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Recap of 1st Quarter 2014

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

Delaware Court of Chancery holds financial advisor liable for aiding and abetting a breach of fiduciary duties by the Rural/Metro board of directors

On March 7, the Delaware Court of Chancery published a post-trial opinion in *In Re Rural Metro Corporation Stockholders Litigation* ("*Rural Metro*") finding Rural/Metro's financial advisor RBC liable for aiding and abetting the Rural/Metro's board of directors' breach of its fiduciary duties in connection with the acquisition of Rural/Metro by Warburg Pincus. The decision is the latest in a series of Delaware opinions concerning conflicts of interest of banks and investment firms in advising companies in buy-out transactions. It demonstrates the importance of good process and evidences Delaware's continuing skepticism regarding staple financing.

Background

In March 2011, Rural/Metro Corporation was acquired by Warburg Pincus for $17.25 per share in cash, a total deal value of approximately $440 million. The sale process was led by a special committee of Rural/Metro's board of directors. The special committee was initially instructed to evaluate strategic alternatives available to the company and report back to the full board on those alternatives, but the special committee exceeded that mandate and hired RBC Capital Markets as its financial advisor to conduct a sale process. RBC recommended running a sale process in parallel with the ongoing sale of competitor Emergency Medical Services Corporation (EMS), suggesting that it would set up potential bidders to acquire both EMS and Rural/Metro and allow the target companies' shareholders to share in the synergies of putting these two companies together by virtue of a buyer being willing to pay a higher price for both companies than for each company in isolation. However, RBC never disclosed to Rural/Metro that one of its primary goals in representing Rural/Metro was to obtain a role in financing bids for EMS in order to generate fees far in excess of its expected advisory fee from Rural/Metro.

The sale process did not unfold as RBC had hoped. Bidders for EMS, including many large private equity funds that would have been potential bidders for Rural/Metro, were generally reluctant to participate in the Rural/Metro sale process out of concern about violating use restrictions in EMS's confidentiality agreement and because participating in the Rural/Metro process would require diverting resources away from the already active EMS process. Additionally, the special committee, acting on advice from RBC, refused to extend the Rural/Metro sales process to allow Clayton, Dubilier & Rice, which had acquired EMS, to prepare a bid even though the sales process had ostensibly been designed to allow the acquirer of EMS to bid. Eventually, Warburg Pincus (who did not seriously participate in the EMS process) emerged as a potential acquirer of Rural/Metro, in part because Warburg Pincus perceived there to be a lack of competition for Rural/Metro.

During the process, RBC failed to provide the Rural/Metro board of directors with any formal valuation analysis of the company in connection with the delivery of its fairness opinion until one hour and 18 minutes before the board meeting approving the Warburg Pincus deal. In terms of the fairness opinion itself, the Court found that RBC engineered the fairness opinion to make the $17.25 per share offer appear reasonable by misrepresenting how market analysts treated certain one-time expenses and manipulating other aspects of their financial analysis. During these crucial moments leading up to signing — and without the knowledge of the Rural/Metro board — RBC continued its push to convince Warburg Pincus to use RBC for its buy-side financing needs in connection with the acquisition of Rural/Metro, including sharing details regarding the internal dynamics of the Rural/Metro board. Despite those efforts, RBC ultimately failed to obtain any role in financing the transaction.

Shortly after the announcement of the Rural/Metro acquisition, various shareholders filed lawsuits objecting to the transaction. The plaintiffs ultimately settled with Rural/Metro directors and the company's secondary financial advisors, but the claims against RBC for aiding and abetting proceeded to trial.

At trial, the Court found that the Rural/Metro directors breached their fiduciary duties by failing to conduct a reasonable sale process and that RBC failed to serve its proper role as an advisor to the board. As a result, the Court found that RBC was liable for aiding and abetting breaches of the Rural/Metro directors' fiduciary duties.

Key Takeaways

Aider and abettor liability. Aider and abettor liability can attach to an agent who knowingly causes a breach of a fiduciary duty by a director, regardless of whether the director herself knows of the breach. In this case, the Court concluded that RBC aided and abetted the Rural/Metro directors' breach of their fiduciary duty of care and disclosure obligations to Rural/Metro stockholders by creating an unreasonable sale process and informational gaps between the Rural/Metro board and its financial advisor (*e.g.*, omitting disclosure on the extent of its conflicts resulting from attempts to gain a place in the buy-side financing for EMS and Rural/Metro). The Court found that RBC perpetuated this informational gap by failing to provide any formal valuation metrics on Rural/Metro until a little more than an hour before the board meeting at which the deal was approved, which metrics Vice Chancellor Laster found to be intentionally engineered to mislead the Rural/Metro directors to conclude the acquisition price was fair. This decision serves as a reminder to financial advisors and their counsel that they are at risk of being held responsible for their clients' process and must actively monitor it.

Statutory limitations on liability do not extend to third-party aiders and abettors. Section 102(b)(7) of the Delaware General Corporation Law, which allows corporations to absolve directors from personal liability to stockholders for monetary damages for breaches of duty of care, does not apply to non-directors who aid and abet a breach of fiduciary duty, even when the directors themselves are otherwise exculpated by a Section 102(b)(7) provision.

Delaware courts remain highly skeptical of staple financing. Vice Chancellor Laster was critical of both the vigor of RBC's desire to participate in buy-side financing (and the conflict of interests it created) and the Rural/Metro board's failure to monitor RBC in the process (such as failing to inquire about the financing and its associated process, provide guidance on when staple financing discussions should begin or end, and impose practical checks on RBC's interest to maximize its fees). This skepticism of staple financing echoes Vice Chancellor Laster's critique of financial advisors in the February 2011 ruling in *In re Del Monte Foods Company Shareholders Litigation*, where financial advisors similarly made efforts to steer the sale process towards buyers that might have provided a financing role (and a portion of financing fees) for the investment bankers. Given the skepticism of the Delaware Courts, boards of Delaware corporations should exercise diligent oversight to ensure that appropriate checks are in place on the inherent conflicts that such staple financing creates.

Process is paramount. As should be well-understood by now, the process by which boards of directors evaluate major transactions is vitally important to good outcomes. Even actions that one might expect to be routinely defensible become highly problematic when the integrity of the process is effectively called into question. In this case, the Court found that the threshold decision to initiate the sale process itself did not satisfy the standard of care as a fiduciary duty matter. This extraordinary result flowed from the Court's finding that the decision to initiate the process was undertaken unilaterally by a special committee chairman who lacked the authority to put the company in play and who, in doing so, acted on the advice of a financial advisor that was motivated by self interest. As the Court acknowledged, a well-informed board might have considered a variety of pros and cons to the timing of the sale process, but the fact that this basic step in the process was omitted helped render even the decision to start the process unreasonable.

Engagement Letter Did Not Suffice to Waive RBC Conflicts. Vice Chancellor Laster rejected RBC's arguments that a generic conflicts acknowledgement in its engagement letter precluded aiding and abetting claims. The Court found that RBC failed to disclose the degree of its conflict to the Rural/Metro board, and Delaware law requires that any conflict waiver be knowing and unambiguous, including with respect to the degree of the conflict. Generic boilerplate signed at the outset of a deal (and before the actual conflict exists) will not suffice.

Buyers Should Diligence the Sale Process. Rural/Metro provides another illustration of the importance for buyers to understand sale processes in M&A transactions in order to understand what (if any) sale-related liabilities they may inherit or become subject to in connection with the target company's actions relating to the sale transaction.

Not All Shareholder Litigation Settlements Will Be Approved by the Court. The case was on the brink of a supplemental disclosure-only settlement in January 2012. However, following an objection to the settlement by a Rural/Metro stockholder who had filed a parallel lawsuit in Arizona, Vice Chancellor Laster rejected the disclosure-only settlement as inadequate, serving as a reminder that proposed settlements need to pass a hearing on fairness before the matter can be resolved. In Delaware, the depth of the fairness inquiry has tended to vary, slightly complicating the predictability of the sufficiency of a disclosure-only settlement in any particular litigation before the Delaware Courts.

In re Rural Metro Corp. Stockholders Litig., C.A. No. 6350-VCL (Del. Ch. Mar. 7, 2014).

Delaware Supreme Court establishes standard of review for controlling stockholder transactions

On March 14, the Delaware Supreme Court issued its much anticipated opinion in *Kahn v. M&F Worldwide Corp.*, affirming the Delaware Court of Chancery's holding in *In re MFW Shareholders Litigation*. The decision provides guidance on steps that controlling stockholders and other deal participants can take to avail themselves of the more favorable business judgment standard of judicial review in stockholder litigation involving squeeze-out transactions where there is a controlling stockholder.

As a general proposition, absent unusual circumstances, Delaware courts apply a deferential business judgment standard of review in challenges to corporate actions approved by a corporation's disinterested directors. Certain circumstances trigger the application of heightened standards of review, such as go-private transactions led by a controlling stockholder that are structured as a one-step merger. These squeeze-out transactions had been subject to a more demanding "entire fairness" standard of review, with defendant directors bearing the burden of proof in establishing that the transaction was fair with respect to both price and process. Under the Delaware Supreme Court *Kahn v. Lynch* line of cases, the burden of proving entire fairness could be shifted to plaintiffs if the transaction with the controlling stockholder was either approved by a special committee of independent directors *or* approved by an informed vote majority of the non-controlling disinterested stockholders.

In *Kahn v. M&F Worldwide Corp.*, the Delaware Supreme Court affirmed the Delaware Court of Chancery's new rule that if a transaction between a corporation and its controlling stockholder is *at the outset* conditioned on both (i) the approval of an independent, adequately-empowered and well-functioning special committee, and (ii) the uncoerced, informed vote of a majority of minority stockholders, then the more deferential business judgment standard of judicial review will apply.

Background

The decision involves a 2011 acquisition by MacAndrews & Forbes Holdings, Inc. ("M&F"), a 43% stockholder in M&F Worldwide Corp. ("MFW"), of the remaining common stock of MFW.

M&F's take-private of MFW was conditioned at the outset on the transaction being (i) negotiated and approved by a special committee of independent MFW directors, and (ii) approved by a majority of stockholders unaffiliated with M&F. In this case, M&F also made clear that it had "no interest" in participating in any alternative sale transaction. Ultimately, the transaction was approved by a vote of 65.4% of MFW's minority stockholders and closed in December 2011.

Various stockholder plaintiffs then brought lawsuits asserting breach of fiduciary duty claims in the Delaware Court of Chancery against M&F and certain of MFW's directors, alleging that the transaction and related process was unfair to MFW's minority stockholders. Summary judgment was granted in the defendants' favor, and the Court of Chancery's conclusion that business judgment review was the appropriate judicial standard of review was appealed to the Delaware Supreme Court.

<u>Key Takeaways</u>

Standard of judicial review. The decision makes clear that the deferential business judgment standard of review will be applied to a squeeze-out transaction involving a controlling stockholder if and only if (i) the controlling stockholder conditions the procession of the transaction on the approval of both a special committee and a majority of minority stockholders, (ii) the special committee is independent, (iii) the special committee is empowered to freely select its own advisors and say no definitively, (iv) the special committee fulfills its duty of care in negotiating a fair price, (v) the vote of the minority stockholders is informed, and (vi) there is no coercion of the minority stockholders. If any of these procedural protections are not established, the transaction will be reviewed under the more exacting "entire fairness" standard. Under the *Kahn v. Lynch* precedent, the burden of proving entire fairness may still be shifted to the plaintiffs if it can be shown that the transaction was either approved by a well-functioning committee of independent directors *or* by an informed and uncoerced vote of a majority of the minority stockholders.

Unifying standards. Under Delaware law, business judgment review is afforded to non-coercive squeeze-out transactions by controlling stockholders structured as tender offers that (i) are negotiated and recommended by a well-functioning and independent special committee, (ii) contain a majority of the minority tender condition and (iii) contain a commitment from the controlling stockholder to consummate a short-form merger at the same price promptly after obtaining 90% of the outstanding shares of stock, whereas any such tender offer that does not meet these conditions is subject to entire fairness review. However, prior to the *Kahn v. M&F Worldwide Corp.*, squeeze-out transactions involving one-step mergers were evaluated under the entire fairness standard, and under no circumstance received business judgment level review. As a result of *Kahn v. M&F Worldwide Corp.*, the standards by which Delaware courts will evaluate a squeeze-out transaction by a controlling stockholder are now closely aligned, irrespective of whether the transaction is structured as a tender offer or a long-form merger.

Possibility of a new gold standard. Going forward, any failure to meet a MFW perquisite will likely be seized by plaintiffs challenging these types of transactions. Now that the roadmap for the "optimal" protective devices has been identified by the Delaware Courts, defendants in squeeze-out transactions may find the Delaware Courts reluctant to conclude in the early stages of litigation that a transaction is entirely fair (irrespective of whether the burden of proving such fairness has shifted).

Potential for prolonged litigation still exists for transactions between a company and its controlling stockholder. While implementing the procedural protections set forth in *Kahn v. M&F Worldwide Corp.* will ultimately lead to a controlling stockholder transaction being reviewed under the more deferential business judgment standard, it may not result in the dismissal of litigation challenging the transaction in the pre-discovery stage and, as a result, the benefits in following this framework should not be overstated. A plaintiff may still survive a motion to dismiss the transaction if its complaint adequately pleads facts challenging the independence, empowerment, or effectiveness of the special committee, or coercion or lack of information affecting the majority-of-the-minority vote. This may not be a particularly high threshold. In a footnote to the opinion, the Delaware Supreme Court suggested that the plaintiffs in *MFW* may have survived a motion to dismiss based on their allegations of inadequate price alone.

In re MFW Shareholders Litig., C.A. No. 6566 (Del. Ch. May 29, 2013), *affirmed, Kahn v. M&F Worldwide Corp.*, No. 334, 2013 (Del. Mar. 14, 2014).

Court of Chancery rejects attempt to stop the accrual of statutory interest in appraisal action

In a statutory appraisal action arising out of Apollo Global Management LLC's 2011 acquisition of CKx, Inc., the Delaware Court of Chancery refused to order Huff Fund Investment Partnership, a 15% stockholder of CKx, to accept the undisputed minimum value of its stock in order to stop the running of interest at Delaware's above-market statutory rate. Given the current low interest rate environment, this decision leaves open the risk of appraisal actions, including how plaintiffs choose to litigate such actions, being motivated by the DGCL's statutory above-market interest rate.

In November 2013, Vice Chancellor Glasscock determined that the fair value of Huff Fund's shares in CKx was the negotiated merger price (see coverage in the January 2014 edition of the Ropes Recap), but for potential appeal-related purposes he permitted the parties to supplement the record with additional information regarding the merger price. Given that the proceedings were still active (and interest was still accruing), CKx filed a motion requesting a partial judgment whereby CKx would immediately pay the minimum amount that Huff Fund would be entitled to receive (plus accrued interest to date) in order to stop the statutory accrual of interest on that minimum amount. CKx argued that although Section 262 of the DGCL does not contemplate this partial judgment mechanism, the Court should approve its request for an order because the DGCL's statutory interest rate for appraisal claims of 5% over the Federal Reserve discount rate creates an arbitrage opportunity in appraisal actions in the current low interest rate environment.

In its decision, the Court held that it has limited discretion in determining interest awards in appraisal actions. Section 262(h) of the DGCL provides that unless "good cause" is shown, interest "shall accrue at 5% over the Federal Reserve discount rate." The Court asserted that its discretion to adjust the statutory interest rate for "good cause" is limited to instances of "bad faith or vexatious litigation," circumstances that were not present in this action.

Some commentators have noted that the availability of above-market statutory interest rates in Delaware appraisal actions may have contributed to a recent spike in appraisal claims, particularly those driven by new hedge funds specializing in appraisal rights.

Huff Fund Inv. Partnership v. CKx, Inc., C.A. No. 6844-VCG (Del. Ch. Feb. 12, 2014).

Delaware reaffirms latitude granted to informed, independent boards of directors in *In re Answers Corporation Shareholders Litigation*

In *In re Answers Corporation Shareholders Litigation*, the Delaware Court of Chancery granted summary judgment in favor of the director defendants facing claims arising out of the sale of Answers Corporation (Answers) in a 2011 go-private transaction. In its ruling, the Court found no evidence that the directors acted in bad faith or that the independent board members were controlled by the CEO or the nominees of the company's controlling stockholder, generally reaffirming the latitude Delaware courts will grant to an informed, independent board of directors.

Prior to the sale, Answers Corporation was a public company, with venture capital firm Redpoint Ventures as its largest shareholder. Redpoint held the right to nominate two directors on the company's seven-member board. Former shareholders of Answers alleged that its directors breached their duty of loyalty and failed to act in good faith in approving the merger, even though a majority of the board consisted of disinterested directors who had approved the transaction. Specifically, the plaintiffs alleged that (i) the two Redpoint-affiliated directors and Answers' CEO, who was also a director, were conflicted and controlled the negotiation process and (ii) that the entire board, including the four disinterested directors, acted in bad faith in selling the company.

Vice Chancellor Noble granted defendants' motion for summary judgment. Regarding the first allegation, the court noted that the plaintiffs failed to explain or demonstrate any evidence of control, or a persuasive theory as to why the independent directors would have decided to abdicate their fiduciary duties. The Court noted that "mere invocation of the phrase 'dominated and controlled' cannot alone create such an issue of disputed fact." On the allegation of bad faith, the court noted that despite plaintiffs' attempts to identify a variety of ways in which they believed the sale process could have been better conducted, there was no evidence that the board consciously disregarded, or utterly failed to attempt to comply with, its fiduciary duties.

In re Answers Corp. Shareholders Litig., C.A. No. 6170-VCN, 2014 Del. Ch. LEXIS 17 (Del. Ch. Feb. 3, 2014).

Court of Chancery allows entire fairness claim involving management rollover in private equity buyout to proceed to trial

A recent case from the Delaware Court of Chancery illustrates litigation risks that can arise in the context of a private equity buyout when managers holding a controlling share of a target company rollover equity into the new company while minority stockholders get cashed out. In *Frank v. Elgamal, et. al*, plaintiffs brought an action alleging the board of directors of American Surgical Holdings, Inc. breached their fiduciary duties by approving a sale to Great Point Partners, a private equity fund. The plaintiffs argued that a group of management stockholders with a controlling interest in the company led the board of directors to accept a deal that benefited management at the expense of the minority stockholders. The court denied the defendants' motion for summary judgment because it was unclear whether managers rolling over shares influenced the company to accept a deal that gave less cash to minority shareholders than an alternative transaction.

American Surgical began exploring a possible sale of the company in the summer of 2009 after receiving an expression of interest from Great Point Partners. The board formed an M&A committee and retained a financial advisor to solicit offers. By late 2009, three potential acquirers, including Great Point Partners, submitted non-binding indications of interest. After the board received those bids, it formed a special committee of independent, non-executive directors to oversee the negotiation process. The special committee decided to proceed to negotiate a merger with Great Point Partners.

In February of 2010, in the course of its diligence, Great Point Partners received notice of accounting problems with American Surgical's 2009 financial statements. Consequently, Great Point Partners sought to renegotiate the terms of the merger. Great Point Partners presented the company with three choices with varying mixes of cash and equity to be provided to the rollover stockholders. Significantly, the option that would have provided to the greatest ratio of cash to equity to the rollover stockholders provided slightly less overall consideration to the minority stockholders ($.04 per share) than if the rollover stockholders took more equity. The special committee and the board of directors ultimately chose the option that was the least favorable to the minority stockholders. This choice, combined with the evidence presented as to the special committee's decision-making process, led Vice Chancellor Noble to dismiss in part the defendants' motion for summary judgment.

In particular, the Court noted that it was not clear whether the special committee was informed of the three options and their varying levels of compensation for minority stockholders. One board member testified that the financial advisor told the special committee about the three options, but the minutes of the special committee meeting in which they adopted the new terms with Great Point Partners do not reflect any such discussion. This procedural defect, coupled with the fact that the management stockholders and the minority stockholders had a direct conflict of interest, led the Court to the conclusion that the "entire fairness" standard – under which the controlling stockholders have to prove that the transaction was fair to the minority stockholders – could apply to this transaction.

This case demonstrates that boards and their advisors should be vigilant about addressing any potential conflicts of interest between insider stockholders – such as managers rolling over their equity into the post-merger entity – and other stockholders. Failure to recognize that a given option deprives minority stockholders of even a few pennies per share of merger consideration can lead to a lawsuit in which the burden lies on the board of directors to prove that the merger price was entirely fair.

Frank v. Elgamal, C.A. No. 6120-VCN (Del. Ch. Mar. 10, 2014).

<u>Hedge Fund asks Court of Chancery to force Sotheby's to withdraw its poison pill</u>

Third Point LLC, a hedge fund founded by noted activist investor Dan Loeb, has filed suit against the auction house Sotheby's in the Delaware Court of Chancery seeking to invalidate Sotheby's "poison pill." The pill prevents investors, such as Third Point, from acquiring more than 10% of a company's stock. Passive investors, however, may acquire up to 20% of the company without triggering the pill. Both the 10% ownership trigger and the fact that the pill applies to "activist" investors rather than passive investors are recent innovations that have yet to be directly addressed by Delaware Courts. Third Point argues that these features of Sotheby's pill are unreasonable and serve only to entrench the positions of the existing directors. Sotheby's contends that the pill is designed to give the board and stockholders sufficient time to consider proposals from investors such as Third Point.

At a hearing on March 31, 2014, Vice Chancellor Donald F. Parsons Jr. noted that Sotheby's pill is "relatively unusual" and that Third Point's claims are plausible. The Court has agreed to hear arguments on Third Point's request for a preliminary injunction on April 25, 2014.

Verified Compl. *Third Point LLC v. Ruprecht*, C.A. No. 9469-VCP (Del. Ch. Mar. 25, 2014).

Matt Chiappardi, *Loeb's Third Point Gets Sotheby's Poison Pill Suit Fast-Tracked*, Law360 (Mar. 31, 2014, 8:37 PM), http://www.law360.com/mergersacquisitions/articles/523289?nl_pk=

2e07cdbd-0015-4040-9a2c-dff171f4c7ba&utm_source=newsletter&utm_medium=email&utm_campaign=mergersacquisitions

California court highlights liability for tortious interference by buyers and their officers in contractual obligations of target companies

A recent California case serves as a cautionary note for buyers and their officers and directors when an acquisition has the potential to have a material negative impact on a key technology license of the target company. The California Supreme Court on March 12 left in place a decision of the California Court of Appeals affirming a $385 million verdict against Actelion Pharmaceuticals and three of its executives, and a separate award of $30 million in punitive damages against the executives, for their interference with a license agreement between a company Actelion acquired, CoTherix Inc., and Asahi Kasei Pharma Corp. It appears that a primary driver for the jury's verdict was its finding that Actelion acquired CoTherix to block the introduction of a drug known as Fasudil to the US market, which would have threatened the market dominance of Actelion's own blockbuster Tracleer drug.

Actelion's target, CoTherix entered into a licensing and development agreement with Asahi in 2006. Under it, CoTherix was to develop and seek U.S. and European regulatory approvals for Asahi's Fasudil drug. After this relationship was announced, Actelion began to contemplate acquiring CoTherix to protect Tracleer's market, which exceeded $1 billion in annual sales. In November 2007, Actelion announced it had entered into an agreement to buy CoTherix.

This prompted Asahi to request that CoTherix and Actelion provide reasonable assurances that they would honor the obligations under the license agreement following the acquisition. Although Actelion had decided internally not to proceed with the development of Fasudil, it apparently told Asahi before the closing that "Actelion does not have any intention to make any delay of [F]asudil development" following the merger. But concurrently with the closing of the acquisition in January 2008, Actelion informed Asahi that it was discontinuing the development of Fasudil for "business and commercial reasons." Efforts to negotiate a termination agreement failed, and Asahi brought a claim against CoTherix for breach of contract on which arbitrators awarded Asahi over $91 million.

Asahi also brought a separate action in California state court against Actelion and certain of its officers under a variety of contract and tort claims, including intentional interference with a contract. The jury awarded compensatory damages against the defendants (which were reduced by the amounts awarded in the arbitration) and further found the executives had acted with malice, oppression or fraud and awarded some $30 million in punitive damages against the executives. The California Court of Appeals largely affirmed the jury's verdict, noting that California law recognizes that corporate owners, officers and directors may be held liable for interfering with contracts – with the burden being on them to show they did not use improper means – and rejecting Actelion's argument that, as the corporate owner of CoTherix, it had an absolute right to interfere with its subsidiaries' agreements.

Asahi Kasei Pharma Corp. v. Actelion Ltd., No. CIV478533, December 18, 2013 (Superior Court of the State of California, County of San Mateo)

News from the Regulators

SEC issues broker-dealer no-action letter for M&A brokers

In January 2014, the SEC issued a no-action letter stating that, under certain circumstances, it would not require a finder, consultant or other intermediary helping to facilitate a private M&A transaction to register with the SEC as a broker-dealer.

It has long been an unresolved legal question whether M&A brokers who refer target companies to potential buyers or investors, and who are paid a fee based on successful completion of a transaction, constitute broker-dealers on account of their intermediary role in the sale of securities. The no-action letter did not take a position on this issue but did clarify that the SEC staff will not recommend enforcement action against a so-called "M&A Broker" for failing to register as a broker-dealer, provided that the M&A Broker arrangement and transaction meet certain conditions, including that: (i) the M&A Broker will not have the ability to bind either the buyer or seller to the transaction; (ii) the M&A Broker will not provide financing for the transaction; (iii) the M&A Broker will facilitate acquisitions with a group of buyers only if the group is formed without the assistance of the M&A Broker; (iv) the buyer, at the end of the transaction, must control and operate the target company; and (v) the acquisition transaction does not involve a public offering of securities.

This no-action letter creates no-action relief for many of the referral arrangements that private equity firms enter into with third-party finders or consultants. In addition, this letter may give some comfort to unregistered private equity sponsors that receive transaction-based fees in connection with portfolio company M&A transactions. While private equity sponsors often will not satisfy each of the specific conditions cited for this no-action relief, because their services in this regard are similar to services provided by M&A Brokers, this letter provides a basis to suggest that private equity fund sponsors should not be required to register with the SEC as broker-dealers because of such activity. For more in-depth information about the no-action letter, see our February 11, 2014 Client Alert.

M&A Brokers, SEC No-Action Letter, 2014 WL 356983 (Jan. 31, 2014).

Tax News

Obama budget proposes further restrictions on corporate expatriations and limits on deductibility of interest paid to foreign parent.

President Obama's budget proposal, which was submitted to Congress on March 4, 2014, includes a provision that, if enacted, would further restrict domestic corporations from expatriating through so-called corporate inversion transactions. The proposals also limit the U.S. tax benefits that can be realized through expatriation transactions.

The President's tax proposals are divided into two categories: (1) general tax revisions intended to reduce the deficit (achieved mainly by increasing the tax burden on upper income individuals) and (2) a revenue neutral package, including the anti-inversion proposals, that are meant to be enacted as part of comprehensive tax reform. Although most observers judge comprehensive tax reform unlikely in the near term, the anti-inversion legislation is significant because it highlights the Treasury Department's awareness that corporate expatriations can be achieved through cross-border business combinations.

In an inversion, the corporate structure of a U.S.-based multinational group is altered so that the historic U.S. parent company becomes a subsidiary of a corporation organized in a foreign jurisdiction. Typically, that foreign jurisdiction (*e.g.*, Ireland, the UK and Switzerland,) affords a preferential tax regime (a tax system with relatively low effective rates and broad exclusions for income earned by or received from foreign subsidiaries) and a tax treaty with the United States. Critically, a non-U.S. organized parent permits planning to reduce the taxable income of U.S. operations through tax deductible payments to the foreign parent, often consisting of interest or royalties, and by facilitating ownership of non-U.S. assets, including subsidiaries, outside of the U.S. tax net.

In the last two decades, legislative and regulatory changes have restricted the opportunities and increased the costs of corporate expatriations. But a remaining strategy for achieving expatriation is for a U.S. company to combine with a non-U.S. entity, which becomes the parent of the combined group with the non-U.S. entity's historic shareholders continuing to own at least 20 percent of the non-U.S. parent shares.

Inversions under current rules are generally permitted if following the inversion the domestic corporation's historic shareholder base owns less than 80% of the foreign acquiring corporation (the "80% test"). If the 80% test is not met, the foreign acquiring corporation is treated as a domestic corporation for all U.S. tax purposes, absent certain difficult to meet exceptions, including where the foreign parent has substantial assets, employees and local customer revenue in the foreign parent's place of organization (the "substantial business exception"). The current anti-inversion rules also can eliminate certain historic U.S. tax assets where pre-combination owners of the domestic corporation continue to own at least 60% of the post-combination foreign parent company (the "60% test").

According to the President's proposal and its official explanation, the adverse tax consequences associated with inversions that meet the 80% test, but fail the 60% test, have not prevented these transactions from occurring, and the increase in inversions in recent years has facilitated the erosion of the U.S. tax base.

The proposal, which would be effective for transactions completed after December 31, 2014, would, among other things:

1) reduce the 80% test to a greater than 50% test, meaning the transaction would need to result in a transfer of a majority of shares to foreign owners;
2) eliminate the 60% test;
3) provide that regardless of the level of shareholder continuity, an inversion will occur if the affiliated group that includes the foreign corporation has substantial activities in the United States and the foreign corporation is primarily managed and controlled in the United States; and
4) provide that an inversion can occur if there is an acquisition either of substantially all of the assets of a domestic partnership (regardless of whether such assets constitute a trade or business), or of substantially all of the assets of a trade or business of a domestic partnership.

The proposal has two key aspects. First, it would prevent domestic corporations from using "reverse acquisitions" (transactions where a larger domestic entity is effectively acquired by a smaller foreign corporation, but the domestic corporation's shareholders and management remain in control of the post-combination group). The proposal also would prevent domestic corporations from relying on the "substantial business exception" to the current inversion rules, if the inverted company is managed and controlled within the United States.

The budget proposal also includes a new rule to limit the U.S. tax deductibility of interest expense payable to a foreign parent when a multinational group's U.S. operations are over-leveraged relative to the group's worldwide operations. Specifically, the U.S. interest expense deduction of any member of a group that prepares consolidated financial statements would be limited to the member's interest income plus the member's proportionate share of the financial reporting group's net interest expense computed under U.S. income tax principles (based on the member's proportionate share of the group's earnings as reflected in the group's financial statements). This provision, which appears to broaden Administration budget proposals to tighten limitations on the deductibility of interest paid by an "expatriated entity" to related persons, would significantly curtail a key earnings stripping strategy. Nonetheless, opportunities would remain for expatriated groups where the foreign parent (or its non-U.S. affiliates) can license intellectual property to the U.S. group.

Finally, although the anti-earning stripping proposal is included in the President's comprehensive tax reform proposals, the Congressional Budget Office indicates it would raise significant revenue. Revenue raisers (to a lesser extent descriptive of the anti-inversion legislation previously discussed) can be attractive provisions to attach to other bills. In this regard, a variation of the anti-earnings stripping proposal was included in Chairman Camp's Proposal for Tax Reform.

Notable Pending Deals

Men's Wearhouse to acquire Jos. A. Bank

On March 11, 2014, Men's Wearhouse announced it had entered into a definitive merger agreement to acquire rival suit maker Jos. A. Bank for cash consideration of approximately $1.8B. The announcement marks the end of nearly six months of strained negotiations between these two companies, which included unsolicited take-over offers by each of the clothiers and a modern application of the so-called "pac-man defense". In connection with the transaction, Jos. A. Bank terminated its agreement to purchase Eddie Bauer and will pay a $48M termination fee in connection with such determination. As of the date of this publication, the tender offer period has been extended through April 9, 2014. The transaction, which is subject to stockholder and regulatory approvals, is expected to close early in the third quarter of 2014.

Albertsons to acquire Safeway

On March 6, 2014, Albertsons announced it would acquire rival grocer Safeway in a cash and stock deal valued at approximately $9B. Albertsons, which is controlled by a Cerberus Capital Management led investor group, faced competition for Safeway from Kroger, the nation's largest grocery chain. While the definitive merger agreement provided for a 21 day initial go-shop period, no alternative proposals emerged for Safeway. The transaction, which is subject to stockholder and regulatory approvals, is expected to close in the fourth quarter of 2014.

Facebook to acquire WhatsApp

On February 19, 2014, Facebook announced it would acquire the venture capital backed messaging service WhatsApp for approximately $16B in cash and Facebook stock. The transaction also provides for up to $3B in restricted Facebook stock for WhatsApp's founders and employees. The transaction, which is expected to close later this year, is one of the largest ever for a venture capital backed startup.

Actavis to acquire Forest Laboratories

On February 18, 2014, Actavis announced it will acquire Forest Laboratories in a cash and stock deal valued at approximately $25B. The transaction which is expected to close in mid-2014, represents a significant win for activist investor, and Forest's second largest shareholder, Carl Icahn. Icahn, who in the past four years has waged two proxy battles at Forest, supported the transaction and stands to profit substantially from the approximately 25 percent transaction premium over Forest's pre-announcement price.

Comcast to acquire Time Warner Cable

On February 13, 2014, Comcast announced it would acquire Time Warner Cable for approximately $45B in an all stock deal. While the announcement seemingly ended the nearly year long takeover attempt of Time Warner Cable by rival cable operator Charter Communications, on March 28, 2014, Charter initiated a proxy solicitation against the Comcast acquisition, citing regulatory approval risk and a flawed deal process. The transaction, which combines the largest two cable operators in the U.S., is expected to face heavy regulatory scrutiny at both the federal and state level. While Comcast is prepared to divest up to three million subscribers in response to regulatory concerns, in the event the transaction fails under regulatory scrutiny, no break up fee will be payable by either party.

Suntory to acquire Beam

On January 13, 2014, Suntory announced it would acquire U.S. bourbon distiller Beam for cash consideration of approximately $16B. At a special meeting held on March 25, 2014, shareholders of Beam voted to approve the pending transaction. While still subject to regulatory approval in the European Union, the transaction is expected to close early in the second quarter of 2014.

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