



FENWICK & WEST LLP

Top Ten Tips and Current Issues for Mergers and Acquisitions

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Recent changes to SEC "best price" rule for tender offers

- Cash mergers used more than cash tender offers due to concerns about rule
- Rule requires that equal amount be paid to all tendering holders
 - > Plaintiffs claimed severance and other pay violated the best price rule
- Effective December 8, 2006, SEC changes clarify that rule only applies to amounts paid for securities tendered, not to payments for services (including severance and other benefit arrangements)
- Provides safe harbor if benefit is approved by independent board committee



Best price, continued

- Tender offers may be useful, because offer can be closed in as few as 20 business days, while a stockholder-approved cash merger may require more time for SEC proxy review and solicitation
- Despite this proposed rule, tenders may not work, e.g., for California targets, due to need to obtain 90% tender, or where the tender would involve issuing an amount of buyer's stock that would result in 20%+ dilution to buyer stockholders, in which case a buyer stockholder vote on the deal (and thus a time consuming proxy solicitation) would be required, negating the timing advantages of a tender



M&A Litigation

- M&A strike suits now “standard practice” even if strong premiums (e.g. Marimba/BMC; InVision/GE)
- New growth area for plaintiff counsel seeking to lead in new “markets”
- Seeking to push settlements up to \$1M
- Typically settled under \$500K range and/or by agreeing to enhanced disclosure and perfunctory discovery



M&A Litigation

- **Threaten injunction to slow deal, claiming either:**
 - > Breach of duty of care by target directors (claimed rush to do deal without adequate shopping, inadequate fairness opinion (e.g., lack of discounted cash flow analysis), inadequate deal value; preclusive deal terms (e.g., bust up fee above 3%))
 - > Breach of duty of loyalty by target directors (e.g., due to loyalty to management or controlling holders, or (bogus) claim that officers or directors are “differently situated” than stockholders due to accelerating options or other benefits)
 - > Lack of adequate disclosure (e.g., re fairness opinion valuation methodology, or as to background (seeking “hidden agenda” to deal only with one acquirer in exchange for alleged *quid pro quo*))
 - > Suing buyer for “overpaying”



M&A Litigation

- **Minimize risks by**
 - > Adequate shopping and due board consideration of all alternatives
 - > Avoiding preclusive deal terms (bust up fee above 4% or triggered by mere vote down; no shop without fiduciary out) (in neither party's interests to have deal enjoined)
 - > Have minutes and full proxy disclosure that demonstrates this
 - > For target, ensuring that neither suit nor settlement enables buyer to walk



Anticipating Earnout Disputes

- Earnouts are contingent payments in a merger to narrow a valuation gap and help ensure retention
- Usually based on achievement of product or technology milestones, or achievement of specific financial milestones involving revenue, bookings or net income
- Earnouts are hard to negotiate, draft and administer because:
 - Hard to anticipate every issue as to which there will be a future ambiguity, leading to disputes or difficult future negotiations
 - Hard to address target's reasonable concerns that buyer will seek to minimize earnout by failing to provide resources, changing product direction or terminating staff
 - Hard to address buyer's reasonable need for continued operational flexibility, even if that reduces earnout
 - Hard to avoid diverging agendas, lack of incentive for new hires and buyer staff cooperation



Anticipating Earnout Disputes

Tips:

- Favor technology/product milestones over financial ones
- If must use financial metrics:
 - Use bookings rather than revenue or net income
 - Anticipate issues such as: bundling, discounts, service deals where products are used but not separately invoiced, contracts that will not qualify as a “booking”, derivative products, etc.
- If use technology milestones:
 - Ensure precise, objective definitions, and 100% completion
 - Ensure milestones incent retention but avoid mandating employment and P&L charge



Anticipating Earnout Disputes

Tips:

- Compromise target's desire to keep current course/budget/headcount and buyer's desire for operational flexibility?
- Avoid promising best efforts or "independence"
- Avoid metrics that may cause a divergence of goals
- Avoid resentment and ensure integration by insisting that deal value include a deduct for a bonus pool to incentivize new hires and buyer personnel who must cooperate to achieve milestones
- Have a well thought out dispute resolution mechanism
- Don't do an earnout with a party you don't trust to be reasonable



Section 3(a)(10) Fairness Hearings

- Enable a merger to qualify for a 3(a)(10) exemption, eliminating need for Form S-4 or Form S-3 registrations that may draw SEC comment
- Dept. of Corp. looks for procedural fairness (e.g., no self-dealing by officers and directors at minority stockholders' expense) and substantive fairness (e.g., of price and other economic terms)
- Department may condition the permit on modest changes to negotiated deal terms to track its guidelines, so buyer board must be warned of that risk



Section 3(a)(10) Fairness Hearings

DOC focus:

- Is the exchange ratio fair to small holders that had no say in negotiating it?
- Are size and term of the escrow fair? (10% and 1 year being the default for non-affiliates, unless more is justified by the facts or a trade for higher deal valuation)
- Is there an unduly long "lock up" on reselling shares? (90 days being the default limit for non-affiliates, absent justification)
- Do voting agreements exceed 70% or were they required from non-affiliates? (see SEC Rule 159)
- Was locking the deal a breach of the target directors' fiduciary duty?
- Is break up fee in excess of 5% of deal value?
- Were rank and file employees treated fairly, e.g. as to deal terms, severance and option assumption, vs. treatment for target officers?
- Is the Notice of Hearing short and in "plain English"?
- Does the permit application justify deviations from these Department guidelines?



Increasing volume of cross-border M&A deals

- **Unocal bid by China National Offshore Oil Corporation for \$18.5bn in cash**
- **Current/Recent deals:**
 - **US-Israel (Cyota/RSA, Shopping.com/eBay)**
 - **US-China/Cayman**
 - **India-UK (AIM listed shell company, special purpose M&A vehicle)**



Increasing volume of cross-border M&A deals

Israeli specific issues, for example:

- Need to pay back prior Israeli "Chief Scientist" funding
- Filing to obtain a securities exemption to assume options
- Tax rulings that assumption of options does not trigger gain
- Ruling in cash deal that there is no Israeli withholding requirement
- Specific time limits
- Need to publish notice of deal (with buyer having a MAC out during this notice period)
- Prospectus issues associated with stock deal, so some deals are done with part stock for US holders only
- Lack of tax deferral for Israeli stockholders also favors cash deals

China issues, for example:

- Continuance of WFOE tax holiday
- Satisfaction of employee withholding obligations



IRC 409A

- **IRC 409A raises difficult target issues, since deal valuation may be far higher than option pricing and the 409A safe harbor does not apply to valuations done internally within 12 months of a merger where a deal was reasonably foreseeable, and lack of certainty on 409A impact may make it hard to agree on fair allocation of risk**
- **Buyer may seek an unqualified 409A representation, indemnity without cap or basket and not limited to escrow, and extended claims period**
- **Target will seek to qualify its 409A representation with a disclosure of the unavailability of the safe harbor, avoid such indemnity or cap it at the escrow and for the escrow period, and eliminate Buyer's right to walk for a breach of the 409A representation**



Other Trends

Deal volume up, but recent increase in number and percentage of busted deals;

Reasons vary, but include deals busting because:

- Diligence issues (SOX, FCPA and open source issues)
- Buyer boards taking a harder line on terms (e.g. insisting on higher % of deal value in form of earnouts, higher % escrows, longer indemnities)
- Buyer boards being more skeptical of taking a chance on a strategic move
- Buyer boards being more wary of dilution absent clear upside
- Target boards being unwilling to agree to these tough demands, hoping for valuations to increase
- In general, tough terms are prevailing and sellers are not agreeing to them
- This is a different environment than 9-12 months ago



Fiduciary Issues

- ***Emerging Communications* teaches that Boards must be sensitive to duty of loyalty optics and can't hide behind a fairness opinion they should know is wrong**
- **Omnicare workarounds now include stockholder consent immediately after closing, and an *Orman v. Cullman/General Cigar* type approach—a voting agreement that prevents votes in favor of a competing deal for 18 months but allows minority holders to block the current deal and stay independent**