Fried Frank
M&A QUARTERLY

A quarterly roundup of key M&A developments

1st Quarter 2013

Controlling the Public Company Sale Process: "Don't Ask, Don't Waive" Standstill Provisions in the Firing Line

In public company sale processes, confidentiality agreements executed by bidders almost universally include "standstill" provisions. These provisions are one of the tools utilized by target companies to control the sale process in order to maximize shareholder value. A standstill generally restricts a bidder from acquiring target company shares and also typically prohibits a bidder from making public *or private* offers to acquire the target unless the board has expressly invited the bidder to make an offer. Furthermore, a standstill typically provides that a bidder may not request that it be waived. These "don't ask, don't waive" provisions are intended to prevent a bidder from getting around the purpose of the standstill by requesting the ability to "make a compelling offer." A waiver request framed in those terms may put a board in a position where it feels compelled to grant the waiver in order to satisfy its fiduciary duties regarding maximization of shareholder value.

In late 2012, Vice Chancellor Laster and Chancellor Strine of the Delaware Court of Chancery each issued a bench ruling discussing the appropriateness of "don't ask, don't waive" standstill provisions in confidentiality agreements.

In *In re Complete Genomics, Inc. Shareholder Litigation*, Vice Chancellor Laster enjoined Complete Genomics, Inc. from enforcing a "don't ask, don't waive" standstill provision because, in his view, the clause impermissibly limited the board's ability to meet its "statutory and fiduciary obligations to provide a current, candid and accurate merger recommendation" to its stockholders. In Vice Chancellor Laster's view, "don't ask, don't waive" provisions are analogous to "no-talk" clauses (which restrict targets from communicating with certain potential bidders), which have been found by Delaware courts to compromise a target board's obligation to remain informed of all material information available. Vice Chancellor Laster reasoned that because the "don't ask, don't waive" provision prevented the board from knowing whether another bidder was open to offering a higher price, it precluded the flow of information to the board and hindered its ability to determine whether to change its merger recommendation.

Three weeks later, in *In re Ancestry.com Inc. Shareholder Litigation*, Chancellor Strine, faced with a similar issue, noted that Delaware courts have been reluctant to create bright-line rules invalidating contract provisions and refused to find that "don't ask, don't waive"

Controlling the Public Company Sale Process (continues on page 7)

Inside

Appraisal Suits: The Next Frontier in Deal Litigation?
Page 2

Delaware Courts Cloud the Waters Regarding LLC Fiduciary Duties
Page 3

Recent China-Related Transactions: CFIUS Lessons for Dealmakers
Page 4

Recent SEC Developments
Page 5

Authors

Abigail P. Bomba
Mario Mancuso
David N. Shine
John E. Sorkin
Robert M. Blum
Adam Brenner
Katherine C. Gomer
Randi Lally
Nicole E. Miklos

Fried Frank M&A Quarterly Copyright © 2013. Fried, Frank, Harris, Shriver & Jacobson LLP. All rights reserved.
Attorney Advertising.

Appraisal Suits: The Next Frontier in Deal Litigation?

In acquisitions of public companies for consideration including a cash component, shareholders who are unhappy with the transaction price may seek judicial appraisal of the fair value of their shares under Delaware law. Historically, however, public company shareholders have not broadly utilized their appraisal rights. Because the appraisal process ultimately requires a court hearing to determine fair value, it can be time-consuming and expensive to pursue. Also, appraisal can, in theory, result in a court valuing the company at a lower price than the deal price. Instead of appraisal, class action lawsuits have been the traditional tool of choice for the shareholder plaintiff's bar. One study found that, in transactions valued at over $500 million announced in 2011, shareholder suits were brought about 95% of the time. Recent experience suggests, however, that appraisal claims may be the next frontier for shareholders seeking to extract additional value in public company transactions.

In several recent acquisitions involving Delaware corporations, the same investment fund, has filed appraisal suits. These transactions include Thoma Bravo's acquisition of Deltek Inc. and Cigna's acquisition of Health Spring, Inc. In both of these transactions, it appears that the plaintiff fund had not been a shareholder prior to announcement of the transaction and, accordingly, could not have been a class action plaintiff. However, based on publicly available information, it appears that the plaintiff fund acquired a significant stake in both companies between signing and closing and filed appraisal claims prior to closing.

One reason why a shareholder plaintiff, including a plaintiff who held stock before announcement of a transaction, might decide to pursue an appraisal claim rather than a traditional class action lawsuit is that an appraisal proceeding is, at its core, financial. The vast majority of Delaware shareholder class action suits relating to mergers now settle based on additional disclosures or changes in transaction terms which do not put additional value into the plaintiff's pocket. On the other hand, if an appraisal claim is successful, the plaintiff will always receive more money and, even if the court were to find equivalent value, the plaintiff will likely be entitled to interest at a rate of 5% over the Federal Discount Rate. This potential benefit, of course, must be weighed against the risk that the appraisal will result in a lower valuation. For example, in May 2012, the Delaware Chancery Court found that the fair value of Just Care, Inc. was approximately 15% lower than the agreed cash acquisition price.

If appraisal really is the next frontier for merger-related litigation, there are a number of risk-mitigation strategies that deal professionals might keep in mind.

If appraisal really is the next frontier for merger- related litigation, there are a number of risk-mitigation strategies that deal professionals might keep in mind.

First, acquirers may want to consider requiring that the merger agreement include a provision allowing the acquirer to refuse to close if more than a specified percentage of shareholders demand appraisal. Such appraisal conditions used to be fairly common, but are not ideal from the acquirer's perspective. Raising the desire for an appraisal condition may make an acquirer a less attractive bidder. Also, refusing to close would not typically be an acquirer's desired remedy. Finally, an appraisal condition may serve as an incentive for dissatisfied shareholders to bring claims as leverage to try to interrupt the transaction.

Second, as an alternative to an appraisal condition, an acquirer may want to consider a structure in which, prior to the merger, the target company reincorporates in a jurisdiction that does not provide appraisal rights (e.g., Maryland, where appraisal is not available for listed targets, even in an all-cash transaction). In order to affect such a structure, the merger agreement would need to provide for shareholders to vote on the reincorporation as a first step in the transaction. Additional, somewhat unusual, merger mechanics would then follow. In considering such a structure, deal professionals would need to also consider the likelihood of shareholder litigation objecting to the circumvention of appraisal rights and how that risk would balance against the potential benefits of avoiding any potential appraisal remedies. ■

Delaware Courts Cloud the Waters Regarding LLC Fiduciary Duties

Delaware courts have generally taken the position that limited liability company managers and members owe fiduciary duties to other members unless such duties are expressly modified or eliminated by contract. For example, in its 2009 *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC* decision, the Chancery Court found that the fiduciary duties of loyalty and care could be imposed upon an LLC managing member where the LLC agreement did not unambiguously eliminate such duties. Subsequently, in its 2010 *Kelly v. Blum* decision, the Chancery Court found fiduciary duties to apply to LLC managers and members because the LLC agreement did not explicitly restrict or eliminate those duties.

The Delaware Supreme Court, however, has recently called into question the existence of these so-called "default" fiduciary duties. In its November 2012 decision in *Gatz Properties, LLC v. Auriga Capital Corporation*, the Delaware Supreme Court rejected a lower court finding that default fiduciary duties exist under the Delaware Limited Liability Company Act and held that the law is unsettled as to whether LLC managers and members are subject to default fiduciary duties where such duties have not been modified or eliminated by contract. However, the Supreme Court did affirm the lower court's finding that Gatz, a managing member, breached both contractual and fiduciary duties by making a series of self-interested decisions that ultimately led to his acquiring the limited liability company as a distressed asset in an auction where he was the sole bidder. Further, the court found that Gatz was not entitled to exculpation under the LLC agreement because he acted in bad faith and made willful misrepresentations in his course of dealing with the minority members of the limited liability company.

In reaching its decision, the Delaware Supreme Court focused on whether Gatz owed contractual fiduciary duties to the minority members of the limited liability company and found that the LLC agreement did impose fiduciary duties on the manager and members in affiliate transactions. Although the relevant provision of the LLC agreement did not use either the term "entire fairness" or the term "fiduciary duties," the Court found both that the provision imposed an equitable standard of entire fairness and that a fair-price obligation was inherent in that standard. Additionally, the Court suggested that if Gatz had conditioned the sale upon the approval of an informed majority of the non-affiliated members, he could have avoided the burden of establishing that his acquisition of the limited liability company was fair.

Gatz highlights that, when an LLC agreement is silent, a court may not necessarily impose traditional fiduciary duties of loyalty and care upon the LLC's managers and members. More importantly, drafters of LLC agreements should consider including specific language indicating whether the entire fairness standard applies in connection with affiliated transactions. Drafters may also want to consider including clear and unambiguous language that defines the duties LLC managers and members owe to each other. Such language should clearly set forth the standards that will apply to LLC managers and members. ■

When an LLC agreement is silent, a court may not necessarily impose traditional fiduciary duties of loyalty and care upon the LLC's managers and members.

Recent China-Related Transactions: CFIUS Lessons for Dealmakers

A trio of recent transactions reviewed by the Committee on Foreign Investment in the United States has put CFIUS – the US regulatory body that reviews "control" transactions by foreign persons involving US businesses for national security purposes – squarely back on the radar of dealmakers. As we describe below, these three transactions, *Ralls Corp.*, *Wanxiang-A123*, and *CNOOC-Nexen* underscore important lessons for US targets, foreign acquirers and cross-border transaction professionals.

No Minimum-Value Threshold

There is a common misconception that CFIUS isn't concerned with small transactions. The reality, however, is that CFIUS is interested in *all* control transactions "by a foreign person involving a US business" which present "national security considerations." In *Ralls Corp.*, the President, upon CFIUS' recommendation, ordered the unwinding of a transaction involving four wind farms in development, which were valued at approximately $6 million plus renewable energy credits. Further, this interest in small deals is not fleeting or new. In 2011, Huawei walked away from its acquisition of a $2 million portfolio of patents acquired in bankruptcy after CFIUS indicated it would recommend that the President forcibly unwind the transaction.

Proximity Matters

CFIUS is a national security review process, but the term "national security" itself is not defined in the CFIUS regulations. While the regulations identify certain illustrative national security factors, *Ralls Corp.* involved a new vector of national security exposure not mentioned anywhere in the regulations: proximity to classified or otherwise sensitive government facilities or air space. In *Ralls Corp.*, the four wind farm projects were all located within or near restricted military airspace. Indeed, the national security concern was so great that the President's order authorized only CFIUS-approved, US citizens to access the properties for the purpose of removing *Ralls* Corp. materials from the wind farm sites.

CFIUS "Best Practices" Vindicated

No amount of planning can overcome a transaction found to present national security risks to the United States. However, relatively few transactions present such dire national security flaws. A keen national security policy sense, and the use of CFIUS best practices, can facilitate the approval of transactions that may otherwise elicit controversy or a second look by regulators. In almost every case, these practices will substantially reduce the risk of embarrassment to the transaction parties – an objective often as important as getting the transaction cleared by CFIUS. Recently, CFIUS granted approval of Wanxiang Group Corp's acquisition of A123 Systems Inc., a lithium-ion battery company, which had previously received US government funding and held significant contracts with the Department of Defense. In the *Wanxiang-A123* transaction, the parties overcame Congressional opposition, lobbying efforts of a US industry competitor, and politically problematic facts to obtain CFIUS approval. In CFIUS matters, as in business, good strategy and tactics matter, including undertaking an early assessment of the potential national security risks posed by a transaction, identifying any political risks, and accounting for these considerations – and related possible CFIUS scenarios – in transaction documents.

The use of CFIUS best practices can facilitate the approval of transactions that may otherwise elicit controversy or a second look by regulators.

Recent China-Related Transactions (continues on next page)

CFIUS in the Deal Documents

In light of the foregoing, we believe that in any potential CFIUS sensitive transaction, there should be a renewed focus on obligations and remedies in connection with the CFIUS process. These sort of provisions have been common with respect to the antitrust approval process and transaction professionals have begun to impose similar concepts into the CFIUS arena. In both *Wanxiang-A123* and *CNOOC-Nexen*, the parties included a variety of CFIUS-related provisions such as:

- A carve-out for the US government-facing portion of the US target's business, and a flexible definition of excluded assets, to include national security-sensitive items, along with any items identified by CFIUS;
- A separate CFIUS deposit and escrow agreement for 10% of the purchase price, payable to the US sellers in certain circumstances;
- A trust structure whereby US citizen designees of the foreign acquirers could, with CFIUS approval, hold the capital stock in trust until CFIUS approval was received or the sensitive assets were divested;
- A designated level-of-efforts covenant to obtain CFIUS approval;
- A requirement that the foreign acquirer pay a reverse-termination fee if the foreign acquirer terminated the agreement because CFIUS did not approve the transaction; and
- The right to extend the termination date in certain circumstances where CFIUS approval was not received. ■

Recent SEC Developments

The SEC Chairman, Commissioners and senior staff highlighted the agency's anticipated areas of emphasis for the upcoming year.

New SEC Chairman

On April 10, 2013, Mary Jo White was sworn in as the 31st Chair of the SEC. Ms. White was nominated by President Obama in January after former SEC Chairman Mary Schapiro stepped down from her post. White was the chief federal prosecutor for the Southern District of New York from 1993 to 2002 and has since been working in private practice. On March 12, 2013, White told senators that her top priority will be to complete SEC rules under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and the Jumpstart Our Business Startups Act (the JOBS Act). Ms. White will fill out the remainder of Schapiro's five-year term, which expires in June 2014, and the Senate will take a later vote on President Obama's nomination of Ms. White for a subsequent five-year term.

SEC Says Social Media OK for Company Announcements if Investors Are Alerted

As the use of social media has proliferated, there has been uncertainty as to whether company communications made through social media channels could constitute selective disclosures subject to Regulation Fair Disclosure (Regulation FD). Regulation FD requires companies to distribute material information in a manner reasonably designed to get that information out to the general public broadly and non-exclusively. It is intended to ensure that all investors have the ability to gain access to material information at the same time.

Recent SEC Developments (continues on next page)

The SEC issued guidance in 2008 clarifying that websites can serve as an effective means of disseminating information to investors if they've been made aware that the website is where to look for it, but a recent investigation has raised questions regarding its application to other forms of emerging technologies. To address this uncertainty, on April 2, 2013, the SEC issued a report making clear that the principles outlined in the SEC's 2008 guidance apply equally to disclosures made through social media channels, and that companies can use social media outlets like Facebook and Twitter to announce key information in compliance with Regulation FD so long as investors have been alerted about which social media outlet will be used to disseminate such information. The SEC report cautions that the guidance offers only a non-exhaustive list of factors to be considered in the analysis and every case must be evaluated on its own facts and circumstances. Companies should take steps to alert the market about which forms of communication they intend to use for the dissemination of material, non-public information, including the social media channels that may be used and the types of information that may be disclosed through these channels.

Conference Highlights Areas of Focus for Division of Corporation Finance in 2013

In February 2012, the Practicing Law Institute held the conference "SEC Speaks in 2013," during which the SEC Chairman, Commissioners and senior staff highlighted the agency's anticipated areas of emphasis for the upcoming year. Representatives of the Division of Corporation Finance noted that the division will be focused on the following areas:

- completing its Dodd-Frank rulemaking project;
- adopting rules disqualifying "bad actors" from certain private placement rules (such as Rule 506, the Regulation D safe harbor);
- adopting rules disqualifying "bad actors" from certain private placement rules (such as Rule 506, the Regulation D safe harbor);
- implementing the JOBS Act, including an outreach effort to provide information to small and midsize businesses about resulting changes;
- revising Regulation A – an exemption from Securities Act registration requirements for small public offerings – so as to increase the threshold from $5 million to $10 million.

NASDAQ Rule Proposals

Internal Audit Function

We recommend that listed companies review their existing processes and procedures to determine whether their internal audit function will satisfy the new requirement.

On March 4, 2013, the SEC published for comment a NASDAQ rule proposal that requires listed companies to establish or maintain an internal audit function. If approved by the SEC, listed companies will be required to provide management and the audit committee with ongoing assessments of the Company's risk management processes and system of internal control. The proposed rule contemplates that listed companies may outsource this function to a third-party service provider other than its independent auditor. The audit committee would be required to meet periodically with the company's internal auditors (whether company personnel or a third-party service provider) and discuss with its outside auditors the responsibilities, budget and staffing of the internal audit function. If the rule is approved, companies listed on NASDAQ on or prior to June 30, 2013 will be required to comply with the new listing requirement by

Recent SEC Developments (continues on next page)

December 31, 2013, and companies listed after June 30, 2013 will be required to establish an internal audit function prior to listing. In anticipation of this new rule, we recommend that listed companies review their existing processes and procedures to determine whether their internal audit function will satisfy the new requirement.

Corporate Governance Update

ISS Issues Final Proxy Voting Policies and Procedures for 2013

In our December 2012 issue of M&A Quarterly we summarized Institutional Shareholder Services' (ISS) Final Corporate Governance Policy 2013 Updates. On January 31, 2013, ISS issued a Frequently Asked Questions report regarding its 2013 Proxy Voting Policies and Procedures, which provides a helpful overview of the ISS voting guidelines for 2013 (excluding compensation-related topics). A copy of the report is available at: friedfrank.com/USProxyVoting. ■

* * *

*Controlling the Public Company Sale Process** *(continued from cover)*

standstills are *per se* invalid. Chancellor Strine noted that such provisions can be employed by sellers as "value-maximizing" tools (a "gavel") throughout the auction process. Nevertheless, he concluded that, in this case, Ancestry had failed to inform its shareholders of the use of the provision and that the board of directors had not appreciated its import in the auction process. Chancellor Strine cautioned that the potency of these provisions requires a board to be cognizant of the provision's effect throughout the sale process.

In short, these recent rulings highlight the continued importance of striking the right balance between the use of deal-finalizing tactics and the board's continuing obligations to evaluate deal alternatives and provide several take-aways for dealmakers and boards of directors. First, it is likely fair to conclude that "don't ask, don't waive" provisions are not per se illegal in Delaware and, accordingly, may continue to be used under the right circumstances and with the right process checks. Second, a target board of directors should be well-informed about, and consider, the pros and cons of these provisions before including them in a confidentiality agreement (which will involve a discussion with the board prior to circulating draft confidentiality agreements to potential bidders). Third, if these provisions are included in the confidentiality agreement, the target board should revisit the appropriateness of maintaining them (and the desirability of waiving them) during the various stages of the sale process. A board could conclude that, depending on the facts and circumstances, it may make sense to unilaterally waive the provisions at some point during a sale process. In particular, the board needs to consider whether it is appropriate to agree to a provision in any definitive acquisition agreement that would prohibit the company from waiving any pre-existing standstill agreements and, potentially, to negotiate the express right to waive pre-existing standstills without violating the "no shop". Finally, in negotiating the "deal protection" provisions of a merger agreement which allow a target company to provide confidential information to another bidder subject to execution of a confidentiality agreement, the target company should make sure that such provisions do not require that the new bidder agree to a standstill provision that would make it impossible to submit a superior proposal. ■

First, it is likely fair to conclude that "don't ask, don't waive" provisions are not *per se* illegal in Delaware and, accordingly, may continue to be used under the right circumstances and with the right process checks.

* A version of this article will be published in the May/June issue of *Directorship Magazine*.

M&A/Private Equity Group Partners

New York

Jeffrey Bagner
jeffrey.bagner@friedfrank.com

Abigail Pickering Bomba
abigail.bomba@friedfrank.com

Andrew J. Colosimo
andrew.colosimo@friedfrank.com

Aviva F. Diamant
aviva.diamant@friedfrank.com

Steven Epstein
steven.epstein@friedfrank.com

Christopher Ewan
christopher.ewan@friedfrank.com

Arthur Fleischer, Jr.*
arthur.fleischer@friedfrank.com

Peter S. Golden
peter.golden@friedfrank.com

Tiffany Pollard
tiffany.pollard@friedfrank.com

Paul M. Reinstein
paul.reinstein@friedfrank.com

Philip Richter
philip.richter@friedfrank.com

Steven G. Scheinfeld
steven.scheinfeld@friedfrank.com

Robert C. Schwenkel
robert.schwenkel@friedfrank.com

David L. Shaw
david.shaw@friedfrank.com

David N. Shine
david.shine@friedfrank.com

John E. Sorkin
john.sorkin@friedfrank.com

Steven J. Steinman
steven.steinman@friedfrank.com

Washington, DC

Jerald S. Howe, Jr.
jerry.howe@friedfrank.com

Mario Mancuso
mario.mancuso@friedfrank.com

Brian T. Mangino
brian.mangino@friedfrank.com

Richard A. Steinwurtzel**
richard.steinwurtzel@friedfrank.com

Andrew P. Varney
andrew.varney@friedfrank.com

Michael A. Yuffee
michael.yuffee@friedfrank.com

London

Laura Brunnen
laura.brunnen@friedfrank.com

Richard May
richard.may@friedfrank.com

Robert P. Mollen
robert.mollen@friedfrank.com

Jerry Walter
jerry.walter@friedfrank.com

Paris

Eric Cafritz
eric.cafritz@friedfrank.com

David Chijner
david.chijner@friedfrank.com

Frankfurt

Dr. Juergen van Kann
vankann@friedfrank.com

Hong Kong

Victor Chen
victor.chen@friedfrank.com

Douglas Freeman
douglas.freeman@friedfrank.com

Carolyn Sng
carolyn.sng@friedfrank.com

*Senior Counsel
**Senior Special Counsel

If you would like to receive Fried Frank M&A Quarterly via email, you may subscribe online at friedfrank.com/subscribe.

New York
One New York Plaza
New York, NY 10004
Tel: +1.212.859.8000
Fax: +1.212.859.4000

Washington, DC
801 17th Street, NW
Washington, DC 20006
Tel: +1.202.639.7000
Fax: +1.202.639.7003

London
99 City Road
London EC1Y 1AX
Tel: +44.20.7972.9600
Fax: +44.20.7972.9602

Paris
5, rue François 1er
75008 Paris
Tel: +33.140.62.22.00
Fax: +33.140.62.22.29

Frankfurt
Taunusanlage 18
60325 Frankfurt am Main
Tel: +49.69.870.030.00
Fax: +49.69.870.030.555

Hong Kong
1601, Chater House
8 Connaught Road Central
Hong Kong
Tel: +852.3760.3600
Fax: +852.3760.3611

Shanghai
Unit 537, East Wing, Shanghai Centre
1376 Nanjing Road West
Shanghai 200040
Tel: +86.21.6289.8962
Fax: +86.21.6289.8963

A Delaware Limited Liability Partnership.

The articles included in Fried Frank M&A Quarterly are general in nature and are not intended to provide legal advice with respect to any specific situation confronted by our clients or other interested persons. Please consult with counsel before taking any action with respect to any matters discussed in Fried Frank M&A Quarterly.