The Mergers & Acquisitions Review

Sixth Edition

Editor
Simon Robinson

Law Business Research

The Mergers & Acquisitions Review

SIXTH EDITION

Reproduced with permission from Law Business Research Ltd.

This article was first published in The Mergers & Acquisitions Review, 6th edition
(published in August 2012 – editor Simon Robinson).

For further information please email
Adam.Sargent@lbresearch.com

The Mergers & Acquisitions Review

Sixth Edition

Editor
Simon Robinson

Law Business Research Ltd

THE LAW REVIEWS

THE MERGERS AND ACQUISITIONS REVIEW

THE RESTRUCTURING REVIEW

THE PRIVATE COMPETITION ENFORCEMENT REVIEW

THE DISPUTE RESOLUTION REVIEW

THE EMPLOYMENT LAW REVIEW

THE PUBLIC COMPETITION ENFORCEMENT REVIEW

THE BANKING REGULATION REVIEW

THE INTERNATIONAL ARBITRATION REVIEW

THE MERGER CONTROL REVIEW

THE TECHNOLOGY, MEDIA AND TELECOMMUNICATIONS REVIEW

THE INWARD INVESTMENT AND INTERNATIONAL TAXATION REVIEW

THE CORPORATE GOVERNANCE REVIEW

THE CORPORATE IMMIGRATION REVIEW

THE INTERNATIONAL INVESTIGATIONS REVIEW

THE PROJECTS AND CONSTRUCTION REVIEW

THE INTERNATIONAL CAPITAL MARKETS REVIEW

THE REAL ESTATE LAW REVIEW

THE PRIVATE EQUITY REVIEW

THE ENERGY REGULATION AND MARKETS REVIEW

THE INTELLECTUAL PROPERTY REVIEW

PUBLISHER
Gideon Roberton

BUSINESS DEVELOPMENT MANAGER
Adam Sargent

MARKETING MANAGERS
Nick Barette, Katherine Jablonowska, Alexandra Wan

PUBLISHING ASSISTANT
Lucy Brewer

EDITORIAL ASSISTANT
Lydia Gerges

PRODUCTION MANAGER
Adam Myers

PRODUCTION EDITOR
Joanne Morley

SUBEDITOR
Caroline Rawson

EDITOR-IN-CHIEF
Callum Campbell

MANAGING DIRECTOR
Richard Davey

Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK

ISBN 978-1-907606-41-0

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following law firms for their learned assistance throughout the preparation of this book:

AABØ-EVENSEN & CO ADVOKATFIRMA

ABDULAZIZ ALGASIM LAW FIRM
IN ASSOCIATION WITH ALLEN & OVERY LLP

ADVOKAADIBÜROO GLIMSTEDT OÜ

ÆLEX

AGUILAR CASTILLO LOVE

ANDERSON MŌRI & TOMOTSUNE

ARIAS, FÁBREGA & FÁBREGA

BEITEN BURKHARDT RECHTSANWALTSGESELLSCHAFT MBH

BERNOTAS & DOMINAS GLIMSTEDT

BOWMAN GILFILLAN INC

BOYANOV & CO

BREDIN PRAT

BRIGARD & URRUTIA ABOGADOS SA

BULBOACA & ASOCIATII SCA

CRAVATH, SWAINE & MOORE LLP

DEBEVOISE & PLIMPTON LLP

DF ADVOCATES

DITTMAR & INDRENIUS

DRYLLERAKIS & ASSOCIATES

ELİG ATTORNEYS-AT-LAW

EUBELIUS

F CASTELO BRANCO & ASSOCIADOS

FONTES, TARSO RIBEIRO ADVOGADOS

GLIMSTEDT & PARTNERS

GORRISSEN FEDERSPIEL

HARNEYS ARISTODEMOU LOIZIDES YIOLITIS LLC

HARNEY, WESTWOOD & RIEGELS

HENGELER MUELLER

JIMÉNEZ DE ARÉCHAGA, VIANA & BRAUSE

KBH KAANUUN

KEMPHOOGSTAD, S.R.O.

KIM & CHANG

KING & WOOD MALLESONS

KINSTELLAR S.R.O., ADVOKÁTNÍ KANCELÁŘ

MAKES & PARTNERS LAW FIRM

MANNHEIMER SWARTLING ADVOKATBYRÅ

MARVAL, O'FARRELL & MAIRAL

MATHESON ORMSBY PRENTICE

MNKS

MORAVČEVIĆ VOJNOVIĆ ZDRAVKOVIĆ
IN COOPERATION WITH SCHÖNHERR

NAGY ÉS TRÓCSÁNYI ÜGYVÉDI IRODA

NOERR OOO

OSLER, HOSKIN & HARCOURT LLP

PIROLA PENNUTO ZEI
& ASSOCIATI

RUBIO LEGUÍA NORMAND

RUŽIČKA CSEKES, S.R.O.

S HOROWITZ & CO

SALANS

SANTAMARINA Y STETA, S.C.

SCHELLENBERG WITTMER

SCHÖNHERR RECHTSANWÄLTE GMBH

SHEARMAN & STERLING LLP

SLAUGHTER AND MAY

STAMFORD LAW CORPORATION

TORRES, PLAZ & ARAUJO

URÍA MENÉNDEZ

VAN DOORNE

VASIL KISIL & PARTNERS

WILSON SONSINI GOODRICH & ROSATI

YOUNG CONAWAY STARGATT & TAYLOR, LLP

CONTENTS

EDITOR'S PREFACE

Deal-making has remained on the agenda in the past year, although the first half of 2011 showed a stronger performance than the second half, which saw a significant fall in transactional activity. In the wake of continuing economic uncertainty, opportunities for acquisitions remain limited to companies and institutions on a stable financial footing. At the same time, corporates are beginning to focus on their core business and looking for ways to return value. Valuations remain favourably low for purchasers, and the prospect of striking a bargain makes cross-border M&A attractive for those who can afford it. While access to the loan market has remained difficult, cash-rich corporations have begun to swing the balance in their favour. Shareholder participation and a desire for control and accountability are on the rise, and an atmosphere of increased regulation, reform and austerity is building. We remain in a state of geopolitical flux, and these factors continue to complicate the global economic scenario. The period of widespread unrest in the Middle East and North Africa seems to be reaching a settled conclusion, although the situation in Syria (and possibly Mali and Sudan) is still volatile. A number of countries have seen fresh elections and a transition of leadership, including France and Russia, and a change of leadership in China is expected following the 18th National People's Congress this autumn, when the US presidential elections will also take place. The sovereign debt crisis and the ongoing uncertainty over the fate of the eurozone are further contributing to the lack of confidence in the markets.

All is not doom and gloom, however, and whereas the global picture remains difficult, there are signs of hope. The emerging markets have shown a persistent growth in outbound investment, spurred on by a desire to build a more prominent global presence and for the purpose of accessing new markets. European targets remain of interest to both US and Middle and Far-Eastern buyers. Inbound investment from the emerging markets into both Africa and Australia is on the rise, and this has strengthened activity in the energy, mining and utilities sector. The technology, media and telecoms sector has also shown signs of promise with some high-profile deals, and must be watched with interest in the coming year. There is hope that, as political and economic factors stabilise, M&A activity will once more gather pace and momentum, and enter a new era of resurgence. We shall see.

Once again, I would like to thank the contributors for their continued support in producing this book. As you read the following chapters, one hopes the spectre of the years past will provide a basis for understanding, and the prospect of years to come will bring hope and optimism.

Simon Robinson
Slaughter and May
London
August 2012

Chapter 62

UNITED STATES

Richard Hall and Mark Greene[1]

I OVERVIEW OF M&A ACTIVITY

The environment for mergers and acquisitions in the United States still faces significant challenges as a result of the 2008 financial collapse. M&A activity continued its gradual recovery through 2011, although it still remains below its highest pre-credit crisis levels. During the 12 months ended 31 December 2011, US M&A activity by dollar volume increased by 31.1 per cent from the previous period, reaching $1.3 trillion in total deal volume.[2] However, the number of transactions was virtually unchanged as compared with the prior year period, with over 11,000 announced transactions.[3] Leveraged buyout ('LBO') activity retreated from a post-crisis high of 15 per cent of total deal value in the fourth quarter of 2010, stabilising at over 5 per cent of total deal value for 2011.[4] The US share of global M&A volume has increased slightly over 2010 levels, with approximately 39 per cent of announced deals by dollar volume.[5]

However, the US M&A market experienced a pullback in the first quarter of 2012, as the total value of US deal activity in this quarter decreased 53 per cent as compared to the first quarter of 2011, falling to $192.7 billion.[6] US M&A activity as

1 Richard Hall and Mark Greene are corporate partners at Cravath, Swaine & Moore LLP. The authors would like to acknowledge the contributions of fellow partners Jennifer Conway, Michael Schler and Christine Varney, specialist attorney Jonathan Clarke and associates Michael Atamas, Andrew Carlon, Audry Casusol, Michael Lucien, Jr. and Jason Semine.

2 Mergers & Acquisitions Review, Full Year 2011, Legal Advisors, Thomson Reuters (2012), http://online.thomsonone.com.

3 Id.

4 Id.

5 Id

6 Mergers & Acquisitions Review, First Quarter 2012, Legal Advisors, Thomson Reuters (2012), http://online.thomsonone.com.

measured by number of deals also decreased in the first quarter of 2012 as compared with the first quarter of 2011, falling 21.5 per cent.[7] However, LBO activity reversed course, rebounding to account for over 10 per cent of total US-targeted M&A activity.[8]

Much of the increase in US deal activity in 2011 was attributable to a general strengthening in the US economy, even in some of the hardest-hit industries,[9] and strong cash reserves of strategic acquirers. Along with an equity market that has yet to rebound to pre-crisis levels, these factors have provided shopping opportunities, particularly for strategic buyers who hope to use their cash positions to capitalise on expected economic recovery and growth. In addition, the divergent fortunes of regional economies have fuelled cross-border transactions, with companies from emerging economies increasingly seeking takeover targets within developed economies.[10]

While the credit markets have recovered significantly, obtaining acquisition financing remains challenging. Relative to pre-credit crisis levels, this environment has resulted in lower levels of private equity activity and lower debt-to-equity ratios in the completed transactions.[11] In addition, financing-related issues have led to greater use of stock consideration among strategic acquirers, as well as more creative methods of reducing cash consideration, including earn-outs. Both financing-related issues and volatility in the equity markets have motivated sellers to focus on certainty of closing, leading to new uses of reverse break-up fees in connection with financing outs.

II GENERAL INTRODUCTION TO THE LEGAL FRAMEWORK FOR M&A

M&A in the United States is governed by a dual regulatory regime, consisting of state corporation laws (for example, the Delaware General Corporation Law) and the federal securities laws (primarily, the Securities Act of 1933 and the Securities Exchange Act of 1934). The Securities and Exchange Commission ('the SEC') is the regulatory agency responsible for administering the federal securities laws. The federal securities laws apply in the context of a merger, including proxy rules that govern the solicitation of shareholder approval in the case of a merger involving a publicly held target company. The federal securities laws relating to tender offers apply in the context of an offer to purchase shares of a publicly held target company. In addition to these laws, an acquisition or merger

7 Id.

8 Id.

9 Nick Bunkley, 'G.M. Earns $865 million as Sales Rise 40 Percent,' *New York Times*, 17 May 2010, www.nytimes.com/2010/05/18/business/18auto.html?ref=business.

10 Evelyn M Rusli, 'On Wall Street, Renewed Optimism for Deal-Making', *New York Times*, 2 January 2012, http://dealbook.nytimes.com/2012/01/02/on-wall-street-a-renewed-optimism-for-deals/.

11 Andrew J Nussbaum, 'Private Equity 2011: A Challenging Year, with Reasons for Optimism, The Harvard Law School Forum on Corporate Governance and Financial Regulation', 20 January 2012, http://blogs.law.harvard.edu/corpgov/2012/01/20/private-equity-2011-a-challenging-year-with-reasons-for-optimism/.

will imply fiduciary duties, as developed and applied in the state of incorporation of the target company.

Unlike most other jurisdictions, the US patchwork of federal and state regulation of acquisitions is not focused on the substantive issue of regulating changes of control of target companies. Rather, US regulation focuses on disclosure, ensuring that common shareholders of target corporations are given the time and information required to make a fully informed decision regarding the acceptance of a tender offer or vote in favor of a merger.

Under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ('the HSR Act'), an acquirer is normally required to make a filing with US antitrust authorities prior to completing the acquisition. Generally, the HSR Act requires notification if the size of the transaction exceeds $68.2 million (adjusted annually for inflation); the requirement was increased from $66 million in 2011.[12]

There is no general statutory review process governing foreign investment in the United States. Under the Exon-Florio Amendment to the Defence Production Act, however, the President, through the Committee on Foreign Investment in the US ('CFIUS'), has the power to investigate, prohibit or unwind transactions involving investments by non-US entities that threaten to impair national security.[13] The 1992 Byrd Amendment also requires CFIUS to conduct a full Exon-Florio review whenever CFIUS receives notice of a non-US government-led takeover of a US business, which may affect national security.[14]

There are also additional industry-specific statutes that may require advance notification of an acquisition to a governmental authority. Examples of sensitive industries include airlines, broadcast licences, electric and gas utilities.

III DEVELOPMENTS IN CORPORATE AND TAKEOVER LAW AND THEIR IMPACT

i Revlon duties

In the case *In re Smurfit-Stone Container Corporation Shareholder Litigation*, the Delaware Court of Chancery held that *Revlon* duties apply to a board of directors of a corporation being sold for an equivalent share of cash and stock consideration.[15]

The *Revlon* standard is a heightened standard of review used to determine whether a board of directors has fulfilled its fiduciary obligations to shareholders in the context of hostile takeovers. In contrast with the traditional business judgment rule, the *Revlon* standard requires the board of directors to focus on maximising immediate shareholder

12 Updates to the Hart-Scott-Rodino Antitrust Improvements Act of 1976, Federal Trade Commission, www.ftc.gov/opa/2012/01/hsr.shtm.

13 50 U.S.C. app, Section 2170.

14 Pub. L. No. 102-484 (1992).

15 *In re Smurfit-Stone Container Corp S'holder Litig*, 2011 Del. Ch. LEXIS 79 (Del. Ch. 20 May 2011).

value by obtaining the highest price possible from any bidders.[16] One scenario under which *Revlon* applies is when a transaction would result in a 'sale or change of control'.[17] All-cash transactions are always considered a change of control for Revlon purposes, since they represent the last chance for shareholders to receive value for their investment.[18] Revlon is not triggered in transactions in which the consideration is entirely stock-based, as shareholders remain investors in the post-merger entity. Prior to the *In re Smurfit-Stone* ruling, it was unclear whether Revlon would be triggered where consideration is an equal mix of cash and stock.

The *In re Smurfit-Stone* case concerned a proposed merger, whereby a subsidiary of the Rock-Tenn Company would merge with the target company, the Smurfit-Stone Container Corp.[19] At the time of signing, the merger agreement called for consideration in the form of a 50/50 split between cash and stock.[20] However, the merger agreement did not contemplate any collar for the stock consideration, and subsequent appreciation of the Rock-Tenn common stock caused the share of stock to rise to 56 per cent of total consideration.[21]

The court distinguished these facts from those of *In re Santa Fe Pacific Corp*, where the Delaware Supreme Court had held a merger agreement that provided for 67 per cent stock consideration and 33 per cent cash consideration did not trigger Revlon, because control of the post-merger entity would remain in a 'large, fluid, changeable and changing public market'.[22] Rather, the court applied its reasoning in *In re Lukens Inc*, where it found the *Revlon* standard applied when target shareholders were granted the right to all-cash consideration, subject to a cap of 62 per cent of the total consideration.[23]

The Delaware Chancery Court asserted that the facts of *In re Smurfit-Stone* were contextually similar to those of *In re Lukens*. The Smurfit-Stone shareholders would receive cash in return for a substantial majority of their holdings, whereas a substantial majority of the Lukens shareholders were compensated entirely in cash.[24] Thus, the court held that because the transaction would 'constitute an end-game for all or a substantial part of a stockholder's investment',[25] the *Revlon* standard must apply to the Smurfit-Stone board.

In considering the lack of a collar, the court noted that the appropriate time to consider the mix of consideration was at the time the merger agreement was executed,

16 *Revlon v. MacAndrews & Forbes Hldgs Inc,* 506 A.2d 173 (Del. 1986).

17 Smurfit-Stone, 2011 Del. Ch. LEXIS at *45 (quoting *In re Santa Fe Pac Corp S'holder Litig*, 669 A.2d 59, 71 (Del. 1995) (citing *Paramount Commc'ns Inc. v. QVC Network Inc.*, 637 A.2d 34, 42-43, 47-48 (Del. 1994))).

18 *TW Servs Inc v. SWT Acq Corp*, 1989 Del. Ch. LEXIS 19, 1989 WL 20290, at *1184 (Del. Ch. 2 March 1989).

19 Smurfit-Stone, 2011 Del. Ch. LEXIS at *4.

20 Id. at *23.

21 Id. at *40 n.80.

22 Id. at *47 n.92 (quoting *In re Santa Fe Pac Corp S'holder Litig*, 669 A.2d 59, 72 (Del. 1995)).

23 Id. at 51-54.

24 Id. at 54.

25 Id. at 55.

so that boards would not have to take into account potential fluctuations of the stock price in order to evaluate whether *Revlon* duties would apply.[26] Thus, where a hostile takeover contemplates at least 50 per cent cash consideration at the time of the merger agreement's execution, the board of directors is subject to the heightened *Revlon* duties.

ii The fiduciary duty of loyalty

In the case *In re Southern Peru Copper Corporation Shareholder Derivative Litigation*, the Delaware Court of Chancery held that a special committee appointed by the board of directors of the Southern Peru Copper Corporation ('Southern Peru') breached its duty to minority shareholders in connection with the acquisition by Southern Peru of its controlling shareholder's subsidiary.[27] The court held that the transaction did not meet the entire fairness standard, as the special committee that was appointed to review the transaction did not act according to a fair process nor did it offer a fair price.[28]

In evaluating whether a special committee of a board of directors has fulfilled its duty of loyalty in a transaction with an interested party (such as a controlling shareholder), Delaware jurisprudence calls for an evaluation of the committee's actions using the entire fairness standard. In applying the entire fairness standard, the Delaware courts will evaluate the entirety of the transaction, focusing on two interrelated prongs: whether the committee adopted a fair process in considering the transaction and whether it paid a fair price upon completing the transaction.

In the *In re Southern Peru Copper Corp* case, Southern Peru Copper's controlling shareholder, Grupo Mexico SAB de CV ('Grupo Mexico'), put forward a proposal in which Southern Peru would acquire Grupo Mexico's controlling stake in Minera Mexico, SA de CV ('Minera Mexico') in exchange for Southern Peru stock.[29] In order to evaluate this proposal, Southern Peru's board of directors created a special committee, made up of disinterested directors. The Special Committee's financial adviser, Goldman Sachs, prepared a 'give/get' analysis, in which it determined that Southern Peru would give $3.05 billion-worth of its stock (Grupo Mexico's asking price) in order to get a company that was worth only approximately $1.7 billion.[30] Soon after, as the court noted 'the Special Committee began to devalue the 'give' in order to make the 'get' look closer in value'.[31]

Ultimately, the special committee and Grupo Mexico reached an agreement in which the stock-based consideration was valued at $3.08 billion at the time the merger agreement was signed.[32] However, the Special Committee agreed to remove any price collar and any condition relating to the approval of a majority of the minority shareholders.[33] Between the merger signing and closing, Southern Peru Copper stock

26 Id. at 57 n.106.

27 *In re S Peru Copper Corp S'holder Derivative Litig*, 30 A.3d 60 (Del. Ch. 2011).

28 S Peru Copper at 114.

29 Id. at 63.

30 Id. at 71.

31 Id. at 72.

32 Id. at 81.

33 Id. at 77.

appreciated significantly. Thus, the purchase price paid at closing amounted to $3.75 billion of Southern Peru stock.[34] While the special committee's financial adviser, Goldman Sachs, issued a fairness opinion at the signing of the merger agreement, it did not update its fairness opinion to reflect the increased purchase price.[35]

The Delaware Court of Chancery found that the transaction failed to meet the entire fairness standard, as the special committee did not use a fair process nor did it pay a fair price. The court focused on several inadequacies of the Special Committee's process. The court found fault in the special committee's use of revised valuations in order to justify Grupo Mexico's proposed price, which the court believed suggested that the committee was not negotiating at arms-length. The court also noted that the board of directors failed to task the special committee with the responsibility to consider alternative transactions, and that the committee in fact did not evaluate any strategic alternatives to the Grupo Mexico transaction. In addition, the failure to include terms that would protect minority shareholders, such as a collar or a majority of the minority approval condition, was found inadequate by the court. Finally, the court noted that the special committee failed to either seek an updated fairness opinion or change its recommendation in light of the appreciation in Southern Peru stock prior to the transaction's closing.[36]

Ultimately, the Court of Chancery found that '[t]hroughout the negotiation process the Special Committee's and Goldman's focus was on finding a way to get the terms of the merger structure proposed by Grupo Mexico to make sense, rather than aggressively testing the assumption that the merger was a good idea in the first place'.[37] A special committee evaluating an interested transaction should be mindful of avoiding these shortcomings, including the failure to negotiate at arms-length, the failure to consider strategic alternatives, the failure to include terms protective of minority shareholders, and the failure to revise a recommendation in light of new information.

iii Buy-side financing of leveraged buyouts

On 6 October 2011, Del Monte Corporation announced that it had reached a settlement of its shareholder litigation concerning a proposed LBO of the corporation.[38] The central claim of the litigation concerned the behaviour of Del Monte's financial adviser, Barclays Capital, and the buy-side financing it offered to Kohlberg, Kravis & Roberts Co ('KKR'), one of the members of the group attempting to buy out Del Monte.[39]

Barclays Capital had served as Del Monte's longstanding financial adviser. Without disclosing its actions or obtaining authorisation from the Del Monte board of directors, Barclays began to pitch a LBO of Del Monte to another of its clients, KKR, as well as other prospective bidders. Barclays planned to provide buy-side financing in the potential

34 Id. at 64.

35 Id. at 111-114.

36 Id. at 97-114.

37 Id. at 101.

38 Tom Hals, 'Del Monte's $89 Million Shareholder Settlement Approved', Reuters, 1 December 2011, www.reuters.com/article/2011/12/01/us-delmonte-kkr-settlement-idUSTRE7B02JZ20111201.

39 *In re Del Monte Foods Co S'holders Litig*, 25 A.3d 813 (Del. Ch. 2011).

LBO, in an arrangement known as 'stapled financing', whereby a target company's financial buyer offers a predetermined financing package to prospective bidders. Del Monte also engaged in discussions with Vestar Capital Partners ('Vestar'), suggesting that it team with KKR on its bid, despite the fact that confidentiality agreements prevented both Vestar and KKR from partnering in their bids.[40]

The Delaware Court of Chancery issued a preliminary injunction postponing the sale of Del Monte, suggesting that the Del Monte board had breached its fiduciary duties, largely as a result of misleading and improper behaviour by Barclays Capital.[41] Thereafter, Del Monte reached a settlement agreement in which it agreed to an $89.4 million payment to shareholders, of which $23.7 million was to be paid by Barclays.[42]

The preliminary injunction and subsequent settlement challenge the legitimacy of stapled financing, particularly in transactions involving public target companies. Stapled financing raises serious conflict of interest questions, as a sell-side adviser has an incentive to steer the bidding process towards bidders for whom it has agreed to provide financing. When considering stapled financing, a board of directors must consider whether the benefits outweigh these conflict of interest risks, and should remain actively involved in order to ensure that the process is not biased as a result.

IV FOREIGN INVOLVEMENT IN M&A TRANSACTIONS

One of the most significant cross-border transactions of 2011 was the takeover by BHP Billiton Ltd ('BHP') of Petrohawk Energy Corporation, a Houston, Texas-based oil and gas exploration company. The Petrohawk acquisition was the largest ever for BHP, and was an important strategic manoeuvre for the Australian multinational.[43]

The emergence of oil and gas extraction from shale has provided a significant boost to the energy sector, and BHP had made it a priority to expand its position in this booming business. It had submitted a failed $39 billion bid for Canadian firm Potash Corp of Saskatchewan Inc, and acquired the shale gas assets of Chesapeake Energy Corp in February 2011 at a price of $4.75 billion.[44] For Petrohawk, the BHP transaction provided an important source of capital, which was vital to growing its shale exploration business.

BHP, the sole bidder throughout the process, initially offered Petrohawk $37.50 per share, which represented a 50 per cent premium over Petrohawk's 45-day average stock price. Nonetheless, Petrohawk rejected the bid and submitted a counter-offer of $40 per share. Ultimately, the two companies agreed a price of $38.75 per share, for a

40 Del Monte Foods at 817-18.

41 Id. at 835-36.

42 Paul D. Brown, 'Key 2011 Corporate Law Decisions Include Notable Stockholder Victories in Delaware Courts', *Business Law Today*, 23 January, 2012, http://apps.americanbar.org/buslaw/blt/content/2012/01/article-2-brown-oconnell.shtml.

43 Claire Poole, 'M&A Deals of the Year: BHP Billiton-Petrohawk,' *The Deal Pipeline*, 26 January 2012, www.thedeal.com/content/energy/ma-deals-of-the-year-bhp-billiton-petrohawk.php.

44 Id.

total purchase price of $15 billion.[45] The price amounted to a 65 per cent premium over Petrohawk's closing price at the time of the merger. The transaction valued Petrohawk at 7.5 times its annual earnings, a multiple that is standard in the industry.[46]

The Petrohawk acquisition is representative of a significant trend in 2011 towards foreign direct investment in US shale gas. In the third quarter of 2011, when the Petrohawk acquisition occurred, foreign buyers represented 76 per cent of the total value of mergers in the oil and gas industry.[47] US oil and gas transactions during the third quarter rose 135 per cent on the prior year period, and 46 per cent of oil and gas transactions involved companies with shale gas operations.[48]

V SIGNIFICANT TRANSACTIONS, KEY TRENDS AND HOT INDUSTRIES

i Technology sector

The technology industry experienced significant deal activity over the course of 2011 and into the first half of 2012. Technology was the most active sector for US M&A activity in 2011, with 1,557 total transactions.[49] Several innovations in particularly played an important role in driving this activity, including social media, mobile devices and cloud computing. Social media activity was led by the world's largest social network, Facebook, which closed its initial public offering on 18 May 2012. Facebook completed 16 transactions over the course of 2011 and through to May 2012, including its purchase of location-based social network Gowalla and photography-sharing social network Instagram. Mobile devices also drove significant deal activity, as extensive patent litigation helped to spur acquisitions, such as an Apple-led group's purchase of Nortel's patent portfolio and Google's subsequent purchase of Motorola Mobility. Finally, SAP and Oracle's desire to strengthen their cloud computing offerings drove a flurry of deal activity in late 2011 and early 2012.

Social media

Much of the activity in the social media sector was revolved around the industry leader Facebook, as it prepared for its IPO in May of 2012. In the months leading up to its historic IPO, Facebook made several key acquisitions. First, in December of 2011, Facebook acquired the location-sharing social network Gowalla for an undisclosed

45 Id.

46 Michael J De La Merced, 'In Petrohawk's Sale to BHP, a Quest for Capital', *New York Times*, 14 July 2011, http://dealbook.nytimes.com/2011/07/14/in-petrohawks-sale-to-bhp-a-quest-for-capital.

47 Gordon Platt, 'M&A: US Shale-Gas Boom Attracts FDI', *Global Finance*, December 2011, www.gfmag.com/archives/145-december-2011/11496-maa-us-shale-gas-boom-attracts-fdi.html#axzz1wqTMKijX.

48 Id.

49 Mergers & Acquisitions Review, Full Year 2011, Legal Advisors, *supra*, footnote 2.

sum.[50] The transaction was an example of an 'acqui-hire', a popular strategy at Facebook and with internet companies in general, in which an acquirer purchases a target company solely to obtain its engineering and other employee talent.[51] Then, in April of 2012, just weeks before its planned IPO was to launch, Facebook announced its largest acquisition to date, of photo-sharing application Instagram. The acquisition signalled Facebook's intention to focus its efforts on its mobile applications, an important source of revenue growth for Facebook in the coming years.[52]

On 18 May 2012, Facebook entered the public markets with an initial public offering priced at $38 per share. The IPO raised $16 billion, and was the third-largest in US history.[53] However, the offering was soon marred by controversy and the poor performance of the Facebook stock. In particular, it was alleged that lead underwriter Morgan Stanley cut its revenue estimates during Facebook's roadshow, but only selectively disclosed the information to potential investors, leading to an investigation by both the SEC and the Financial Industry Regulatory Authority.[54] By 5 June 2012, several weeks after the IPO, Facebook shares had fallen nearly 32 per cent from their initial price.[55] The difficulties surrounding the Facebook IPO caused an overall pullback in the IPO market, as five companies delayed planned IPOs in the following weeks.[56]

Mobile devices

The mobile device market continued its strong growth in 2011, particularly with the rapid adoption of the smartphone category. Worldwide smartphone sales increased by over 61 per cent between 2010 and 2011.[57] However, the profitability and growth of the industry was hampered by a wave of patent litigation, which led many mobile device developers to pursue acquisitions in order to consolidate their intellectual property portfolios.

In July of 2011, the bankrupt Nortel Networks Corporation held an auction for its patent portfolio. The 6,000-patent portfolio was eventually sold to a group of bidders

50 Laurie Segall, 'Facebook Buys Gowalla,' CNN Money, 2 December 2011, http://money.cnn.com/ 2011/12/02/technology/gowalla_facebook/index.htm.

51 John Letzing, 'Facebook Buys More Talent With Gowalla', *Wall Street Journal*, 5 December 2011, http://blogs.wsj.com/digits/2011/12/05/facebook-buys-more-talent-with-gowalla-deal/.

52 Id.

53 Andrew Tangell and Walter Hamilton, 'Stakes Are High on Facebook's First Day of Trading', 17 May 2012, www.latimes.com/business/la-fi-facebook-pricing-20120518,0,3426310.story.

54 Suzanne Barlyn and Ryan Vlastelica, 'SEC, FINRA to Review Facebook Issues, Nasdaq Sued,' Reuters, 22 May 2012, http://finance.yahoo.com/news/facebook-shares-fall-valuation-doubts-134021024.html.

55 The stock price climbed in subsequent weeks, closing at $33.05 on 22 June, still more than 13 per cent below the opening price.

56 Maureen Farrell, 'Post-Facebook IPO Market Frozen,' CNN Money, 4 June 2012, http://money.cnn.com/2012/06/04/investing/ipo-freeze/index.htm.

57 Press Release, 'Int'l Data Corp., Smartphone Market Hits All-Time Quarterly High Due to Seasonal Strength and Wider Variety of Offerings, According to IDC', 6 February 2012, http://www.idc.com/getdoc.jsp?containerId=prUS23299912.

that included Apple Inc, Microsoft Corp and Research in Motion Ltd for $4.5 billion, a price that was five times the initial bid.[58] The significant demand for the portfolio, evidenced by the dramatic price increase over the course of the auction, underscored the strategic importance of patents in the mobile device market.

Google Inc was the most significant player in the mobile market left out of the Nortel patent sale, which was likely a factor in its move to acquire cellphone manufacturer Motorola Mobility Holdings for $12.5 billion, a 63.5 per cent premium over its market value.[59] Motorola Mobility held 17,000 patents in its portfolio, many of which would prove valuable to Google when defending claims of infringement related to its mobile operating system, Android.[60]

Google's strong motivation to close the Motorola Mobility deal was evidenced by the $2.5 billion reverse termination fee it agreed to as part of the acquisition. The fee was one of the five largest reverse termination fees since 2000, and was the second-largest as a percentage of total deal value over the same period of time.[61]

Cloud computing

Cloud computing, also referred to as software-as-a-service, has led to a revolution in the way software is distributed. While traditional software resides on a user's local hard drive, cloud computing allows a user to access software via the internet, cutting down cost and improving the ease of adoption. Cloud computing software is projected to be a $17.32 billion market by 2013, triple the size of the market in 2009.[62] The significant growth in cloud computing has prompted a wave of acquisitions, as large software providers seek to gain a foothold in the market.

Two rival software corporations, Oracle Corp and SAP AG, have each been particularly aggressive in seeking acquisitions in the cloud computing space. Oracle began the recent wave of acquisitions with its purchase of cloud-based customer service software provider RightNow Technologies Inc for $1.5 billion in October 2011. SAP,[63] which had

58 Peg Brickley, 'Nortel $4.5-Billion Patent Sale to Apple, Microsoft, Others Approved,' *Wall Street Journal*, 11 July 2011, http://online.wsj.com/article/SB100014240527023038121045 76440161959082234.html.

59 Michael J De La Merced, 'In Google's Motorola Deal, Icahn Gets His Wish (Again),' *New York Times*, 8 August 2011, http://dealbook.nytimes.com/2011/08/15/in-googles-motorola-deal-icahn-gets-his-wish-again.

60 Evelyn M Rusli, '$12 Billion Deal Will Put Google in Mobile Market,' *New York Times*, 16 August 2011, http://query.nytimes.com/gst/fullpage.html?res=940DE2DF1739F935A2575B C0A9679D8B63&ref=mot.s.

61 'Ranking Google's Hefty Motorola Breakup Fee, DealBook', *New York Times*, 18 August 2011, http://dealbook.nytimes.com/2011/08/18/ranking-googles-hefty-motorola-break-up-fee/.

62 Jim Finkle and Sayantani Ghosh, 'Oracle Buying Taleo for $1.9 Billion, Cloud War Brews,' Reuters, 9 February 2012, www.reuters.com/article/2012/02/09/us-taleo-oracle-idUSTRE81813U20120209.

63 Oracle Press Release, 'Oracle Buys RightNow', 24 October 2011,www.oracle.com/ us/ corporate/press/519740.

traditionally pursued a strategy to build cloud computing capability in-house,[64] switched course by acquiring cloud-based HR management software provider SuccessFactors Inc for $3.4 billion in December 2011.[65] Just two months later, Oracle responded by announcing that it had agreed to buy Taleo Corp, which makes cloud-based recruitment software, for $1.9 billion. These aggressive moves into cloud computing by Oracle and SAP were viewed by many as an attempt to keep pace with the industry leader in cloud-based enterprise software, Salesforce.com Inc.[66]

ii Energy and power sector

While the technology sector led US M&A activity in terms of number of transactions, the energy and power sector was the most prolific as measured by deal volume. This sector accounted for $248.7 billion worth of transactions, which represented 24.8 per cent of all M&A deal volume in 2011.[67] The US's largest M&A transaction of the year occurred within the energy sector, as natural gas pipeline operator Kinder Morgan Inc acquired its competitor El Paso Corporation.

Kinder Morgan/El Paso

On 16 October 2011, Kinder Morgan and El Paso entered into a merger agreement in which Kinder Morgan would acquire El Paso for $26.87 per share through a mix of cash, stock and warrants. Kinder Morgan had initiated the negotiations, and it planned to acquire El Paso, spin-off the El Paso exploration and production ('E&P') business and retain the El Paso pipeline business. El Paso had, in fact, been looking into a spin-off of the E&P business on its own when it was first approached by Kinder Morgan. Kinder Morgan initially offered $25.50 per share to acquire El Paso, and the parties eventually agreed to a purchase price of $27.55. However, Kinder Morgan later reduced its bid to $26.87, and El Paso accepted the reduced offer.

The resulting negotiations raised several conflict of interest issues, which were ultimately litigated in a shareholder lawsuit seeking to enjoin the vote to approve the merger. First, El Paso's CEO Douglas Foshee, who negotiated the transaction with Kinder Morgan, intended to make a bid on the El Paso E&P business in the eventual spin-off by Kinder Morgan. Foshee mentioned this intention to Kinder Morgan during the negotiations but failed to disclose the conflict of interest to the El Paso board. Moreover, the lead banker of El Paso's financial adviser, Steve Daniel of Goldman Sachs, owned approximately $340,000 in Kinder Morgan stock, yet he failed to disclose these holdings to the El Paso board.

These conflicts of interest led to a shareholder lawsuit in the Delaware Court of Chancery. Chancellor Leo Strine declined to enjoin the shareholder vote, noting that the lack of other offers for El Paso could leave shareholders without a viable alternative

64 Ragnhild Kjetland and Aaron Ricadela, 'SAP Sheds M&A Shyness as Oracle Rivalry Moves to the Cloud', Bloomberg, 5 December 2011, www.bloomberg.com/news/2011-12-04/sap-sheds-m-a-shyness-with-successfactors-as-oracle-rivalry-moves-to-cloud.html.

65 Id.

66 Finkle, *supra*, footnote 62.

67 Mergers & Acquisitions Review, Full Year 2011, Legal Advisors, *supra*, footnote 2.

to the Kinder Morgan offer. However, his opinion made clear that the transaction had been 'tainted by disloyalty', pointing to the conflicts of interest by CEO Foshee and lead banker Daniels. Strine also criticised Foshee for accepting Kinder Morgan's reduced offer, and argued that it would have been more appropriate to force Kinder Morgan to submit a hostile bid in order to attain the highest amount possible for El Paso shareholders.

Ultimately, the El Paso shareholders approved the Kinder Morgan merger on 9 March 2012, with 95 per cent of voters supporting the transaction. Kinder Morgan then spun off the El Paso E&P business in a sale to Apollo Global Management LLC for $7.15 billion.[68]

VI FINANCING OF M&A MAIN SOURCES AND DEVELOPMENTS

Credit markets continued to strengthen over 2011 and into the first quarter of 2012. In particular, high-yield issuances approached volumes and returns similar to those of the height of the 2006–2007 credit boom. However, a smaller share of high-yield issuances went to finance M&A activity. While $19.8 billion of high-yield issuances (17.8 per cent of total issuances) went towards M&A activity in 2011, 23.2 per cent of high-yield bonds were used to finance M&A in 2010, and nearly 51 per cent of such bonds were used to finance M&A in 2007.

As a result, the strengthened credit markets translated into only modest growth in LBO activity. For the year ending 31 December 2011, the United States experienced approximately $54 billion in LBO deal volume, a nearly 10 per cent increase over LBO activity in 2010.[69] As a share of the overall M&A activity, LBOs remained stable, comprising approximately 15 per cent of the total market. These levels stand in contrast to the heights reached in late 2006, when LBOs made up more than 30 per cent of the total US M&A volume.[70]

Nonetheless, several factors suggest that LBO activity will continue to strengthen. Private equity firms held $371.8 of available capital in the buyout funds (referred to as 'dry powder').[71] Significantly, it is estimated that nearly half of these funds will be forfeited if they are not used prior to 2014.[72] In addition, private equity firms have recently succeeded in negotiating more favourable equity contributions. Whereas the traditional equity contribution in an LBO has ranged between 30 and 40 per cent, a greater appetite for risk among private equity firms has led to contributions as low as 25 per cent.[73]

68 David Marcus, 'Strine Casts Wary Eye on El Paso-Kinder Morgan', *The Deal Magazine*, 13 March 2012, www.thedeal.com/magazine/2012/03/strine_casts_wary_eye_on_el_pasokinder_morgan/.

69 Mergers & Acquisitions Review, Full Year 2011, Legal Advisors, *supra*, footnote 2.

70 Id.

71 Lisa Lee, 'Bank Balance Sheet Concerns Hamper LBOs', Reuters, 5 April 2012, www.preqin.com/item/bank-balance-sheet-concerns-hamper-lbos/102/5039.

72 Id.

73 Matthew Sheehan, 'Private Equity Gets Freer Hand on Leveraged Buyout Deals', 24 May 2012, www.themiddlemarket.com/news/pe_freer_hand_leveraged_buyout_deals-230536-1.html.

In contrast with recent years, an increasing number of transactions in 2011 were financed exclusively with cash. In part, this reflects the significant amount of cash on the balance sheets of the US's largest companies. In 2011, the amount of cash held by the largest five public companies was approximately $230 billion, nearly double what it had been just a year earlier.[74] However, the use of all-cash consideration also reflected a more robust credit market and greater access to financing, made possible by low interest rates and the expansionary policies pursued by the Federal Reserve Board in 2011.

However, financing has remained challenging relative to the credit boom of 2006–2007, particularly over the second half of 2011. These challenges contributed to the continued focus on deal certainty, as demonstrated by the use of high reverse break-up fees. Reverse break-up fees serve to protect the target if the buyer abandons its bid, and have traditionally been limited to 3 per cent of deal value. Yet, there were 15 reverse break-up fees used in M&A deals in 2011 that exceeded 6 per cent of deal value, 12 of which took place in the first six months of the year.[75] Moreover, 46.4 per cent of all deals included a reverse break-up fee in the first half of 2011, whereas that percentage that fell to 38.3 per cent in the second half of the year. This decline in number and size of reverse break-up fees in the second half of 2011 were reflective of the overall decrease in debt-financed deals in that time period.

VII EMPLOYMENT LAW

As a result of recent regulatory changes in the US, including the Dodd-Frank Wall Street Reform and Consumer Protection Act ('Dodd-Frank') and the SEC regulations implementing that legislation, shareholders of publicly traded companies in the United States have been granted increased disclosure regarding, and an advisory vote on, the material components of such companies' executive pay practices (such vote, a say-on-pay or 'SOP' vote). SOP votes on executive pay provide a platform from which shareholders may voice their opinions about executive pay practices employed by the company. Although the SOP regulations have been in effect for only two proxy seasons, certain patterns and practices have emerged as new standards; nonetheless, it remains unclear what the long-term effects of the regulatory changes will be.

i Say-on-pay votes and compensation adjustments

Although SOP votes are advisory, companies have generally demonstrated concern for the outcome of the vote as the influence of proxy advisory firms such as Institutional Shareholder Services ('ISS') and Glass, Lewis & Co. on such votes continues to grow. During 2011, 44 companies received 'failed' SOP votes (defined as receiving 50 per cent or fewer votes in support, excluding abstentions) and, as of mid-June, 2012,

74 Tom Tunguz, 'The 2012 M&A Powder Keg, *ex post facto*', 9 February 2012, http://tomastunguz.com/2012/02/09/the-2012-ma-powder-keg/.

75 Practical Law Company, '2011 Year-end Public M&A Wrap-up', 1 February 2012, http://us.practicallaw.com/4-508-7741.

49 companies have had failed SOP votes for 2012, many after a proxy adviser had recommended a 'no' vote.

Data suggest that companies with high CEO pay or low stock price performance, in each case, relative to their peer companies, are the ones most at risk of a failed SOP vote. Companies with executive pay above the 75th percentile in their peer group are twice as likely to receive low shareholder support as companies that award less compensation.[76] Likewise, companies with poor stock price performance are three times as likely as companies with better performance to receive low shareholder support for their executive pay programmes, even if the CEO received pay below the median.[77] Many companies have altered their pay practices, at least with respect to their CEOs, presumably as a reaction to a real or perceived sense of low shareholder support for the existing programme, and there has been a noticeable shift from cash payment to equity and performance-based compensation.[78]

These regulatory reforms have similar application to M&A transactions. The regulations call for disclosure of the amounts to be paid to executives upon a change in control (triggered by most types of M&A transactions) and grant to shareholders an advisory vote on this compensation (a say on golden parachute or 'SOGP' vote). Certain change in control benefits which, historically, have been relatively common in connection with such transactions (e.g., 'single-trigger' acceleration of equity-based awards and gross-ups for the golden parachute excise tax pursuant to Section 280G of the US Internal Revenue Code, which applies to certain transaction-related payments above a threshold) have been singled out by proxy adviser firms and have drawn the particular ire of shareholders.[79] ISS's published policy guidance clearly states that it will render a negative SOP vote recommendation or a 'withhold' vote recommendation for directors when a 280G gross-up is included in a new change-in-control agreement, even if no M&A transaction is imminent at the time such agreement is signed.[80] Additionally, an informal coalition of institutional investors managed to persuade seven companies,

76 Towers Watson, Presentation, Executive Compensation in the 2012 Proxy Season (5 April 2012), at 4, www.towerswatson.com/assets/events/Towers-Watson-Exec-Compensation-in-the-2012-Proxy-Season-Presentation-April2012.pdf.

77 Id.

78 See, e.g., Associated Press, 'Typical CEO made $9.6M last year, AP study finds', 28 May 2012, www.cbsnews.com/8301-505245_162-57442493/typical-ceo-made-$9.6m-last-year-ap-study-finds/.

79 The existence of these pay practices presents risks to a favourable SOGP or SOP vote, and such practices are particularly highlighted in the SOGP disclosure. Indeed, the first failed SOGP vote has already occurred in 2012, with Advance America, Cash Advance Centers Inc receiving only 48 per cent of shareholder support for its golden parachute arrangements.

80 In one notable example, ISS rendered a negative SOP vote recommendation against the Walt Disney Company in the 2011 proxy season, which was later reversed when the company withdrew recently added 280G gross-ups and announced a ban on the practice for all future employment agreements.

whose SOP votes narrowly passed in 2011, to ban certain tax gross-ups, in order to avoid a failed vote in the 2012 proxy season.[81]

ii Shareholder litigation

Through litigation, emboldened shareholders are applying increased formal pressure on companies to change their executive pay practices. As predicted in last year's review, there has been an increase in strike suits following SOP votes that achieve less than 70 per cent support,[82] with plaintiffs typically alleging breach of fiduciary duties and corporate waste. This is consistent with a trend generally toward increased shareholder litigation, particularly in connection with an announced M&A transaction.[83] Such suits have tended to allege insufficiency of deal consideration, corporate waste or breach by the target board of fiduciary duties of loyalty, care, good faith or disclosure, often focusing on the post-closing compensation arrangements of the target's executives.[84]

Thus far, particularly in Delaware, the courts have generally dismissed these cases, finding that Dodd-Frank imposed no additional fiduciary duties on boards and noting that executive pay is soundly within the purview of business judgment.[85] Judicial treatment has not been entirely uniform, however, with at least one court, in *NECA-IBEW Pension Fund v. Cox*, denying the defendant's motion to dismiss on business judgment grounds a lawsuit that followed a failed SOP vote, therefore allowing the suit to go forward.[86] The state action related to the suit was later settled for less than $1 million and certain corporate governance changes.[87] Similar suits in forums outside of Delaware have been settled for sums of up to nearly $2 million.[88] Accordingly, as long as there is a chance that such cases will make it past the initial pleading stages, plaintiffs

81 See Joann S Lubin, 'Executive Pay Votes Spur Shifts in Policies', *Wall Street Journal*, 5 March 2012, http://online.wsj.com/article/SB10001424052970204571404577255641531516510.html.

82 ISS has designated 70 per cent as the threshold amount of support a company must receive in order for its SOP vote to be considered successful.

83 A recent study involving SEC filings related to acquisitions of US public companies valued over $100 million and announced in 2010 or 2011 found that nearly every such acquisition drew multiple lawsuits by target shareholders, few of whom received compensation as a result. Data indicates that non-monetary results, including additional disclosure or changes to the transaction documents, were often involved in resolving such suits.

84 See, e.g., *Strategic Trading Co v. Fishback*, No. 112CV216048 (Cal. Super. Ct. filed 4 January 2012); *Se Penn Transp Auth v. S Union Co*, No. 6615-CS (Del. Ch. filed 25 August 2011).

85 See, e.g., *Freedman v. Adams*, C.A. No. 4199-VCN, 2012 WL 1099893, at *14 (Del. Ch. 30 March 2012) (noting that 'the size and structure of executive compensation are inherently matters of judgment')(quoting *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000)).

86 *NECA-IBEW Pension Fund v. Cox*, No. 1:11-cv-451, 2011 WL 4383368 (S.D. Ohio 20 September 2011).

87 See Cincinnati Bell Inc, Quarterly Report (Form 10-Q), at 31 (7 May 2012).

88 See, e.g., Amended Stipulation and Notice of Settlement, *In Re KeyCorp Derivative Litigation*, No. 1:10-cv-01786-DAP (N.D. Ohio 26 April 2011).

almost assuredly will seek out similarly sympathetic judges or forums with generous demand laws in future filings.

iii Looking ahead

Although predictions are always hazardous, the movements of the past year point to areas that are almost certain to see interesting developments in the near future as a result of the changes described above. Shareholders are likely to continue exploring other avenues for influencing the pay practices of unresponsive companies. In at least one case, a company that received 80 per cent opposition to its SOP vote also saw two directors receive only 26 and 27 per cent support, respectively, for re-election – the lowest support of any S&P 500 company director in the past five years.[89] It is likely that shareholders will continue to express frustration over compensation practices by voting against re-election of directors, particularly those involved in compensation decisions. The practices identified as most troublesome by ISS and other proxy advisory firms likely will become increasingly rare. Compensation, even with respect to perquisites and other fringe benefits, is expected to shift ever more away from cash to equity and performance-based awards, such as Dell's recent decision to grant its relocation bonuses in part in the form of equity as opposed to cash.[90] It is unclear what the effect of this migration to equity and performance-based pay, coupled with the elimination of single-trigger vesting, will have on future M&A transactions.

VIII TAX LAW

i Treasury department regulations

Bright-line substantial presence test for corporate inversions

A US corporation with significant foreign operations may wish to become a subsidiary of a foreign parent corporation in order to reduce the amount of the group's foreign source income that will be subject to tax in the United States. Several domestic corporations have engaged in 'inversion' transactions that achieved this result. Congress responded to such transactions by enacting Section 7874. This section treats the new foreign parent corporation as a domestic corporation if 80 per cent or more of the foreign corporation's stock is held by stockholders of the domestic corporation by reason of their holding stock in the domestic corporation. If shareholders of the domestic corporation hold 60 per cent of the stock of the foreign corporation by reason of holding stock in the domestic corporation, the domestic corporation faces certain penalties and anti-abuse rules.

The rules under Section 7874 do not apply if the expanded affiliated group to which the domestic corporation belongs has 'substantial business activities' in the country where the foreign acquiring corporation is organised. Temporary regulations issued in 2006 provided that the substantial business activities test is based on all the

89 See Russell Gold and Daniel Gilbert, 'Chesapeake Directors Rejected by Shareholders', *Wall Street Journal*, 9 June 2012, http://online.wsj.com/article/SB10001424052702303753904577454132886187926.html.

90 See Dell Inc, Definitive Proxy Statement (Form DEF 14-A), at 52 (24 May 2012).

facts and circumstances, with a safe-harbour if 10 per cent of the group's employees, assets, and income are in the foreign jurisdiction in which the new corporation is organised. However, the Treasury believed that the safe harbour was too liberal, and issued temporary regulations in 2009 removing the safe harbour. This left only the facts-and-circumstances test, and commentators criticised this test on the grounds that it did not provide sufficient certainty.

The Treasury recently issued proposed and temporary regulations that replace the facts-and-circumstances test with a bright-line mathematical rule.[91] Under that rule, a corporation meets the substantial business activities test in a particular country if, and only if, 25 per cent of the group's employees, assets, and income are all in that country. These regulations will greatly limit the ability of corporations to satisfy the substantial business activity test, since many affiliated groups do not have 25 per cent of their activities in any one country. As a result, these regulations will severely restrict the ability of US corporations to engage in inversion transactions. It is still possible, however, for a US corporation to become a subsidiary of a pre-existing foreign corporation, as long as the shareholders of the US corporation end up owning less than 80 per cent of the stock of the foreign corporation.

Continuity of interest regulations

To qualify as a tax-free reorganisation, an acquisition must satisfy the continuity of interest ('COI') requirement. This requirement is satisfied if 40 per cent or more of the value of the consideration paid to the target corporation's shareholders consists of stock of the acquiring corporation.[92] Historically, this test was applicable at the closing of the transaction, so that fluctuations in the value of acquirer stock between signing and closing could adversely affect the acquisition's eligibility for tax free treatment. Recently adopted final COI regulations include a 'signing date rule.' They provide that, in general, if an acquisition is pursuant to a binding contract that provides for fixed consideration, the stock of the acquirer will be valued on the day before signing.[93] This permits assurance on the signing date that the COI requirements will be satisfied, regardless of future changes in value of acquiror stock.

The final regulations apply only if the acquisition consideration is 'fixed'. This does not allow for many common formulae for issuing acquiror stock, such as where the number of shares of acquiror stock to be issued can vary as the value of acquiror stock varies above a floor price (or below a ceiling price), but does not vary if the value of acquirer stock is below the floor price (or above the ceiling price). Recently proposed regulations, however, would expand the application of the signing date rule to include situations where the amount of acquirer stock to be issued takes into account floor and ceiling prices.[94] In addition, if a contract specifies that the number of shares of acquirer stock to be issued is based on an average of prices of acquirer stock occurring after the signing date and before the closing date, the taxpayer may apply the COI test by using

91 Prop. Treas. Reg. §1.7874-3.

92 See Treas. Reg. §1.368-1(e)(1); Treas. Reg. §1.368-1(e)(2)(v), example 1.

93 See Treas. Reg. §1.368-1(e)(2)(i).

94 Prop. Treas. Reg. §1.368-1(e)(2)(vi)(A)&(B).

that average of prices as the value of acquirer stock. If adopted, these rules would expand situations where certainty of meeting the COI requirements can be obtained on the signing date.

Allocation of earnings and profits in tax-free transfers

In a tax-free reorganisation, a target corporation may merge into the acquiring corporation or may transfer substantially all its assets to an acquiring corporation. In these situations, under Section 381, the tax attributes of the target corporation (e.g., tax basis of assets, net operating losses, etc.) carry over to the acquiring corporation. However, if the acquiring corporation transfers all the target assets to another corporation, all the attributes move to that corporation. If only a portion of the assets are transferred to another corporation (e.g., even if all but $1 of the assets are transferred), all the attributes remain with the acquiring corporation.

The regulations under Section 312, which determine the movement of earnings and profits ('E&P'), are not completely clear as to whether the same rule applies for the movement of E&P. Most practitioners, however, believe that this is the case. The Treasury department has now proposed regulations clarifying that E&P receives the same treatment under Section 312 as do other tax attributes under Section 381. This confirms that E&P of the target corporation cannot be split between more than one acquiring corporation even if the target assets end up being divided among two or more acquiring corporations.[95]

Calculating limitations on net operating losses

If a corporation with net operating losses ('NOLs') has an 'ownership change', Section 382 limits the amount of the corporation's pre-change NOLs that can be used to offset post-change taxable income. An ownership change occurs if any 5 per cent shareholders have increased their ownership in the loss corporation stock by more than 50 per cent over a three-year period. Section 382 applies special rules for less-than-5 per cent shareholders ('small shareholders') and aggregates such small shareholders into one 5 per cent shareholder, generally referred to as the 'public group.' However, more than one 'public group' may be deemed to exist after certain transactions, such as tax-free reorganisations under Section 368. Keeping track of multiple 'public groups' can be quite complex.

Recently proposed regulations attempt to reduce the complexity of tracking the public group by providing exceptions for transactions unlikely to implicate the policy concerns of Section 382.[96] For example, secondary transfers from 5 per cent shareholders to the public group would not result in a new public group. These rules, if adopted, would simplify the calculations necessary under Section 382 and reduce the likelihood that transfers by small shareholders would create an ownership change.

In addition, the ownership percentage of a shareholder under Section 382 is based on the value of stock owned by the shareholder compared to the value of all

95 Prop. Treas. Reg. §1.312-11. E&P is primarily relevant in determining whether distributions by a corporation to its shareholders are characterised as dividends.

96 Prop. Treas. Reg. §1.382-3.

outstanding stock of the corporation. When a corporation has two or more classes of stock outstanding (e.g., common and preferred stock), it is not clear how to determine changes in percentage ownership of the stock held by a particular shareholder. The issue arises because even if there is no transfer of ownership of any shares, the pre-existing stock owned by a particular shareholder may represent a different percentage of the total value of the outstanding stock at different times, due to changes in the relative value of different classes of stock. Logically, in determining a shareholder's increase in percentage ownership in the corporation under Section 382, changes in percentage ownership arising from changes in the relative value of pre-existing stock held by the shareholder should be disregarded. The IRS recently provided interim guidance on how to take such fluctuations in stock value into account in determining ownership shifts of loss corporations. The IRS described two methodologies and stated that, until final rules are issued, either method is acceptable.[97] This IRS guidance will greatly simplify and clarify the calculation of changes of ownership under Section 382.

Application of Section 367 to Section 304

Section 304 applies when one corporation, the acquirer, buys the stock of another corporation, the target, from a common parent, the seller. Section 304 recharacterises this transaction into two steps. The seller is deemed to contribute the target stock to the acquirer in exchange for acquirer shares in a deemed tax-free 'Section 351 exchange'. The acquirer is then deemed to redeem from parent the acquirer shares issued in the deemed Section 351 transaction. This redemption may be treated as a dividend or as a sale or exchange under Sections 301 and 302.

Sections 367(a)(1) provides for recognition of gain in certain transactions involving transfers of property to a foreign corporation that would otherwise be tax-free, including Section 351 exchanges. Therefore, absent a special rule, if Section 304 applied to a transaction in which the acquirer is foreign, then the deemed transfer of target stock to the acquirer could also cause Section 367 to apply. This could cause taxable gain to the seller. In 2006, the IRS stated that Section 367 would not apply in this situation.[98]

In a recent Notice, however, the IRS reversed course and announced that it will amend the regulations so that Section 367 will apply in this situation.[99] In the example above, the seller would realise gains under Section 367 if the seller is domestic and the acquirer is foreign, and the seller could then realise dividend income on the second step of the Section 304 transaction. The Notice has been criticised because the result can be double taxation of the gain in the stock of target. The Notice ameliorates, but does not eliminate, that problem by allowing the seller to enter into a gain recognition agreement to defer recognition of the gain until certain triggering events occur. The amendments to the regulations will apply to transactions occurring after 10 February 2012.

97 See IRS Notice 2010-50, 2010-27 IRB 12 (11 June 2010).

98 T.D. 9250, 2006-1 CB 588.

99 Notice 2012-15, 2012-9 IRB 424 (10 February 2012).

ii IRS guidance

Economic substance doctrine

In 2010, Congress enacted legislation to codify the judicial 'economic substance doctrine', which courts invoke to deny tax benefits generated by transactions that lack true economic substance. Section 7701(o) provides that, in the case of any transaction to which the economic substance doctrine is relevant, the transaction will be treated as having economic substance only if (1) the transaction changes the taxpayer's economic position in a meaningful way (ignoring the transaction's US federal income tax effects) and (2) the taxpayer has a substantial purpose for entering into the transaction (apart from the transaction's US federal income tax effects). The legislation also imposed a strict 20 per cent liability penalty for any underpayment of tax by reason of a transaction lacking economic substance (40 per cent if the taxpayer does not adequately disclose the relevant facts of the transaction in the return).

The IRS has issued guidance on Section 7701(o), stating that the IRS will analyse each prong of the two-prong conjunctive test by applying cases under the common-law economic substance doctrine and will generally continue to apply the economic substance doctrine in the same fashion as it did prior to the enactment of Section 7701(o).[100] The IRS has also indicated that it does not intend to issue general administrative guidance regarding the types of transactions to which the economic substance doctrine applies, including private letter rulings as to whether any transaction complies with the requirements of Section 7701(o).

The IRS recently released guidance instructing its examiners on the application of the economic substance doctrine.[101] The guidance provides four steps for applying the doctrine. The purpose of this guidance is to achieve a more uniform administration of the economic substance doctrine by the IRS and to avoid the possibility that individual IRS agents will bring cases in inappropriate circumstances. However, this guidance is internal guidance for use by the IRS, and taxpayers may not rely on it.

Rescission doctrine no-ruling policy

The rescission doctrine allows a transaction to be ignored for tax purposes if the parties involved revert to the pre-transaction state in the same taxable year. Existing guidance on the rescission doctrine that taxpayers can rely on is scant.[102] Thus, the exact requirements for a successful rescission are not clear. However, certain non-precedential private letter rulings issued by the IRS have been very liberal in allowing transactions, including acquisition transactions, to be rescinded during the same tax year. For example, a rescission was allowed where a company had made a mistake in a transaction and would rescind and then engage in the same transaction without the mistake.[103]

The IRS has now announced that the rescission doctrine is currently being studied and that no rulings will be issued until the IRS publishes a regulation or other guidance on

100 See IRS Notice 2010-62, 2010-40 IRB 411 (9 September 2010).

101 LB&I-4-0711-015.

102 See *Penn v. Robertson*, 115 F.2d 167 (4th Cir. 1940); Rev. Rul. 80-58.

103 PLR 201021002.

the subject.[104] The joint Treasury and IRS 2011–12 Priority Guidance Plan states that the issuance of clarifying guidance on the rescission doctrine is a priority for the coming year.[105]

iii SEC guidance on tax opinions in registered offerings

In 2011, the SEC issued a bulletin detailing its views on tax opinions in registered offerings.[106] A tax opinion is required in registered offerings where the tax consequences are 'material' to an investor. Tax consequences are material when a reasonable investor is likely to consider the information important in making an investment decision. Tax-free mergers or exchanges are generally included in this category.

The SEC guidance states that the tax opinion must address each material tax consequence and state both a conclusion and the relevant Internal Revenue Code provision, regulation, or revenue ruling providing the basis for the opinion. If counsel is unable to give an opinion for a particular item, the reasons for the inability to give an opinion should be clearly expressed and justified. If, due to a lack of authority or conflicting authority on a particular issue, tax counsel can only issue a 'should' or 'more likely than not' opinion, the opinion must explain why counsel could not issue a 'will' opinion as well as detail the risks from the uncertain tax consequences. In all cases, a mere description of the applicable law is insufficient; the opinion must apply the law to the facts of the given situation.

In general, the tax opinion must be filed before the registration statement becomes effective. However, it may be filed later provided that three conditions are met: the merger agreement must require, as a non-waivable condition on closing, a tax opinion stating that the merger will be treated as tax-free reorganisation; the prospectus must discuss the substance of the tax opinion that will be provided at closing; and the opinion must be filed prior to closing as a post-effective amendment.

The opinion may suggest that investors consult their own tax counsel, but it may not include a disclaimer against reliance on the opinion. All counsel and accountants providing tax opinions must be named in the opinion, must provide written consent, and cannot deny that they are experts within the meanings of Sections 7 and 11 of the Securities Act.

IX COMPETITION LAW

The past 12 months have seen a continuation of the Obama Administration's vigorous merger enforcement agenda. HSR Act second requests and complaints have risen significantly as a percentage of total HSR filings since President Obama assumed office. The Department of Justice (the 'DoJ') and the Federal Trade Commission (the 'FTC') also continued an aggressive programme of filing complaints in 'under the radar' cases in which no HSR filing was required but the transaction came to their attention by

104 Rev. Proc. 2012-3, 2012-1 IRB 113 (2 January 2012).

105 2011–2012 Priority Guidance Plan, Department of the Treasury (2 September 2011), www.irs.gov/pub/irs-utl/2011-2012_pgp.pdf.

106 Staff Legal Bulletin No. 19 (CF).

other means. As discussed further below, both the DoJ and the FTC demonstrated the willingness and capacity to litigate those matters in which a satisfactory resolution could not be achieved by consent decree.

Private merger enforcement also appears to be on the rise despite obstacles to standing for competitor plaintiffs. Suits by Sprint and Cellular South to halt the high-profile merger of competitors AT&T and T-Mobile survived in part the merging parties' motions to dismiss.[107] Had the merging parties not abandoned the transaction, the private suits would have proceeded concurrent with the government case, imposing substantial burden on AT&T. Remarkably, Sirius XM agreed to a $180 million settlement with a purported class of consumer plaintiffs several years after the Antitrust Division cleared the merger of predecesors Sirius and XM.[108] While private suits rarely halt mergers, plaintiffs in such suits may succeed in extracting nuisance settlements either prior to closing or post-consummation.

In August 2011, the DoJ and the FTC began using a revised HSR pre-notification form that is substantially different from the form that had been used with few changes for two decades. During the notice and comment period prior to the new form's adoption, the FTC cited two primary goals of the revisions: (1) to streamline the HSR reporting process by eliminating items of information that had proved to be of little use to the agencies in evaluating the competitive effects of proposed transactions; and (2) to provide the agencies with additional information relevant to their competitive effects analysis and not solicited in the existing notification form.[109] Foreign manufacturers, who now must report revenues under a US-based classification system that they likely have not previously employed in their own accounting, and hedge funds, private equity finds, and other investment vehicles, who now must provide information regarding the holdings of 'associates' affiliated with the acquiring entity, are the most likely to face extra burden under the revised form. Filing parties not subject to these requirements likely will find the revised form somewhat less burdensome.

There were changes in senior leadership at both agencies. At the Antitrust Division, Assistant Attorney General Christine Varney departed for private practice. She was succeeded first by Sharis Pozen and then by Joseph Wayland, both serving in an interim capacity. President Obama has announced the nomination of William J Baer to be the next Assistant Attorney General for the Antitrust Division.[110] Mr Baer previously served in several senior positions at the FTC and has been a prominent figure in the Washington antitrust bar for several decades. His nomination likely will be approved

107 *Sprint Nextel Corp v. AT&T et al*, Civ. A. 11-1600 (D.D.C. 2 November 2011).

108 Don Jeffrey, 'SiriusXM Wins Subscriber Class-Action Accord Court Approval,' Bloomberg (24 August 2011), available at www.bloomberg.com/news/2011-08-24/sirius-xm-wins-court-approval-of-subscriber-class-actionlawsuit-accord.html.

109 Notice of Proposed Rulemaking available at http://ftc.gov/os/fedreg/2011/07/110707hsrfrn.pdf.

110 White House press release, 'President Obama Announces More Key Administration Posts', 3 February 2012, available at www.whitehouse.gov/the-press-office/2012/02/03/president-obama-announces-more-key-administration-posts.

by the Senate barring election-year complications. At the FTC, Maureen Ohlhausen replaced William Kovacic as a Commissioner in April 2012.[111] She previously served as Director of the FTC's Office of Policy Planning from 2004 to 2008. Her expertise is primarily in cybersecurity and data privacy.

i Department of Justice

The Antitrust Division of the DoJustice reviewed a number of high-profile transactions over the past 12 months, most notably the proposed merger of telecom giants AT&T and T-Mobile. In addition, the Division has made building its litigation capacity a priority, and the performance of the Division's trial team in the *H&R Block* matter (discussed below) impressed most observers.

H&R Block/TaxAct

On 31 October 2011, a federal district court judge in Washington, DC granted the Antitrust Division's request for a permanent injunction blocking H&R Block's proposed acquisition of 2SS Holdings Inc ('TaxAct'), the maker of TaxAct software, giving the Division its first merger trial victory in nearly a decade.[112] The decision turned substantially on market definition, with the Division asserting a product market of digital do-it-yourself ('DDIY') tax preparation products and the defendants arguing that the relevant market included all methods of tax preparation, including CPAs, storefront tax preparers, and pen and paper. Once the court accepted the Division's market definition, the result was largely assured. The DDIY market was dominated by three competitors whose combined market share exceeded 90 per cent. The merger of H&R Block and TaxAct thus would have created a duopoly, the result of which would have been the elimination of direct competition between the merging firms and an increased likelihood of coordination on price and output between the remaining firms. While H&R Block was a relatively straightforward case analytically, it was notable for demonstrating the Division's willingness to litigate and its capacity to do so at a high level.

AT&T/T-Mobile

The Division's high-profile victory in *H&R Block* may have influenced AT&T's decision to abandon its proposed $39 billion acquisition of rival wireless provider T-Mobile despite the fact that the deal's termination triggered payment of a $4 billion termination fee to T-Mobile. The Antitrust Division's chief trial counsel, Joseph Wayland, led the Division's effort in *H&R Block* and would have performed the same role in a trial against AT&T.

AT&T's cause was damaged by an FCC staff report[113] highly critical of the likely competitive effects of the merger, which would have combined the second and fourth-

111 Federal Trade Commission press release, 'Maureen Ohlhausen Sworn in as Federal Trade Commissioner', 4 April 2012, available at http://ftc.gov/opa/2012/04/ohlhausen.shtm.

112 *US v. H&R Block Inc, et al*, Civ.A. 11-00948 (D.D.C. 10 November 2011).

113 Bloomberg News, 'FCC Report Details Merger Shortcomings', 29 November 2011, available at www.nytimes.com/2011/11/30/business/media/fcc-report-on-att-deal-details-merger-shortcomings.html.

largest wireless service providers in a highly-concentrated market, leaving AT&T and Verizon with a combined 75 per cent share. AT&T argued that its acquisition of T-Mobile was necessary for it to meet the growing spectrum demands created by its customers' use of smartphones. The FCC report rejected this argument, asserting that AT&T could meet its spectrum needs without the merger by investing in expending its existing capacity. AT&T conducted an ambitious public relations campaign in an attempt to generate political support for the merger, but this effort ultimately proved unsuccessful.

Both the FCC report and the DoJ complaint[114] identified T-Mobile as a 'maverick' firm that had a history of stimulating competition among wireless providers through the introduction of attractive pricing plans and by working closely with handset manufacturers to introduce new models. The Horizontal Merger Guidelines identify elimination of a maverick as posing particular risk of coordinated effects.[115] The DoJ also concluded that the deal would pose a risk of unilateral effects arising from the elimination of head-to-head competition between the merging firms. Unilateral effects theories of harm, which rely heavily on econometric modelling of diversion ratios,[116] continue to be important to the agencies' analyses.

George's Foods/Tyson Foods

In June 2011, the Division announced that it had reached a settlement ending its efforts to stop the acquisition by poultry processor George's Foods of a plant owned by rival Tyson's Foods located in the Shenandoah Valley region of Virginia and West Virginia.[117] The transaction was valued at only $3.1 million and was not HSR-reportable. The Division nonetheless learned of the proposed deal, which was publicly announced by the companies, and opened an investigation. George's assumed an aggressive posture, closing the transaction while the Division was still investigating and declining in certain respects to cooperate with that investigation. The Division ultimately filed a complaint[118] challenging the transaction, asserting that it was a merger to duopoly in the Shenandoah Valley market for poultry processors and would allow the merged firm to exercise monopsony power over growers. George's argued that the transaction could not possibly have anti-competitive effects since the Tyson's plant was in poor condition and operating well below capacity. The settlement, whose terms are somewhat unusual, calls for George's to make capital improvements and modifications to the Tyson's facility that will allow George's to increase production.[119] This in turn will increase George's demand for the services of growers and prevent George's from exercising monopsony power over the growers, most of whom are small, family-run operations.

114 Available at www.justice.gov/opa/documents/Justice-ATT-TMobile-Complaint.pdf.

115 Horizontal Merger Guidelines §2.1.5.

116 Horizontal Merger Guidelines §6.1.

117 Department of Justice press release, Justice Department Reaches Settlement With George's, Inc, 23 June 2011, available at www.justice.gov/atr/public/press_releases/2011/272510.pdf.

118 Complaint, *US v. George's Foods LLC, et al*, 5:11-cv-00043 (W.D. Va. 10 May 2011).

119 Final Judgement, *US v. George's Foods LLC, et al*, 5:11-cv-00043 (W.D. Va. 4 November 2011).

The *George's* case illustrates several emerging trends at the Antitrust Division. First, the Division has made agriculture markets, which are generally highly-concentrated, an enforcement priority.[120] Second, the conduct remedy here is another in a series of such remedies agreed to by the Division, altering what had been perceived as a strong preference for structural remedies to address competition concerns arising from proposed mergers. Third, the Division continues to oppose relatively small, non-reportable transactions that it feels present a clear risk to competition. Fourth, the Division has demonstrated increasing concern with the exercise of monopsony power by firms with substantial share in downstream markets.

Google/Motorola Mobility, et al

In February 2012, the Antitrust Division closed its investigation of three separate but analytically similar transactions involving the transfer of substantial patent portfolios related to the development of smartphone and tablet computer operating systems.[121] Both of these markets are somewhat concentrated, with Google's Android operating system the leader in both. The Division's initial concern was that the acquisition of these patents, among them many essential to practicing the established operating system standard, would give acquiring firms Google, Microsoft, Apple and Research in Motion the ability and incentive to engage in opportunistic licensing practices (sometimes called 'patent hold-up') that would foreclose competition or raise the costs of their competitors. The Division's concerns were somewhat assuaged by public statements made by the acquiring firms regarding their licensing practices. While the statements differed among the firms, each committed to license its essential patents on fair, reasonable, and non-discriminatory ('FRAND') terms and, for the most part, to refrain from seeking to enjoin competitors from practicing the covered technology in the absence of a license agreement. In part as a result of these statements, the Division was ultimately convinced that the acquisitions did not pose a threat to competition. This result received considerable public scrutiny and a measure of criticism, with some observers arguing that the Division had used the merger review process improperly to extract arguably welfare-enhancing concessions from the acquiring companies despite the fact that acquisitions themselves did not pose a risk to competition.[122] While the Division closed its investigation without action, the

120 Christine A Varney, Assistant Attorney General, Antitrust Div, US Dept. of Justice, 'Crisis on the Farm: The State of Cooperation and Prospects for Sustainability in the Northeast Dairy Industry', Field Hearing Before the Senate Committee on the Judiciary, 111th Congress, 2009, available at www.usdoj.gov/atr/public/testimony/250178.htm ('Competition issues affecting agriculture have been a priority… since I was confirmed last spring').

121 DoJ press release, Statement of the Department of Justice's Antittrust Division on Its Decision to Close the Investigations of Google Inc's Acquisition of Motorola Mobility Holdings Inc and the Acquisitions of Certain Patents by Apple Inc, Microsoft Corp and Research in Motion Ltd, 13 February 2012, available at www.justice.gov/opa/pr/2012/February/12-at-210.html. See Section V.i, *supra*, for a discussion of Google's acquisition of Motorola Mobility.

122 Joshua Wright, 'Truth On The Market Blog, The DOJ's Problematic Attack on Property Rights Through Merger Review', 14 March 2012. ('For an agency to extract concessions that go

deals highlight the complex interaction of intellectual property rights and antitrust law that the agencies increasingly confront in technology markets.

ii Federal Trade Commission

Mergers in health care markets continue to be a primary focus of concern at the FTC. As discussed below, a number of the agency's high-profile reviews over the past 12 months have involved horizontal mergers between hospitals, pharmaceuticals companies, and pharmacy benefits managers.

Promedica/St Luke's Hospital

On 5 December 2011, an FTC administrative law judge ('ALJ') issued his Initial Decision requiring ProMedica to divest previously acquired competitor St. Luke's Hospital.[123] The FTC had earlier challenged the consummated transaction in district court and sought a temporary restraining order and preliminary injunction to enjoin the hospitals from consolidating their operations. The FTC alleged that the acquisition would give ProMedica control of nearly 60 percent of the market for general acute-care inpatient hospital services and over 80 percent of the market for inpatient obstetrical services in the area of Toledo, Ohio.[124] The district court granted the preliminary injunction pending a full administrative trial on the merits.[125] The ALJ subsequently found that the acquisition would increase ProMedica's bargaining power with commercial payors, leading to consumer harm in the form of higher reimbursement rates. The ALJ rejected the hospitals' contention that (1) the pro-competitive benefits and increased efficiencies from the deal outweighed any anti-competitive effects; (2) the merger should be allowed to proceed since St Luke's was in financial distress; and (3) a viable alternative remedy to divestiture would be the establishment of a separate 'firewalled' negotiation team that would negotiate and administer contracts on behalf of only St Luke's. ProMedica's appeal of the ALJ's decision to the full Commission was subsequently denied in a 4–0 decision.[126]

Omnicare/PharMerica

In February 2012, Omnicare Inc announced that it would abandon its cash tender offer to acquire PharMerica Corporation, a competitor in the long-term care pharmacy market.[127] Omnicare's decision came one month after the FTC filed a complaint seeking

beyond the scope of the antitrust laws at all, much less through merger review of transactions that do not raise competitive concerns themselves, raises serious concerns.')

123 Initial Decision In the Matter of Promedica Health System Inc, Docket No 9346, 12 December 2011, available at www.ftc.gov/os/adjpro/d9346/120105promedicadecision.pdf.

124 Adminstrative Complaint In the Matter of Promedica Health System Inc, Docket No 9346, 6 January 2011, available at www.ftc.gov/os/adjpro/d9346/110106promedicacmpt.pdf.

125 *FTC v. Promedica Health System Inc*, No. 3:11-cv-47 (N.D. Ohio March 29, 2011).

126 Opinion of the Commission In the Matter of Promedica Health System Inc, Docket No 9346, 28 March 2012, available at www.ftc.gov/os/adjpro/d9346/120328promedicabrillopinion.pdf.

127 Federal Trade Commission press release, 'Omnicare Abandons Plan to Buy Rival Pharmacy in Light of FTC Lawsuit; FTC Votes to Dismiss its Complaint Seeking to Block the Transaction',

to block the deal, which it believed would give the merged firm substantial market power in its negotiations with Medicare Part D sponsors.[128] PharMerica's board had not favoured the acquisition of its shares and cited the risk that the deal would not be approved in urging its shareholders to reject Omnicare's offer, a notable defensive use of antitrust in the M&A context.

Express Scripts/Medco

On 2 April 2012, the FTC surprised some observers by approving, with limited conditions, the $29 billion merger of pharmacy benefits managers ('PBMs') Express Scripts and Medco, a deal vigorously opposed by some lawmakers, trade groups and consumer groups.[129] Market definition once again played an important role in the outcome. Opponents of the deal argued for a product market definition of PBM services to large employers, which would have made the deal a merger to duopoly. The FTC ultimately assessed the deal as impacting the provision of PBM services to all employers, a market that it characterised as moderately concentrated, including nine firms post-merger. The FTC concluded that coordinated action was unlikely, both because of the large number of remaining firms and the fact that industry pricing was complex and opaque. The staff's analysis likewise showed that unilateral effects were unlikely because the merging firms had different customer bases and were not particularly close competitors.

The closing statement credited the parties' claims that the transaction would result in appreciable efficiencies that would be passed along to consumers in the form of lower prices.[130] It also noted that a major pharmacy chain, CVS Caremark, had vertically integrated into the PBM business and achieved considerable success. Also likely influencing the FTC's analysis was the fact that the merging parties' customers, principally large corporations and public programs like Medicare, mostly supported the deal.

Commissioner Brill dissented from the decision, calling the deal a merger to duopoly and criticising the staff's unilateral effects analysis.[131] Several trade groups filed private suit seeking to block the transaction, but on 25 April 2012, a federal district

23 February 2012, available at www.ftc.gov/opa/2012/02/omnicare.shtm.

128 Administrative Complaint In the Matter of Omnicare Inc, Docket No. 9352, 27 January 2012, available at www.ftc.gov/os/adjpro/d9352/120127omnicareadmincmpt.pdf.

129 Federal Trade Commission press release, 'FTC Closes Eight-Month Investigation of Express Scripts, Inc's Proposed Acquisition of Pharmacy Benefits Manager Medco Health Solutions Inc', 2 April 2012, available at http://ftc.gov/opa/2012/04/medco.shtm.

130 Statement of the Federal Trade Commission Concerning the Proposed Acquisition of Medco Health Solutions by Express Scripts Inc, FTC File No. 111-0210, 2 April 2012, available at http://ftc.gov/os/2012/04/120402expressmedcostatement.pdf.

131 Dissenting Statement of Commissioner Julie Brill Concerning the Proposed Acquisition of Medco Health Solutions Inc (Medco) by Express Scripts Inc (ESI), FTC File No. 111-0210, 2 April 2012, available at http://ftc.gov/os/2012/04/120402medcobrillstatement.pdf.

court judge declined to issue a preliminary injunction, permitting the companies to begin integrating their operations pending a full merits trial.[132]

Ovation and Phoebe Putney

The Commission suffered surprising setbacks in the *Ovation* and *Phoebe Putney* matters. In *Ovation*, the FTC and the State of Minnesota filed suit challenging the consummated acquisition by Ovation Pharmaceuticals, the manufacturer of the leading treatment for a rare heart defect in premature infants, of the only other branded product available to treat the condition. The deal had fallen below the HSR threshold, but the FTC became aware of it when Minnesota Senator Amy Klobuchar complained publicly that Ovation had imposed a 1,300 per cent increase in the price of the products post-acquisition. Surprisingly, a Minnesota district court judge handed a trial victory to the defence, finding that the FTC had failed to prove that the two drugs were part of the same product market, since the evidence demonstrated that neonatologists were not sensitive to price and chose between the treatments based primarily on efficacy and safety.[133] This decision was sharply criticised both by FTC leadership and outside observers. Nonetheless, the Eighth Circuit affirmed it, expressing doubts about the outcome but noting that it owed substantial deference to the trial court's findings of fact.[134]

Phoebe Putney involved a proposed merger of the only two hospitals in the rural Albany, Georgia market. This merger to monopoly was clearly objectionable on antitrust grounds, but the merging parties argued that they were entitled to antitrust immunity under the state action doctrine, which immunises state-mandated restraints of trade. The state mandate here, the parties argued, arose from the fact that the local hospital authority had played a role in facilitating the deal. The district court agreed, holding that state action immunity applied and denying the FTC's request for injunctive relief.[135] The Eleventh Circuit affirmed, creating a split with a number of other circuits regarding the scope of the antitrust state action doctrine.[136] The FTC has petitioned the Supreme Court – which has not issued an opinion in a merger case since 1975 – to review the Eleventh Circuit's opinion.[137]

While the losses in *Ovation* and *Phoebe Putney* were no doubt disappointing for the FTC, the cases were decided on their own somewhat peculiar facts, and there is little reason to believe either that the opinions will have substantial influence in future cases or that the FTC will feel chastened by these results. The Commission appears to have

132 Jonathan Stempel, Reuters, 'Express Scripts Judge Won't Derail Medco Merger', 25 April 2012, available at http://articles.chicagotribune.com/2012-04-25/business/chi-express-scripts-judge-wont-derail-medco-merger-20120425_1_express-scripts-medco-health-solutions-processing-prescriptions.

133 *FTC v. Lundbeck Inc*, 2010 WL 3810015 (D. Minn. Aug. 31, 2010).

134 *FTC v. Lundbeck Inc*, 650 F.3d 1236 (8th Cir. 2011).

135 *FTC v. Phoebe Putney Health System Inc, et al*, No. 1:11-cv-58 (M.D. Ga. 27 June 2011).

136 *FTC v. Phoebe Putney Health System Inc, et al*, 663 F.3d 1369 (8th Cir. 2011).

137 The FTC's cert. petition, filed on 23 March 2012, is available at www.ftc.gov/os/caselist/1110067/120323phoebeputneypetition.pdf.

every intention of litigating as necessary to achieve its desired ends in cases that cannot be settled by consent decree.

iii Conclusion

The Antitrust Division and the FTC have been very active in merger enforcement in the past 12 months, focusing their attention in particular the health-care, agriculture and high-tech sectors. Both agencies have substantial litigation capacity and are prepared to take cases to trial rather than yield to a settlement that they do not believe will adequately protect competition. While the agencies have de-emphasised market definition in their internal deliberations, a change reflected in the revised 2010 Horizontal Merger Guidelines, market definition will continue to be a core issue in merger litigation, as demonstrated by the *H&R Block*, *Express Scripts* and *Ovation* matters.

If President Obama is re-elected in November 2012, the merger enforcement climate will remain substantially as it is. The election of Mitt Romney, by contrast, would likely lead to a reduction in enforcement intensity. Governor Romney is advised on antitrust policy by Judge Robert Bork, a noted antitrust minimalist. For example, Judge Bork has written that vertical mergers, a source of renewed interest at the Obama Antitrust Division, pose virtually no potential to harm competition, and that antitrust enforcement should largely be confined to punishing cartels and blocking mergers to monopoly.[138] While Judge Bork, at age 85, would be unlikely to serve a Romney Administration in any formal capacity, his presence in the campaign sends a signal regarding Governor Romney's views. Indeed, Governor Romney has sought broadly to associate himself with the *laissez-faire* economic policies of the Reagan era. It seems fair to assume, then, that a Romney Administration would be less assertive in enforcing antitrust laws across the board.

X OUTLOOK

While M&A activity remains below its highs of 2006 and 2007, it is steadily approaching its pre-'boom' levels. Improved credit markets and strong cash reserves of strategic acquirers have driven the uptick in M&A activity. In addition, private equity and LBO activity continue to strengthen as the credit markets strengthen. Significant uncertainty remains, however, including the continued economic destabilisation in Europe, particularly the specter of Greece exiting the euro, as well as the potential for an economic slowdown in China and other emerging markets. Along with the looming presidential election in the autumn of 2012, these uncertainties may create additional challenges for the US financial system.

138 See generally Robert H Bork, *The Antitrust Paradox* (Free Press, ISBN 0-465-00369-9).

Appendix 1

ABOUT THE AUTHORS

RICHARD HALL

Cravath, Swaine & Moore LLP

Richard Hall is a partner in Cravath's corporate department and is the practice leader of the firm's merger and acquisitions practice. He focuses on mergers and acquisitions, particularly in the international arena and natural resources sector, and corporate governance advice. Mr Hall has represented non-US companies in their acquisitions of US companies, US companies in their acquisitions by non-US companies, and non-US companies in their combinations with other non-US companies. He has also advised in the areas of unsolicited activity, takeover defence and in general corporate matters. Mr Hall received a BComm with honours in 1984 and an LLB with honours in 1986 from the University of Melbourne, and an LLM from Harvard University in 1988. He joined Cravath in 1988 and became a partner in 1996.

MARK I GREENE

Cravath, Swaine & Moore LLP

Mark I Greene is a partner in Cravath's corporate department and is practice leader of the international practice. He focuses on mergers and acquisitions, corporate governance and securities matters, including advising on cross-border transactions, private equity deals, complex restructuring transactions, proxy fights, takeover defence and global securities offerings. Mr Greene received a BA from Cornell University in 1989 and a JD from the University of Pennsylvania in 1993. After a clerkship with the Hon Charles Legge of the US District Court for the Northern District of California, he joined Cravath in 1994 and became a partner in 2001.

CRAVATH, SWAINE & MOORE LLP
825 Eighth Avenue
New York
NY 10019-7475
United States
Tel: +1 212 474 1000
Fax: +1 212 474 3700
newyork@cravath.com
www.cravath.com