the parties would "negotiate in good faith with the intention of executing" a license agreement should the merger fail. The merger ultimately did fail, and in its May 2013 decision the Delaware Supreme Court affirmed the Chancery Court's conclusion that SIGA Technologies breached its contractual obligation to negotiate a license agreement in good faith after such failure.

On January 15, 2015, the Delaware Chancery Court held that SIGA Technologies was liable to PharmAthene for a total judgment of $195 million, consisting of expectation damages of $113 million, plus pre-judgment interest, legal fees, costs and expenses. The Chancery Court further ordered that the remaining claims and counterclaims made by SIGA Technologies and PharmAthene be dismissed with prejudice, including claims by PharmAthene for specific performance related to the license agreement and term sheet. The resolution of this case serves as a reminder of the magnitude of the damages that can result from an agreement to negotiate in good faith set forth in a letter of intent.

PharmAthene v. SIGA Techs., Inc., C.A. No. 2627-VCP (Del. Ch. Jan. 15, 2015).

Delaware Legislative Update

On March 6, 2015, a committee of the Corporation Law Section of the Delaware State Bar Association, the Corporation Law Council ("Council"), released new proposed amendments to the Delaware General Corporation Law ("DGCL") that address, among other topics, fee-shifting bylaw provisions and appraisal arbitrage. If adopted, the amendments would become effective as of August 1, 2015. While the proposed amendments remain subject to the approval of required groups within the state bar association, the Council's proposals merit attention because historically they often have been approved without change by the Delaware Legislature.

Fee-Shifting Provisions

As reported in our Second Quarter 2014 edition of the Ropes Recap, the Delaware Supreme Court's decision in *ATP Tour, Inc. v. Deutscher Tennis Bund*, 91 A.3d 554 (Del. 2014) sparked substantial debate about fee-shifting bylaw provisions. In *ATP*, the court held that fee-shifting provisions in the bylaws of a Delaware non-stock corporation are on their face valid and are enforceable against members who joined before their adoption. The Court also stated that adopting fee-shifting provisions with an intent to deter litigation would not necessarily render such bylaws unenforceable. Although *ATP* was decided in the context of a non-stock corporation, the Court's conclusion logically extended to Delaware stock corporations.

If adopted, the Council's proposed amendments would prohibit a provision in the certificate of incorporation or bylaws of a stock corporation that would impose liability on a stockholder for the attorneys' fees or expenses of the corporation or any other party in connection with "intracorporate claims." "Intracorporate claims" are defined in the proposed legislation as claims (including derivative claims) based upon a violation of a duty by a current or former director or officer or stockholder in such capacity or as to which the DGCL confers jurisdiction upon the Court of Chancery. In light of this proposed amendment, fee-shifting provisions continue to run the risk of being rendered invalid by future legislative action. To the extent the adoption of an *ATP*-style bylaw is considered notwithstanding this uncertainty, Delaware corporations and their Boards should consider the corporate environment in which such provisions are adopted, including how stockholders and proxy advisory firms may react and whether such provisions may be seen as an anti-corporate governance maneuver.

Appraisal Arbitrage

As discussed above in the context of the *Ancestry.com* ruling, "appraisal arbitrage" has become an increasing phenomenon in recent years, with hedge funds in particular purchasing stock in public companies after a merger is announced with the specific intent of pursuing an appraisal claim. One factor contributing to the popularity of appraisal arbitrage is that the DGCL has a high statutory interest rate—the Federal Reserve discount rate plus 5%—that accrues with quarterly compounding from the effective date of the merger through a judgment on the appraisal claim at the conclusion of the litigation years later. To address this particular economic incentive,

the Council's proposed amendments would allow corporations to limit the accrual of interest on appraisal awards by paying to appraisal claimants a sum of the corporation's choosing at any time during the appraisal action. Under the proposed amendment, interest would only accrue if the judgment exceeded the amount the corporation elected to pay and only on the difference between the appraisal award and the amount already paid to the stockholder. This proposed amendment would reverse a 2014 Chancery Court decision the Delaware Supreme Court recently affirmed which held that the appraisal statute does not authorize the tolling of the statutory interest where a corporation makes a partial payment to the appraisal claimants. *See Huff Fund Inv. P'ship v. CKx, Inc.*, No. 348 (Del. Feb. 12, 2015); *Huff Fund Inv. P'ship v. CKx, Inc.*, C.A. No. 6844-VCG (Del. Ch. Feb. 12, 2014) (addressed in our First Quarter 2014 edition of the Ropes Recap). The Council's proposed amendments on appraisal also include a *de minimis* exception intended to eliminate so-called nuisance claims by allowing for the dismissal of appraisal petitions if the claimants do not hold at least one percent of the total shares entitled to appraisal rights or the merger consideration applicable to the shares as to which appraisal is being claimed is less than $1 million.

The Council's proposed amendments have been criticized as refraining from making more sweeping changes to render appraisal arbitrage less attractive. Some advocate amendments to address the level of the statutory interest rate itself or the standing requirements that currently allow appraisal arbitrageurs to purchase shares after a merger's announcement.

Notable Deals

Kraft and Heinz to Merge in Deal Orchestrated by Warren Buffet and 3G Capital

On March 25, 2015, Kraft Foods ("Kraft") and H.J. Heinz ("Heinz") announced the companies were merging to create one of the world's largest food brands. Heinz is privately owned by Buffet's Berkshire Hathaway Inc. as well as 3G Capital, a Brazilian investment firm focused on food brands and known for its acquisitions of Burger King and Tim Hortons.

Heinz will control 51% of the combined company, while Kraft shareholders will hold a 49% ownership stake. Shares of the new company, Kraft Heinz Co., will be publicly traded on the Nasdaq. As part of the transaction, Kraft shareholders will receive a special dividend of $16.50 a share. Berkshire Hathaway and 3G Capital will provide the $10 billion to fund the special dividend.

The deal is 2015's largest so far, reported at roughly $45 billion in size. Commentary on the transaction emphasized Buffet's return to so-called megadeals and the absence of a large banking institution from the transaction (it involved no debt financing). The transaction is subject to approval by Kraft shareholders, receipt of regulatory approvals and other customary closing conditions and is expected to close in the second half of 2015.

Bidding War Ends for Salix Pharmaceuticals

On March 13, 2015, Valeant Pharmaceuticals ("Valeant") teamed with other investors, including William Ackman's Pershing Square Capital Management, to raise its offer to acquire Salix Pharmaceuticals in the face of a rival bid by Endo International ("Endo"). According to press reports, Valeant's increased offer represented a $11 billion all-cash bid for Salix, a specialty pharmaceutical company based in Raleigh, North Carolina focused on treatments for gastrointestinal disorders. Salix's board accepted Valeant's bid over a competing proposal from Endo that consisted mainly of stock and was subject to additional conditions absent from Valeant's offer, including shareholder approval by both companies. Endo reportedly withdrew its bid in the wake of Valeant's offer.

Commentary on Valeant's bid, which topped its prior offer by 9%, has suggested that by increasing its offer so substantially, Valeant may be contributing to a M&A frenzy in the pharmaceutical industry that could spoil Valeant's core acquisition strategy. Commentators have questioned whether rising multiples will hamper Valeant's strategy of acquiring pharma companies with the intent of cutting costs to create a more profitable pharma conglomerate.

London Update

The Small Business, Enterprise and Employment Bill: Timeline for Implementation of Key Corporate Aspects

In the Third Quarter 2014 edition of the Ropes Recap, we reported on the proposed Small Business, Enterprise and Employment Bill. Our particular focus was the anticipated introduction for companies of the statutory public register of persons with significant control (the "PSC Register"), the most significant of the proposed changes to English company law to be implemented by the new legislation.

By way of update, the Small Business, Enterprise and Employment Act (the "Act") has been passed at the end of March 2015. The Government had already published a provisional timetable for the phased implementation of the key corporate aspects of the new law, but the specific timings have yet to be confirmed. The provisional timetable for the headline changes is as follows:

Phase 1 (estimated May 2015): Abolition of bearer shares

Under the new regime, with effect from May 2015 (this date has yet to be finally confirmed), companies will no longer be able to issue bearer shares. Perhaps more importantly for existing corporate structures, if a UK company already has bearer shares in issue, it will have a nine-month transitional period during which to liaise with shareholders to convert these bearer shares into certificated form. Any affected companies should take note that this nine-month timeline is likely to start in May of this year on the indicative timetable.

Phase 2 (October 2015): Prohibition on appointment of corporate directors

With effect from October 2015, companies will no longer be able to appoint corporate entities to serve as directors and all company directors will need to be natural persons. In addition, this date will signal the start of a twelve-month period during which existing corporate directors will need to resign. A limited number of categories of corporate director will be permitted; the scope and extent of these exemptions has not yet been finalised. Any affected companies should be on notice of the fact that adjustments may need to be made to their boards.

Phase 3a (January 2016): Companies obliged to maintain PSC Register

With effect from January 2016 all eligible companies will be required to maintain a PSC Register (see Third Quarter 2014 edition of the Ropes Recap). Eligible companies can now start to consider identifying any individuals that exercise significant influence or control within the scope of the Act.

Guidance is to be published in October 2015 that will assist companies both in respect of determining who constitutes a person with significant control and how the statutory register

should be completed and maintained. Eligible companies will need to ensure that they have the requisite information to compile their PSC Register in time for the January 2016 deadline and that this information is presented in the requisite way.

Phase 3b (April 2016): PSC Register available for public review

With effect from April 2016, a company's PSC Register will be available for public review.

In addition, a number of company law administrative changes will take effect from April 2016: (i) a company's annual return will be replaced with an annual confirmation statement; and (ii) private companies will be able to elect to maintain their registers centrally at Companies House.

Asia Update

China Continues Foreign Investment Reforms by Revising Foreign Investment Catalogue

On March 13, 2015, the National Development and Reform Commission (the "NDRC") and the Ministry of Commerce (the "MOFCOM") of China jointly published a new version of the Catalogue for the Guidance of Foreign Investment Industries (the "2015 Catalogue"). The 2015 Catalogue will become effective on April 10, 2015 and supersede the last version released in 2011. Until China eventually adopts a so-called "negative list" approach nationwide (see discussion below), the 2015 Catalogue will continue to play a key role in China's foreign investment regulatory regime. The release of the 2015 Catalogue is one of many steps China has taken in recent years to reform its foreign investment regulatory regime.

Major Changes

The first foreign investment catalogue was published by the NDRC in 1995. Foreign investment in specific sectors may be encouraged, permitted, restricted or prohibited in accordance with the foreign investment catalogue. As China's industrial policies for foreign investment have evolved, the foreign investment catalogue has been revised in 1997, 2002, 2004, 2007 and 2011, respectively. The revisions this year aim to utilize advanced technology, encourage environment-friendly and energy-conserving foreign investment projects, satisfy unmet market demands, open new markets, upgrade product quality or increase China's competitive positions internationally.

The 2015 Catalogue significantly reduces the number of sectors restricted for foreign investment from 79 to 38, lowers the number of industries limited to foreign investment only to joint ventures with Chinese partners from 43 to 15, and cuts the sectors that require foreign investment projects to have Chinese majority shareholders from 44 to 35. Note that the practical impact of these changes may be less than what the number of the changes would suggest because many changes are not new rules but merely to codify existing provisions in industry-specific regulations and policies.

The changes in the 2015 Catalogue affect a wide range of industries, including, among others, automobiles, life sciences and health care, services, education, real estate and infrastructure, technology, e-commerce and financial services. The vast majority of the changes are positive for foreign investment. For example, the 2015 Catalogue greatly reduces the regulation of foreign investment in the manufacturing industry, in particular for the transportation equipment manufacturing segment. The 2015 Catalogue also removes the joint venture requirement or the minimum domestic shareholding requirement in a number of key service sectors, including, among others, operating e-commerce platforms, construction and operation of urban subways, light railway and other rail transport and scheduled or unscheduled international marine transportation services. On the other hand, there are some changes that have tightened up the restrictions on foreign investments in certain sectors. For example, foreign investment in the

complete automobile, special purpose vehicle and motorcycle industries and in medical institutions has been shifted from the "permitted" category to the "restricted" category. Also, higher education, ordinary senior high schools and pre-school education are now explicitly classified as "restricted" and foreign investment is limited to cooperative joint ventures led by the Chinese partners. Foreign investment in some sensitive sectors remains prohibited, for example, online publishing and online audio-visual program services.

Foreign Investment Law

Notably as covered in our Fourth Quarter 2014 edition of the Ropes Recap, the MOFCOM has released for public comment a draft version of the Foreign Investment Law on January 19, 2015. The draft Foreign Investment Law proposes to unify China's foreign investment regulatory regime, which currently consists of various laws, regulations and industry-specific policies. The draft Foreign Investment Law also proposes a general national treatment for foreign investment together with a "negative list" for foreign investment in specified sectors. The 2015 Catalogue likely will be superseded when the Foreign Investment Law is enacted. For more information about the draft Foreign Investment Law, please refer to our Fourth Quarter edition of the Recap, published on January 29, 2015.

Contributors

Partners:

Jason Freedman (San Francisco)
jason.freedman@ropesgray.com

Jane Goldstein (Boston/New York) (co-head of M&A)
jane.goldstein@ropesgray.com

Howard Glazer (San Francisco)
howard.glazer@ropesgray.com

James Lidbury (Hong Kong) (co-head of M&A)
james.lidbury@ropesgray.com

Carl Marcellino (New York)
carl.marcellino@ropesgray.com

Philip Sanderson (London)
philip.sanderson@ropesgray.com

Peter Welsh (Boston)
peter.welsh@ropesgray.com

Marko Zatylny (Boston)
marko.zatylny@ropesgray.com

Counsel:

Martin Crisp (New York)
martin.crisp@ropesgray.com

Chief of Legal Knowledge Management:
Patrick Diaz (Boston)
patrick.diaz@ropesgray.com

Associates:
Zachary Blume (Boston)
zachary.blume@ropesgray.com

C. Thomas Brown (Boston)
thomas.brown@ropesgray.com

James Davis (Chicago)
james.davis@ropesgray.com

Gregory Demers (Boston)
gregory.demers@ropesgray.com

Darryl Hazelwood (New York)
darryl.hazelwood@ropesgray.com

Jeffery Koh (Chicago)
jeffrey.koh@ropesgray.com

Natalie Logan (San Francisco)
natalie.logan@ropesgray.com

Marc Migliazzo (Boston)
marc.migliazzo@ropesgray.com

Anne Johnson Palmer (San Francisco)
anne.johnsonpalmer@ropesgray.com

Hunter Sharp (Chicago)
hunter.sharp@ropesgray.com

Larissa Smith (New York)
larissa.smith@ropesgray.com

Jarret Szeftel (New York)
jarrett.szeftel@ropesgray.com

Boxin Wang (Hong Kong)
boxin.wang@ropesgray.com

Owen Wang (Hong Kong)
owen.wang@ropesgray.com

Peter Wang (San Francisco)
peter.wang@ropesgray.com

Christian Westra (Boston)
christian.westra@ropesgray.com